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A Fairer Tax Deal for All America's Companies

By R. Glenn Hubbard

Corporate tax reform, which is gaining momentum in Congress, should focus on improving the competitiveness of U.S. firms operating abroad. A key aspect of that objective is to avoid double taxation.

While economists and pundits debate the economic effects of the tax cut President George W. Bush signed into law in May 2003, new corporate tax cut bills have begun to surface in the U.S. Congress. The likelihood of a further cut in corporate tax is high, but what form would it—or should it—take? The bills in Congress are answers; but what is the question?

At 35 percent, the U.S. corporate tax rate is surpassed only by that of Japan's among leading industrialized nations. For U.S. multinational corporations, the story is particularly bleak. Double taxation of U.S. companies' overseas operations raises the cost of capital, damping investment in economic activity at home and reducing the competitiveness of U.S. companies' exports.

This is where the new tax cut bills come in. Discussion centers around international tax policy because the United States needs to replace U.S. export subsidies judged illegal by the World Trade Organization (WTO). Subsequently, the WTO arbitration proceeding determined that the European Union is entitled to $4 billion in retaliation. Both the finding and the retaliation amount—unprecedented in trade-related damages—highlight the importance of this issue. But this necessary change offers an opportunity to tackle wider problems in corporate taxation.

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In the U.S. Congress, we are at a fork in the road. On the one hand, a recent bill sponsored by Rep. Phil Crane (R-Ill.) and Rep. Charles Rangel (D-N.Y.) would try to replicate the status quo with special-interest tax laws. The bill proposes a reduction in corporate tax for domestic manufacturing operations but seeks to recover the cut from foreign manufacturing activities. Such a proposal pits manufacturing companies against nonmanufacturing companies and suggests U.S. companies producing overseas are damaging American growth and jobs.

On the other hand, Rep. Bill Thomas (R-Tex.) and, separately, Sen. Orrin Hatch (R-Utah) have put forward a tax change that would improve the competitiveness of American companies by reducing double taxation and expanding incentives for business investment—the weak spot in the economy's recovery.

The Crane-Rangel bill's approach to tax policy is flawed because it does not deal with the problem of increased cost of capital and ignores the contribution of U.S. multinationals to the U.S. economy. Each business decision taken by a multinational—including how much to invest and where—is influenced by tax policy, particularly how income from foreign investment is taxed.

The Profitability of Multinationals

The starting point for multinationals' investment in foreign countries is the same as for investment at home: profitability. Multinationals capitalize on the value of brands and intangibles, and their

overseas investments are very profitable—and benefit U.S. shareholders (and the U.S. government) through tax revenue. Indeed, each dollar of foreign direct investment by U.S. companies, in present value, generates 70 percent more interest and dividend receipts and U.S. tax revenues than the equivalent dollar of domestic investment.

But the U.S. approach to international taxation dates from the 1960s, when U.S. companies provided half of all foreign direct investment, produced about 40 percent of the world's output, and made the United States the largest capital exporter in the world. The United States is now the largest importer of capital and no longer dominates foreign markets.

In the past, the U.S. tax system has chosen to tax income from foreign investment at the same rate as it taxes domestic income under a principle called capital export neutrality. The principle is based on the idea that investment abroad is a substitute for investment (and jobs) at home and is founded on the assumption that global markets are perfectly competitive. Capital export neutrality was seen as a laudable object in the 1960s when the United States was the primary source of capital investment and dominated world markets. Both the global economic setting and the accepted view of global markets have changed dramatically since the 1960s. In the past few decades, other countries have come to challenge the United States' preeminent position in the global market, and the United States has become a net recipient of foreign investment, as opposed to the largest source. There is mounting evidence that foreign affiliates are in fact complements to domestic investment and employment and therefore should, if anything, be encouraged.

If U.S. businesses are to succeed in the global economy, the U.S. tax system must not hamper their ability to compete against foreign-based companies—especially in foreign markets.

A Bias in the System

At the moment, however, the tax system contains a bias against U.S.-based multinationals because it differs in several important respects from the system operated by most of America's trading partners. While about half the leading industrial countries do not tax the active income earned by a foreign subsidiary (that is, they have a "territorial" tax system), the United States taxes all income earned through a foreign company. The United States also places greater restrictions on the use of foreign tax credits, leading to double taxation of international income. The Thomas bill tackles these problems directly. It also avoids the prospect of European Union retaliation—which could provoke a trade war at a time when prospects for a global economic recovery are cloudy.

As for the question of how to help individuals losing jobs in U.S. manufacturing, that could be dealt with by incorporating into the tax cut bills the personal reemployment accounts—proposed by Mr. Bush earlier this year—that would provide substantial support for new training and benefits.

The Crane-Rangel approach is the sort of special interest tax policy that breeds cynicism about the tax code and promotes the interests of lobbyists over economic growth. The Thomas bill, on the other hand, represents sound international tax policy and increases the chance of a broad tax reform that could make all of us better off.

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