Executive Summary
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Making American Companies More Competitive

Daniel J. Mitchell, Ph.D.

The World Trade Organization (WTO) has repeatedly sided with the European Union (EU) and ruled that provisions of U.S. tax law provide impermissible "subsidies" because business income from exports is sometimes not taxed at the same rate as other forms of corporate income. More specifically, the WTO twice ruled that the Foreign Sales Corporation (FSC) portion of the tax code violated trade rules, leading U.S. lawmakers to replace FSC with the Extraterritorial Income Act (ETI). But the EU argued that the new law also was an impermissible subsidy, and the WTO subsequently ruled two more times against the United States.

The WTO decisions put the United States in a difficult position. If FSC/ETI is not repealed, the EU has the right to impose more than $4 billion of "compensatory" tariffs on American products each year. These taxes on U.S. exports, which could be as high as 100 percent, would fall on over 1,800 different products including agriculture, jewelry, steel, machinery and mechanical appliances, wool and cotton textiles, and toys. Yet repealing the law means higher corporate income taxes—also about $4 billion annually—for companies that benefit from the law. This seems like a no-win situation—either higher taxes on corporate income or higher taxes on exports.

An Unexpected Opportunity. While not desirable, the WTO decisions could be a blessing in disguise if they spurred much-needed tax reform. Ideally, lawmakers should engage in wholesale change, junking America's "worldwide" tax system (whereby companies are taxed on income earned in other countries) and replacing it with a "territorial" tax system (the common-sense practice of taxing only income earned inside national borders). This reform would allow U.S.-based companies to compete on a level playing field with foreign competitors, particularly if it is accompanied by a significant reduction in the corporate tax rate.

Worldwide taxation is very anti-competitive, subjecting U.S. companies to higher tax rates than those paid by companies based in other nations. For example, an American-based company operating in Ireland is at a disadvantage since its profits are subject to the 35 percent U.S. corporate income tax in addition to Ireland's 12.5 percent corporate tax. The U.S. company generally can claim a credit for the taxes paid to Ireland, so the overall tax rate on Irish-source income should not exceed 35 percent. But this still means the U.S. firm pays nearly three times as much tax as an Irish company. It also means that the U.S. firm pays nearly three times as much tax as a Dutch firm competing in Ireland, since Holland has a territorial tax system. Furthermore, foreign tax credits are not always available, as they can expire or be limited by other factors.

Incremental Reform. A wholesale shift to territorial taxation is a major undertaking, especially

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with the pressure to act quickly in order to avoid EU sanctions. But this does not preclude progress. Even incremental reform could significantly improve U.S. competitiveness and boost economic performance. In particular, lawmakers could:

- **Make interest expense allocation less onerous.** Companies should not be required to pretend some interest costs are incurred overseas, a policy that results in higher tax burdens.
- **Reduce foreign tax credit baskets.** Companies should not be required to engage in complicated calculations that limit their ability to avoid double taxation.
- **Allow deferral of foreign base company sales and services income.** Companies should not be required to pay U.S. tax when a subsidiary in one foreign country sells to a subsidiary in another foreign country, so any delay in a U.S. tax liability is a positive step.
- **Protect against expiring foreign tax credits.** Companies should be allowed to benefit fully from their foreign tax credits to minimize the adverse impact of worldwide taxation.
- **Permit repatriation of overseas income.** Companies should be encouraged to bring profits back to the U.S., a policy that will boost domestic investment and move the tax code closer to territorial system.

Reform or Else. In 1960, America was home to 18 of the world's 20 largest corporations. By 1996, however, only eight of the world's 20 largest companies were based in America. Tax policy surely was not the only factor in this shift, but worldwide taxation is unquestionably hindering the competitiveness of U.S.-based companies. American companies that compete in global markets face significantly higher effective tax rates than their foreign counterparts.

There are many other signs that worldwide taxation imposes unacceptably high costs, including corporate inversions. Most companies that have rechartered in jurisdictions with better tax law presumably would have remained U.S. companies if America had a territorial tax system, but they were not willing to sacrifice the interests of their workers and shareholders just for the "privilege" of enduring worldwide taxation.

Cross-border mergers are another warning sign. In general, there is no reason for concern if a foreign-based company becomes the "parent" following a merger with a U.S.-based company. However, if foreign-based companies are taking over U.S.-based companies because worldwide taxation reduces the competitiveness and lowers the value of American companies—a factor that has been cited in some high-profile acquisitions of U.S. companies, such as Daimler's merger with Chrysler—worldwide taxation should be repealed.

Territorial taxation is good tax policy. It is simple, it is pro–tax reform, and it will help the U.S. economy. Territorial taxation means more jobs, better jobs, and improved competitiveness of U.S. companies.

By dragging America to the WTO, the European Union has unwittingly given policymakers a golden opportunity to improve the tax treatment of internationally active U.S. companies. If Congress lacks the political will to engage in fundamental reform, it should at least go as far toward a territorial tax system as possible.

—Daniel J. Mitchell, Ph.D., is McKenna Senior Research Fellow in the Thomas A. Roe Institute for Economic Policy Studies at The Heritage Foundation.

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The World Trade Organization (WTO) has repeatedly sided with the European Union (EU) and ruled that provisions of U.S. tax law provide impermissible "subsidies" because business income from exports is sometimes not taxed at the same rate as other forms of corporate income. More specifically, the WTO twice ruled that the Foreign Sales Corporation (FSC) portion of the tax code violated trade rules, leading U.S. lawmakers to replace FSC with the Extraterritorial Income Act (ETI). But the EU argued that the new law also was an impermissible subsidy, and the WTO subsequently ruled two more times against the United States.

The WTO decisions put the United States in a difficult position. If FSC/ETI is not repealed, the EU has the right to impose more than $4 billion of "compensatory" tariffs every year on American products. These taxes on U.S. exports, which could be as high as 100 percent, would fall on over 1,800 different products including agriculture, jewelry, steel, machinery and mechanical appliances, wool and cotton textiles, and toys.[1] Yet repealing the law means higher corporate income taxes—also about $4 billion annually—for companies that benefit from the law. This seems like a no-win situation—either higher taxes on corporate income or higher taxes on exports.

