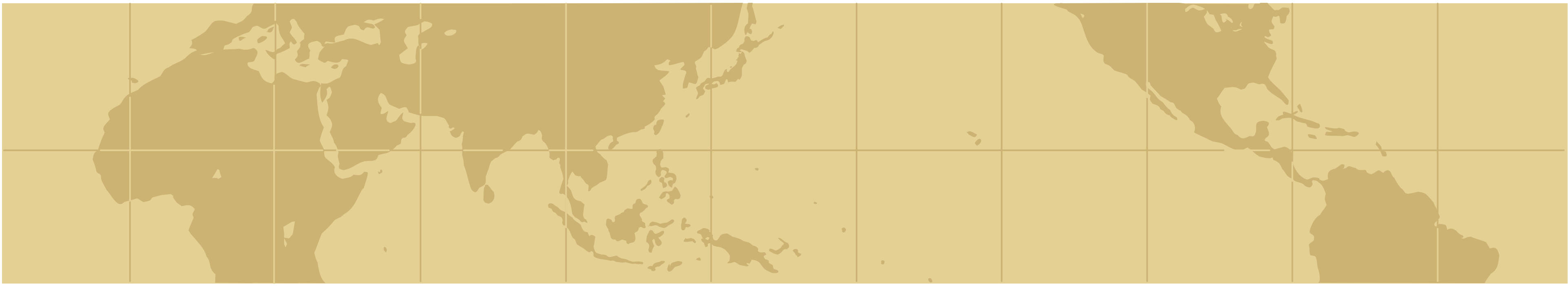
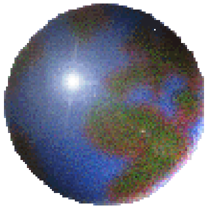


Taxation and Global Competitiveness



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Harvard University and NBER

President's Advisory Panel on Federal Tax Reform

San Francisco, CA

March 31, 2005

Outline

I. The changing scale and scope of multinational firm activity

II. How do multinational firms respond to tax rules?

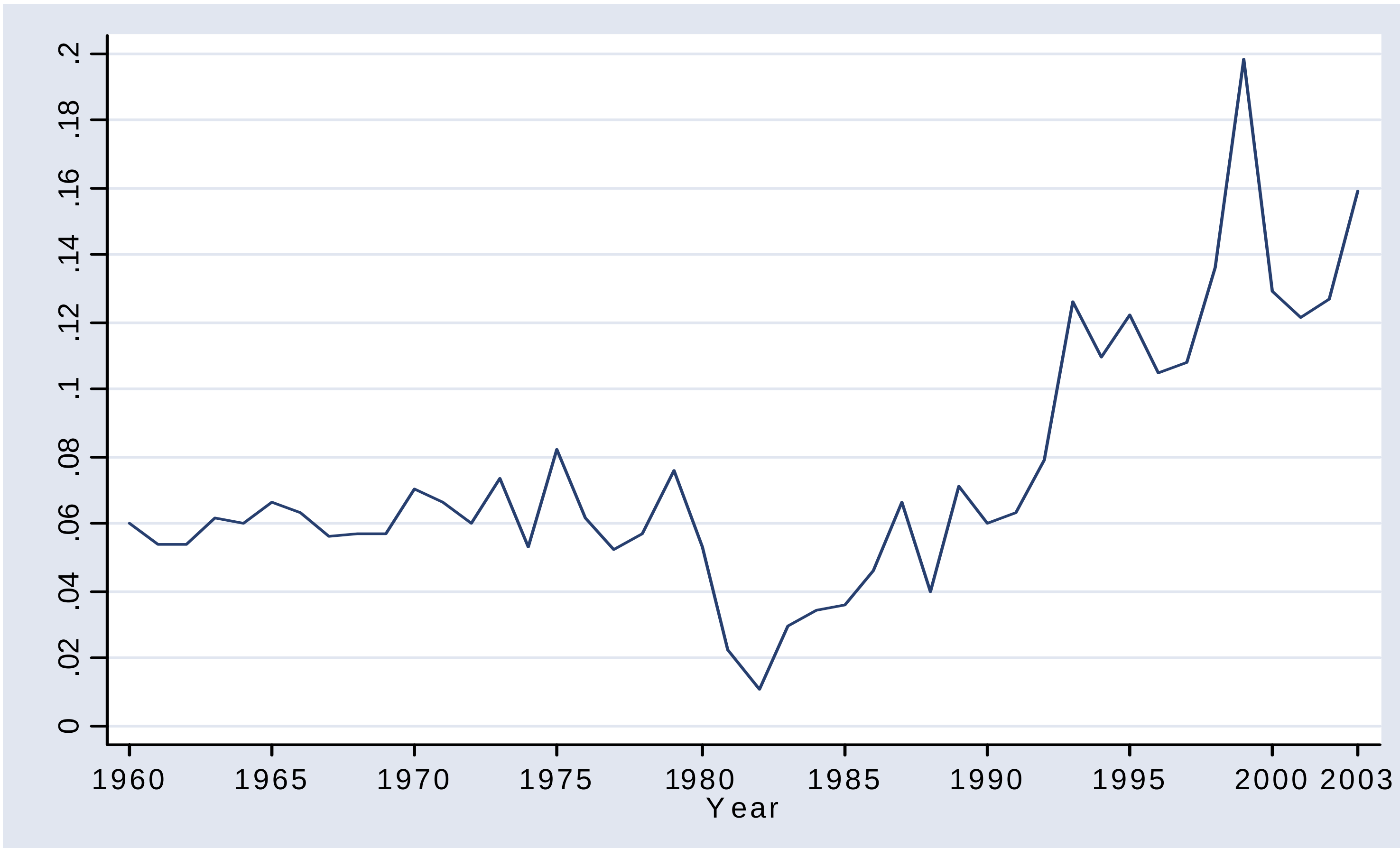
III. What does economics tell us about the efficient way to tax international activities?

