

Does the Tax System Create Excessive Incentives to Move Activity Abroad?

Glenn Hubbard
Columbia University and A.E.I.

Remarks

International Tax Policy Forum
Washington DC
December 2, 2004

A Starting Point: What Do MNCs 'Do'?

- Policy debate begins with a 'model' of MNC decisions that doesn't always fit the way economists – and real people – think of MNCs
 - 'CEN' v. 'CIN' (It ain't the '60's anymore – economy and economics)
 - Focus on 'tax avoidance' in MNC location decision
- 'Imperfect competition' views of the MNC (**Horstmann and Markusen; and Devereux and Hubbard**) stress the value of outbound FDI in raising the value of domestically owned rents.

- Under fairly general conditions, cash flow taxation of outbound FDI dominates current inclusion – even if domestic investment is taxed less generously than under a cash flow tax.
- Factual basis for “runaway plant”/“runaway employee” stories is also limited.
 - **Lipsey** on location of investment – US MNCs have about three-fourths of overseas and employment in OECD countries (not tax avoidance)
 - **Slaughter** on employment in MNCs (complementarity; 2-for-1; **Lou Dobbs** needs to go back to school); others show that wage effect of “outsourcing” are modest.
 - MNCs are an intrinsic part of globalization, accounting for about two-thirds of U.S. exports

- **Feldstein** on investment: An extra dollar of FDI, in present value, leads to 70 percent more interest and dividend receipts and U.S. tax payments than an extra dollar of domestic investment.
- A number of studies have emphasized the costly effects of U.S. tax policy on “runaway headquarters”
- “Runaway revenue” is also doubtful: **Hines** finds that, among American firms, \$1 of reported foreign profitability is associated with the same level of dividend payments to common shareholders as \$3 of reported domestic profitability.

What if the U.S. Were “Territorial”?

- About half of OECD countries have a territorial tax system under which a parent company is not subject to tax on the active income earned by a foreign subsidiary; until recently, U.S. also offered only limited integration relief.

- Financial policy distortions would be reduced...
 - Adopting a territorial system would remove the incentive to delay paying dividends to avoid U.S. tax.
 - Now we don't have any experience of U.S. firms in a territorial system...
 - ...but we can compare the repatriation behavior of foreign incorporated and unincorporated affiliates
 - **Desai, Foley, and Hines** find that the repatriation tax reduces dividend payouts and economic efficiency – equivalent to an extra annual tax on U.S. on MNCs of 2.5 percent of dividends.

- ...but what about the (politically sensitive topic of) location decision?
 - Fear is that a territorial tax system would lead to a reallocation of U.S. investment to foreign locales.
 - Now we don't have any experience of U.S. firms in a territorial system...
 - ...but we can compare the behavior of firms that face no residual U.S. taxes on low-tax foreign earnings (those with excess foreign tax credits) with those that are taxed at the U.S. rate (those without excess foreign tax credits).
 - **Altshuler and Grubert** find no consistent evidence that location decisions would be significantly changed if dividend remittances were to be exempt from U.S. corporate taxation.

“Tax Reform” and Multinationals

- Pressures for reform
 - Economic efficiency aficionados (ok, a small group)
 - “International tax” reformers
 - Corporate tax reformers (Treasury/ALI/Bush?)
 - ✓ **Engen and Hassett:** U.S. statutory rate is relatively high
 - ✓ Possible implication: Financing social spending in a world with mobile capital might require greater reliance on consumption taxation.

- And territoriality...?
 - Extension of Bush's desire to eliminate dividend taxes
 - Flat Tax or CBIT
- *Bottom line*: Case that MNC's are important for the economy will shape the tax reform debate – *and* tax reform will shape MNC taxation in potentially radical ways.