

International Tax Competition A 21st-Century Restraint on Government

by Chris Edwards and Veronique de Rugy

Executive Summary

Globalization is knitting separate national economies into a single world economy. That is occurring as a result of rising trade and investment flows, greater labor mobility, and rapid transfers of technology.

As economic integration increases, individuals and businesses gain greater freedom to take advantage of foreign economic opportunities. That, in turn, increases the sensitivity of investment and location decisions to taxation. Countries feel pressure to reduce tax rates to avoid driving away their tax bases. International “tax competition” is increasing as capital and labor mobility rises.

Most industrial countries have pursued tax reforms to ensure that their economies remain attractive for investment. The average top personal income tax rate in the major industrial countries of the Organization for Economic Cooperation and Development has fallen 20 percentage points since 1980. The average top corporate income tax rate has fallen 6 percentage points in just the past six years.

Rising tax competition has caused governments to also adopt defensive rules to prevent residents and businesses from enjoying lower tax rates abroad. In the United States, such tax rules are

hugely complex and affect the ability of U.S. companies to compete in world markets. Other defensive responses to tax competition include proposals to harmonize taxes across countries and to restrict countries from offering tax climates that are too hospitable to foreign investment inflows.

Those defensive responses to tax competition are a dead end. They do nothing to promote economic growth or reform inefficient tax systems. A more constructive response to tax competition would be to learn from foreign reforms and adopt pro-growth tax policies at home. The United States should be a leader but has fallen behind on tax reform. For example, the United States now has one of the highest corporate tax rates among major nations. The chairman of the president’s Council of Economic Advisers, Glenn Hubbard, believes that “from an income tax perspective, the United States has become one of the least attractive industrial countries in which to locate the headquarters of a multinational corporation.”

As international capital and labor mobility rises, the risks associated with not having an efficient federal tax structure increase. This country should respond to rising tax competition by moving toward a low-rate consumption-based system.

High taxes on capital create an increasing drag on growth as capital mobility increases.

Introduction

In past decades, many governments shunned inflows of foreign investment and restricted their citizens' investments abroad. But a sea change in political attitudes toward foreign investment has occurred since the 1970s. Most governments today actively encourage inflows of foreign investment because they recognize that it is a key factor in maximizing economic growth.

Foreign investment exploded with the removal of capital controls and the deregulation of financial markets in major economies in the 1970s and 1980s. Many developing countries followed suit in the 1990s. Reforms included allowing foreign currency exchange, allowing the purchase of foreign securities, and allowing foreigners to buy domestic securities and acquire domestic firms. As has been widely observed, advances in technology and communications have spurred capital and labor flows, with the Internet and other tools opening up global investment and work options for individuals and businesses.

High tax rates are more difficult to sustain in the new economic environment. That is particularly true for taxes on capital, which include taxes on business profits and taxes on individual receipts of dividends, interest, and capital gains. Basic economic theory suggests that high taxes on capital create an increasing drag on growth as capital mobility increases. High taxation of capital causes capital flight, thus reducing domestic productivity, wages, and incomes.¹ Martin Feldstein, James Hines, and Glenn Hubbard, the chairman of president's Council of Economic Advisers, have made that point with respect to the corporate income tax:

Many economists argue that it is inefficient to use corporate income taxes to raise revenue in open economies. If capital is internationally mobile, the burden of corporate taxes falls largely on other immobile factors (such as labor), and the tax

system would be more efficient if these other factors were instead taxed directly.²

Two centuries ago Adam Smith similarly recognized that heavy taxes on mobile "stock," or capital, would cause a loss to workers and the economy:

Secondly, land is a subject which cannot be removed, whereas stock easily may. The proprietor of land is necessarily a citizen of the particular country in which his estate lies. The proprietor of stock is properly a citizen of the world, and is not necessarily attached to any particular country. He would be apt to abandon the country in which he was exposed to a vexatious inquisition, in order to be assessed to a burdensome tax, and would remove his stock to some other country where he could either carry on his business, or enjoy his fortune more at his ease. By removing his stock he would put an end to all the industry which it had maintained in the country which he left. Stock cultivates land; stock employs labour. A tax which tended to drive away stock from any particular country, would so far tend to dry up every source of revenue, both to the sovereign and to the society. Not only the profits of stock, but the rent of land and the wages of labour, would necessarily be more or less diminished by its removal.³

What is new since Smith's time is the greater ability of corporations and individuals to move themselves and their investments across borders. In closed economies, high taxes on capital income and skilled workers stunt economic growth. As economies open up, such bad tax policy causes even larger economic losses due to greater impacts on investment and labor flows.⁴ As a result, tax competition is becoming more important all the time.

Tax competition may be broadly defined to include the tax policy influence that countries exert on each other. If neighboring countries are prospering under low tax rates, citizens and policy experts may demand the same from their own government. Consider Ireland. In 2000 that small country of 3.8 million people attracted more foreign direct investment (FDI) than either Japan or Italy.⁵ The main draw for foreign investors has been a 10 percent corporate tax rate on manufacturing, financial services, and other activities.⁶ As a result, Ireland has boomed and now has one of the highest standards of living in the world.⁷ A United Nations report called Ireland “the most dynamic country in the developed world in terms of recent growth and competitive performance” and hailed its change from “a backward low-productivity economy into a center of technology-intensive manufacturing and software activity.”⁸

But such tax cut success stories concern some economists who view tax competition as distortionary. It is thought that if different tax rates cause capital and labor to migrate across borders, those resources may not end up in their most productive uses. So Ireland is receiving “too much” investment because of its low tax rates, according to that view. But that loses sight of a larger issue: high tax rates shackle economic growth. Thus, to the extent that tax competition creates pressure to reduce tax rates globally, all countries gain from increased growth and higher incomes.

Opposition to international tax competition is wrapped in the language of economics but seems to stem mainly from political concerns. In particular, some people worry that tax competition reduces governments’ ability to redistribute income. When borders are opened, businesses and individuals that are taxed heavily to pay for redistribution will rationally look to better locations for working and investing. A high-profile 1998 report from the Organization for Economic Cooperation and Development on “harmful tax competition” calls such tax avoidance behavior “free riding” that “may hamper the application of progressive tax rates and the

achievement of redistributive goals.”⁹

Like many of the OECD report’s arguments, that one is internally contradictory. Redistribution involves taxing some people at high rates and others at low rates. The “free riders” would seem to be the latter group, who pay a less than proportionate share of their income in taxes. In our view, international tax competition may indeed hamper income redistribution, but that is a beneficial outcome because redistribution has progressed to a remarkably high degree in most industrial countries.¹⁰

In addition to OECD and other international efforts to dampen tax competition, governments are taking numerous defensive measures on their own. For example, they are imposing layers of complex tax rules on the foreign operations of corporations. In this regard, the United States enacted its “subpart F” regime in 1962 and has beefed up those rules a number of times since. Other countries have followed suit with similar rules designed to limit the benefits of investment in foreign countries that have lower taxes. But the U.S. rules are usually considered the most complex, and they damage the ability of U.S. companies to compete abroad. Such rules are merely Band-Aids that cover the need for more fundamental tax reforms.

This study examines the growth of global capital and labor mobility, the global fall in tax rates since the 1980s, the basics of U.S. international tax rules, the responsiveness of investment flows to taxation, tax competition theory, and government responses to tax competition. It concludes by examining policy options for the United States, including replacing the individual and corporate income taxes with a low-rate consumption-based tax system.

Growing Capital and Labor Mobility

Capital Mobility

World economies have become more tightly integrated in recent decades. Rapid

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growth in cross-border investment has been a key dimension of that integration. In past decades, many countries erected barriers to foreign investment, but today most countries realize that foreign investment means new jobs, new factories, and access to leading-edge technology. As a result, governments have removed the shackles they once placed on international investment flows.

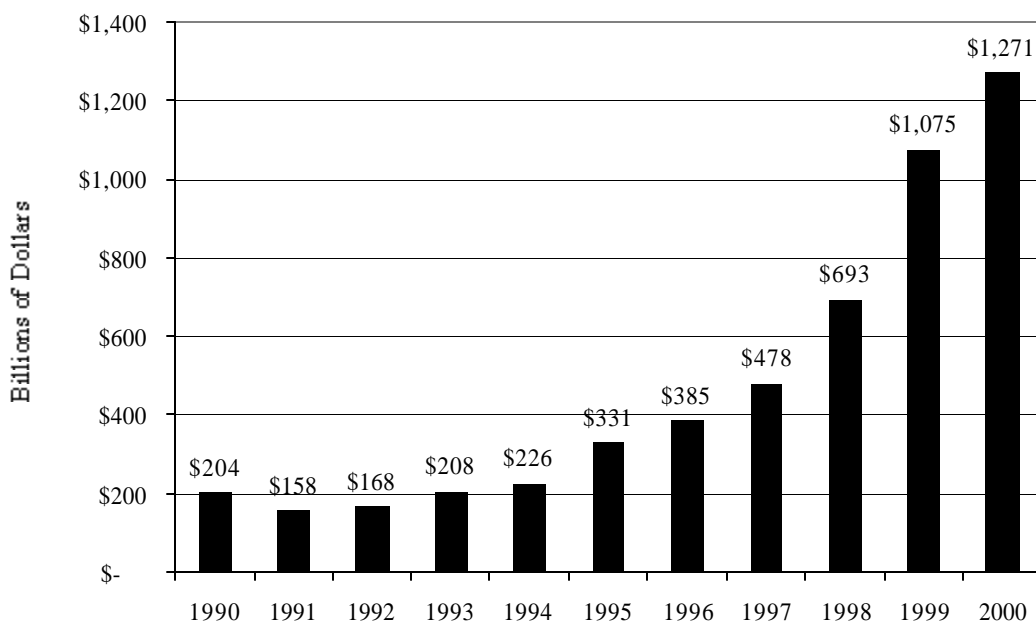
Since the 1970s most countries have eliminated foreign exchange controls.¹¹ With the widespread adoption of floating currency exchange rates, countries were able to open their borders to free flows of investment capital, while still maintaining independent monetary policies. Other deregulatory actions have also promoted investment flows. For example, hundreds of bilateral investment treaties have been signed to reduce investment barriers. A United Nations report found that 95 percent of government FDI rules in the 1990s were in the direction of deregulation.¹² Financial mar-

kets have been deregulated around the world, making them more attractive to foreign investors. Coincident with that trend, large selloffs of state-owned companies increased investment opportunities in many formerly closed economies.

Technology has also greatly boosted investment flows. Dramatic reductions in communication and transportation costs, huge gains in computer power, and the rise of the Internet have facilitated rising capital flows.¹³ Richard McKenzie and Dwight Lee explored those trends in their 1991 book, *Quicksilver Capital*.¹⁴ More recently, Vito Tanzi described how globalization has combined with new technologies, such as electronic commerce, to create “fiscal termites” that oblige governments to reduce tax rates so as to retain their tax bases.¹⁵

Technology and deregulation have worked in a virtuous circle to spur international tax competition. For example, containerized ship-

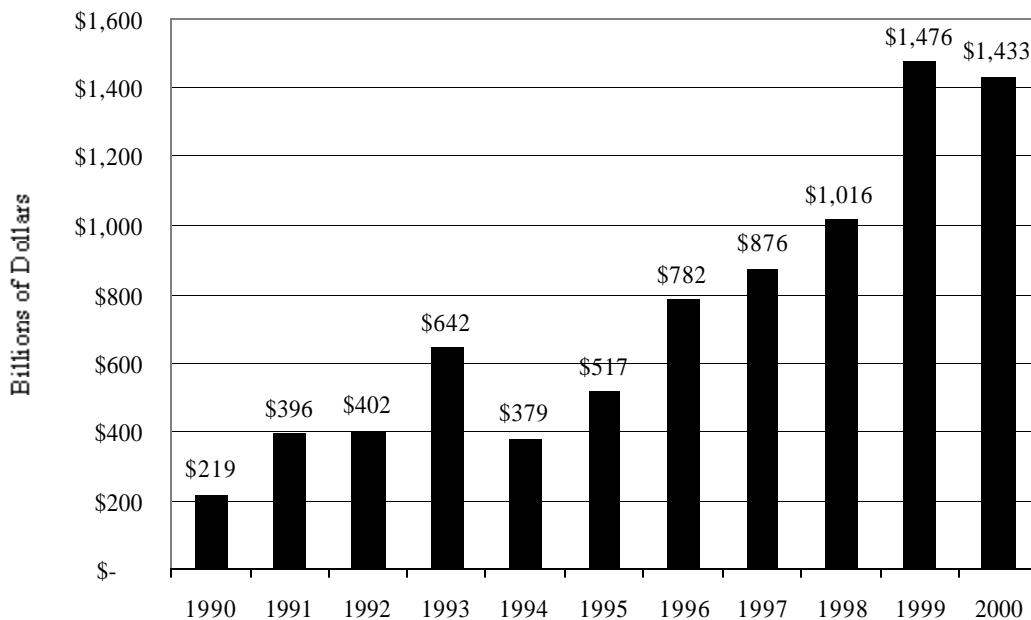
Figure 1
World Foreign Direct Investment Flows



Sources: United Nations, *World Investment Report 2001* (New York: United Nations Conference on Trade and Development, 2001); and United Nations, *World Investment Report 1996* (New York: United Nations Conference on Trade and Development, 1996).

Note: Figures are foreign direct investment inflows.