While not desirable, the WTO decisions could be a blessing in disguise if they spurred much-needed tax reform. The tax code has numerous features that sig-

- **Improve interest expense allocation.** Companies should not be required to pretend some interest costs are incurred overseas, a policy that results in higher tax burdens.
- **Reduce foreign tax credit baskets.** Companies should not be required to engage in complicated calculations that limit their ability to avoid double taxation.
- **Allow greater deferral.** Companies should not be required to pay U.S. tax when a subsidiary in one foreign country sells to a subsidiary in another foreign country, so delaying the tax is a positive step.
- **Protect against expiring credits.** Companies should be allowed to benefit fully from their foreign tax credits to minimize the adverse impact of worldwide taxation.
- **Permit repatriation of overseas income.** Companies should be encouraged to bring profits back to the U.S., a policy that will boost domestic invest-

1. For the full retaliation list, see *waysandmeans.house.gov/media/pdf/fsc/FSC%20Retal%20List.pdf.*

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The WTO Ruling Is Dangerous and Discriminatory

The ETI provision is not ideal tax policy, but the WTO should not have any authority to interfere with the tax laws of sovereign nations. The WTO was created to reduce trade barriers, and the Geneva-based bureaucracy should refocus on that important mission.[1]

The WTO's actions are particularly troubling because Europe's high-tax nations will probably use the decisions as a precedent to argue that nations with lower tax burdens and less oppressive tax rates are somehow "subsidizing" domestic producers and "distorting" trade patterns. As summarized by *The Wall Street Journal*:

> Once tax policy is on the table, there's no end to what the WTO might meddle in. Which may be exactly what some Europeans want. Saddled with their own anti-competitive, high-tax regimes, they'd love to use the global trade bureaucracy to force Britain, the U.S. and other lower-tax countries to become just as uncompetitive. This is an offer the U.S. can refuse.[2]

Indeed, it is worth noting that many European welfare states, working through international bureaucracies like the Organisation for Economic Co-operation and Development (OECD) and the European Union (EU), are already pushing for tax harmonization policies in an effort to hinder America's competitive advantage.

It also is rather ironic that the EU dragged the United States before the WTO for the supposed subsidies provided by FSC and ETI. EU governments provide their companies with a rebate of value-added taxes on all exported products, a tax benefit that is many times larger than the benefit of FSC and ETI to U.S. companies.

1. For a thorough analysis of the history of the WTO decision and an explanation of its discriminatory features, see Gary Clyde Hufbauer, "The Foreign Sales Corporation Drama: Reaching the Last Act?" Institute for International Economics *Policy Brief* No. PB02–10, November 2002, at *www.iie.com/publications/pb/pb02-10.pdf*.
2. Editorial, "Pandora's Trade War," *The Wall Street Journal*, January 17, 2002.

nificantly undermine the competitiveness of U.S.-based companies. The bad news is that fixing these problems would "cost" money (according to static revenue-estimating models). The good news, in a manner of speaking, is that repealing ETI would generate about $49.4 billion in tax revenue over the next 10 years—money that can be used to ameliorate the anti-competitive provisions of the tax code.[2]

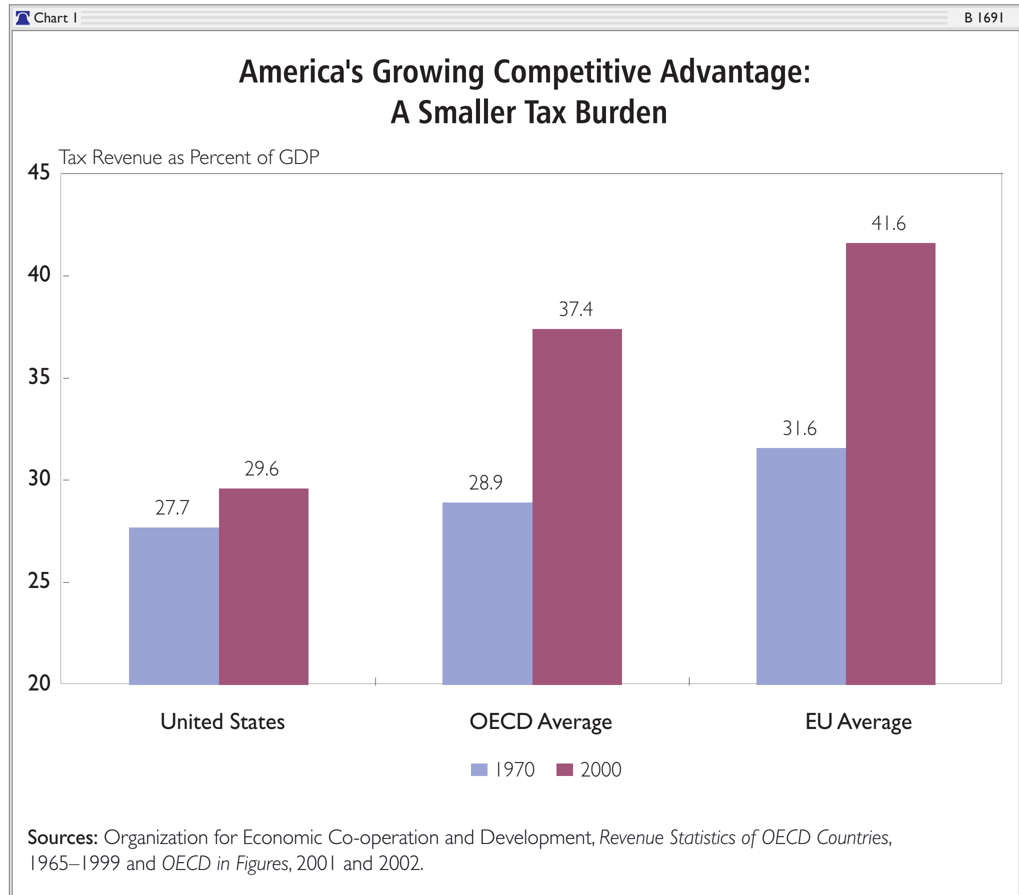
Ideally, lawmakers should engage in wholesale change, junking America's "worldwide" tax system (whereby companies are taxed on income earned in other nations) and replacing it with a "territorial" tax system (the common-sense practice of taxing only income earned inside national borders). This reform would allow U.S.-based companies to compete on a level playing field with foreign competitors, particularly if it is accompanied by a significant reduction in the corporate tax rate.

Even incremental reform could significantly improve U.S. competitiveness and boost economic performance. In particular, lawmakers could:

- **Make interest expense allocation less onerous.** Companies should not be required to pretend some of their interest costs are incurred overseas, a policy that results in higher tax burdens.
- **Reduce foreign tax credit baskets.** Companies should not be required to engage in complicated calculations that limit their ability to avoid being double-taxed on foreign-source income.

2. Joint Committee on Taxation, U.S. Congress, "Estimated Revenue Effects of H.R. 2896, The 'American Jobs Creation Act of 2003,'" August 1, 2003, at *www.house.gov/jct/x-71-03.pdf*.

- **Allow deferral of foreign base company sales and services income.** Companies should not be required to pay U.S. tax when a subsidiary in one foreign country sells to a subsidiary in another foreign country, so any delay in the U.S. tax liability is a positive step.
- **Protect against expiring foreign tax credits.** Companies should be allowed to benefit fully from their foreign tax credits to minimize the adverse impact of worldwide taxation on competitiveness.
- **Permit repatriation of overseas income.** Companies should be allowed to bring profits back to the U.S. at a much lower tax rate, a policy that will boost domestic investment and move the tax system closer to territoriality.



Sources: Organization for Economic Co-operation and Development, *Revenue Statistics of OECD Countries*, 1965–1999 and *OECD in Figures*, 2001 and 2002.

These reforms, discussed in greater detail below, are incorporated into legislation being considered on Capitol Hill. Such proposals would help U.S. companies compete in global markets.

