

## **Reply to Grubert**

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The increasingly global nature of American business activity implies that the future of the U.S. corporate income tax hinges on its complicated international tax provisions. Current U.S. provisions for taxing foreign income, and much of the thinking that underlies them, are based on concepts that are commonsensical but often inconsistent with the underlying economics.

The spirited comment by Grubert (2005) on Desai and Hines (2004) is a useful continuation in the ongoing debate on the appropriate taxation of foreign income. It raises numerous points on which intuition can easily go astray, and thereby indirectly illustrates the benefits of hard and dispassionate analysis. While it is tempting to reply individually to every point raised in this comment, its length suggests that interested readers would benefit most from revisiting the original article. Accordingly, the function of this reply is to address some of the central issues in a manner that may serve to prevent further confusion.

The article by Desai and Hines (2004) (hereafter, DH) makes three related points. The first point is that the U.S. tax system currently imposes a significant burden on foreign income earned by American corporations. In order to measure the magnitude of the economic burden it is necessary to identify incentives created by the tax system, an elementary insight that is easily lost by instead applying methods used to calculate tax revenue for government budgets. The second point is that countries with worldwide tax systems such as that used by the United States would improve their own welfares, and world welfare, by reducing the burden of their taxation of foreign income. The reason is that ownership-based systems of worldwide taxation distort ownership patterns, and the ownership of foreign assets is critical to their productivity and tax revenue potential.

Finally, DH note that these preceding points arise because the concepts and attitudes used to guide the formation of U.S. international tax policy are more than 40 years old and need to be revisited in the light of modern economic experience.

The first issue is the magnitude of the U.S. tax burden on foreign income as of 1999, the last year for which comprehensive aggregate data are publicly available. The starting point of the DH calculation of total tax burden is to multiply the statutory U.S. tax rate (35%) by aggregate foreign income reported by American corporations. Grubert (2005) criticizes this step, noting that not all foreign income is taxable in the year earned, since some taxpayers have tax losses from other sources that can be used to reduce or even eliminate current taxation of foreign income. This observation is certainly correct, and indeed, DH makes this point on p. 947; but it is not correct to conclude, as Grubert (2005) does, that the economic burden of home country taxation of foreign income is zero whenever current taxes need not be paid. The simple reason, elaborated in footnote 12 of DH, and interestingly also in footnote 2 of Grubert (2005), is that firms using domestic tax losses to reduce current taxation of foreign income incur significant costs in the form of reduced net operating loss carryforwards that can be applied against future domestic or foreign income. These costs can be, and indeed typically are, just slightly smaller in magnitude than the cost of paying taxes on all income as earned, particularly for the large multinational firms earning the vast majority of foreign income. Hence Grubert (2005)'s proposed downward adjustment of the initial tax burden from \$20 billion to \$12.7 billion is grossly overstated as a measure of economic burden, and the true figure remains close to the initial estimate of \$20 billion.

This distinction between revenue currently collected and true economic burden resolves a number of other apparent inconsistencies between DH and Grubert (2005). For example, home country tax systems can impose significant burdens on unrepatriated foreign income, even though such income does not generate current tax revenue. These burdens take two forms – the tax that must be paid when income is ultimately repatriated at a future date and the lower economic return that a firm incurs in undertaking operations (such as foreign reinvestment) that are motivated by tax avoidance rather than the pursuit of pretax profits. For a profit-maximizing firm, it pays to defer repatriation even if the burdens associated with deferral are only minutely lower than the burdens

associated with immediate repatriation – and the two are equal for firms at the margin of repatriation. As a consequence, it does not follow that the ability to defer repatriation removes the burden of home country taxation.<sup>1</sup> Indeed, the evidence cited in DH is quite inconsistent with such a proposition. The common finding that home country taxes influence repatriation behavior reveals that firms respond to tax incentives, and that repatriation tax burdens differ, but not that repatriation tax burdens are inconsequential.<sup>2</sup>

A similar confusion marks the discussion of expense allocation issues that constitutes a large part of Grubert (2005). Current U.S. tax rules require taxpayers to allocate portions of certain expenses incurred in the United States, including interest expense, research expenses, and general administrative overhead expenses, against foreign income in calculating foreign tax credit limits. The amount of expenses allocated against foreign income is determined by complicated formulas based on differences between domestic and foreign economic activity. What this produces in practice is that firms with significant foreign operations may be unable to benefit from the full tax deductibility of expenses incurred in the United States. Since foreign governments do not make offsetting adjustments in their taxation of American operations abroad, it follows that the formulary allocation methods used by the United States effectively penalize foreign business operations of American firms. A firm with \$10 million to invest, and contemplating otherwise equivalent investments in the United States or in a foreign country, faces a higher cost in investing in the foreign country than in the United States, since additional foreign assets reduce the domestic portion of allocated expenses such as interest costs.<sup>3</sup> This outcome is the more or less inevitable consequence of any system