Figure 2
World Foreign Portfolio Investment Flows



Source: International Monetary Fund, *Balance of Payments Statistics Yearbook, 2001* (Washington: IMF, 2001).

Note: These are private flows of financial securities (stocks and bonds). Figures are the average of inflows and outflows.

ping has increased global transportation efficiencies. That has coincided with reductions in international trade barriers. Together, those trends allow production in many industries to be placed nearly anywhere in the world with goods shipped cheaply to the final destination. As a result, countries must work hard to provide a competitive business climate for global corporations scouting for new factory locations.

There have been dramatic increases in both FDI and foreign *portfolio* investment. Direct investment refers to investments by multinational corporations that result in a large ownership stake (more than 10 percent) in a foreign company, called an affiliate.¹⁶ Foreign affiliates may be established by creating a new company or acquiring an existing company. Direct investments are usually made with long-term investment goals in mind.

By contrast, foreign portfolio investment refers to financial investments that do not result in large ownership stakes (no more

than 10 percent) in any one company. Portfolio investment is more volatile than direct investment and is usually undertaken with shorter-term investment goals in mind.

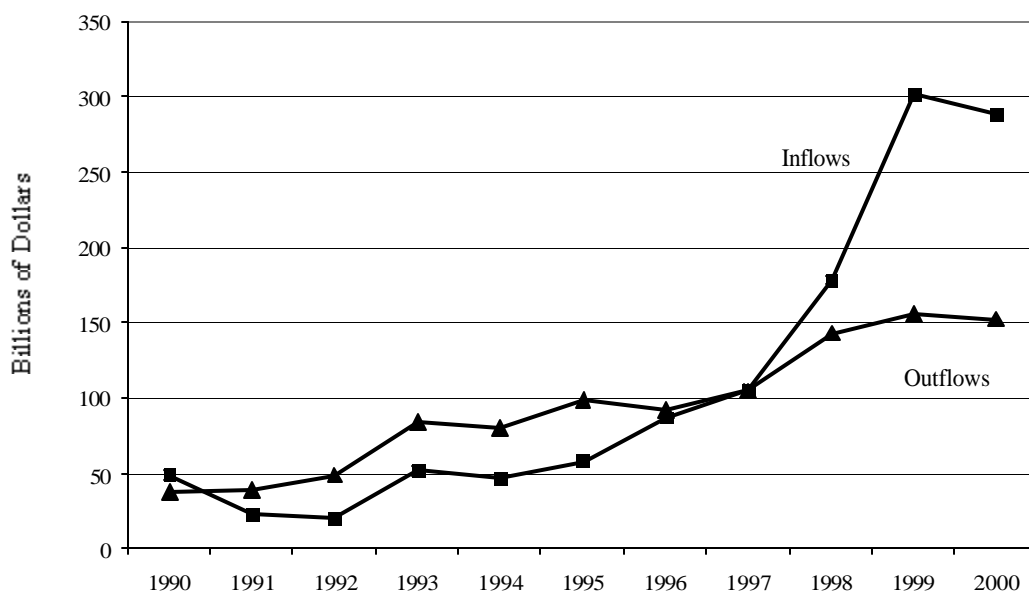
World direct investment flows soared to \$1.3 trillion in 2000, up from just \$204 billion in 1990 (Figure 1). World portfolio investment flows increased to \$1.4 trillion in 2000, up from \$219 billion in 1990 (Figure 2). Foreign investment flows were down in 2001 because of the global economic slowdown. In recent years, direct and portfolio investment, on net, has flowed out of Europe and Japan and into the United States and fast-growing developing countries.¹⁷ Figures 3 and 4 show the growth in direct and portfolio investment flows to and from the United States.¹⁸

Direct investment flows allow multinational corporations to establish global production and sales networks. One-third of the sales of the 500 largest U.S. companies is now from their foreign affiliates.¹⁹ Those affiliates

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Figure 3
U.S. Foreign Direct Investment Flows



Source: U.S. Department of Commerce, *Survey of Current Business*, various issues, Tables F.2, G.1.

serve as conduits for the movement of U.S. exports into foreign markets.²⁰ U.S. corporations had about 24,000 foreign affiliates in 1998, up 40 percent from a decade earlier.²¹ The bulk of those affiliates are in high-income industrial countries, not developing countries or tax havens.²² Globally, there are now about 60,000 multinational corporations with 500,000 foreign affiliates.²³

Portfolio investment flows have risen as countries have expanded their stock markets, debt has become securitized, and financial wealth holdings have risen. The International Monetary Fund reports that global assets managed by institutional investors topped \$30 trillion by 1998, having doubled since 1990.²⁴ Market capitalization of foreign firms on the New York Stock Exchange is more than \$3 trillion.²⁵

Despite the large volumes of cross-border investment flows, research has suggested that world capital markets are still far from fully integrated. For example, investors have substantial “home-country bias” because

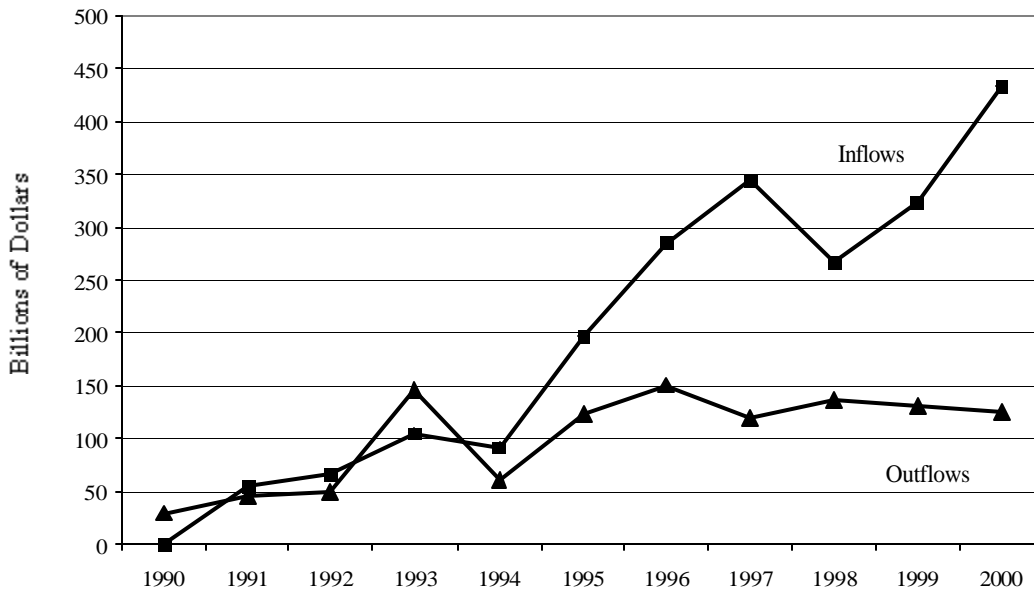
they do not have full information about foreign markets.²⁶ Therefore, it seems likely that we are at just the beginning of a long process of global integration and that economic forces and technology will continue to drive foreign investment flows even higher.

Taxation and Capital Flows

To attract foreign investment, countries must first get the economic fundamentals right. They need to establish a stable currency, have reliable legal rules to prevent expropriation of assets, and have liquid and transparent financial markets. For example, an unstable currency caused by loose monetary policy gives a clear signal to potential investors that a devaluation, which would threaten to reduce the value of any profits made in that currency, is likely.

Dozens of formerly socialist countries in Latin America, Asia, and Eastern Europe have begun to get the economic fundamentals right in the past two decades. Many industrial countries have also made substantial market

Figure 4
U.S. Foreign Portfolio Investment Flows



Source: U.S. Department of Commerce, *Survey of Current Business*, various issues, Tables F.2, G.1.

Note: These are private flows of financial securities (stocks and bonds).

reforms. As a consequence, tax policy has risen in importance as a factor influencing global investment flows. That is, as nontax factors become more equalized between countries, tax competition becomes more intensive.

Consider business location decisions. Traditionally, an important reason to invest abroad was to gain access to fixed resources, such as oil deposits. Today, more industries are footloose and can be located just about anywhere. Finance and services, for example, are the two fastest growing areas of U.S. direct investment abroad.²⁷ Also, an increasing share of product value is in the form of intangibles such as knowledge, trademarks, and patents. The profits from intangibles may be easily moved to low-tax countries. As a result, corporations are much more sensitive to different countries' tax rates today than they were previously.

Indeed, empirical research finds that FDI is becoming more sensitive to taxation. In a new compilation of studies on the issue, editor James Hines of the University of

Michigan Business School concludes that "recent evidence indicates that taxation significantly influences the location of FDI, corporate borrowing, transfer pricing, dividend and royalty payments, and research and development performance."²⁸

A study by Rosanne Altshuler, Harry Grubert, and Scott Newlon found that U.S. multinationals became more sensitive to taxes on FDI between 1984 and 1992.²⁹ For 1992, their results suggest that countries with tax rates 10 percent higher than those of other countries received 30 percent less U.S. FDI, controlling for other factors. Results from other studies have found lower but still substantial behavioral responses. The authors note that "most recent studies indicate that taxes exert a strong influence on location decisions."³⁰

Similarly, a recent IMF study found "strong evidence" that direct investment flows are affected by tax systems.³¹ The study's results showed that lower-tax countries had larger inflows of FDI

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than did the higher-tax countries examined. Four European countries with favorable tax regimes—Ireland, the Netherlands, Luxembourg, and Switzerland—accounted for 9 percent of European GDP but attracted 38 percent of U.S. FDI to Europe between 1996 and 2000.³² Evidence also indicates that taxes affect FDI flows at the subnational level. One recent study found that U.S. states with higher taxes attract fewer new investments and plant expansions from foreign corporations than do lower-tax states.³³

Portfolio investment flows have also become more responsive to taxes. A recent IMF report noted that “amid widespread capital account liberalization and increased reliance on securities markets, these investable funds became increasingly responsive to changing opportunities and risks in a widening set of regions and countries.”³⁴ Portfolio flows can be shifted in and out of foreign investments quickly and are more sensitive to short-term returns than is FDI. Many countries have eliminated taxation altogether on certain inflows of portfolio investment because of increased tax sensitivity. For example, the United States eliminated taxation of portfolio interest earned by foreigners in the early 1980s for that reason.

The effect of tax competition on portfolio investment flows is being felt intensely in the European Union. High-tax countries such as Germany and Sweden have had substantial outflows of savings, often not reported to authorities, to lower-tax EU countries.³⁵ A 10 percent German withholding tax on domestic interest payments was introduced in 1989 and “caused a massive movement of funds to Luxembourg.”³⁶ The tax was abolished. The adoption of the euro has intensified tax competition pressures because it eliminates currency risk and narrows interest rate differentials across Europe. The introduction of the euro adds to the pressure for tax competition created by prior reforms, such as the removal of internal migration barriers in 1992, which increased pressure to reduce tax rates on labor.

Labor Mobility

International tax competition is generat-

ed by mobile labor as well as mobile capital. While national borders impose large barriers to the free movement of persons, technological advances, regional trading zones, and greater information about foreign opportunities are creating rising cross-border labor flows. That is particularly the case for highly skilled labor in industries such as high-tech and finance. Countries sharing a common language and culture, such as Canada and the United States, may expect to feel the strongest tax competition pressure.

Millions of people migrate each year for nonfinancial reasons, such as family reunification or to escape from oppressive political regimes. An analysis by the OECD found that, while family and political factors remain important causes for migration, there has been a rise in migration for economic reasons.³⁷ One of those reasons is personal taxes, which vary substantially between countries, particularly for people with high incomes. Income taxes in most countries have marginal rates that rise with income, so it is the most skilled workers with the highest incomes who are most responsive to tax competition.

Numerous factors have increased the importance of taxes to international migration. First, the Internet has increased information about foreign opportunities and allowed firms to broaden international job searches. Second, falling travel and communication costs have made it easier for workers to take employment in foreign countries and maintain close contact with relatives. Third, emigration restrictions in many formerly repressive regimes have been eliminated.

A fourth trend is the increased technological ability to perform work in foreign countries while residing elsewhere. The Internet allows software writers and other professionals to earn wages anywhere in the world and remain connected to customers electronically, while living in countries with attractive tax climates.

Fifth, regional trading pacts have allowed increased worker mobility. The EU allows complete mobility for workers in member countries. The North American Free Trade Agreement allows for some increased mobili-

ty of skilled professionals. Labor mobility often increases as a side effect of trade agreements because trade and investment flows are facilitated by the cross-border movement of technicians and managers.³⁸

Sixth, a number of countries have raised immigration limits for highly skilled workers.³⁹ In the United States, the H1-B annual work visa limit for skilled professionals was substantially increased until 2003.⁴⁰ Some countries, notably Canada, have tilted their immigration systems toward people who are highly skilled or have money to invest. In addition, many countries have signed bilateral immigration and tax treaties, which ease immigration and prevent double taxing of labor income.⁴¹

The success of immigrants in the high-tech sector illustrates the gains that accrue to the U.S. economy as a result of encouraging those with high skill levels to immigrate. One study found that Chinese and Indian immigrants were running 24 percent of Silicon Valley high-tech firms in 1998.⁴² Other studies have found that some immigrant groups, including Koreans and Middle Easterners, have strong propensities to start businesses.⁴³ The message to policymakers is that building an attractive economic climate with low tax rates can give the economy a substantial boost from highly skilled imported labor.