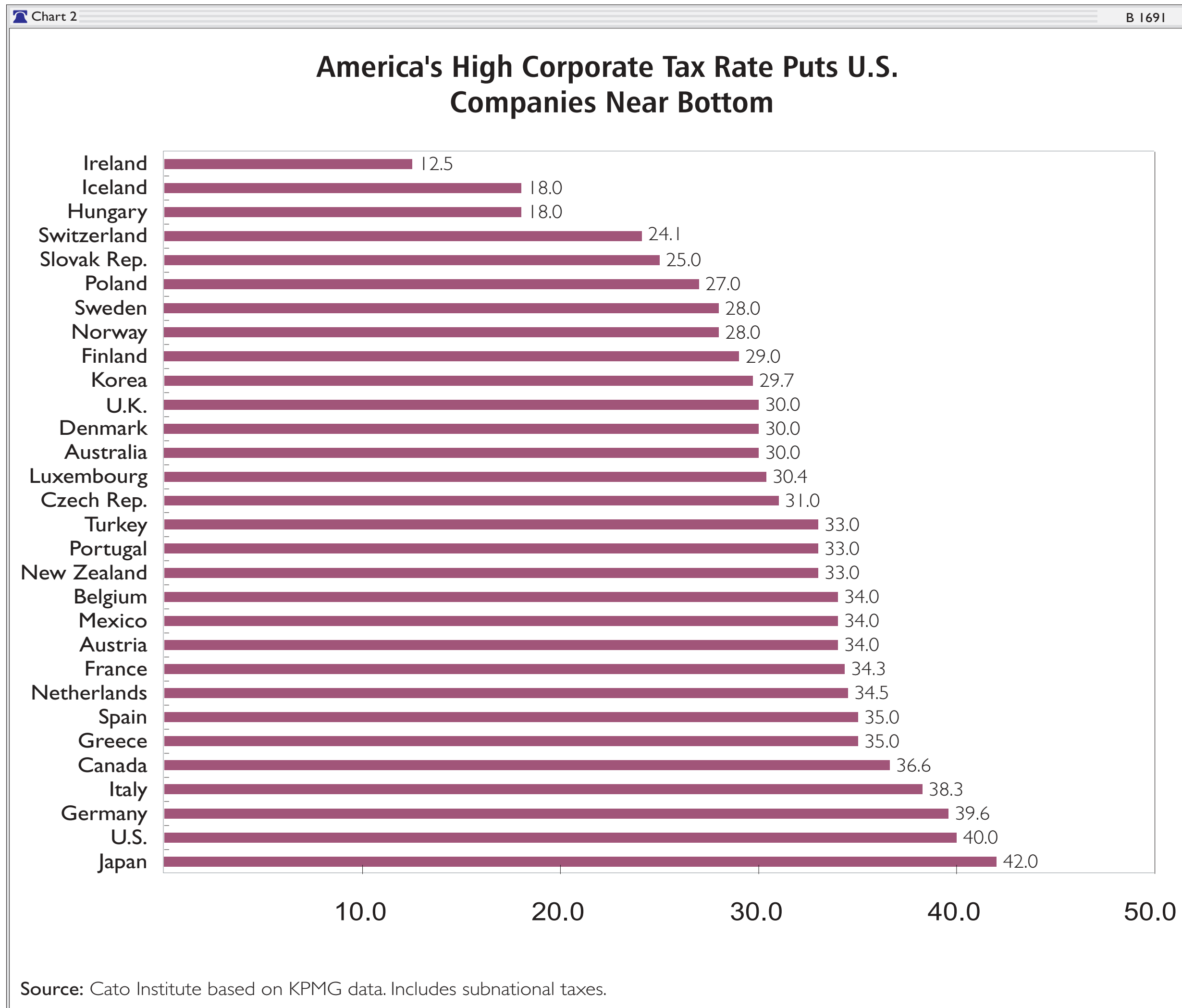
Current Tax Law Treatment of U.S.-Based Companies

The aggregate tax burden in America is too high, but most other industrialized nations have a tax burden that is far more onerous. This would suggest that U.S.-based companies have a competitive advantage in the global economy, but this is not the case. The U.S. corporate tax rate is among the highest in the world, and companies are forced to pay that tax on income that is earned—and subject to tax—in other nations. The combination of these features brings to mind Clint Eastwood's "spaghetti Western" *The Good, the Bad, and the Ugly.*

The Good: A Lower Total Tax Burden. As indicated in Chart 1, federal, state, and local taxes consume about 30 percent of national economic output in the United States. This is far too high, but the burden of government is much heavier in most European nations. In the EU, taxes consume about 42 percent of gross domestic product.

Not surprisingly, America's lower tax burden translates into superior economic performance. Per capita economic output in the U.S. is nearly 50 percent higher than in the EU. America also enjoys much more job creation, resulting in significantly less unemployment.

Aggregate tax figures are important, but they do not necessarily reveal the tax burden on different types of economic activity. One reason the United States has a big overall advantage, for instance, is the absence of a national sales tax. Countries in the EU, by contrast, are required to levy a value-added tax of at least 15 percent. This consumption-based levy is at least partially responsible for the bloated welfare states in most EU nations.



Source: Cato Institute based on KPMG data. Includes subnational taxes.

America also tends to have lower payroll and personal income tax rates. Significant changes in tax rates since 2001—lowering personal income and capital gains tax rates, slashing the dividend tax rates, and a move toward expensing of investment—have further improved the competitiveness of the U.S. tax code.

The Bad: A High Corporate Tax Rate. The overall tax burden in the United States may be low compared to Europe, but this does not mean that America has an advantage in all areas. The United States, for instance, has one of the highest corporate income tax rates in the industrialized world. The federal government imposes a corporate income tax rate of 35 percent, and state corporate tax burdens increase the effective tax rate to 40 percent. According to Organisation for Economic Co-operation and Development (OECD) and KPMG data, this is the second-highest corporate tax burden of any developed nation.

America has fallen behind because many other nations—particularly in Europe—have dramatically lowered their corporate tax rates in the past 15 years. This vigorous tax competition has led to better tax policy. Ireland is perhaps the most spectacular example, lowering its corporate rate from 50 percent to just 12.5 percent.

Many other nations have also reduced corporate rates to help their companies compete in the global economy. Iceland and Hungary have 18 percent tax rates on business income, and even socialist nations like France and Sweden have lower corporate tax rates than America. The average corporate tax rate in

Key Definitions

Governments have the sovereign power to tax income earned inside national borders. Some governments, however, also assert the right to tax some or all of the income earned in other countries by their citizens (individual and/or corporate). This decision has important implications for competitiveness, especially if a nation imposes high tax rates.

Worldwide taxation, sometimes referred to as **residence-based taxation**, occurs when a government taxes the income earned by its citizens in other nations (often referred to as **foreign-source income**). But since foreign governments have the primary right to tax income earned inside their borders, this creates the risk of double taxation. To protect against **double taxation**, a government that imposes worldwide taxation generally allows taxpayers to reduce their tax bill on foreign-source income by subtracting—using a **foreign tax credit**—any taxes paid to the foreign government.

