How does the tax system affect US competitiveness?

The international tax policies that best encourage firms to invest in the United States are not necessarily the policies that best help US multinational companies compete with foreign-based multinationals. Policymakers face a trade-off among goals.

WHAT IS COMPETITIVENESS?

Many—really all—politicians favor "international competitiveness," but the term means different things to different people. To some, it is the ability of domestic firms or industries to compete with their foreign counterparts in a global marketplace. For them, this translates into support for "mercantilist" policies that seek to increase exports, reduce imports, or promote more US activity in certain sectors, such as manufacturing.

An alternative form of mercantilism seeks to promote the growth of a country's resident multinational corporations without regard to whether they produce at home or overseas. Concerns about the competitiveness of US multinationals often follow from an assumption that these firms generate spillover benefits for the economy in which they are headquartered. For example, the knowledge created by the research and development (R&D) that these firms conduct (typically at headquarters) often gets diffused to other domestic producers, boosting their competitiveness.

By contrast, many economists view free trade and capital movements as mutually beneficial because they tend to raise living standards in all countries. These economists define "competitive" policies as those that increase the standard of living of Americans over the long run, without regard to their effects on the balance of trade, the net direction of international capital flows, or success in expanding specific activities, such as manufacturing or R&D.

Global international tax practices seek to promote free capital movements by preventing double taxation of international capital flows. These same practices assign rights to tax profits to the capital-importing countries (i.e., the country where production facilities are located).

The capital-exporting country has two ways to avoid double taxation. The first is simply to exempt taxation of the foreign-source income of its residents. The second is to tax the worldwide income of its residents but to allow credits for foreign income taxes they pay so that their income is taxed at the home-country rate rather than the rate in the country where the income is earned. These two

approaches have very different implications for a country's attractiveness as a location for productive investment or as a place for multinational corporations to establish residence.

Although the promise of beneficial spillovers from R&D and other headquarters activities is a strong argument for using the tax code to promote them, lower taxes on such activities might lead to a shortchanging of other activities in the economy (such as education, health, and infrastructure) that also provide beneficial external effects. More direct incentives, such as subsidies for R&D, might better encourage the desired spillovers.

TAX POLICIES TO ATTRACT INVESTMENT

The US corporate tax system discourages investment in the United States by both US- and foreign-based corporations because the top corporate tax rate in the United States (if state-level taxes are included) is higher than the top corporate tax rate in all of our major trading partners. However, this disadvantage to US investment is partially offset by capital recovery provisions that are more generous in the United States than in many other countries.

The US tax system also encourages US-based multinationals to invest overseas instead of at home because US multinationals can defer US tax on the income of their foreign-owned subsidiaries in low-tax countries until that income is repatriated to the US parent firm. The effects of this incentive for foreign investment are partially offset, though, if the shift of investment overseas by US multinationals raises pre-tax returns on investment in the United States and thereby encourages an inflow of capital from foreign-based firms.

TAX POLICIES TO ATTRACT CORPORATE HEADQUARTERS

The US tax system arguably places US multinationals at a competitive disadvantage with foreign-based multinationals with income from low-tax countries because US companies must pay the difference between the US tax rate and foreign tax rates when they repatriate profits from their foreign affiliates. In contrast, most countries in the Organisation for Economic Co-operation and Development and all the other countries in the G7 (Canada, France, Germany, Italy, Japan, and the United Kingdom) have exemption systems that allow their resident multinationals to pay only the foreign-tax rate on their overseas profits.

In addition, the US controlled foreign corporation (CFC) rules tax some forms of foreign-source income of US multinationals as it accrues in their foreign subsidiaries. The goal is to prevent schemes that strip reported profits from US tax jurisdiction to low-tax foreign countries. The CFC rules, however, only apply

to US-resident multinationals and do not prevent similar schemes by foreign-resident multinationals to strip profits from their US affiliates.

Others argue that US multinationals are not, on balance, put at a disadvantage by the US tax system. They point to the ability of US companies, especially those with significant assets in intellectual property, such as firms in the high-tech and pharmaceutical sectors, to shift reported profits to low-tax jurisdictions. They also note that since 1997, "check-the-box" regulations have effectively enabled US multinationals to shift reported profits from production in high-tax foreign jurisdictions to tax havens without being subject to US CFC rules.

WOULD A VALUE-ADDED TAX INCREASE US COMPETITIVENESS?

Some commentators argue that substituting a value-added tax (VAT) for all or part of the corporate income tax would improve the US trade balance because, unlike the corporate income tax and other levies imposed on income earned in the United States, VATs typically exempt exports and tax imports.

But most economists dispute the claim that a VAT would improve the trade balance, arguing that any benefit to net exports from a VAT would be offset by a resulting appreciation of the US dollar relative to other currencies. In fact, some research suggests that countries that rely heavily on VATs for revenue have lower net exports than those that don't.

Replacing some or all of the corporate income tax with a VAT would, however, affect the trade position of some industries relative to others. Exemptions and lower rates within a VAT affect the relative prices consumers pay for different goods and services but do not distort trade patterns because VAT burdens do not depend on where goods and services are produced. In contrast, preferences within the corporate income tax do affect production location, improving the competitiveness of some US producers while worsening the competitiveness of others because the tax does affect relative costs of production.

Further Reading

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