Taxation and Labor Flows

In a world where the cost of and restrictions on labor mobility are falling, citizens dissatisfied with government benefits received compared to taxes paid can vote with their feet and move to more favorable economic climates. Because nonfinancial factors play a large role in immigration, we expect to see the largest effects of tax competition when those other factors are equalized. A good example is the tax competition pressure on Canada from its lower-tax neighbor, the United States.

The Canadian "brain drain" to the United States has been a top concern of Canadian policymakers.⁴⁴ NAFTA intensified labor mobility with a new work visa for skilled professionals called "TN." It is estimated that for

each skilled American who moves to Canada there are six Canadians who migrate to the United States under this visa category.⁴⁵ Canadian studies have identified the differences in tax rates as an important factor causing the brain drain.⁴⁶

Anecdotal evidence of the brain drain has substantially affected Canadian tax debates. John Roth, when he was head of Canada's top high-tech firm, Nortel, routinely warned the Canadian government that tax rates needed to be cut because his best engineers and managers were moving to the United States, often to work for Nortel's U.S. operations.⁴⁷ Roth also noted that when top managers left, they often took some of their best workers with them.

Since the removal of internal migration restrictions in the EU in 1992, Europeans have also become more sensitive to tax differences between countries. Although there are still large language and cultural barriers to migration within Europe, there has been an influx of young, skilled workers to cities, such as London, with more opportunities and lower taxes, particularly in fields such as technology and finance. London's workforce is about 23 percent foreign, and many of those workers are from higher-tax France.⁴⁸ About 500,000 French citizens now live in Britain, and hundreds of high-growth entrepreneurial French companies have moved to Britain in recent years.⁴⁹ A French government report notes that a large share of the country's engineering graduates leaves the country each year and that 40,000 French high-tech workers have left to work in Silicon Valley.⁵⁰

Ireland is another interesting case study of taxes and migration. For years, many young Irish, who were English speaking and often well educated, sought a better life in England or the United States. But corporate tax cuts, followed by individual tax cuts, reversed the Irish migration pattern. Ireland now has record net immigration of more than 20,000 annually, caused by a marked increase in immigration and a fall in emigration during the past decade.⁵¹ The Irish brain drain was plugged with tax cuts.

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International tax competition with respect to labor is highly visible in the high-paid celebrity world of musicians, models, actors, and sports stars. In 1999 French supermodel Laetitia Casta was selected to be the new Marianne, the country's national symbol of virtue and beauty. But soon after, Casta became notorious by moving to Britain to escape high French taxes. Casta was not alone. Many top French soccer and tennis players, artists, and models have moved to Switzerland, Britain, the United States, and elsewhere. Tax avoidance has long been a popular game among celebrities in Europe. Luciano Pavarotti long claimed residence in Monte Carlo but was chased down by the Italian government for \$12 million in unpaid taxes.⁵² Tennis star Boris Becker, who claimed residence in Monaco and later Switzerland, has had trouble with the German tax authorities.⁵³

Although the United States has generally been a beneficiary of skilled labor migration, it cannot rest on its laurels. As noted, other major economies have cut income tax rates in recent years. If foreign skilled professionals stay home because of tax cuts in their home countries, the United States loses brainpower. And U.S. emigration for tax reasons may be increasing, although accurate numbers are not available. Somewhere between 1 and 6 million Americans live abroad.⁵⁴ Unfortunately for them, the United States is one of just a small handful of countries that tax their citizens' foreign earnings (above an exemption amount) even when they live abroad.⁵⁵ As a consequence, some Americans living abroad have renounced their U.S. citizenship to avoid U.S. taxes. The federal government responded in 1996 with a law that taxes earnings of such individuals for 10 years after they have given up their citizenship.⁵⁶ Chasing after Americans living abroad seems an overly aggressive and unfair tax policy that misses the point that U.S. tax rates are too high and should be reduced in accordance with foreign trends. The United States should adopt tax rates that encourage workers and high-wealth individuals to remain resident, rather than

give them incentives to take their skills and investment capital elsewhere.

Global Reduction in Tax Rates

The vast majority of industrial nations have reduced their personal and corporate income tax rates since the 1980s. The average top corporate tax rate for national governments in the OECD fell from 41 percent in 1986 to 32 percent in 2000 (Table 1). The U.S. federal rate is 35 percent. A new survey by the accounting firm KPMG, which takes into account both national and subnational taxes, found that the average 40 percent U.S. federal and state corporate rate combined is almost 9 percentage points higher than the OECD average in 2002 of 31.4 percent (Table 2).

The average top national individual income tax rate in OECD countries fell from 55 percent in 1986 to 41 percent by 2000.⁵⁷ That rate is comparable to the current top U.S. federal rate of 38.6 percent, which is scheduled to fall to 35 percent by 2006.⁵⁸ The annual *Economic Freedom of the World* report, which includes both national and subnational taxes, found that the average top individual tax rate in OECD countries fell from 67 percent in 1980 to 47 percent by 2000 (Table 3).⁵⁹

Capital gains taxes have also been cut in numerous countries. For example, Canada cut its capital gains income inclusion from 75 percent to 50 percent in 2000, thus reducing the effective gains rate to half of the ordinary marginal tax rate.⁶⁰ In many countries such efforts have been spurred by the desire to emulate U.S. high-tech success, which was fueled by investment sensitive to capital gains taxes, including "angel" financing, venture capital, and public stock offerings.⁶¹ Note that a number of countries, such as the Netherlands, New Zealand, Hong Kong, and Taiwan, generally do not tax capital gains.⁶²

Corporate capital gains taxes are also an important tax factor. The Netherlands, for example, does not tax corporate capital gains, thus reducing taxes on corporate restructur-

Table 1
Top Corporate Income Tax Rates (percent), 1986–2000 (national-level taxes only)

Country	1986	1991	1995	2000	Change 1986–2000
Australia	49	39	33	34	-15
Austria	30	30	34	34	4
Belgium	45	39	39	39	-6
Canada	36	29	29	28	-8
Denmark	50	38	34	32	-20
Finland	33	23	25	29	-4
France	45	42	33	33	-12
Germany	56	50	45	40	-16
Greece	49	46	40	40	-9
Iceland	51	45	33	30	-21
Ireland	50	43	40	24	-26
Italy	36	36	36	37	1
Japan	43	38	38	27	-16
Korea	30	34	32	28	-2
Luxembourg	40	33	33	37	-3
Mexico	34	34	34	35	1
Netherlands	42	35	35	35	-7
New Zealand	45	33	33	33	-12
Norway	28	27	19	28	0
Portugal	47	36	36	32	-15
Spain	35	35	35	35	0
Sweden	52	30	28	28	-24
Switzerland	10	10	10	8	-2
Turkey	46	49	25	33	-13
United Kingdom	35	34	33	30	-5
United States	46	34	35	35	-11
Average for 26 OECD countries	41	35	33	32	-9

Source: OECD, “Tax Rates Are Falling,” *OECD in Washington*, March–April 2001.

ings. That and other tax factors make the Netherlands a good location for holding companies and multinational headquarters.⁶³ Germany’s recent corporate tax reforms abolished its 50 percent capital gains tax on sales of stakes in other companies because of competitiveness concerns. Those reforms prompted the European Union to express concern that this may constitute “unfair tax competition” because it will attract foreign holding companies to Germany.⁶⁴

Tax competition has spurred other tax reforms. A group of Nordic countries has

installed dual income tax systems that feature a low flat rate on capital income (interest, dividends, and capital gains) but retain progressive rates on labor income. Denmark, Finland, Norway, and Sweden implemented such reforms a decade ago. The Netherlands and Austria have recently enacted similar reforms, and other European countries have moved in that direction.⁶⁵ The OECD notes that those “moves toward a lower and flat tax on capital income have often reflected the need to remain competitive on the international capital markets.”⁶⁶ Dual income tax

A group of Nordic countries has installed dual income tax systems that feature a low flat rate on capital income.

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dends, and other
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Table 2
Top Corporate Income Tax Rates (percent), 1996–2002
(national and state or provincial taxes)

Country	1996	1997	1998	1999	2000	2001	2002	Change 1996–2002
Australia	36.0	36.0	36.0	36.0	36.0	34.0	30.0	-6
Austria	34.0	34.0	34.0	34.0	34.0	34.0	34.0	0
Belgium	40.2	40.2	40.2	40.2	40.2	40.2	40.2	0
Canada	44.6	44.6	44.6	44.6	44.6	42.1	38.6	-6
Czech Republic	39.0	39.0	35.0	35.0	31.0	31.0	31.0	-8
Denmark	34.0	34.0	34.0	32.0	32.0	30.0	30.0	-4
Finland	28.0	28.0	28.0	28.0	29.0	29.0	29.0	1
France	36.7	36.7	41.7	40.0	36.7	35.3	34.3	-2
Germany	57.4	57.4	56.7	52.3	51.6	38.4	38.4	-19
Greece	40.0	40.0	40.0	40.0	40.0	37.5	35.0	-5
Hungary	33.3	18.0	18.0	18.0	18.0	18.0	18.0	-15
Iceland	33.0	33.0	30.0	30.0	30.0	30.0	18.0	-15
Ireland	38.0	36.0	32.0	28.0	24.0	20.0	16.0	-22
Italy	53.2	53.2	41.3	41.3	41.3	40.3	40.3	-13
Japan	51.6	51.6	51.6	48.0	42.0	42.0	42.0	-10
Korea	33.0	30.8	30.8	30.8	30.8	30.8	29.7	-3
Luxembourg	40.3	39.3	37.5	37.5	37.5	37.5	30.4	-10
Mexico	34.0	34.0	34.0	35.0	35.0	35.0	35.0	1
Netherlands	35.0	35.0	35.0	35.0	35.0	35.0	34.5	-1
New Zealand	33.0	33.0	33.0	33.0	33.0	33.0	33.0	0
Norway	28.0	28.0	28.0	28.0	28.0	28.0	28.0	0
Poland	40.0	38.0	36.0	34.0	30.0	28.0	28.0	-12
Portugal	39.6	39.6	37.4	37.4	35.2	35.2	33.0	-7
Slovak Republic	n/a	n/a	n/a	n/a	n/a	29.0	25.0	n/a
Spain	35.0	35.0	35.0	35.0	35.0	35.0	35.0	0
Sweden	28.0	28.0	28.0	28.0	28.0	28.0	28.0	0
Switzerland	28.5	28.5	27.8	25.1	25.1	24.7	24.5	-4
Turkey	44.0	44.0	44.0	33.0	33.0	33.0	33.0	-11
United Kingdom	33.0	31.0	31.0	31.0	30.0	30.0	30.0	-3
United States	40.0	40.0	40.0	40.0	40.0	40.0	40.0	0
Average for 30 OECD countries	37.6	36.8	35.9	34.8	34.0	32.8	31.4	-6

Source: KPMG, "Corporate Tax Rate Survey," January 2002, www.us.kpmg.com/microsite/Global_Tax/TaxFacts.

systems with lower tax rates on capital income are a constructive response to the widespread tax avoidance and evasion that have occurred under Europe's high tax rates.

Another policy response to tax competition has been the reduction and elimination of special taxes on wealth in Europe. Capital mobility has undermined the ability to col-

lect those redistributionist taxes. In the 1990s Norway and Sweden reduced their wealth taxes, and Denmark, the Netherlands, Austria, and Germany abolished them.⁶⁷ One survey of 19 countries found that the average wealth tax has fallen 40 percent since the mid-1980s.⁶⁸

Tax competition has also driven down with-

Table 3
Top Personal Income Tax Rates (percent), 1980–2000
(national and state or provincial taxes)

Country	1980	1985	1990	1995	2000	Change 1980–2000
Australia	62	60	49	47	47	-15
Austria	62	62	50	50	50	-12
Belgium	76	76	55	58	58	-18
Canada	60	50	44	44	44	-16
Denmark	66	73	68	64	59	-7
Finland	65	64	63	55	52	-13
France	60	65	53	51	54	-6
Germany	65	65	65	66	59	-6
Greece	60	63	50	45	43	-17
Iceland	63	56	40	47	45	-18
Ireland	60	65	58	48	42	-18
Italy	72	81	66	67	51	-21
Japan	75	70	65	65	50	-25
Korea	89	65	60	48	44	-45
Luxembourg	57	57	56	50	49	-8
Mexico	55	55	40	35	40	-15
Netherlands	72	72	72	60	52	-20
New Zealand	62	66	33	33	39	-23
Norway	75	64	54	42	48	-27
Portugal	84	69	40	40	40	-44
Spain	66	66	56	56	48	-18
Sweden	87	80	72	58	51	-36
Switzerland	31	33	33	35	31	0
Turkey	75	63	50	55	45	-30
United Kingdom	83	60	40	40	40	-43
United States	70	50	33	42	42	-28
Average for 26 OECD countries	67	63	53	50	47	-20

Source: James Gwartney and Robert Lawson, *Economic Freedom of the World: Annual Report 2001* (Vancouver: Fraser Institute, 2001), chap. 5. Figures include the lowest state or provincial tax rate, as applicable.

holding taxes on payments to foreigners of interest, dividends, and other investment returns. Withholding taxes create an investment disincentive by placing an “exit fee” on repatriated earnings. For example, businesses are dissuaded from building factories in countries that place a high tax on repatriated dividends. One survey of 19 major economies found that the withholding tax on bank interest has been more than cut in half in the past decade.⁶⁹

Britain and the United States jump-started the worldwide move toward lower tax rates in the 1980s. Between 1982 and 1986 Britain cut its corporate tax rate from 52 to

35 percent and the United States followed in 1986 by cutting its rate from 46 to 34 percent. Substantial cuts followed in Australia in 1988, Canada between 1986 and 1988, France between 1986 and 1993, Germany in 1990, and Japan between 1989 and 1991.⁷⁰

Both the direct threat of a disappearing tax base and general intellectual trends led to those reforms. Countries that have close economic ties will naturally respond more strongly to each other’s tax reforms. After the 1986 U.S. tax cut, Canadian policymakers were very concerned that U.S. corporations would shift profits from their high-tax

Britain and the United States jump-started the worldwide move toward lower tax rates in the 1980s.