In general, a domestic tax liability on foreign-source income occurs when the foreign country has a lower tax rate. If the foreign country has a higher tax rate, the foreign tax on foreign-source income creates a credit that completely offsets any domestic tax liability.

Governments with worldwide tax systems also sometimes allow business taxpayers to postpone taxes—a practice known as **deferral**—on foreign-source income if the income is being actively utilized in business operations. The United States has deferral, but **Subpart F** of the tax code strictly limits its reach.

Territorial taxation, sometimes referred to as **source-based taxation**, occurs when governments tax only income that is earned inside national borders. The United States has a very aggressive worldwide tax system. U.S.-based corporations are taxed on their worldwide income, and U.S. citizens and resident aliens are taxed on any savings and investment income earned in other nations. Other than deferral, the only exception to the worldwide tax reach of the Internal Revenue Service (IRS) is that citizens who live and work abroad are not subject to worldwide taxation on their first $80,000 of wage and salary income—a provision in the tax code known as the **Section 911 exclusion**.

Territorial taxation has long been a goal for those supporting fundamental tax reform. The flat tax, USA tax,[1] and national retail sales tax all would eliminate the worldwide reach of the current tax system.

1. The unlimited savings account (USA) tax is similar to the flat tax. The most significant difference is that under the USA tax, income is taxed only in the year during which it is consumed. In other words, taxpayers would get an "up-front" deduction for all individual saving—sometimes referred to as an unlimited "front-ended" IRA—but then pay tax on all withdrawals. Under the flat tax, by contrast, the one layer of tax is imposed when the income is earned, and double taxation is avoided by not imposing any additional tax if individuals save their after-tax income and receive a return.

Europe has fallen by about 7 percentage points just since 1996.[3]

The Ugly: Worldwide Taxation. American-based companies are taxed on their worldwide income.[4] This policy is very anti-competitive, subjecting U.S. companies to higher tax rates than those paid by companies based in other nations.

3. KPMG, Corporate Tax Rate Survey, January 2003, at *www.us.kpmg.com/microsite/global_tax/ctr_survey/2003CorprorateTaxSurveyFINAL.pdf.*

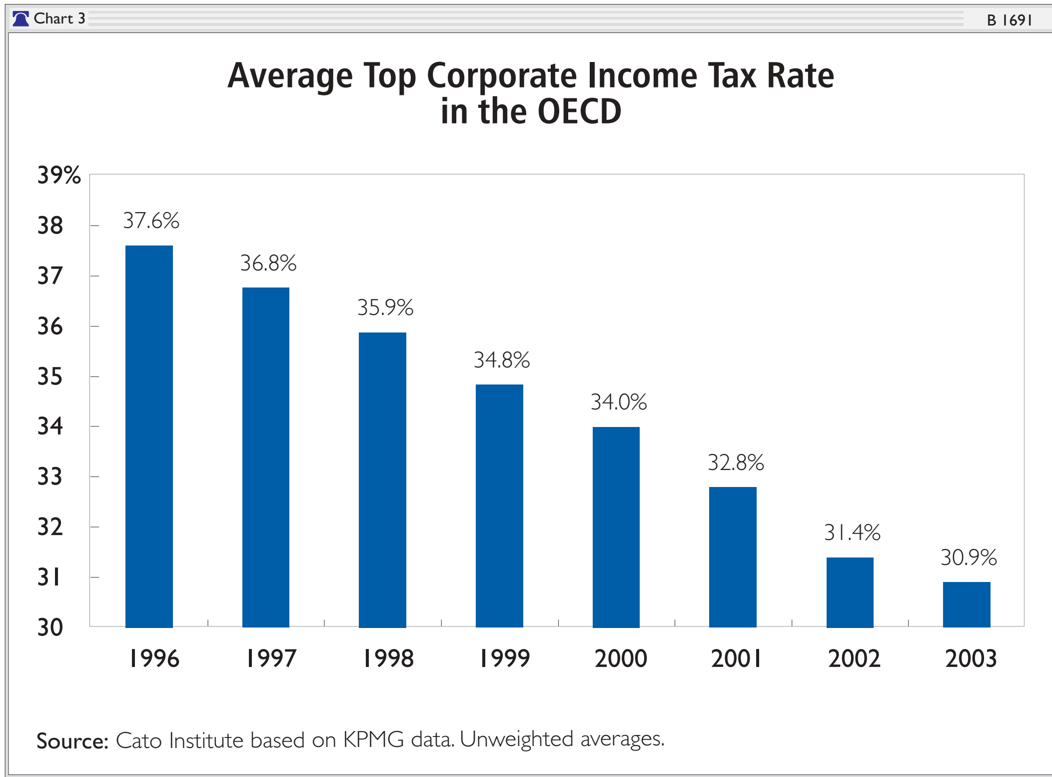
4. Determining taxable foreign-source income is complicated. According to the Joint Committee on Taxation, the tax code has an "extensive set of rules governing the determination of the source, either U.S. or foreign, of items of income and the allocation and apportionment of items of expense against such categories of income." See Joint Committee on Taxation, U.S. Congress, *Description and Analysis of Present-Law Rules Relating to International Taxation*, June 28, 1999, at *www.house.gov/jct/x-40-99.htm.*

Table 1 B 1691

Worldwide Taxation Punishes U.S. Company Competing in Ireland

	Profit	Irish Tax	Additional Tax	Total Tax
U.S. company	$100	$12.5	$22.50 to IRS	$35
Local company	$100	$12.5	0	$12.5
Dutch company	$100	$12.5	0	$12.5

Source: Author's calculations.



Source: Cato Institute based on KPMG data. Unweighted averages.

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The Misguided Theory Behind Worldwide Taxation

If territorial taxation is a good idea, why do some countries impose worldwide taxation? In part, the answer is that politicians are greedy. Worldwide taxation means more income to tax, which translates into more money to spend. In the long run, of course, the additional revenue is almost certainly less than originally expected because companies operating under such a system will be less competitive. Such companies will experience lower sales and reduced employment, resulting in less revenue.

Yet worldwide taxation is not just a matter of greedy politicians making myopic decisions. There also is an ideological argument for worldwide taxation, bolstered by the theory of capital export neutrality (CEN).

According to CEN, growth will be maximized if individuals ignore tax considerations when making economic decisions. Proponents of this view fear that "substantial amounts of capital could be diverted to jurisdictions with the lowest tax rates instead of flowing to investment projects with the highest pre-tax rate of return."[1] Stopping this flow of capital requires harmonization of tax rates, either by having all nations adopt similar tax systems or by having individual nations implement worldwide taxation—which is an indirect form of harmonization since resident taxpayers are unable to lower their tax rates by working, saving, or investing outside national borders.

While it sounds preposterous, CEN is not without merit. Differential tax rates do lead to the misallocation of capital, which is one of the reasons a flat tax—which treats all income equally—improves economic efficiency and increases living standards. Advocates of CEN make a critical mistake, however, by ignoring the interaction between fiscal competition and overall tax burdens.