IV. The costs and benefits of the current system

Appendix: Selective References

I. The Rising Importance of Foreign Direct Investment (FDI)

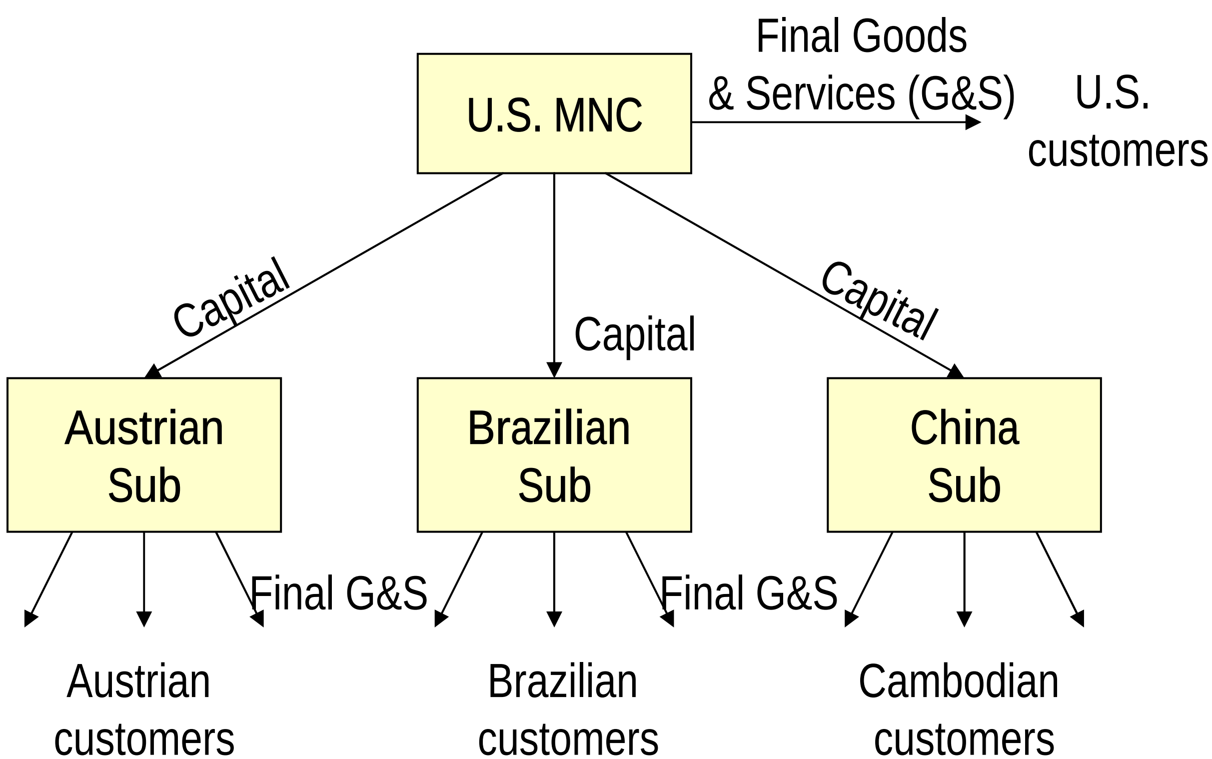
Ratio of Outbound FDI to Private Nonresidential Fixed Investment (for US firms)