Corporate tax rates have been recently cut in Australia, Germany, Canada, and Denmark.

Canadian subsidiaries back to their U.S. parent companies.⁷¹ They could do that fairly easily by increasing their debt financing in their Canadian subsidiaries to shift taxable income out of Canada. As a consequence, Canada moved quickly to cut its corporate tax rate to avoid losing its tax base.

Since the mid-1990s, another round of marginal rate cuts has occurred. Major economies that have reduced top personal tax rates in recent years include Germany, the Netherlands, and the United States. Corporate tax rates have been recently cut in Australia, Germany, Canada, and Denmark.⁷² For example, Canada is phasing in a cut of its federal corporate rate from 28 percent in 2000 to 21 percent by 2004.⁷³

Note that, with regard to the corporate income tax, the statutory rate is just one factor in the attractiveness of a business tax climate. The overall, or effective, marginal tax rate is affected by depreciation deductions, investment credits, and other provisions. Effective corporate tax rates have fallen in the OECD countries in recent years, but not by as much as statutory rates.⁷⁴ Nonetheless, statutory rates are the relevant tax factor to consider in making many corporate decisions. For example, tax advantages gained by shifting corporate borrowing between countries depend on statutory rates.⁷⁵ As one study found, "Reported income of corporations can be highly elastic with respect to the statutory tax rate since income can be easily shifted from one tax jurisdiction to another without moving real assets."⁷⁶

In addition to broad-based tax cuts, some governments offer special narrowly focused tax breaks to firms scouting for new locations.⁷⁷ Those types of special deals are often made by subnational governments to attract highly valued investments such as computer chip plants.⁷⁸ But targeted tax breaks are discouraged by economists, who favor broad-based tax reductions. Narrow tax incentives add complexity and unfairness and increase opportunities for corruption. Also, special incentives are often Band-Aids that cover more fundamental policy problems such as

excessive regulation. For example, Indonesia and India frequently offer such tax incentives to lure investment and yet rank 72nd and 92nd, respectively, in the world in terms of basic economic freedoms.⁷⁹

In summary, tax competition has caused substantial cuts in individual and corporate statutory income tax rates. Other reforms have included reductions in wealth taxes; withholding taxes; and taxes on individual interest, dividends, and capital gains. Although those reductions in tax rates have been very beneficial, tax competition has not yet reduced overall tax levels in most countries. Total taxes as a percentage of GDP rose from 32.1 percent in 1980 to 37.3 percent by 1999, on average, in the OECD countries.⁸⁰ Therefore, international tax competition has not yet caused Big Government to melt away. That is due in part to the numerous defensive measures governments have taken to protect their tax bases, including the enactment of complex tax rules on income earned abroad.

U.S. International Tax Rules and Their Effects

Theories of International Taxation

With regard to domestic taxation, economists support more neutral tax systems that allow investment to flow to the highest-valued uses. Taxation can distort neutrality by favoring some investments over others or by favoring consumption over investment. However, neutrality can have a number of different meanings in an international context, thus making the choice of the most efficient tax rules tricky.⁸¹

Capital export neutrality (CEN) posits that investors should face the same tax rate on a marginal investment both at home and abroad, taking into account taxes in both the home country of the investor and the host country where the investment is located. CEN suggests, for example, that "too much" investment would flow to the United States if a German company faced, say, a 40 percent tax on a German investment but only a 35

percent tax on a similar U.S. investment. CEN may be achieved by taxing residents on a worldwide basis and providing a credit for foreign taxes paid to prevent double taxation. Supporters of CEN believe that it would maximize world economic efficiency by removing tax considerations from location decisions on investments.

Capital import neutrality (CIN) posits that investments in a particular country should face the same tax rate no matter where the investor resides. That standard would be violated, for example, if a U.S. company faced a 35 percent tax on a British investment, but a British company faced a 30 percent tax on the same British investment. That situation occurs under current law because a U.S. company would pay the U.S. government a residual 5 percent tax on the investment, in addition to the British tax. Supporters of CIN argue that the U.S. company should face the same 30 percent British tax as the British company without any residual U.S. claim. CIN may be achieved under a “territorial” tax system that would not place a U.S. tax on foreign investments of Americans.

The United States developed its complex and jerry-built international tax structure around the CEN principle, although with many exceptions.⁸² Since the early 1960s, Congress has used CEN as justification to expand the taxation of U.S. firms doing business abroad. Meanwhile, the CEN view of tax neutrality has become less achievable and more irrelevant in a global economy with large portfolio capital flows and many countries that do not adhere to CEN.⁸³ It often seems that the federal government claims allegiance to CEN simply to promote tax proposals the sole aim of which is to raise money from large corporations, unseen by average citizens who ultimately bear the burden.

There is growing concern that the U.S. adherence to CEN creates excessive tax complexity and damages the ability of U.S. corporations to compete in world markets.⁸⁴ It also creates a disincentive to locate headquarters of multinational corporations in the United

States.⁸⁵ For those reasons, we conclude that the United States should adopt a territorial approach to international business taxation.

Background on U.S. International Tax Rules

The United States taxes U.S. residents and corporations on their worldwide income. For example, a U.S. resident who owns stock in a British corporation, or a U.S. corporation that has a production facility in Germany, reports the income from his foreign activities on his U.S. tax return. That worldwide approach to taxation follows from the CEN principle, which seeks to equalize tax on investments by U.S. residents and businesses regardless of where the investments are located.

With regard to individuals, most, but not all, countries follow a more or less expansive worldwide taxation approach.⁸⁶ That is, most countries tax the foreign investment income of their residents to some extent. With regard to businesses, some countries follow the worldwide tax approach of the United States, but many do not. About half of OECD countries, such as France and the Netherlands, have territorial systems of business taxation, which means that foreign-source income is not taxed.⁸⁷ However, most countries do not follow either approach strictly.

Much of the focus of international tax competition is on the activities of multinational corporations. To understand some of the tax incentives and disincentives for corporate investment decisions, it is necessary to grasp some of the basic features of U.S. international tax rules under the corporate income tax.

U.S. foreign affiliates are generally structured as either branches or subsidiaries. Branches are not separately incorporated abroad, and their profits are immediately subject to the U.S. income tax. By contrast, subsidiaries are separately incorporated abroad. Most are “controlled foreign corporations” (CFCs), that is, subsidiaries that are more than 50 percent owned by U.S. shareholders.⁸⁸ U.S. tax is generally assessed on CFC profits only when they are repatriated, or sent home to the United States. Put another

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er way, U.S. tax is “deferred” until profits are repatriated.

In addition to U.S. tax, U.S. foreign affiliates face tax in the host countries where investments are located. To avoid double taxation, the United States provides a tax credit for foreign taxes paid on that income. However, the foreign tax credit is limited to the 35 percent U.S. corporate tax rate. As a result, U.S. affiliates in high-tax countries pay the higher foreign tax rate. For example, profits of a U.S. affiliate in Belgium that pays a 40 percent Belgium tax receive a 35 percent tax credit to offset the 35 percent U.S. tax on that income. As a result, that foreign income will be taxed at an overall rate of 40 percent.

By contrast, U.S. affiliates in low-tax countries must pay at least the U.S. tax rate on foreign income. For example, the profits of a U.S. affiliate in the United Kingdom are assessed the 35 percent U.S. tax and the 30 percent U.K. tax. A foreign tax credit can be taken up to the 30 percent level of the U.K. tax. On net, that income will end up facing a 30 percent U.K. tax plus a residual 5 percent tax paid to the U.S. government.

Within limits, U.S. corporations can blend income from their affiliates located in high-tax and low-tax countries to reduce the residual U.S. tax on their foreign operations and take maximum advantage of foreign tax credits. U.S. businesses that operate in high-tax foreign countries generate “excess foreign tax credits” and cannot offset all their foreign taxes with U.S. foreign tax credits. Firms in this situation have a strong incentive to shop around for investments in low-tax countries to use the excess credits.⁸⁹ By contrast, U.S. businesses that have most of their operations in low-tax countries do not have excess foreign tax credits. As a result, they are less interested in shopping around for other low-tax jurisdictions when making new investments abroad.

The effect of the foreign tax credit on investment incentives can be illustrated with reference to the Tax Reform Act of 1986 (TRA86). TRA86 reduced the U.S. corporate tax rate from 46 to 34 percent, a rate below the rates of many other major countries at the

time. As a result, many U.S. companies were expected to be pushed into an excess foreign tax credit position. That provided increased incentives for U.S. firms to locate new investments in low-tax countries; U.S. foreign investment became more tax sensitive. As a consequence, many foreign governments reduced their own corporate tax rates after 1986 for fear of losing U.S. investment inflows.⁹⁰

The Intolerable Complexity of International Business Taxation

Although the federal government claims the right to tax the worldwide income of U.S. businesses, there have traditionally been limits to that claim. As noted, business profits earned abroad in CFCs are generally not taxed by the federal government until repatriated to the United States. And firms may average income in high-tax and low-tax countries to reduce residual U.S. tax on foreign income and take full advantage of foreign tax credits.

However, in recent decades the federal government has aggressively expanded the taxation of foreign income of U.S. companies. Legislation in 1962, 1986, and other years has added layers of new rules designed to deny U.S. taxpayers the benefits of investing in low-tax foreign jurisdictions. In some cases, those rules end up double taxing the foreign income of U.S. businesses. Many other countries have followed the U.S. lead by beefing up their own tax rules on foreign income. The flood of such anti-avoidance and anti-deferral legislation has muted international tax competition.

A key thrust of government efforts has been to limit the ability of firms to defer tax on CFC earnings until repatriated. The primary U.S. anti-deferral rules, called “subpart F,” were introduced in 1962 and have since been expanded a number of times.⁹¹ For example, rules under TRA86 expanded subpart F to end deferral of the tax on income earned by financial services subsidiaries.⁹²

Subpart F aims to tax when earned a CFC’s passive investment income, such as dividends and interest. For example, if a U.S. subsidiary in Ireland earned profits

in its computer manufacturing plant that it then invested in U.K. equities, the earnings of those financial investments would be immediately taxed in the United States. The subpart F rules also aim to immediately tax foreign “base company” sales and services income, meaning sales into third countries from certain U.S. foreign subsidiaries.⁹³ For example, profits from export sales to Germany from a U.S.-owned Swiss affiliate may be immediately taxable in the United States.

The subpart F regime has been joined by other anti-deferral rules in the U.S. tax code.⁹⁴ In all there are six often-overlapping anti-deferral regimes that create a complex web for Americans to navigate through when investing abroad. The U.S. international tax rules are generally considered the most complex and aggressive among the industrial nations. In a 1999 report, the National Foreign Trade Council concluded that “U.S. anti-deferral rules have been subject to constant legislative tinkering, which has created both instability and a forbiddingly arcane web of rules, exceptions, exceptions to exceptions, interactions, cross references, and effective dates, giving rise to a level of complexity that is intolerable.”⁹⁵

In addition to the anti-deferral rules, numerous other provisions raise taxes on U.S. firms’ foreign income and add great complexity. For example, the United States has special rules to allocate interest and research and development (R&D) expenses between domestic and foreign income. Those rules can result in firms being denied legitimate business deductions. The constant changes to the R&D rules during the past decade have been a poster child for the instability and complexity of the U.S. international tax system.

Limits on foreign tax credits also greatly increase the complexity of the U.S. corporate tax system. The operation of the foreign tax credit makes it advantageous for firms to balance income earned in high-tax and low-tax countries. But the ability to average high- and low-tax foreign income is limited by the require-

ment that foreign income be placed in nine different categories, or “baskets,” that cannot be blended. For example, financial services income, shipping income, and passive investment income are placed in separate baskets requiring separate foreign tax credit calculations. Other countries do not have such excessively complex foreign tax credit systems.⁹⁶

All in all, U.S. rules raise the tax rate on foreign investment higher than that on foreign investment by firms headquartered in other major countries.⁹⁷ The complexity of tax rules on U.S. foreign income is so great that one estimate found that 46 percent of federal tax compliance costs for Fortune 500 companies stemmed from rules on foreign income.⁹⁸ As a result, U.S. companies are at a tax disadvantage in world markets. The chairman of the Council of Economic Advisers, Glenn Hubbard, noted that “in many instances, current law creates barriers that harm the competitiveness of U.S. companies. These rules are also horribly complex both for U.S. multinationals to comply with and for the Internal Revenue Service to administer.”⁹⁹

The anti-competitive U.S. business tax rules are due in part to policymakers who view multinational corporations as “cash cows” able to absorb tax hikes, unseen by voters.¹⁰⁰ In addition, many policymakers seem to view foreign business activity with suspicion. Foreign operations are seen, incorrectly, as a loss to the U.S. economy. The evidence shows the contrary.¹⁰¹ For example, about two-thirds of U.S. export trade is facilitated by U.S. multinational companies and their foreign affiliates.¹⁰²

Tax Rules for Foreign Investment in the United States

The complex tax rules on U.S. investment abroad are paired with different tax rules for investment by foreigners in the United States.¹⁰³ The corporate income tax rules for U.S.-incorporated businesses owned by foreigners are similar to those for U.S.-owned corporations. There is a separate set of rules for taxing foreign-owned businesses operating as branches in the United States.