Simply stated, tax harmonization policies encourage higher tax rates and bigger government. The resulting economic damage is far greater than the theoretical problems associated with differential tax policies among nations. Tax competition, by contrast, results in lower tax rates and reduces the tax bias against saving and investment—policies that enhance an economy's performance.

1. See Joint Committee on Taxation, U.S. Congress, *Overview of Present-Law Rules and Economic Issues in International Taxation*, March 11, 1999, at *www.house.gov/jct/x-13-99.htm*.

For example, an American-based company operating in Ireland is at a disadvantage since its profits are subject to the 35 percent U.S. corporate income tax in addition to Ireland's 12.5 percent corporate tax. The U.S. company generally can claim a credit for the taxes paid to Ireland, so the overall tax rate on Irish-source income should not exceed 35 percent. As Table 1 indicates, however, this still means the U.S. firm pays nearly three times as much tax as an Irish company. It also means that the U.S. firm pays nearly three times as much tax as a Dutch firm competing in Ireland, since Holland has a territorial tax system. Furthermore, these foreign tax credits are not always available because they can expire or be limited by other factors.

Making matters worse, the tax code contains a plethora of rules that make it even harder for companies to compete. Tax rules for using foreign tax credits, for instance, are so onerous that companies sometimes are double-taxed on foreign-source income. Companies also are forced to misallocate certain expenses in order to increase taxable income. Even features designed to mitigate the anti-competitive nature of worldwide taxation—such as deferral—are subject to a multiplicity of restrictions.[5]

Worldwide taxation means that U.S.-based companies are not allowed to compete on a level playing field. Most nations do not tax companies on their worldwide income. This means that compa-

5. As the Joint Committee on Taxation explains, "A variety of complex anti-deferral regimes impose current U.S. tax on income earned by a U.S. person through a foreign corporation." See Joint Committee on Taxation, *Description and Analysis of Present-Law Rules Relating to International Taxation.*

nies based in those nations can take full advantage of the low corporate tax rates that now exist in so many countries.[6] Adding insult to injury, compliance costs for foreign-source income are extraordinarily high, forcing internationally active American companies to spend huge amounts of money and to divert a substantial amount of time and energy just to fill out tax forms.

Making American-Based Companies More Competitive

Fundamental Reform. Policymakers should junk America's worldwide tax on corporate income and shift to territorial taxation. Such a step would be poetic justice. The EU filed the WTO cases against America in hopes of forcing lawmakers to increase the tax burden on U.S. companies. If lawmakers instead use the WTO rulings as an impetus to improve the tax code, American companies will become more effective competitors in the world economy, and the EU will regret its attack on U.S. fiscal sovereignty.

However, getting revenge on the EU is the last reason to fix the tax code. The main reason to shift to territorial taxation is that it is good, pro-growth tax policy. Specifically, territorial taxation promotes:

- **A level playing field.** American companies would be allowed to operate under the same rules as companies from other nations. Income earned in a foreign country would be taxed by the foreign country, and all corporations—whether from that country or anyplace else in the world—would be treated the same.
- **Competitiveness.** American companies would not face a second layer of tax when competing in a low-tax jurisdiction. Paying the local tax rate (instead of the local tax rate and a tax to the IRS) would enable American companies to get more business (which is very important in low-tax economies since, not surprisingly, they tend to grow faster and attract more economic activity).
- **Simplicity.** American companies no longer would need to include foreign revenues and expenses in their U.S. tax return, which requires immense amounts of paperwork and complex calculations of foreign tax credits and the resulting U.S. tax.[7] A survey of Fortune 500 companies found that international tax rules accounted for nearly 44 percent of compliance costs, a disproportionately high number since companies generally have a much smaller share of their employment, sales, and assets outside of the U.S. economy.[8] Under a territorial system, companies would merely need to track revenues and expenses in each country in which they operate.
- **Tax reform.** Territorial taxation is part of every serious tax reform plan. The flat tax eliminates worldwide taxation. The national retail sales tax eliminates worldwide taxation. The inflow-outflow tax (sometimes known as the USA tax) eliminates worldwide taxation.[9] Shifting from worldwide taxation to territorial taxation is both

6. According to the Joint Committee on Taxation, "if a source [foreign] country provides low effective tax rates on manufacturing income, a taxpayer resident in a country with a territorial tax system will fully enjoy the benefits of the lower source-country rate, while a taxpayer resident in a country with a worldwide tax system generally will not." See Joint Committee on Taxation, U.S. Congress, *The U.S. International Tax Rules: Background and Selected Issues Relating to the Competitiveness of U.S. Businesses Abroad*, July 14, 2003, at *www.house.gov/jct/x-68-03.pdf.*
7. According to the Joint Committee on Taxation, "the foreign tax credit and anti-deferral regimes, two of the most complex features of a worldwide tax system, are not necessary in a pure territorial system." See Joint Committee on Taxation, *The U.S. International Tax Rules.*
8. Marsha Blumenthal and Joel Slemrod, "The Compliance Costs of Taxing Foreign-Source Income: Its Magnitude, Determinants, and Policy Implications," *International Tax and Public Finance*, Vol. 2, No. 1 (1995), pp. 37–54.
9. The inflow-outflow tax is similar to a flat tax. The biggest difference is that a flat tax protects against double taxation of personal saving by providing the equivalent of an unlimited and universal back-ended individual retirement account (IRA). This means people would pay a layer of tax when they earn income but would not be subject to an additional layer of tax if they save and invest the income left after paying the first layer of tax. The inflow-outflow tax, by contrast, protects against double taxation of personal saving by providing the equivalent of an unlimited and universal front-ended IRA. In other words, people would not have to pay any tax on the income they save and invest, but they would have to pay a layer of tax when any money—including both principal and earnings—is withdrawn from the IRA-style account.

The "Runaway Plant" Myth

Some critics fear that territorial taxation will encourage companies to relocate factories from America to low-tax countries. Companies do have an incentive to create jobs and expand operations in jurisdictions with better tax law, but critics are completely wrong if they believe that worldwide taxation therefore protects American jobs.

According to the Council of Economic Advisers, "it is highly doubtful that U.S. direct investment abroad reduces U.S. exports or displaces U.S. jobs."[1] Companies invest abroad primarily to compete abroad. Commerce Department data show that sales to U.S. consumers account for only 11 percent of the sales of U.S.-controlled foreign companies.[2]

Worldwide taxation simply means that U.S. companies will have a competitive disadvantage abroad and, therefore, a smaller share of the global market. It is important to understand that worldwide taxation merely limits the degree to which U.S. companies can benefit by operating in low-tax jurisdictions. It does not discourage foreign companies (particularly those from countries with territorial tax systems) from building new factories in jurisdictions with good tax law. It does not discourage foreign companies from building new factories in the United States or from exporting products to the United States.

In other words, worldwide taxation neither limits competition from factories in low-tax countries nor restricts imports. Instead, it merely makes it difficult for U.S. companies to maintain profitable operations in foreign countries.

