Slashing Corporate Taxes: Foreign Investors Are Surprise Winners

by Steven M. Rosenthal

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In this article, Rosenthal evaluates the benefit to foreign investors from lowering the corporate income tax rate.

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I. Introduction

The Unified Framework for Fixing Our Broken Tax Code (the “Big Six” tax plan) would revise business and individual taxes. Most significantly, on the business side, the Big Six tax plan would lower the corporate income tax rate from 35 percent to 20 percent, which would reduce corporate taxes by an average of $200 billion a year, or $2 trillion over the 10-year budget window.¹ However, in the short run, a surprisingly large portion of this relief would end up in the pockets of foreign investors.

There is considerable debate among economists about the long-run incidence of a corporate income tax. Most mainstream economists believe that in the long run a corporate tax cut would benefit all owners of capital and, to a lesser degree, U.S. workers. At the extreme end of the spectrum, the Trump administration claims the pending plan to cut the corporate tax rate would increase wages for U.S. workers by $4,000 or more a year in the “long run.”² It does not specify the time needed to reach the long run.

However, in the short run, everyone agrees: A cut in the corporate tax rate would benefit the current owners of U.S. corporate equity. I estimate that foreign investors own about 35 percent of U.S. corporate stock and thus would receive about 35 percent of the short-run benefit. This translates to approximately $70 billion a year, about three times the $23 billion that all middle-income households would see under the preliminary estimates of the Big Six tax plan.³ I also explain why the short run relief for foreign investors could persist for many years.

II. Foreign Investment Expanded Sharply

Congress last lowered the top corporate tax rate in 1986, from 46 percent to 34 percent (which was subsequently raised to 35 percent in 1993).⁴ In

³ The TPC calculated that the average middle-income household (in the 40th to 60th percentile) saved $660 for 2018, and there are 34.3 million of those households, which totals to savings of $22.6 billion. TPC Unified Framework Table T17-0225, “Distribution of Federal Tax Change by Expanded Cash Income Percentile, 2018” (Sept. 29, 2017).
⁴ In 1986 Congress also broadened the corporate tax base to offset the loss from lowering the rate. In net, Congress increased corporate taxes.
1986 foreigners owned relatively little U.S. stock, which lawmakers arguably could ignore. But foreign investors now own a significant portion of U.S. stock. Their 35 percent share exceeds each of the following: U.S. taxable shareholders; defined benefit plans; defined contribution plans; and nonprofit institutions, which are the other significant holders of U.S. corporate stock. Estimates of tax incidence should reflect these changed circumstances.

As Arnold C. Harberger, the early pioneer of modern corporate tax incidence analysis, emphasized in 2008, “The idea always has been that the owners or shareholders of an enterprise . . . will initially bear the incidence of a new [corporate] tax wedge.” But those owners now include many foreign investors, which has been given little attention.

III. Foreign Investors Windfall

The Big Six tax plan would lower the corporate tax rate to 20 percent (and repeal the corporate alternative minimum tax), eliminate taxation of future foreign profits of U.S.-based companies (with unspecified safeguards to prevent income shifting), and impose a reduced tax on deferred corporate earnings of foreign subsidiaries of U.S. multinationals (now estimated at $2.6 trillion). It would also make other changes to business taxes, some of which

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7 U.S. investors also increased their share of foreign corporate stocks, both portfolio holdings and foreign direct equity investment. However, income from those holdings is largely unaffected in the short run from reducing the U.S. corporate tax rate.


10 Letter from JCT Chief of Staff Thomas Barthold to House Ways and Means Committee Chair Kevin Brady, R-Texas, and member Richard E. Neal, D-Mass. (Aug. 31, 2016).
are unspecified. This article estimates the benefit to foreign investors from lowering the corporate income tax rate. It does not evaluate the switch to the territorial system, the one-time tax for repatriated earnings, or other, smaller, business tax changes.\footnote{Some of these other elements could hinder foreign shareholders, such as the cut in passthrough rates (which could lower returns in the corporate sector, in which foreigners participate extensively, and increase returns in the passthrough sector, in which foreigners participate less extensively) and expensing (which could reduce the value of existing corporate capital).}

Today, U.S. corporations generally pay a 35 percent federal income tax rate.\footnote{U.S. corporations report their tax payments annually to the IRS on Form 1120.} The corporate tax rate extends to the income of a business in the United States, either through a branch or a partnership, conducted by a foreign corporation.\footnote{In both cases, a foreign corporation must report its tax payments annually on Form 1120-F. Foreigners also pay a flat 30 percent tax on their passive income (dividends, interest, etc.), although this rate often is reduced by treaty. Foreigners typically pay no tax on their capital gains, which generally are sourced to the foreigner’s country. Congress is not revisiting these flat taxes.}

Foreign investors may hold the shares of U.S. corporations in two ways. They can hold portfolio stock (for example, Apple stock held by a Canadian), or they can make direct equity investments (for example, Siemens USA, which is wholly owned by Siemens AG, a German multinational). In either case, a portion of the incidence of the corporate income tax is borne by the foreign investor, at least in the short run.