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If the United States adopted a low-rate consumption-based tax system, it would become a tax haven for all types of portfolio and direct investment flows from abroad.

When U.S.-source financial payments, such as dividends, interest, and royalties, are made to foreigners, the United States withholds taxes. Withholding taxes attempt to roughly duplicate the individual-level taxes that would apply if a U.S. resident received those forms of income. The basic flat rate U.S. withholding tax is 30 percent, but that rate is generally reduced in bilateral tax treaties to a range of from 0 to 15 percent. As noted, tax competition has caused U.S. and foreign withholding taxes to trend downward in recent years.

Important exceptions to U.S. withholding tax rules are made for interest and capital gains. Bank deposit interest paid to foreigners has long been exempt from U.S. taxation.¹⁰⁴ And since 1984 portfolio interest earned by foreigners on government and private securities is not taxed by the United States. These rules were implemented because of the realization that competition from low-tax foreign jurisdictions for the funds of international investors would make any U.S. tax on those forms of interest uncompetitive.¹⁰⁵ Similarly, capital gains, except for gains on real estate, earned by foreigners in the United States are exempt from U.S. taxation.

Those rules have attracted large flows of foreign investment to the United States. Today, there is more than \$1.1 trillion of foreign deposits in U.S. banks.¹⁰⁶ That mobile investment capital helps fuel our economy and would end up elsewhere if not for favorable tax policies. For example, Miami has become an international banking center for Latin America because of the tax exemption on interest, in combination with the fact that a number of Latin American countries have territorial tax systems with respect to their residents' foreign income.¹⁰⁷

Some experts have argued that the interest and capital gains tax exemptions ought to be expanded to include dividends, so as to further attract foreign investment flows to the United States.¹⁰⁸ Even better, if the United States adopted a low-rate consumption-based tax system, it would become a tax

haven for all types of portfolio and direct investment flows from abroad.

Three Business Responses to International Tax Competition

Complex tax rules on international investment mean that investment decisions are multifaceted and involve more than simply finding the jurisdictions with the lowest statutory rates. Businesses may be repelled or attracted by tax rules in different countries. Multi-national corporations respond in three ways to different tax structures. First, firms can move the physical location of their facilities, including corporate headquarters, manufacturing plants, and R&D facilities. Different aspects of tax systems affect the attractiveness of jurisdictions for each of those activities. For example:

- Rapid depreciation deductions, or immediate write-off of capital purchases (expensing), attracts capital-intensive industries, such as manufacturing.
- Large R&D tax credits and the ability to expense R&D investments attract R&D facilities.
- Territorial tax systems attract corporate headquarters of multinational firms. Under a territorial system, affiliates are able to compete in foreign markets without an extra layer of taxation imposed in the headquarters country.

Some of the ways that tax rules affect location decisions are illustrated by TRA86, which reduced the U.S. corporate income tax rate from 46 to 34 percent, a rate lower than that of other major countries at the time. Increased investment flows into the United States were expected. But TRA86 also eliminated the investment tax credit and reduced depreciation deductions, thus making the United States a less attractive location for investment. Joel Slemrod of the University of Michigan Business School examined the offsetting effects of TRA86 and figured that overall effective tax rates on investment in the United States rose slightly.¹⁰⁹ At the same time, the tax rate on foreign investment by

U.S. businesses fell because repatriations of foreign profits faced the lower U.S. tax rate but were not affected by the less generous capital investment rules. So, on net, TRA86 was expected to create a modest outflow of direct investment from the United States.

The second business response to different countries' tax systems is to financially restructure so as to pay the lowest overall global tax rate. There are many ways that firms can do that:

- Firms may optimally time dividend repatriations from high- and low-tax foreign affiliates in order to maximize usage of foreign tax credits.
- Firms may repatriate money from abroad in different forms, including dividends, interest, rent, and royalties. Each type of payment may be subject to different taxes, such as different withholding tax rates.
- Firms may change their debt/equity structure and the allocation of debt and equity issuance between parent company and subsidiaries. For example, firms can maximize borrowing in countries with high tax rates to maximize the benefit of interest deductions.
- Firms may move the profits attributable to intangible assets, such as patents and copyrights, to low-tax countries and shift the expense payments for using those intangibles to high-tax countries.
- Firms may use different business structures to operate abroad, including branches, subsidiaries, holding companies, partnerships, and "hybrids." (Hybrids are considered different business structures under foreign and U.S. laws.) For example, operations in low-tax countries can be set up as CFCs, not branches, in order to benefit from deferral of U.S. income tax.

The third response of companies to different tax systems is to use "transfer pricing" to shift profits to low-tax countries. That means

setting prices on purchases from and sales to foreign affiliates too high or too low in order to effectively move taxable income between countries. For example, if a U.S. corporation overbills its Belgium subsidiary for materials purchased, it has shifted profits from high-tax Belgium to the lower-tax United States.

Evidence indicates that tax avoidance through transfer pricing is substantial, but it is unclear exactly how large the activity is. In fact, it is often very difficult to determine what the correct price or profit margin on particular transactions should be. Although intra-company transactions are supposed to be carried out at arm's-length or market prices, many transactions are unique and have no market comparison. Many intracompany transactions, for example, involve the returns to unique intangible assets. As a result, some experts think that the transfer pricing rules are "economically illogical" and "inherently unadministerable."¹¹⁰ Many countries, led by the United States, have implemented increasingly complex rules, including greater reporting and penalties, to thwart perceived abuses and protect the tax base.

Empirical studies have confirmed the importance of each of the three different types of business response to international tax incentives. In summarizing recent studies, the University of Michigan's James Hines finds that "evidence indicates that taxation significantly influences the location of FDI, corporate borrowing, transfer pricing, dividend and royalty payments, and research and development performance."¹¹¹

Tax Competition Theory and Politics

Tiebout Theory

The economics literature on tax competition traces its lineage to a 1956 study by Charles Tiebout examining the provision of public goods by local governments.¹¹² According to Tiebout's analysis, competition between local governments for mobile households enhances society's overall welfare. To

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Tax competition provides politicians with incentives to improve government efficiency.

avoid losing residents, jurisdictions must tailor public spending and tax levels to suit local preferences. Individuals choose the jurisdictions in which they live according to their demand for public goods relative to local tax levels. If some households desire well-financed public schools, they may choose to pay higher property taxes. If not, they may move to jurisdictions with lower taxes and more efficient, or more limited, government services.

Competition between governments is akin to market competition for products. Market competition encourages production efficiency and satisfaction of consumer demands. Tax competition provides politicians with incentives to improve government efficiency and satisfy voter demands. The result of tax competition should be that the level of taxes reflects typical preferences within each jurisdiction. Tiebout's theory focused on local governments, but with growing international flows of labor and capital, national governments are becoming more like local governments as they compete for taxpayers across national borders.

Finding Inefficiencies in Tiebout's Theory

Since Tiebout's study, many theorists have constructed highly stylized models of tax competition to judge its effect on social welfare.¹¹³ As in other areas of academic economics, these mathematical models rely on underlying assumptions that often end up driving the conclusions. Some theorists have tweaked the assumptions and concluded that tax competition is efficient. Others have tweaked the assumptions and concluded that tax competition is inefficient because it leads to a "race to the bottom" with tax levels that are too low.

The latter results have been used to argue that tax competition between countries is inefficient. As investment flows to low-tax countries, inefficiency is thought to occur because resources may not end up in the highest-valued uses. The idea is that the tax system ought to be "neutral" and have no effect on investment decisions. The EU uses these arguments in its ongoing program to

get its low-tax member countries to raise their taxes. A European Parliament fact sheet says that harmonization of business taxes "may be required to prevent distortions of competition, particularly of investment decisions. Where tax systems are non-neutral . . . resources will be misallocated."¹¹⁴

Similar concerns have led the OECD to pursue a global program of curtailing "harmful tax competition." In an important 1998 report, *Harmful Tax Competition: An Emerging Global Issue*, the OECD concluded that "harmful" tax policies create "potential distortions in the patterns of trade and investment and reduce global welfare."¹¹⁵ Reports by the OECD, the EU, and other critics of tax competition are wrapped in seemingly neutral language such as "distortion," "welfare," "nonneutral," and "misallocated." But the economics of the critics is often contradictory or based on questionable assumptions. Often, beneath the economic language, are political goals, not economic theory.

Do Low Taxes Harm Global Welfare?

What is the harm in "harmful" tax competition? The 1998 OECD report launched a robust international debate on the issue, so it is useful to examine the report's assumptions in detail. The report identifies six negative effects of harmful low-tax regimes.¹¹⁶ Of the six, it appears that at least four harms—"distorting financial and, indirectly, real investment flows," "undermining the integrity and fairness of tax structures," "discouraging compliance by all taxpayers," and "increasing the administrative costs and compliance burdens on tax authorities and taxpayers"—are probably more true of high-tax regimes. The fifth harm cited is hollow bureaucrat-speak: "re-shaping the desired level and mix of taxes and public spending." The sixth harm—"causing undesired shifts of part of the tax burden to less mobile tax bases, such as labour, property and consumption"—gets it backwards. The last effect is a desired and expected shift in a globalized economy.

From the report's perspective, a key source of harm occurs when tax policy in one country affects the tax base of other countries.

Those effects are called “spillover effects” or “externalities.” The 1998 OECD report said that harmful tax policies erode the tax bases of other countries by “bidding aggressively” for foreign investment flows.¹¹⁷ A follow-up OECD report in 2000 said that harmful tax practices “unfairly erode the tax bases of other countries and distort the location of capital and services.”¹¹⁸ At the same time, the OECD says it supports recent income tax rate reductions that have occurred in many countries in response to globalization. But the reforms that the OECD supports also attract foreign investment inflows and “erode” other nations’ tax bases. That is a key inconsistency in the OECD position.

The 1998 OECD report finds that “globalisation has also been one of the driving forces behind tax reforms,” including rate cuts.¹¹⁹ A 2001 OECD report on the issue finds that “the more open and competitive environment of the last decades has . . . encouraged countries to make their tax systems more attractive to investors. In addition to reducing overall tax rates, a competitive environment can promote greater efficiency in government expenditure programs.”¹²⁰ To the OECD, cutting taxes to attract investors is sometimes good policy, but other times it “erodes” tax bases.

Public finance expert Wallace Oates describes the harm of tax competition as “a kind of fiscal externality in that local officials do not take into account the impact their decisions have on the tax bases of other jurisdictions. This typically leads to decisions involving suboptimal tax rates.”¹²¹ A European Parliament study similarly described the supposed problem:

The second goal of tax harmonization is to avoid the negative externalities that can follow an individual tax reform in one country. . . . More specifically, cutting taxes in one country raises the competitiveness and/or attractiveness of this country relative to others. The resulting flows of goods, capital—and also, possibly, high-skilled labour—is detrimental

to partner countries in term of economic activity and in terms of tax revenues.¹²²

Such criticisms of tax competition purport to examine the effects on “global welfare.” Suppose the United States cut taxes to boost investment but did not take into account the effect on Germany. That would be deemed an inefficiency or “externality” of tax competition. If countries do right by their own citizens with tax cuts, they supposedly harm other nations. That conclusion can clearly fly in the face of national sovereignty and therefore cannot be a guide for U.S. tax policy. U.S. policymakers seek first and foremost to design policies that benefit the American economy. It would not make sense to hold off on U.S. tax cuts because of concerns of foreign jurisdictions that have more inefficient high-rate systems.

Tax Competition Is Not Zero-Sum

The allegation of harmful “fiscal externalities” assumes a false zero-sum view of tax policy. In reality, the large economic gains made possible by tax rate cuts mean that tax competition is not a negative-sum game for the United States or the world as a whole. As any one country adopts a more efficient tax system to maximize growth, other countries follow suit, with the result that global investment and output rise. The round of income tax reductions following U.S. tax reforms in 1986 is a good example. All countries end up better off as each country pursues its own interest.

The supposed “global welfare” cost of tax competition is based on how tax differences alter the allocation of an assumed fixed amount of investment across countries. But far more serious welfare costs occur within countries that have high income tax rates, particularly on capital and skilled workers. High marginal income tax rates create large “deadweight losses.” Those losses, or inefficiency costs, rise more than proportionally as marginal tax rates increase, so even modest rate reductions lead to large economic gains.¹²³ For example, Martin Feldstein, president of the National Bureau of Economic Research, estimated that President

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Governments that do not face competition operate like private monopolists and have little incentive to reduce waste and increase quality.

Bush's income tax cut plan of last year would reduce deadweight losses caused by the tax system by about \$600 billion over 10 years.¹²⁴ Tax competition creates downward pressure on income taxes, particularly inefficient capital income taxes, and thus boosts investment and economic growth worldwide.