Ironically, America's worldwide tax system almost surely reduces job creation because U.S. companies with overseas operations are more likely to use U.S.-based suppliers for raw materials and intermediate goods. Indeed, foreign subsidiaries of U.S. companies purchased more than $200 billion worth of goods from America in 2000.[3] But since worldwide taxation reduces the presence of U.S. companies in foreign markets, this means exports are not as high as they could be, and this lowers the demand for employment in America.

1. Council of Economic Advisers, *Economic Report of the President* (Washington, D.C.: U.S. Government Printing Office), February 1991, p. 259.
2. Peter Merrill, "U.S. Tax Policy and International Competitiveness," testimony before the Committee on Ways and Means, U.S. House of Representatives, February 27, 2002, at *waysandmeans.house.gov/legacy/fullcomm/107cong/2-27-02/2-27merr.htm.*
3. Coalition for Fair International Taxation, letter to Bush Administration and Capitol Hill tax officials, January 13, 2002.

necessary and desirable for a fair, simple, pro-growth tax system.

- **Respect for sovereignty.** Territorial taxation is the fiscal equivalent of a "good neighbor policy." Each nation taxes activity inside its own borders but respects the right of other nations to determine the tax treatment of income earned inside their borders. This is in stark contrast to worldwide taxation, which necessarily requires governments to impose laws on an extraterritorial basis.
- **Fiscal competition.** Worldwide tax systems mean that companies always pay the highest possible tax—either the tax of their home country or the tax of the country in which they are operating.[10] With territorial tax systems, by contrast, companies can benefit from lower tax rates in fiscally responsible jurisdictions. This enhances the flow of jobs and capital to lower-tax jurisdictions and promotes tax competition as a liberalizing force in the world economy.[11] As the Joint Committee on Taxation acknowledges, "Without the constraint of some resi-

10. The National Foreign Trade Council puts it succinctly, stating that foreign-source income "is taxed at the U.S. rate to the extent that rate is higher than the local [foreign] tax rate." See National Foreign Trade Council, "Territorial Tax Study Report," June 11, 2002, at *www.nftc.org/default/tax/territorial%20Report.pdf.*

dence-based taxation of foreign-source income, a major barrier to tax competition would be removed."[12]

- **More exports.** Territorial taxation means that U.S.-based companies will earn a larger share of global business. This is good for exports and domestic employment since successful international companies often buy raw materials and intermediate goods from their home country. The OECD estimates that every dollar of direct investment overseas by a nation's companies yields $2 of additional exports for that country.[13] Foreign production also generates exports. A survey of the empirical literature reveals that one dollar of overseas production by U.S. affiliates generates an average of $0.16 in exports from the United States.[14]
- **No more inversions.** To improve their competitiveness and protect the interests of workers and shareholders, some companies have rechartered (a process sometimes known as "inversion") in jurisdictions with better tax law. Companies that charter in Bermuda and Cayman still keep their headquarters and factories in the United States, and they still pay tax to the IRS on their U.S.-source income, but they escape worldwide taxation. Inversions protect American economic interests, but they are a second-best option. Shifting to a territorial tax system is the best approach.
- **Fewer foreign takeovers.** Glenn Hubbard, former Chairman of the Council of Economic Advisers, has noted 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."[15] If U.S. companies become subsidiaries of foreign firms, however, their market value will rise because they escape worldwide taxation. This is why foreign-based companies "take over" U.S.-based companies three-fourths of the time when there is a cross-border merger.[16] There is nothing wrong with cross-border mergers, and there is nothing wrong with foreign-based companies acquiring U.S.-based companies, but bad U.S. tax law should not be the cause. Territorial taxation will put U.S.-based companies on a level playing field.
- **WTO-compliant policy.** Territorial taxation is fully consistent with international treaty obligations. Most nations use this approach, and the WTO has already ruled that territorial taxation does not violate trade rules.[17]

Worldwide taxation is bad tax policy and should be repealed. Nations are sometimes guilty of enacting laws—including tax laws—to give their compa-

11. For more information, see Daniel J. Mitchell, "An OECD Proposal to Eliminate Tax Competition Would Mean Higher Taxes and Less Privacy," Heritage Foundation *Backgrounder* No. 1395, September 18, 2000, at *www.heritage.org/library/backgrounder/bg1395.html*, and Chris Edwards and Veronique de Rugy, "International Tax Competition: A 21st-Century Restraint on Government," Cato Institute *Policy Analysis* No. 431, April 12, 2000, at *www.cato.org/pubs/pas/pa431.pdf.*
12. Joint Committee on Taxation, *The U.S. International Tax Rules.*
13. Organisation for Economic Co-operation and Development, *Open Markets Matter: The Benefits of Trade and Investment Liberalization*, October 1999, at *www1.oecd.org/publications/pol_brief/1999/9906-eng.pdf.*
14. Robert E. Lipsey, "Outward Direct Investment and the U.S. Economy," in Martin Feldstein, James R. Hines, Jr., and R. Glenn Hubbard, eds., *The Effects of Taxation on Multinational Corporations* (Chicago: University of Chicago Press, 1995). In a more recent survey, Lipsey reached similar conclusions; see Robert E. Lipsey, "Home and Host Country Effects of FDI," National Bureau of Economic Research *Working Paper* No. 9293, October 2002.
15. Glenn Hubbard, "Comments on Sen. McCain's Tax Policy Toward U.S. Multinationals," *Tax Notes,* March 6, 2000.
16. Peter Merrill, "U.S. Tax Policy and International Competitiveness," testimony before the Committee on Ways and Means, U.S. House of Representatives, February 27, 2002, at *waysandmeans.house.gov/legacy/fullcomm/107cong/2-27-02/2-27merr.htm.*
17. As the Joint Committee on Taxation explains, "countries with predominantly worldwide tax systems are arguably placed at a disadvantage relative to countries with more territorial-based tax systems. In other words, the more territorial-based systems are arguably allowed to provide an inherent export incentive without violating international trade law, while attempts to replicate this benefit under a more worldwide-based system have been found to violate this law." See Joint Committee on Taxation, *The U.S. International Tax Rules.*

The Right Way to Address Corporate Inversion

Many companies, including Tyco, Ingersoll–Rand, Cooper Industries, McDermott International, Nabors Industries, the Noble Corporation, and Foster–Wheeler, have given up their U.S. charters and reincorporated in low-tax jurisdictions that have territorial tax regimes. Other companies, such as Accenture, have chosen low-tax jurisdictions when making the decision to incorporate. On a similar note, an Intel Vice President remarked that Intel would organize as a foreign company if it could start over again.[1]

Inversions have created considerable controversy on Capitol Hill, leading some to advocate fiscal protectionism, but forcing these companies back into America's worldwide tax system is ultimately self-destructive. As a former Treasury Department official has written, "punitively taxing these companies would harm U.S. workers and shareholders by making American companies less competitive."[2] Shifting to a territorial system, by contrast, will make America's tax system more competitive and solve this problem.[3]

Even the Joint Committee on Taxation acknowledges this point:

> [T]he adoption of a territorial system also would arguably make the United States a more attractive place in which to incorporate, which may help to create or preserve various "headquarters" jobs, such as R&D, financial, corporate, and other administrative services. This could arguably help to halt or reverse the recent trend toward "corporate expatriation" from the United States, via cross-border mergers or otherwise.[4]

1. Robert Perlman, "U.S. International Tax Reform," testimony before the Committee on Finance, U.S. Senate, March 11, 1999, at *finance.senate.gov/3-11perl.htm.*
2. Bruce Bartlett, "Corporate Taxes," National Center for Policy Analysis *Brief Analysis* No. 451, August 14, 2003, at *www.ncpa.org/pub/ba/ba451.*
3. See Daniel J. Mitchell, "Corporate Expatriation Protects American Jobs," Heritage Foundation *Executive Memorandum* No. 829, August 29, 2002, at *www.heritage.org/Research/Taxes/em829.cfm.*
4. Joint Committee on Taxation, U.S. Congress, *The U.S. International Tax Rules: Background and Selected Issues Relating to the Competitiveness of U.S. Businesses Abroad*, July 14, 2003, at *www.house.gov/jct/x-68-03.pdf.*

nies a special advantage. The United States is guilty of this practice, but in the perverse sense that American tax laws put U.S.-based companies at a competitive disadvantage.

Good tax policy should neither subsidize nor penalize any company, regardless of whether it is foreign or domestic. This is why territorial taxation is ideal policy. If the U.S. had a territorial system, every company operating in the United States, regardless of where it is chartered, would pay tax to the IRS on its U.S.-source income.

This, of course, happens now. What would change, though, is that the foreign-source income of U.S. companies would be taxed only by foreign governments, thereby allowing American firms to compete on a level playing field with companies from other countries.

Incremental Reform. To the extent that fundamental reform is not immediately feasible, lawmakers should fix at least some of the worst features of the current tax system. Repealing the ETI provision will generate about $49.4 billion over 10 years, but this is not nearly enough money to finance a complete shift to a territorial system, especially since Congress continues to rely on inaccurate "static scoring" methodology to estimate the revenue impact of major tax legislation. Congress could increase the amount of available money by extending some trade-related fees (and this is widely expected), but it is unlikely that the total pool of money will exceed $100 billion over 10 years.

It is therefore essential for lawmakers to choose reforms that will generate the most "bang for the buck," and two lawmakers have undertaken this much-needed task. Important incremental reforms

are included in H.R. 2896, sponsored by Representative Bill Thomas (R–CA), chairman of the House Ways and Means Committee, and S. 1475, sponsored by Senator Orrin Hatch (R–UT), a senior member of the Senate Finance Committee.

The following proposals certainly would help to improve the competitiveness of U.S.-based companies and are critical incremental steps toward a territorial tax system because they reduce and delay taxation of foreign-source income.

- **Make interest expense allocation less onerous.** Internationally active U.S. companies are required to pretend that some of their domestic interest costs are incurred overseas. This artificially reduces foreign-source income, which causes additional double taxation since it simultaneously reduces the amount of foreign tax credits that can be claimed—notwithstanding the amount of foreign taxes that have actually been paid.[18] The rules boost effective tax rates for U.S. companies, most notably for investments overseas, but also on their U.S. investments.[19] Yet this rule generally does not apply to foreign companies operating in the United States.[20]

  One way to ameliorate this unfair practice is to take into account a company's international interest costs—the "worldwide fungibility" approach.[21] Chairman Thomas and Senator Hatch propose to give companies greater ability to use this method, which "would significantly expand the ability of many U.S.-based multinational enterprises to claim foreign tax credits."[22]

- **Reduce foreign tax credit baskets.** U.S. companies are forced to segregate their foreign-source income into nine separate "baskets," and foreign taxes paid on income in one basket cannot be credited against U.S. taxes on foreign-source income in another basket. Each basket corresponds to a type of income such as "withholding tax interest" or "financial services income." This policy "creates unnecessary complexity and distorts business decision making."[23] And since it makes it harder for U.S. companies to get credit for taxes paid overseas, this policy means the effective tax rate on foreign-source income can be higher than the statutory tax rate in either the United States or the country where the income is earned.

  Chairman Thomas and Senator Hatch would reduce the number of baskets from nine to two, a step that would reduce double taxation, lower compliance costs, and promote tax competition.[24]

- **Allow deferral of foreign base company sales and services income.** To reduce the burden of worldwide taxation, companies are supposed to be able to "defer" U.S. taxes on some forms of foreign-source income. But another part of the tax code—Subpart F—is supposed to limit the applicability of deferral to "active" income (as opposed to investment income such as the interest companies earn in bank accounts). Even by this misguided standard, however, some types of foreign-source income are not treated properly, including income a U.S. subsidiary (the base company) in one foreign country earns by selling to another U.S. subsidiary in a different country.

  Chairman Thomas and Senator Hatch would extend deferral so that this income is protected from immediate taxation. This would lower compliance costs and allow U.S.-based multina-

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18. Merrill, "U.S. Tax Policy and International Competitiveness."
19. Roseanne Altshuler and Jack Mintz, "U.S. Interest Allocation Rules: Effects and Policy," *International Tax and Public Finance*, Vol. 2, No. 1 (1995), pp. 7–35.
20. Alan W. Cranwell, Peter R. Merrill, and Carl A. Dubert, *Taxation of U.S. Corporations Doing Business Abroad: U.S. Rules and Competitiveness Issues*, Financial Executives Research Foundation, 1996.
21. National Foreign Trade Council, "Territorial Tax Study Report."
22. Joint Committee on Taxation, *The U.S. International Tax Rules.*
23. *Ibid.*
24. Cranwell *et al.*, *Taxation of U.S. Corporations Doing Business Abroad.*

tionals to improve the efficiency of their overseas operations by centralizing sales and services functions for a number of different foreign markets within a single foreign entity.[25]

This reform also is a major step toward a territorial tax system. As noted by the U.S. Treasury in a report published in 2000, "The deferral achieved by operating abroad through a foreign subsidiary…can neutralize the effect of worldwide taxation…. Moreover, in certain circumstances, deferral can effectively make what is nominally a worldwide system into a territorial system."[26]

- **Protect against expiring foreign tax credits.** The tax code allows an American company to claim a credit for taxes paid to foreign countries, but these foreign tax credits expire after five years, and many companies lose their credits or must engage in complicated, inefficient transactions to use them. Any time a foreign tax credit expires, the U.S. company is subject to a form of double taxation that can increase effective tax rates above the tax rate either in the United States or in the country where the income is earned.

  To ameliorate this risk, the Thomas bill extends the life of foreign tax credits to 10 years, and the Hatch bill extends it to 20 years.

- **Permit repatriation of overseas income.** Deferral allows a company to postpone tax on foreign-source income, but the tax saving exists only if the company does not "repatriate" the money. Of course, discouraging the flow of capital to America is foolish.