Increasingly, it is impossible to analyze corporate taxation and its reform without considering international provisions

I. The Changing Nature of Multinational Firm Activity

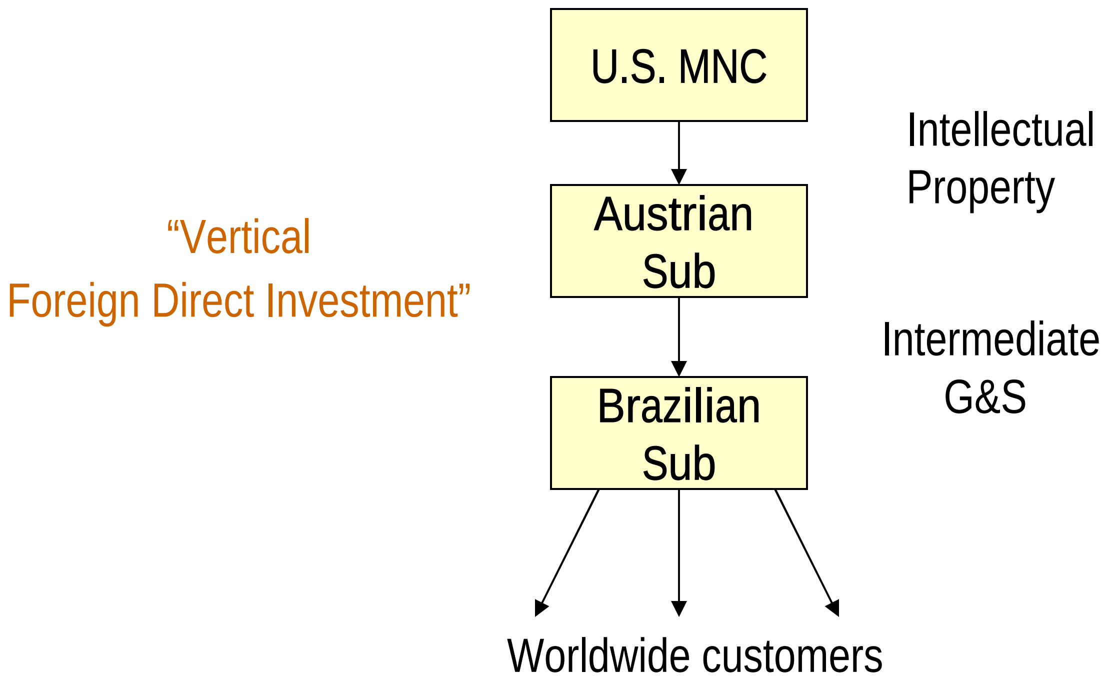
The older model of multinational firm activity stressed capital flows that duplicated activity to overcome tariffs & transport costs…



"Horizontal Foreign Direct Investment"

I. The Changing Nature of Multinational Firm Activity (cont.)

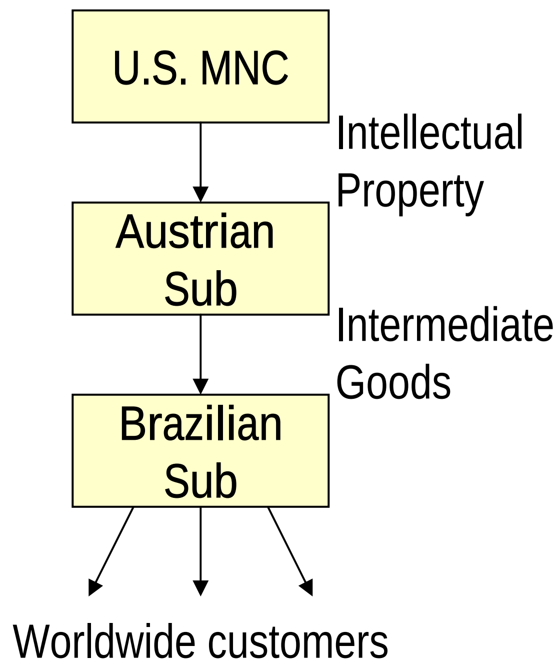
With falling tariffs and transport costs, firms are less likely to duplicate activities around the world - Now, FDI creates integrated production processes that must be highly efficient for very competitive markets