Public Interest vs. Public Choice

Most policymakers would probably not disagree that tax rate reductions enhance economic growth. But the concern is that tax competition ends up driving tax rates "too low." But how low is too low? As University of Chicago professor Julie Roin notes, "Advocates of tax harmonization appear to regard any departure from the level and distribution of the tax burden set in the non-competitive world as unduly low."¹²⁵ That is in large part because of the assumptions built into their models. The status quo government is taken to be the optimal size, determined by efficient political decisionmaking. In a recent study, the European Parliament exhibited the status quo mindset by criticizing tax competition on the basis that "each country has an incentive to lower corporate taxes below the level that would be consistent with its natural position."¹²⁶ But what in the world is the "natural" position? Harmful tax competition theories implicitly assume the "public interest" theory of government. Government is assumed to be a benevolent maximizer of citizens' welfare. Tax competition is seen as throwing a wrench into the optimal fiscal balance achieved when governments have monopoly control over capital and labor.

An alternative model of government, the "public choice" view, regards public officials as engaged in self-interested behavior that may or may not maximize social welfare. Instead of steering fiscal policy toward achieving the general public good, policymakers and bureaucrats "seek to maximize budgets, and thereby to obtain greater power, larger salaries, and other perquisites. Budget maximization results in higher government spending overall, inefficient allocation among government agencies, and inefficient production within them."¹²⁷

According to the public choice view, international tax competition enhances welfare because it constrains government from growing inefficiently large. Governments that do not face competition operate like private monopolists and have little incentive to reduce waste and increase quality. Just as globalization limits the power of private monopolies in domestic markets, it also acts to limit the power of government monopolies. The "race to the bottom" proposition focuses only on the outcome of mathematically stylized competition and ignores the real-world benefits of the competitive process itself. That process involves forcing tough choices to be made, creating innovations, discarding bad ideas, and organizational learning to produce better products at lower costs. Nobel prize-winning economist Gary Becker observed that "competition among nations tends to produce a race to the top rather than to the bottom by limiting the ability of powerful and voracious groups and politicians in each nation to impose their will at the expense of the interests of the vast majority of their populations."¹²⁸

Neutrality and Diversity

Another key idea behind concerns about international tax competition is tax "neutrality." Economists generally support tax systems that do not distort economic decisions, for example, by favoring one industry over another. No tax is completely neutral, but governments should collect revenue in a manner that minimizes distortions of the domestic economy. But the good idea of tax neutrality within national borders is not easily translated to cross-border economic issues. We noted that CEN and CIN both aim for "neutrality" of international taxation, but each results in different policy prescriptions.

The broader issue is that taxation is but one of many government policies that impact international trade and investment flows. Many policy decisions create what may be viewed as nonneutralities. Consider two countries that have identical tax systems. The government in one country spends mainly

on efficiency-enhancing education and transportation infrastructure. The other government spends mainly to support declining industries and redistribution programs. The difference in government spending may cause investment to flow to the former country, which practices “unfair infrastructure competition.” International agreements could be drafted to require countries to have minimum levels of inefficient redistribution spending and place maximum limits on efficiency-enhancing infrastructure spending.

In the real world, national governments differ substantially in their priorities. “Government competition” between countries occurs in many dimensions, including taxation, spending, regulation, efficiency of court systems, and other items. All those policy differences may generate cross-border investment and labor flows. For example, countries known for greater political stability and efficient legal systems will attract more foreign investment than unstable and corrupt regimes. It is not clear why tax policies require international harmonization when huge nonneutralities exist in many other government attributes.

Tax harmonization would have countries impose similar taxes regardless of substantial material or cultural differences, with the result that some countries would have taxes that were too high from their citizens’ perspective.¹²⁹ For example, research by Richard Baldwin and Paul Krugman finds that harmonizing tax rates across “core” and “periphery” regions within Europe would be inefficient because those two areas have different economic structures.¹³⁰

Allowing diversity in fiscal systems is superior to enforcing global harmonization. With diversity and competition, different tax policies may result in different levels of success. Citizens gain knowledge about policies that work in neighboring jurisdictions and would demand the same from their own legislature. Recent global pro-growth trends, such as the privatization revolution and income tax rate cuts, did not result from a top-down scheme imposed by an interna-

tional organization. Those policy reforms resulted from countries acting for their own domestic benefit after learning from other countries’ experiences. Attempts to place global restrictions on tax systems through international bodies will put a straightjacket on the beneficial evolution of independent national fiscal systems.

Such a straightjacket would be particularly harmful for lower-income countries pursuing tax reduction strategies. Attraction of private foreign capital is crucial to the development of poorer countries, and tax cuts are one method of pursuing growth that should be open to every country. As Julie Roin notes, residents of a wealthy area may not want a new automobile plant because of added congestion or pollution, but an area with high unemployment would be happy to forgo substantial tax revenues to lure the plant.¹³¹ Regions and countries are very diverse in many ways, so international policies that prevent poor countries from expressing their preference for more growth through less taxation are very unfair.

Defensive Responses to Tax Competition

Layering New Tax Rules on Foreign Income

Countries have responded to international tax competition in a variety of ways. Like the United States, most major countries have cut statutory tax rates on individual and corporate income. Many countries have also followed the U.S. lead with the enactment of defensive measures that increase tax complexity and limit tax competition, including anti-deferral rules and tougher transfer pricing rules.¹³² For example, after Britain abolished exchange controls in 1979, the tax base became more vulnerable. Britain responded with substantial corporate and individual tax cuts, but it also enacted anti-deferral legislation for CFCs in 1984.¹³³

Similarly, as Germany has opened its borders under European economic integration, it has both cut tax rates and added new tax

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Efforts to expand the taxation of foreign income can backfire because corporations have the option of migrating abroad.

rules on foreign income. Germany had a particularly high corporate tax rate to defend, and German corporations have been aggressive in reducing their German taxable income.¹³⁴ German firms have found many lower-tax investments abroad, including U.S. real estate and Irish financial services. The German government responded by cutting the corporate tax rate from about 60 percent in the early 1990s to 38 percent by 2002.¹³⁵ The title of a 1994 tax cut law indicates the tax competition pressure Germany felt: "Law to Secure the Competitiveness of Germany as a Location for Enterprises in a Common Market."¹³⁶ The government also responded with anti-deferral rules for CFCs to stem the outflow of capital to lower-tax countries.

The OECD has been urging countries to adopt anti-deferral and anti-avoidance rules, and by the mid-1990s about half of OECD member countries had done so.¹³⁷ Other countries have added rules since then, such as Italy in 2000. The U.S. rules, however, are still generally considered the most aggressive and complex. The 1999 National Foreign Trade Council study found that, while other countries have mimicked the U.S. rules, "in virtually every scenario considered, however, the U.S. imposed the severest regime."¹³⁸ For example, most countries limit deferral for just passive investment income, but the United States also limits deferral for some types of active business income.¹³⁹

Some countries have not followed the U.S. path of expanding the taxation of foreign income. The Netherlands, as noted, has a very attractive environment for corporate location given its territorial tax system and absence of capital gains taxation. The Netherlands officially touts its lack of CFC rules as an important advantage for companies considering investment locations, as described on the Netherlands Foreign Investment Agency website:

The Netherlands is one of the few countries in Europe that does not (yet) bear the burden of Controlled Foreign Company (CFC) rules. CFC rules aim

to prohibit the use of low tax environments and other tax planning ideas. By their nature, these rules contain many elements of overkill and prohibit establishment of a tax efficient group structure. It is therefore very important to choose a holding location that does not have CFC rules.¹⁴⁰

The overkill the Dutch warn about is already evident in U.S. tax rules. For example, U.S. efforts to increase the taxation of foreign shipping income have evidently caused the U.S.-owned "open registry" shipping fleet to nearly disappear. Oceangoing ships often fly the flags of open-registry countries such as Panama, while their owners reside elsewhere. The U.S.-owned share of the open-registry fleet plummeted from 26 percent in 1975 to just 5 percent by 1996, apparently because of the aggressive expansion of U.S. taxation of that income source.¹⁴¹ Before 1975 foreign shipping income could be deferred until repatriated to the United States. But U.S. anti-deferral legislation in 1975 and 1986 made foreign shipping income immediately taxable. That raised the costs of U.S. ship ownership and led to the transfer of U.S. ships to foreign ownership. So that federal effort to raise money from corporations ended up losing money as the tax base disappeared.

Efforts to expand the taxation of foreign income can backfire because corporations have the option of migrating abroad. U.S. firms are reincorporating abroad with increasing frequency.¹⁴² Certainly, governments need to put efforts into reducing tax evasion. But those efforts have substantial costs, including high complexity, reduced business efficiency, and disappearance of the tax base. Some level of avoidance and evasion is normal for any tax system, so the knee-jerk response to every international tax issue should not be a new layer of rules.

As noted, overall levels of taxation in most OECD countries are still at record highs, so tax competition is not causing the tax base to disappear overnight. In the meantime, governments need to implement simpler, lower-

rate, consumption-based systems that are easier to police and provide fewer incentives for taxpayers to avoid and evade.

Curbing Tax Competition through International Cartels

Another government response to rising tax competition is the various efforts to coordinate tax systems across countries to limit competition in the manner of a cartel. The EU has been a leader in this response to tax competition and has pushed its member countries to harmonize their tax systems. A recent European Parliament fact sheet explains: "The objective of more recent moves towards a general taxation policy has been to prevent the harmful effects of tax competition, notably the migration of national tax bases as firms move between Member States in search of the most favourable tax regime."¹⁴³ Another fact sheet called for further harmonization of business taxation "to prevent the undermining of revenues through 'tax competition.'"¹⁴⁴

To date, the most far-reaching EU harmonization effort was the imposition in 1992 of a minimum standard value-added tax (VAT) rate of 15 percent. The EU has also tried to get member countries to harmonize income tax rates. The 1992 Ruding Commission proposed creating a minimum corporate tax rate of 30 percent.¹⁴⁵ Going back further, a 1975 European Commission draft directive called for harmonizing corporate rates at between 45 and 55 percent.¹⁴⁶ Luckily for European citizens, those plans were not enacted because they could have prevented the reductions in corporate tax rates that have occurred in EU countries in recent years. The average EU corporate tax rate fell from 38.2 percent in 1996 to just 32.5 percent in 2002.¹⁴⁷ The drop in rates has improved the efficiency of European taxation, a benefit that would not have occurred if harmonization had put a straightjacket on reform.

While EU documents admit that tax competition has some good aspects, there is a strong movement to squelch it.¹⁴⁸ For example, the EU has pushed low-tax European countries

to impose withholding taxes on outflows of capital income to prevent citizens from benefiting from lower taxes on their savings in other countries. The German chancellor recently called for fully integrating European taxation.¹⁴⁹ The head of the European Central Bank recently said that the euro would lead to greater harmonization of all taxes in Europe.¹⁵⁰ France's prime minister has condemned tax competition as "fiscal dumping" and said that "the corporate tax system as a whole will have to be harmonised" since it is unfair for corporate headquarters to move to low-tax EU regions.¹⁵¹

Those developments are important for the United States because the same arguments used to support tax harmonization within Europe are being heard in global forums. For example, a high-level United Nations panel has proposed creating a International Tax Organization that would develop norms for tax policy, engage in surveillance of tax systems, and negotiate with countries to "desist from harmful tax competition."¹⁵² The ITO would be akin to the World Trade Organization, which handles trade disputes. But economists nearly universally agree on the benchmark of free trade.¹⁵³ There is no such agreement in the tax world: proponents of broad-based income taxes and proponents of consumption-based tax systems would come to vastly different conclusions about what an ITO should enforce.

Another important reason to oppose a new international tax bureaucracy is the large bias it would have toward tax increases. The UN report proposing an ITO makes that clear. The report suggests creation of a "global source of funds" from a "high yielding tax source."¹⁵⁴ The report suggests future study of a "Tobin tax" on foreign exchange market transactions to finance "global public goods." The report says that an ITO "could take a lead role in restraining the tax competition designed to attract multinationals."¹⁵⁵ Another suggestion in the UN report, which is very disturbing from a civil liberties point of view, is for the proposed ITO to operate a global system of taxing emigrants because brain drains "expose source countries to the

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risk of economic loss when many of their most able citizens emigrate.”¹⁵⁶ The idea seems to be that the proposed ITO would assess a tax on, say, new U.S. citizens of Chinese origin and send the money back to the government of China.

Although the UN has not yet acted on its proposals, the OECD has been at the forefront of global efforts to stifle tax competition.¹⁵⁷ Its April 2000 report on the issue found that “harmful tax competition is by its very nature a global phenomenon and therefore its solution requires a global endorsement and global participation.”¹⁵⁸ The United States needs to decide where it stands on this new international crusade.

“Global participation” so far includes pressuring a list of tax haven countries to change various laws deemed harmful and requiring changes to a long list of “harmful preferential tax regimes” in major industrial countries, including one tax break in the United States.¹⁵⁹ In tax havens, the OECD focus is on indirect methods of nullifying tax competition, such as information sharing between governments. The idea is to give tax collectors in each country access to information about the economic activities of its citizens abroad, in hopes that this will eliminate the attractiveness of low-tax countries. Many countries tax individual residents on some portion of their income on a worldwide basis, so gaining access to foreign information helps high-tax countries sustain their high rates. Information exchanges raise serious issues of financial privacy and national sovereignty.

