Key Elements of the U.S. Tax System

Q. How does the tax system affect US competitiveness?

A. 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 means domestic firms or industries can 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 research and development (R&D) (typically conducted at headquarters) often gets diffused to other domestic producers, boosting productivity more broadly.

By contrast, many economists view free trade and capital movements as mutually beneficial because they raise living standards in all countries. These economists define "competitive" policies as those that increase Americans' standard of living 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 the capital-importing countries rights to tax profits (i.e., the country where production facilities are located).

The capital-exporting country has two ways to avoid double taxation. The first method is simply to exempt taxation of the foreign-source income of its resident companies. The second method is to tax the worldwide income of its resident companies but to allow them to claim credits for foreign income taxes 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 different implications for a country's attractiveness either as a location for productive investment or as a place for multinational corporations to establish residence.

Although the promise of beneficial spillovers provides an argument for using the tax code to promote R&D

and other headquarters activities, direct subsidies such as research credits would be a more cost-effective way to encourage research.

HOW CAN TAX POLICIES ATTRACT INVESTMENT?

Following the 2017 Tax Cuts and Jobs Act (TCJA), the US corporate tax system no longer discourages investment in the United States by US- and foreign-based corporations. Now the top corporate tax rate in the United States (including the effect of state-level taxes) is slightly below the average corporate tax rate of our major trading partners. In addition, capital recovery provisions are more generous in the United States than in many other countries, especially through 2022 when companies can immediately deduct 100 percent of costs of machinery and equipment investment in the United States. (This bonus depreciation provision phases out between 2023 and 2027 at 20 percentage points per year.)

Provisions that make it easier in the United States than in most other countries to establish businesses whose owners benefit from limited liability without being subject to corporate-level taxation also encourage domestic investment. For example, many US corporations lease office buildings from real-estate investment trusts, which pay no corporate income tax, instead of owning them and facing US corporate income tax on the profits they generate.

The US tax system after TCJA continues to encourage US-based multinationals to invest in low-tax foreign countries instead of at home. US multinationals pay no US tax on foreign-source income up to 10 percent of the value of their tangible foreign capital (the value, net of past depreciation, of machinery, equipment, and structures). But most of the overseas tangible capital of US multinationals is in other major economies with corporate tax rates now similar to or slightly higher than the US corporate tax rate. Exemption of these profits, then, provides little additional benefit. On these investments, there would be no US tax liability—even in a worldwide system—because the credit for foreign income taxes would fully offset US corporate income tax liability.

HOW CAN TAX POLICIES ATTRACT CORPORATE HEADQUARTERS?

The US tax system places US multinationals at a competitive disadvantage with foreign-based multinationals that have income from low-tax countries. US companies now face a 10.5 percent minimum tax on global intangible low-taxed income, defined as global profits above 10 percent of tangible capital. 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 most of their overseas profits.

The US and many other countries have controlled foreign corporation (CFC) rules that tax some forms of US multinationals' foreign-source income as it accrues in their foreign subsidiaries at the same rate as domestic-source income. The goal of CFC rules is to prevent schemes that shift the reported profits resident multinationals earn at home to their affiliates in low-tax foreign countries. Because CFC rules, however, apply only to domestic-resident multinationals, they do not prevent similar schemes by foreign-resident multinationals to strip profits from their affiliates in high-tax countries.

Several countries have enacted new taxes on foreign-resident multinationals operating in their countries, including the diverted profits tax in the United Kingdom and similar measures in Italy and India. Many countries also have "thin-capitalization" rules that limit interest deductions to prevent outbound income shifting. The base erosion and anti-abuse tax (BEAT) in TCJA is a new measure that limits income shifting out of the United States by both US and foreign-resident companies. The BEAT imposes an alternative minimum tax on a tax base that disallows the deduction of certain payments to related parties. Some companies may find ways to avoid the BEAT, and the provision may also do unintended collateral harm to other companies, so its effectiveness is debatable. Nonetheless, BEAT is an effort to improve the competitive position of US-based multinationals by limiting the ability of foreign-based companies to strip profits from their US operations.

WOULD A VALUE-ADDED TAX OR DESTINATION-BASED CASH FLOW 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. 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.

In 2017, House Republicans considered and then abandoned a plan for a destination-based cash flow tax (DBCFT) to replace the corporate income tax. The DBCFT was similar to a VAT in that it would have allowed immediate recovery of capital expenses and would have exempted exports from tax and disallowed a deduction for imports. (It differed from a VAT by allowing companies to deduct wages.) Many commentators expressed concern that the DBCFT would hurt US importers, but prominent economists argued that exchange rates would adjust to neutralize any trade effects of its border-adjustments feature.

Key Elements of the U.S. Tax System

How does the tax system affect US competitiveness?

Further Reading

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