I. The Changing Nature of Multinational Firm Activity (cont.)

This transformation has several implications…

- Transfer pricing issues loom larger…
- Worldwide frictionless markets create greater pressures for efficiency
  - ⇨ Tax costs/advantages more likely to be pivotal
- A good tax regime must ensure that firms can create these networks as efficiently as possible
- New research suggests that FDI stimulates domestic investment



II. How do multinationals respond to international tax rules?

- Very actively – and in three distinct ways…

1. Avoidance
   - Transfer pricing of goods and services – e.g. paper clips
   - Financing patterns – e.g. dividend repatriations
   - Location of intangible property – e.g. patent transfers
     - Consequences: Plenty of resources dedicated to rearranging profits
     - Magnitudes: e.g. 10% tax rate difference associated with changed reported profit rates of 2.3%; 13% lower repatriations because of taxes

II. How do multinationals respond to international tax rules? (cont.)

2. Ownership patterns

- Joint ventures
- Expatriations
- Mergers and acquisitions
  - Consequences: Who owns what (and in what form) shaped by tax rules
  - Magnitudes: e.g. Joint ventures by U.S. companies fell in response to 1986 tax law changes, firms changing nationality

II. How do multinationals respond to international tax rules? (cont.)

3. Investment

- Across countries
- Between home and abroad
  - Consequences: Where and how much firms invest is shaped by tax incentives
  - Magnitudes: e.g. 10 percent differences in tax rates associated with 10 percent differences in investment

III. What does economic theory tell us about the efficient way to tax foreign activities?

The spectrum of choices for taxing multinational firms…

Taxation in host countries only		Double taxation
Exemption of foreign income	Full taxation with full credits for foreign taxes paid	Full taxation with no relief for foreign taxes paid
Several countries explicitly or effectively do this	Not done as countries would be subsidizing other tax systems	No one does this

III. What does economic theory tell us about the efficient way to tax foreign activities? (cont.)

Taxation in host countries only

Double taxation

Exemption of foreign income

Full taxation with full credits for foreign taxes paid

Full taxation with no relief

What do we do?

Full taxation with *partial* credits but with *deferral* and with complex *allocation* rules – one of the more costly and complex regimes in the world

Which way have we been heading?

Toward exemption: e.g. repatriation tax holiday…

Away from exemption: e.g. restrictions on deferral, tougher allocation rules

In circles…

III. What does economic theory tell us about the efficient way to tax foreign activities? (cont.)

Taxation in host countries only

Double taxation

Exemption of foreign income

Full taxation with full credits for foreign taxes paid

Full taxation with no relief

Efficient if FDI represents better owners owning what they should…

Why? Tax rules should leave ownership patterns undisturbed and exemption does this

Efficient if FDI represents flows of capital between countries …

Why? Tax rules should leave these flows undisturbed and full credits do this

Highly distortionary

IV. The costs and benefits of the current system

Costs of the current system

- Desai & Hines (2004) estimate very large efficiency costs relative to an exemption system (because firms are so responsive) creating a large ratio of efficiency costs to revenues
- Compliance costs are also enormous
- American firms compete with firms not facing these costs…

IV. The costs and benefits of the current system (cont.)

Costs of going to exemption

- Could exemption lead toward more outbound FDI? Altshuler & Grubert (2001) suggest there may be little locational response
  - Even if it did, would this necessarily be a bad thing?
- Could it lead to erosion of corporate tax revenues?
  - Some of this is happening already…all depends on allocation rules

IV. The costs and benefits of the current system (cont.)

Returning to the President's criteria for reform:

- *Simplicity* - The current system is extremely complex - exemption could be simpler but depends critically on allocation rules
- *Fairness* - Complex system with costly avoidance opportunities tilt the playing field toward larger firms AND U.S. firms compete with global firms with less costly regimes
- *Growth* - Enhancing the competitiveness of U.S. firms helps at home AND current rules have large efficiency costs

Conclusions

- International tax rules are central to the operation of the corporate tax
- Multinational firms are highly sensitive to these rules on several margins – avoidance, ownership and investment
- Multinational firms should not be viewed as a threat to the domestic economy and reform should reflect their competitive environment
- The efficient design of tax rules should emphasize the minimization of distortions to ownership patterns – this suggests lighter taxation of foreign activities
- Overall, the current system is extremely distortionary and, consequently, costly

Appendix: *Selective* References on Various Topics

Changing nature of multinational firm activities

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