What is really driving the efforts to suppress tax competition is the politics of redistribution. The primary tax used for redistributive purposes, the income tax, has the most mobile of tax bases and thus is most affected by international tax competition. The 1998 OECD report concluded that international tax competition “may hamper the application of progressive tax rates and the achievement of redistributive goals.” That occurs because, when borders are opened, businesses and individuals that are taxed heavily to pay for redistribution move their activities to

more hospitable locations. The OECD calls such tax avoidance behavior “free riding.” A recent European Parliament report echoed that view, calling it “free loading.”¹⁶⁰

That is an odd characterization. “Free riding” better describes those on the receiving end of government redistribution, who face little or no taxation while others carry a heavy burden. IRS data show that the highest-income 5 percent of U.S. taxpayers paid 55 percent of all federal income taxes in 1999.¹⁶¹ So, while international tax competition may indeed hamper income redistribution, that seems to be a positive outcome because redistribution has reached severe proportions. Curtailment of redistribution is an advantage, not a disadvantage, of international tax competition.

The redistribution issue also highlights the underlying “income tax-centric” view of the world that critics of tax competition hold. A central feature of “harmful tax competition” is said to be no or low taxation of capital income. But many economists think that consumption-based taxes are superior to income-based taxes, which aim to heavily tax capital income. Treasury Secretary Paul O’Neill has suggested that the United States consider scrapping the corporate income tax.¹⁶² Such reforms, aimed at reducing the tax burden on capital income, would be deemed harmful because they would “poach” flows of capital from high-tax countries and cause “fiscal externalities.”

The OECD says that “countries should remain free to design their own tax systems as long as they abide by internationally accepted standards in doing so.”¹⁶³ The United States should be very concerned that the OECD or other international bodies do not start creating international “standards” that lock in high-rate income tax systems and thus preclude pro-growth consumption-based tax reform.

Options for U.S. Tax Policy

Cut Tax Rates

While the United States raised tax rates in the 1990s, other major countries were cut-

ting tax rates and pursuing other tax reforms. As noted in a recent European Parliament report, "Since the 1990s, a wind of tax reforms has been blowing through the European Union . . . most reforms can be seen as supply-side oriented."¹⁶⁴ The president of the International Fiscal Association noted that tax cuts would likely continue and that the average corporate rate in Europe would eventually fall to about 25 percent.¹⁶⁵ That rate would be 10 percentage points lower than the 35 percent U.S. federal corporate tax rate. The combined U.S. federal and average state corporate tax rate of 40 percent is currently higher than the rates in all but 3 of 30 OECD countries.¹⁶⁶ Effective corporate rates have also been falling in Europe.¹⁶⁷ The United States should move to get back the business tax advantage it gained in 1986 by immediately reducing its corporate income tax rate to 20 percent.

Personal income tax rate cuts enacted in 2001 were a step in the right direction for the U.S. tax system. But more must be done. As a step toward a low-rate consumption-based tax system, Congress could consider the Nordic approach of retaining the current tax rates on labor income but taxing capital income at a low, flat rate. That would help to rectify the heavy taxation on dividend income in the United States, which is taxed at the corporate level and again at the individual level. Two-thirds of OECD countries partly or fully relieve the double taxation on dividend income.¹⁶⁸ But the United States does not and as a result has the fourth highest overall tax rate on dividends in the OECD.¹⁶⁹ This heavy taxation has a negative effect on competitiveness because it raises the cost of capital for U.S. companies.¹⁷⁰ To begin reducing capital income taxation, the United States could adopt a flat 10 percent tax rate for dividends, interest, and capital gains at the individual level.

As noted, tax rate cuts would increase economic growth by reducing the distortions, or deadweight losses, that the tax system imposes on the economy.¹⁷¹ Aside from the growth advantages of tax rate cuts, lower rates would

greatly reduce the need for the complex defensive measures that the federal government has taken in areas such as anti-deferral rules and transfer pricing. Lower marginal tax rates would reduce tax evasion and tax avoidance behavior by individuals and corporations.¹⁷² Empirical studies have shown that over time lower rates produce a larger tax base due to reduced avoidance and evasion and increased economic activity.¹⁷³

Oppose Efforts to Curtail Tax Competition

The release of the 1998 OECD report on "harmful" tax competition created continuing controversy over the broad sweep and aggressive stance taken by the organization. The OECD followed up with a report in 2000 that identified harmful tax practices by member countries and listed 35 tax havens that could face a variety of proposed sanctions. A further update report was issued in 2001. As the largest OECD member country, the United States has a key role to play in the debate. The following discussion provides a brief overview of where the debate stands.¹⁷⁴

Since coming to office, the Bush administration has slowed down the ambitious plans of the OECD to build an international cartel to curb tax competition. Treasury Secretary O'Neill expressed his reservations about the OECD project in congressional testimony last year: "I felt that it was not in the interest of the United States to stifle tax competition that forces governments—like businesses—to create efficiencies."¹⁷⁵ For example, he disagreed with OECD efforts to prevent countries from offering preferential tax treatment to foreign investors (so-called ring fencing).

Much of the debate has focused on indirect efforts to curb tax competition. In particular, the OECD is pressuring offshore financial centers, or tax havens, to agree to exchanges of tax information or face sanctions from OECD countries. There are also demands for more transparency in those jurisdictions, which means eliminating special reduced tax rates and reducing bank secrecy. Offshore financial centers combine low-tax climates with high levels of financial

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privacy, so these demands strike at core factors behind their economic success. Not surprisingly, targeted jurisdictions have resisted outside demands to change their tax and financial policies. After all, attracting financial services can be a successful development strategy for poorer countries in the Caribbean and elsewhere that have few natural resources on which to build an economy.

There has also been substantial opposition in Congress, led by House Majority Leader Dick Armey (R-Tex.), to U.S. involvement with the OECD initiative. Armey has argued that the United States should not support “a global network of tax police” and that it is unfair for large wealthy countries to bully small, often poorer nations to change successful economic policies.¹⁷⁶ In fact, targeted nations have argued that the OECD pressure and threatened sanctions are breaches of international law and violations of their sovereignty.¹⁷⁷ They resent the unfairness of the whole process, including the fact that many OECD countries also have supposedly harmful tax rules that have not been fixed.¹⁷⁸ Nonetheless, more than a dozen targeted jurisdictions have made deals to change some of their laws in order to call off the OECD dogs.¹⁷⁹

One part of the OECD initiative that O'Neill supports is pushing foreign countries to enter into taxpayer information exchange agreements. The United States already has agreements for such information exchanges with about 60 countries. O'Neill says those should be limited to particular investigations and not general “fishing expeditions.”¹⁸⁰ But the United States needs to be very careful with the idea of information exchanges because the United States is itself a large tax haven. An immediate threat is a proposed U.S. Treasury regulation that would require U.S. banks to report interest earned by foreigners to the IRS and then share that information with other countries.¹⁸¹ As noted, the tax exemption for foreigners on U.S. bank interest has helped attract more than \$1.1 trillion in bank deposits to the United States.¹⁸² As one

national banking organization noted, if this regulation were finalized and the IRS breached the financial privacy of those deposits, it “could trigger massive withdrawals of foreign deposits from U.S. banks.”¹⁸³ The money would flee to more attractive investment climates with stricter privacy standards.

O'Neill also testified to Congress with respect to the OECD initiative that the United States should “not interfere in the internal tax policy decisions of other countries.”¹⁸⁴ But hunting for income tax evaders in countries that do not have tax systems similar to ours does indeed intrude on the tax policy of those countries. There is an underlying OECD bias in favor of high-rate, broad-based income tax systems. Since many tax havens do not have income taxes, or have low rates, their tax systems are eyed with suspicion. Without an income tax, governments generally do not need to know personal financial investment information. A benefit of replacing the income tax with some version of a consumption-based tax in this country would be added financial privacy. For example, under Armey's flat tax there would be no need for citizens to report savings income (dividends, interest, and capital gains) to the government as they currently do. Thus, it does not seem fair to tell other countries to change their higher standards of financial privacy for the benefit of OECD income tax systems that many economists agree should be replaced with consumption-based tax systems.

Since September 11, concerns about offshore financial centers as tax havens have taken a back seat to concerns about criminal activity in those jurisdictions. The United States has stepped up its efforts against money laundering and financing of terrorism activities. Tax policy and financial privacy rules of offshore centers need not conflict with these important criminal investigation priorities. Many banking centers such as Switzerland and the Cayman Islands have mutual legal assistance agreements with the United States to exchange information on

criminal matters.¹⁸⁵ But the United States should pressure jurisdictions that do refuse to cooperate on criminal matters to do so.

So far, it appears that offshore centers have not stood in the way of U.S. law enforcement. The September 11 terrorists apparently did not rely on offshore or tax haven banks; instead they relied on banking systems in the United States, Europe, and the Middle East, including the informal “hawala” system.¹⁸⁶ A large share of criminal money is laundered in wealthy industrial nations, not tax havens. For example, it is estimated that about half of all laundered money goes through U.S. financial institutions.¹⁸⁷ Smart criminals often avoid tax havens because of the obvious red flag their use provides to authorities.

For those reasons, the United States should not participate in international efforts to bully foreign jurisdictions to weaken their own economies in order to prop up inefficient tax policies in some OECD countries.¹⁸⁸ Arney believes that applying such pressure could make those countries less willing to aid us in the more important mission of stemming terrorism and other criminal activity.¹⁸⁹ Besides, as noted, the United States is itself a large tax haven in certain respects with more than \$1.1 trillion of foreign deposits in U.S. banks attracted by low taxation, security, and financial privacy.¹⁹⁰

Stomping out tax competition through a cartel may seem to be an easy way out of the new realities of globalization.¹⁹¹ But going down the global tax cartel road is not an easy way out. The tone and content of OECD, EU, and UN reports and comments by political leaders suggest that the ultimate end goal is to morph initial international tax agreements into a permanent global tax law. But the ambiguity and contradictions of the economics behind “harmful” tax competition would make this an area for continuous expansion of stiflingly complex bureaucratic laws and regulations. The United States does not need a global tax superstructure on top of its current 45,662-page tax rule book.¹⁹² Instead, the United States should proceed

with the heavy lifting of consumption-based tax reform to allow us to avoid the troubles of chasing tax avoiders and evaders to the far ends of the earth.

Reform U.S. International Business Taxation

The U.S. response to intensified international tax competition must include an overhaul of the worldwide system of business taxation. That system greatly complicates business planning and raises taxes on U.S. firms’ foreign income above those on firms headquartered in other countries.¹⁹³ Yet the worldwide tax system is thought to raise little federal revenue, and it may actually lose revenue in comparison with the alternative of a territorial tax system.¹⁹⁴ Hubbard has noted that “the present U.S. system of taxing multinationals’ income may be raising little U.S. tax revenue, while stimulating a host of tax-motivated financial transactions.”¹⁹⁵ Hubbard believes that “from an income tax perspective, the United States has become one of the least attractive industrial countries in which to locate the headquarters of a multinational corporation.”¹⁹⁶ So the current rules impose a high cost with apparently no revenue benefit to the government.

Calls for reform have come from many quarters. The vice president for taxes at Intel Corporation testified before Congress a few years ago that “the degree to which our tax code intrudes upon business decision-making is unparalleled in the world . . . other countries do not have such complex rules.”¹⁹⁷

The American Bar Association recently concluded that “these rules may never be truly simple, but actions can be taken to temper the extraordinary complexity of the current regime.”¹⁹⁸ The ABA notes that it is becoming increasingly difficult to comply with the foreign tax credit rules and that the subpart F rules “sorely need to be updated to deal with today’s global environment.”¹⁹⁹ Calls for reform have been especially strong since the passage of TRA86, which made U.S. tax rules on business much more complex and uncompetitive.²⁰⁰

Price Waterhouse and the U.S. Chamber of Commerce completed a major study in

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1991 illustrating how U.S. international tax rules put U.S. companies at a disadvantage in foreign markets.²⁰¹ Most of the problems that were identified still plague the tax code. In a major report on U.S. tax rules in 1999, the NFTC concluded that “no other country taxes the active business income of CFCs as aggressively as the United States.”²⁰²

There is growing support for replacing the U.S. worldwide method of taxation with a territorial method. As noted, about half of OECD countries already have a territorial system.²⁰³ Switching to a territorial tax system would entail generally exempting the foreign business income of U.S. companies from U.S. tax. Both fairness and economic reasons support such a policy. On fairness grounds, it is not clear why business operations located abroad should be subject to U.S. tax at all. Foreign affiliates are primarily staffed by foreign workers, and more than three-quarters of affiliate financing is from foreign sources.²⁰⁴ Foreign affiliates primarily benefit from infrastructure offered by foreign countries, not by the U.S. government. So foreign affiliates create foreign economic activity that does not impose costs on U.S. taxpayers. In fact, as numerous studies have documented, U.S. foreign affiliates are very beneficial to the U.S. economy; for example they boost U.S. foreign trade.²⁰⁵

On economic grounds, a territorial system is superior to a worldwide system in numerous ways. A territorial system would make the United States an excellent location for headquarters of multinational corporations. Under a territorial system, foreign affiliates could earn profits abroad and not face a tax disincentive to repatriating earnings to U.S. shareholders. Multinational headquarters bring to the United States highly skilled workers and high-income jobs in management, finance, marketing, R&D, and other high-level corporate functions. For example, while 71 percent of U.S. multinational firms’ employees are located in the United States, 87 percent of their R&D is performed here.²⁰⁶ The larger and more successful the foreign affiliates of U.S. firms are in world markets,

the more headquarters functions will be required in the United States.