  Chairman Thomas and Senator Hatch propose to give companies a period during which they can bring money back to the United States without having to pay the 35 percent tax rate on corporate income. Instead, the tax would be only 5.25 percent. This proposal could attract $300 billion to the American economy,[27] money that could fund new investments, increase dividends, and help pay down debt to improve balance sheets. Best of all, "pressure might then arise to 'extend' the provision, thus rendering an ostensibly temporary stimulus provision a further step toward the adoption of a territorial-type tax system."[28]

The international provisions of the tax code desperately need reform, and Representative Thomas and Senator Hatch have identified some high-priority targets for incremental reform. But many "domestic" tax policy changes could help U.S. companies become more competitive. Lowering the corporate income tax rate clearly would help, as would a shift from depreciation to expensing.[29]

The Thomas bill takes some big steps toward these goals by lowering the corporate tax rate for all businesses with less than $10 million in taxable income, extending a temporary provision that reduces the tax bias against new investment through 2005, and further reducing the burden of depreciation for manufacturing equipment. The Hatch bill, meanwhile, allows 100 percent expensing for investments through 2006.

These are important steps to fundamental tax reform. Shifting to a flat tax, needless to say, would solve all of the problems in the tax code, both domestic and international.[30]

25. Joint Committee on Taxation, *The U.S. International Tax Rules.*
26. U.S. Department of the Treasury, Office of Tax Policy, *The Deferral of Income Earned Through U.S. Controlled Foreign Corporations*, p. x, at *www.treas.gov/offices/tax-policy/library/subpartf.pdf.*
27. JPMorgan Securities, Inc., "Introducing the Homeland Investment Act," May 1, 2003.
28. Joint Committee on Taxation, *The U.S. International Tax Rules.*
29. Under current law (depreciation), companies are not allowed to deduct the full cost of new investment when calculating taxable income. Instead, they must pretend that substantial portions of investment expenditures are incurred in future years (at which point they can be deducted). Since money today has more value than money in the future, depreciation is a tax on new investment. Expensing, by contrast, is the common-sense practice of allowing companies to deduct costs when they occur.

What About Exporters?

International tax reform is complicated by an understandable desire to make sure that companies benefiting from ETI are not subject to higher taxes. At first, this does not seem that challenging. After all, most major companies are both exporters and multinationals (in other words, they have operations in other nations). Therefore, replacing the export preferences in ETI with reforms that bring America closer to a territorial system should protect most companies from a net tax increase.

Nonetheless, some companies have large amounts of export-related income and very little—if any—overseas income. Repealing ETI and using the money for international tax reform will help the economy and bring the U.S. into compliance with the WTO, but it will mean higher taxes for these companies.

In an effort to minimize the tax increase on these companies, Representatives Philip Crane (R–IL) and Charles Rangel (D–NY) have proposed to repeal ETI and use the money to create an income exclusion for large domestic manufacturing companies. However, since the Crane–Rangel bill is revenue neutral, and since the ETI money cannot be used for both international tax reform and a domestic manufacturing income exclusion, this has created a contest on Capitol Hill between supporters of the Crane–Rangel legislation and supporters of the Thomas–Hatch legislation.

Congressmen Crane and Rangel have identified an important issue. Some export-oriented companies will not see much benefit from international tax reform. These companies will benefit only from domestic tax reform, and the most important domestic reform is probably a reduction in America's onerous 35 percent corporate tax rate. Researchers have shown that exports are very sensitive to tax burdens and that a reduction of 5 percentage points in the tax rate could increase exports by as much as 20 percent.[1]

The Crane–Rangel legislation can be viewed as an indirect reduction in the corporate tax rate, albeit only for certain manufacturers. Moreover, the Crane–Rangel legislation limits their income exclusion benefit by linking it to the percentage of a company's non-U.S. manufacturing and production. This restriction effectively imposes a tax penalty on firms that expand abroad, a worrisome provision given the increasingly global nature of the economy. If the Crane–Rangel legislation were revised to reduce the corporate tax rate for all industries—perhaps down to 30 percent—the economic benefits would be much more significant. Such a revision also would address some of the criticisms leveled against the legislation.[2]

Many provisions in the Thomas bill would benefit exporters—not because of a special tax preference, but because of improvements in tax law for all companies. The legislation reduces the tax bias against new investment by shortening the depreciation lives of all manufacturing equipment from 10, seven, and five years to seven, five, and three years, respectively. This supply-side approach takes the tax code toward full expensing of investment, a component of all tax reform proposals. The bill also reduces the corporate tax rate to 32 percent for every corporation with less than $10 million in taxable income, which means a lower tax rate for 99.7 percent of all corporations.

1. Gary Clyde Hufbauer, "The Foreign Sales Corporation Drama: Reaching the Last Act?" Institute for International Economics *Policy Brief* No. PB02–10, November 2002, at *www.iie.com/publications/pb/pb02-10.pdf.*
2. Lawrence Lindsey, "How to Start a Trade War," *The Wall Street Journal*," June 25, 2003.

Conclusion

In 1960, America was home to 18 of the world's 20 largest corporations. By 1996, however, only eight of the world's 20 largest companies were based in America.[31] Tax policy surely was not the only factor in this shift, but worldwide taxation is unquestionably hindering the competitiveness of U.S.-based companies. American companies that compete in global markets face significantly higher effective tax rates than their foreign counterparts.[32]

There are many other signs that worldwide taxation imposes unacceptably high costs, including corporate inversions. Most companies that have rechartered in jurisdictions with better tax law presumably would have remained U.S. companies if America had a territorial tax system, but they were not willing to sacrifice the interests of their workers and shareholders just for the "privilege" of enduring worldwide taxation.

Cross-border mergers are another warning sign. In general, there is no reason for concern if a foreign-based company becomes the "parent" following a merger with a U.S.-based company. However, if foreign-based companies are taking over U.S.-based companies because worldwide taxation reduces the competitiveness and lowers the value of American companies—a factor that has been cited in some high-profile acquisitions of U.S. companies, such as Daimler's merger with Chrysler[33]—worldwide taxation should be repealed.

Territorial taxation is good tax policy. It is simple, it is pro–tax reform, and it will help the U.S. economy. Territorial taxation means more jobs, better jobs, and improved competitiveness of U.S. companies.

By dragging America to the WTO, the European Union has unwittingly given policymakers a golden opportunity to improve the tax treatment of internationally active U.S. companies. If Congress lacks the political will to engage in fundamental reform, it should at least go as far toward a territorial tax system as possible.

—Daniel J. Mitchell, Ph.D., is McKenna Senior Research Fellow in the Thomas A. Roe Institute for Economic Policy Studies at The Heritage Foundation.

30. For more information on tax reform, see Daniel J. Mitchell, "Jobs, Growth, Freedom, and Fairness: Why America Needs a Flat Tax," Heritage Foundation *Backgrounder* No. 1035, May 25, 1995, at *www.heritage.org/Research/Taxes/BG1035.cfm.*
31. Merrill, "U.S. Tax Policy and International Competitiveness."
32. Cranwell *et al.*, *Taxation of U.S. Corporations Doing Business Abroad.*
33. John Loffredo, "U.S. International Tax Reform," testimony before the Committee on Finance, U.S. Senate, March 11, 1999, at *finance.senate.gov/3-11loff.htm.*