I estimate that foreigners now own about 35 percent of U.S. stock, as detailed in the Appendix. That estimate sums (1) the portfolio stock held by foreign investors (less than 10 percent stakes in U.S. corporations) and (2) the direct corporate equity investments by foreigners (10 percent or greater stakes, typically a U.S. subsidiary by a foreign multinational)\footnote{In the appendix, I discount foreign direct equity investment to reflect U.S. ownership of the foreign multinationals that invest in U.S. corporate equity. Figures 1 and 2 do not reflect that discount, which is small, but difficult to quantify, for early years.} and then divides that total by the total outstanding U.S. corporate equity.

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**Figure 2. Foreigners’ Holdings of U.S. Corporate Stock as a Share of Total Corporate Equity and Foreign Direct Investment, 1982-2016 (market value in 2017 dollars)**

![Graph showing the percentage of foreign ownership in U.S. corporate stock and foreign direct investment from 1982 to 2016.](image)

Given that 35 percent of all shares are held by foreign investors, and given that all the short-run benefit of lowering the corporate tax rate are assigned to shareholders of U.S. corporations, I conclude that 35 percent of the approximately $200 billion in annual corporate tax savings in the first years after the proposal comes into effect would accrue to foreign investors. This amounts to $70 billion a year.

IV. How Long Would the Short Run Last?

Harberger and other economists who study tax incidence have always attributed the entire burden of the corporate tax, in the short run, to stockholders. But in the long run, Harberger originally attributed the tax burden to the holders of all U.S. capital. His original model relied on several assumptions, most importantly on a closed economy in which capital could not shift to or from other countries.

Harberger’s original model became dated as global trade and capital flows increased markedly. Economists still accepted Harberger’s short-run analysis, but many relaxed his assumption of a closed economy and suggested that higher U.S. corporate taxes might cause capital to gradually shift abroad (and lower global capital returns in the long run). Some also suggested that wages in the United States might fall. They posited that after capital shifted abroad, U.S. workers would have less capital to work with, and U.S. worker productivity might decline (and lead to a lower return to U.S. labor). A lowering of the corporate tax would have the reverse effect.

But how long will the short-run effects last before the long-run effects are felt? Harberger believes the answer is close to unknowable. He acknowledges that adjustment is faster if a tax change is small. But adjustment is longer with a big tax wedge and “might take ten years to reach the long-run solution.”

As Alan J. Auerbach observed, “Labor, and especially capital, cannot freely shift from one sector of production to another. While computers can be moved from one office to another, it is considerably more difficult to turn a nuclear power plant into a tractor.”

Finally, as my colleague, Howard Gleckman, observed, there is a four-part story to higher wages: “Lower U.S. corporate tax rates must attract lots of new investment capital. Corporations must use the money to purchase a lot of new equipment for their U.S. businesses. All that new investment must make U.S. workers much more productive. And, finally, that productivity growth must translate into far higher wages.”

V. Implications

The corporate tax is an appropriate toll paid to engage in business in the United States. Congress and the administration are considering measures to lower that toll considerably but are not proposing to offset the revenue loss with increases of other taxes or spending cuts. This deficit-financed tax cut would benefit foreign investors substantially, but future generations of U.S. taxpayers would eventually repay the shortfall through new tax increases or spending cuts.

U.S. tax reform may inevitably allow incidental benefits to foreigners. But the windfall to foreigners from lowering U.S. corporate income tax rates from 35 percent to 20 percent is exceptionally large. As estimated here, a lower corporate income tax rate would benefit foreign

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16 Workers cannot move to other countries as easily as capital investments can move.
17 Harberger, supra note 8, at 303.
investors by $70 billion in the first year alone. All the individual and business tax cuts in the Big Six tax plan, as currently described, would benefit middle-income U.S. households (those in the 40th to 60th income percentile) by only $23 billion in the first year.

There are ways to reform corporate taxes that would limit the size of the windfall to foreigners. Congress could keep the current 35 percent rate but adopt full corporate tax integration. For example, Congress could permit U.S. corporations to deduct the dividends they pay to their shareholders, as advocated by Senate Finance Committee Chair Orrin G. Hatch, R-Utah. And Congress could require corporations to withhold taxes on those dividends, with a nonrefundable tax credit to the shareholders.  

Alternatively, Congress could lower the corporate tax rate some but offset the cost by broadening the corporate tax base. So, on balance, corporations would contribute the same level of taxes.

VI. Appendix

This appendix describes the calculation of the 35 percent share of U.S. corporation stock held by foreign investors. The estimate added the market value of both foreign portfolio holdings and foreign direct corporate equity and divided by the market value of total outstanding corporate equity. The estimate of foreign direct equity was corroborated by tax return data compiled independently by the IRS.