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<sup>1</sup> Note that this is true despite the finding of Hartman (1985) that a home country tax system that permits deferral does not affect the steady-state size of a mature foreign affiliate. There is a recurring confusion in the literature, including Grubert (2005), on this point. As DH notes, home country taxes impose significant burdens on foreign investment without affecting the first-order conditions of mature subsidiaries; see also Sinn (1993) and Hines (1994).

<sup>2</sup> Grubert (2005) notes that Desai, Foley and Hines (2001) report only modest efficiency costs of tax-induced repatriation distortions for American multinational firms. The Desai, Foley and Hines (2001) calculation is relevant, however, only to the limited choice of whether a profitable subsidiary repatriates or reinvests current-year foreign profits. This calculation does not incorporate distortions at many related margins, including choices among financing alternatives that entail differing degrees of deferral, decisions of where and how much to invest, and many others that DH attempt to capture. As Grubert (2005) suggests, these alternatives need to be included in any calculation of the true economic burden of repressed repatriations.

<sup>3</sup> For an analysis of some of the effects of this system, see Hines (1993) and Froot and Hines (1995). Grubert (2005, footnote 11) maintains that the expense allocation calculations in DH misrepresent pre-2004

that limits but does not trace expenses, and is certainly a feature of current U.S. taxation. In order to consider the efficiency costs of the current system, DH benchmark the costs of the current system relative to an alternative in which expenses are not allocated. In contrast, Grubert (2005) and Grubert and Mutti (2001) consider the revenue consequences of various expense allocation methods. These two exercises are entirely distinct.

Grubert (2005) questions certain aspects of the ownership neutrality benchmarks proposed in Desai and Hines (2003) and elaborated in DH. The distortions that ownership neutrality emphasize are predicated on the intuitions that levels of domestic investment need not decline dollar for dollar with outbound foreign direct investment, that taxation influences asset ownership patterns, and that the productivity of an asset is affected by its ownership. The logic that firms employ intangible assets – extending brands, transferring lessons of how to design productions processes and managing talent effectively – to create ownership advantages abroad without diminishing domestic efforts is now well-accepted in the broader research community on multinational firms. As a consequence, tax-induced ownership distortions need not significantly change levels and locations of plant and equipment investment in order to entail very large productive and allocative inefficiencies. There is some confusion in Grubert (2005) about the evidence that is relevant to evaluating the magnitude of ownership distortions, a confusion that may be attributable to the general equilibrium nature of the problem.<sup>4</sup>

Pressing questions about the future of the U.S. corporate tax, particularly with respect to its international provisions, require thoughtful answers based on cool assessments. It is tempting, in Washington and elsewhere, to equate tax burdens with tax collections. Sadly, this is not the right way to think about the economic consequences of taxation, since behavioral responses to taxation can create enormous costs that never

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U.S. law. This represents an incorrect reading of p. 949 of DH, as the DH calculation refers to the alternative proposed in Grubert and Mutti (2001) – which, as DH note, is presented in insufficient detail for a reader to determine the allocation method being analyzed.

<sup>4</sup> Grubert (2005) cites Desai, Foley and Hines (2004) as evidence that investment by a firm in one location affects capital accumulation elsewhere. This is a misreading of the evidence. The results presented in Desai, Foley and Hines (2004) indicate that ownership of assets in one location affects asset demands elsewhere by the same firm. The distinction is that firms can adjust their asset ownership without the economy changing its supplies of assets as long as relative prices of different assets can move.

materialize as revenues.<sup>5</sup> Viewed as economic burdens, the international provisions of U.S. income taxation loom considerably larger than they do as current-year budget projections. These burdens, in turn, impose significant costs in the form of distorted ownership of productive assets.

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<sup>5</sup> Of all the assumptions, opinions, and calculations that Grubert (2005) inaccurately attributes to DH, none is more mystifying than the line that "throughout the paper, Desai and Hines assume that that companies are passive, naïve victims of government policy without any ability to engage in tax avoidance strategies." It is precisely because companies are otherwise that taxation distorts behavior and therefore creates economic burdens that exceed revenue collections.