Current U.S. tax rules put U.S. foreign affiliates at a competitive disadvantage compared with affiliates of firms headquartered in other countries. Thus the United States is currently a poor tax choice for the location of multinational headquarters. Intel’s vice president for taxes testified before Congress that, “if I had known at Intel’s founding what I know today about the international tax rules, I would have advised that the parent company be established outside of the U.S.”²⁰⁷

The United States may be beginning to have a problem with “runaway” corporate headquarters. High-tax Sweden has had this problem as firms such as IKEA have moved out.²⁰⁸ In the United States, numerous mid-sized companies, such as Fruit-of-the-Loom, have moved abroad. Moving is particularly attractive to firms that already have most of their operations outside the United States.²⁰⁹ The U.S. Treasury recently announced that there has been a “marked increase” in the number and size of companies that are reincorporating abroad, and the Treasury finds that taxes are a key reason for those moves.²¹⁰

The most prominent example of a U.S. corporate expatriation was the 1998 Daimler-Chrysler merger. The merged company established corporate headquarters in Germany, in part because of its more favorable tax rules.²¹¹ A PricewaterhouseCoopers study found that uncompetitive tax rules may be causing numerous U.S. companies to migrate abroad through mergers and acquisitions. The study reported that “in 1998, 1999, and 2000, U.S. companies were the target (and foreign companies the acquirer) in 86, 73, and 79 percent, respectively, of the large cross-border mergers and acquisitions as measured by value.”²¹² Note that cross-border mergers and acquisitions used to be rare, but in the past decade or so they have exploded in number and value. This is one of many changes occurring in the global economy that demand that the United States revisit its antiquated system of taxing international businesses.

Gary Hufbauer of the Institute for International Economics, who is a prominent advocate of moving to a territorial tax system, has noted that “the worldwide tax approach is justified by emotion not logic.”²¹³ He thinks that “the tensions stretching back to 1918 between the impractical general [worldwide] rule and the practical exceptions have generated an extraordinarily complex U.S. tax code.” Hufbauer concludes that we should replace the current impractical general rule with the practical general rule of territoriality.

Others have pointed out that the worldwide tax system, based on the idea of CEN, is a form of tax protectionism or “beggar-my-neighbor neutrality.”²¹⁴ It ends up making all countries worse off by increasing capital taxation and reducing the worldwide capital stock. In pursuit of the questionable notion of “neutrality,” it hurts U.S. companies and foreign economies without aiding the U.S. economy. Norman Ture and George Carlson observed a decade ago that “capital export neutrality, in effect, is preoccupied with the respective domestic and foreign shares of a smaller pie (the stock of capital) rather than making a bigger pie.”²¹⁵ That focus on redistributing the “pie” rather than making it bigger is a preoccupation of people who oppose international tax competition in general.

The United States could move to a territorial tax system for businesses within the framework of the current income tax, which at its simplest would mean exempting from U.S. taxation the active business profits of U.S. foreign affiliates.²¹⁶ Some taxation of foreign portfolio income would still be needed if the United States retained a broad-based income tax system. Better still, we could move to a full territorial system for individuals and businesses if we adopted a major consumption-based tax reform.

Pursue Consumption-Based Tax Reform

In recent years, there has been great interest in replacing the individual and corporate income taxes with a consumption-based tax system. Proposals have included a national

retail sales tax and the flat tax introduced by Armev.²¹⁷ Consumption-based tax reform would be good domestic tax policy, and it would be the best response to rising international tax competition. A replacement consumption-based tax would increase investment and economic growth and greatly simplify federal taxation. In addition, the lower tax rate under most tax reform proposals would reduce wasteful tax avoidance and evasion activities. To replace the revenue currently raised by the corporate and individual income taxes, the sales tax or flat tax rate would need to be roughly 20 percent.²¹⁸

The consumption base and territorial nature of the retail sales tax and the flat tax would eliminate most U.S. international tax rules. There would be no need for rules on foreign affiliates’ earnings, foreign tax credits, or other parts of the current international tax apparatus. As noted, a territorial tax would allow U.S. businesses to compete in foreign markets without tax burdens imposed by the federal government.

A reform as large as adopting a sales or flat tax could have substantial effects on international investment flows. Changes may cause investment to flow into the United States in some situations and out of the country in other situations. On net, most experts think that a low-rate consumption-based tax would make this country a tax haven and attract substantial net investment inflows.

Under a territorial tax, U.S. individuals could search for low-tax investment opportunities abroad, free of U.S. tax on foreign earnings. However, neither the retail sales tax nor the flat tax would be imposed on domestic investment returns either, so individuals would likely keep most financial investments in the United States.²¹⁹ For foreign individuals, the United States would be a tax haven because interest, dividends, and capital gains would not be taxed by the federal government. This policy would expand on the current tax exemption for bank and portfolio interest earned by foreigners in the United States. Overall, there likely would be a net increase in portfolio investment flows to the United States.

A consumption-based tax would increase investment and economic growth and greatly simplify federal taxation.

The territorial nature of the flat tax and sales tax would make the United States an attractive location for corporate headquarters.

Table 4
Investment Location Decisions under a U.S. Income Tax

	Investment Location		
	United States	Foreign A	Foreign B
Tax rate	35%	10%	45%
Net cost of machine	1,000	1,000	1,000
Return, before tax	100	100	100
Foreign income tax	—	10	45
U.S. income tax	35	35	35
Foreign tax credit	—	10	35
Total tax	35	35	45
Return, after tax	65	65	55
Net after-tax rate of return	6.5%	6.5%	5.5%

Source: Adopted from U.S. International Trade Commission, *Implications for U.S. Trade and Competitiveness of a Broad-Based Consumption Tax*, June 1998, www.usitc.gov, p. 17.

Note: Except as otherwise indicated, values are dollars.

The elimination of individual taxation on savings and investment returns would substantially reduce tax avoidance and evasion activity. However, it is likely that any new tax system would provide some channels for tax evasion. For example, a national retail sales tax would create incentives for people to shop abroad. However, evasion is likely to be lower under a consumption tax than an income tax because consumption is less mobile than flows of investment capital, which are taxed under the current system. Therefore, a consumption-based tax would provide a more stable tax base in the face of increasing global tax competition.

For multinational corporations, consumption tax reform would lead to changes in incentives for real investment, financial restructuring, and transfer pricing. For real investment, the low rate of the flat tax, and lack of a business-level tax under a sales tax, would make the United States a great location for domestic and foreign businesses.²²⁰ Direct investment would flow into the United States, particularly from countries with territorial tax systems because firms based in those countries would receive the full benefit of the lower U.S. tax rate.

The provision for business expensing under the flat tax would create an incentive

for capital-intensive industries to locate in the United States. “Expensing” means allowing firms to immediately deduct capital purchases, such as buildings and equipment. Tables 4 and 5 illustrate the location advantage for a U.S. investor that the United States would achieve under a 20 percent flat tax with expensing. Table 4 shows that, under an income tax, an investment in the United States or a low-tax country, A, would earn a 6.5 percent after-tax rate of return. A lower 5.5 percent return would be earned in a high-tax country, B. Table 5 indicates that, under a U.S. flat tax, the return on investment would rise the most for investments in the United States. And it shows that Americans would have an even greater disincentive to invest in high-tax countries, thus increasing international tax competition.

The territorial nature of the flat tax and sales tax would make the United States an attractive location for corporate headquarters, since foreign operations would not be taxed by the U.S. government. A territorial system would eliminate the current disincentive to repatriate foreign profits because they could be brought home tax-free. Hines concludes that “on net, the attractiveness of the United States as a profit location after fun-

Table 5
Investment Location Decisions under a U.S. Flat Tax

	Investment Location		
	United States	Foreign A	Foreign B
Tax rate	20%	10%	45%
Net cost of machine	800	1,000	1,000
Return, before tax	100	100	100
Foreign income tax	—	10	45
U.S. flat tax	20	—	—
Foreign tax credit	—	—	—
Total tax	20	10	45
Return, after tax	80	90	55
Net after-tax rate of return	10.0%	9.0%	5.5%

Source: Adopted from U.S. International Trade Commission, *Implications for U.S. Trade and Competitiveness of a Broad-Based Consumption Tax*, June 1998, www.usitc.gov, p. 17.

Note: Except as otherwise indicated, values are dollars.

damental tax reform implies that U.S. firms will very likely shift some of their investments from foreign countries back to the United States, and that foreign investors will locate more of their investment in the United States as well.”²²¹

Incentives related to R&D and intangible assets may also change. Under the sales tax, royalties received from licensing intangibles to foreigners would not create any taxable income in the United States, thus increasing incentives for performing R&D domestically. Under the flat tax, foreign royalties received probably would be taxable since the tax base includes export receipts. Nonetheless, the lower tax rate under the flat tax would still make the United States an attractive location for R&D.²²² In addition, the current R&D expense allocation rules, which create an R&D disincentive for some firms, would be eliminated under both proposals. Overall, tax reform would be expected to increase U.S. R&D expenditures.²²³

There are a number of differences between a flat tax and a sales tax with regard to international trade. Although both tax proposals are territorial, they differ with regard to imports and exports. A retail sales tax would be “border adjustable” so that imports would face U.S. taxation, but exports would be

exempt. By contrast, the flat tax, like the current income tax, is not border adjustable and thus would tax export receipts but allow deductions for imports.²²⁴ Most economists think border adjustability would not have large effects in the long run since the exchange rate would adjust for the tax difference.²²⁵ But to the extent that the exchange rate did not offset border adjustability, these taxes might have somewhat different effects on international trade.

It is true that under a territorial tax, such as the flat tax, some businesses may move some activities to foreign jurisdictions that have tax rates even lower than a 20 percent flat tax. Replacing the income tax with a flat tax may cause both outflows and inflows of foreign investment. However, most studies, including a 1998 report by the U.S. International Trade Commission, conclude that a consumption-based territorial tax would, on net, attract investment inflows and encourage U.S. firms to increase domestic capital investment.²²⁶

With regard to corporate financial transactions, tax reform would change a number of incentives. As noted, a territorial tax would encourage the repatriation of profits from foreign affiliates. As a result, some share of the large stock of currently unrepatriated for-

Most studies conclude that a consumption-based territorial tax would, on net, attract investment inflows and encourage U.S. firms to increase domestic capital investment.

Just as the United States led the world in tax reform in the 1980s, U.S. consumption-based tax reforms would launch a new round of tax reforms around the world.

eign earnings would flow back to the United States with the adoption of a flat tax or sales tax.²²⁷ Also, there would be an incentive for businesses to shift interest income to the United States under the flat tax and sales tax, as those receipts would not be taxed.

On the other hand, new financial strategies to reduce U.S. taxes could be expected under any major tax reform. For example, the flat tax's exclusion of interest would create an incentive to relabel export receipts as interest income to avoid taxes. In addition, companies would want to repatriate foreign earnings as interest because it would be deductible in the foreign country and not taxable in the United States. In general, since the United States would be a low-tax country after tax reform, U.S. and foreign firms would alter debt and equity financing structures to move taxable income into this country. Overall, the United States would be expected to gain from such financial adjustments.

Under the sales tax, the need for U.S. transfer pricing rules would be eliminated. Under the flat tax, U.S. firms would continue to have incentives to use transfer pricing to shift taxable income to low-tax countries. But the United States itself would have a low tax rate, so both U.S. and foreign firms would likely shift profits into the United States. Experts conclude that the overall pressure on U.S. transfer pricing would be reduced under a flat tax.²²⁸ Hines finds that "all of the proposed fundamental tax reforms greatly reduce incentives created by the U.S. tax system to relocate profits abroad."²²⁹ He also notes that "on net, the tax base of the United States would increase, not decrease, through transfer pricing of American and foreign multinationals after fundamental tax reform."²³⁰

What would be the reaction of other governments to consumption-based tax reform in this country? Governments could take measures to defend their tax bases from increased U.S. competition. There is, for example, concern that some countries may revoke benefits of U.S. investors under current tax treaties. But most governments would have a strong incentive to reform their

own tax systems along the lines of the new U.S. tax system.²³¹ Countries would be put under great pressure to reduce tax rates on capital income because the United States would become an even bigger magnet for global capital flows than it already is.

The territorial nature of a consumption-based tax in the United States would put great pressure on high-tax countries. That would occur because of the elimination of the U.S. foreign tax credit, which currently shields some tax paid by U.S. firms in high-tax countries because of the partial ability to blend high- and low-tax foreign income. Without that mechanism, U.S. companies would reduce investment in high-tax countries.²³² Countries dependent on income taxes would have a strong incentive to adopt a consumption-based system to prevent investment from flooding to the United States.

As other countries reduced tax rates on capital income, global output would rise as capital investment increased and tax-induced distortions were reduced. Just as the United States led the world in tax reform in the 1980s, U.S. consumption-based tax reforms would launch a new round of tax reforms around the world.

Notes

1. "A domestic corporate tax increase will therefore tend to cause an outflow of corporate capital, and in the long run, the resulting shortage of capital in the domestic economy will drive up the pre-tax rate of return to wage earners, because the lower capital intensity of domestic production will reduce labour productivity and real wage rates. Part of the burden may also fall on owners of immobile factors of production such as falling land rents and land prices." Organization for Economic Cooperation and Development (OECD), *Taxing Profits in a Global Economy* (Paris: OECD, 1991), p. 34.

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