The Federal Reserve reports the amount of outstanding U.S. corporate equity quarterly in the “Financial Accounts of the United States,” previously the “Flow of Funds Accounts.” The Fed reports both foreign portfolio stock (for less than 10 percent holdings) and foreign direct investments (for 10 percent or greater equity holdings). Notably, the portfolio and direct investment are published on separate tables, which can be missed.

The Fed obtains its portfolio data from a joint survey by the Fed, the Federal Bank of New York, and Treasury. It obtains foreign direct investment data from surveys by the Commerce Department’s Bureau of Economic Analysis (BEA).

A. Outstanding U.S. Corporate Stock

The Fed showed a total market value of $38.6 trillion in corporate equity at the end of 2016, which excluded U.S. intercorporate holdings of public stock and foreign direct equity in U.S. corporations.

The Fed included (1) foreign stock held by U.S. residents and (2) stock issued by U.S. passthrough corporations. Because I wanted to measure only the outstanding stock of corporations that are taxable by the United States, I subtracted both. I also added the foreign direct equity in U.S. corporations. As a result, I estimated that a market value of $30.4 trillion of U.S. corporate stock was outstanding at the end of 2016 (see Table 1).

24 Such an integration plan would provide a windfall to domestic shareholders, which would need to be taken into account in the tax reform process.

Corporate Equity Outstanding
(2016, market value in billions)

| Total foreign and domestic corporate stock (including stock issued by C and S corporations, exchange-traded funds, closed-end funds, and real estate investment trusts) | $38,589 |
| $6,997 |
| ($3,172) |
| ($2,524) |
| ($262) |
| ($1,019) |
| $5,784 |
| $30,399 |

B. Foreign Ownership of U.S. Corporate Stock

Foreigners owned about $5.8 trillion of portfolio stock of U.S. corporations at the end of 2016. The $5.8 trillion of portfolio stock excluded mutual funds and money market shares, but included exchange-traded funds, closed-end funds, and real estate investment trusts.

In theory, to calculate foreign portfolio holdings more precisely, the estimate would (1) add the underlying common stock held by the excluded mutual funds; (2) exclude exchange-traded funds, closed-end funds, and REITs; and (3) add back any underlying stock held by exchange-traded funds, closed-end funds, and REITs. I believe this process would increase the portfolio holdings held by foreigners by a relatively small amount. Finally, the estimate assumed that U.S. residents do not hold much U.S. portfolio stock through offshore trusts, in light of recent U.S. legislation and IRS enforcement efforts to curtail that practice.

Foreigners also held about $5.8 trillion of foreign direct equity in U.S. corporations, which typically reflects holdings of U.S. subsidiaries by foreign multinational corporations. Because U.S. residents may own some of the stock of those foreign multinationals, I attributed a portion (18 percent) of the foreign direct investment to U.S. residents. Thus, foreigners beneficially owned $4.8 trillion of foreign direct equity.

In total, by my estimate, foreigners held about $10.6 trillion of U.S. stock, or about 35 percent of the $30.4 trillion outstanding U.S. equity in 2016.

C. Corroborating With IRS Data

In 2013, the foreign direct equity investment was $4.4 trillion, without a discount to reflect the U.S. ownership of the foreign multinationals that hold those direct equity investments. That amount is a little less than 17 percent of $26.3 trillion of total U.S. corporate equity for the year.

In 2013, the most recent year available, foreign-majority-owned U.S. corporations paid $50 billion of the total $293 billion paid by all U.S. corporations to the IRS, or 17 percent. U.S. corporations that are 10-50 percent owned by foreigners would have paid more, but there were relatively few of these corporations, and the taxes paid were not reported. Thus, the 17 percent share calculated from foreign direct equity investment corresponds roughly to the 17 percent share calculated from IRS data.

30 I estimated the U.S. portfolio share of the market capitalization of listed securities in Canada, France, Germany, Japan, Switzerland, and the United Kingdom, because those countries account for most of the foreign direct equity investment in U.S. corporations. To perform this calculation, I started with the market value of corporate equities and investment funds held by U.S. residents that had been issued by companies from each of six countries, as reported by the International Monetary Fund. I divided the amounts by the total market capitalization of all listed companies for each of these countries, as reported by the World Bank. I then averaged, arriving at 18 percent. I believe an 18 percent discount is too high, since I did not include the market capitalization of non-listed securities, in my denominator.

31 The set of U.S. corporations that are more than 50-percent controlled by foreigners is more than 90 percent of foreign direct equity investment, by employment and assets. See BEA, “International Economic Accounts.”

32 Foreign corporations also paid another $3 billion of tax on income from U.S. noncorporate businesses, which was reported on Form 1120-F (also 2013 data).