University of Oregon
Department of Economics

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To: Distinguished Members of the United States Senate Committee on Finance

From: Nicholas Sly
Assistant Professor
Economics
University of Oregon

Caroline Weber
Assistant Professor
Economics
University of Oregon

This letter is a response to the call posted March 11, 2015 by Finance Committee Chairman Orrin Hatch and Ranking Member Ron Wyden to solicit data and further information about potential tax reform policies, in particular with regard to international tax policies. On March 17, 2015 the Committee also held a hearing at which statements by both the Chairman and Ranking Member cited the importance of reforming US international tax policy. In this letter, our goal is to provide information to the Committee about the potential macroeconomic implications of reforms to US international tax policies.

A key point we wish to highlight is that greater coordination on international fiscal policies with other countries is an important avenue by which national economies become more integrated. Such economic integration facilitates the transmission of macroeconomic shocks across borders, thereby exposing the US economy to the ebbs and flows of international business cycles, and visa versa. In our research, we have documented the extent to which coordination on international fiscal policies synchronizes business cycles across nations, and find economically substantial consequences.[1] By way of comparison, we find that global fiscal policies are just as important as international trade linkages in facilitating the transmission of business cycles across borders.

[1]See Sly & Weber (2015) *International Fiscal Policy Coordination and GDP Comovement*, CESifo Working Paper no. 4358.

It is always difficult to forecast the consequences of policy actions. In this instance, the best evidence available can be found looking at the effects of similar international tax policy changes over the last thirty years. In particular, bilateral tax treaties between nations alter withholding rates for multinational enterprises, adjust the appropriate tax base used to calculate foreign and domestic tax liabilities, reduce the incidence of double taxation for cross-border activities, and attempt to limit the scope for tax avoidance behavior. These are quite similar to the policy objectives held by the Committee now, and so evidence on the macroeconomic impact of bilateral tax treaties is highly informative in this context. Our research suggests that changes to US tax policy which contain rules that conform to typical bilateral tax treaties will further synchronize US business cycles with rest of the world.

To understand how reform to US international tax rules may facilitate the transmission of economic shocks, it is important to first recognize that US policy shifts will alter the effective tax rate on global activities, either by changes in the statutory corporate tax rate or by changes in rules governing, dividend exemptions, rules governing the international/domestic tax base, or transfer pricing rules. Policies that reduce effective tax rates on global economic activities can promote greater cross-border investment by multinational enterprises. The evidence from changes in bilateral tax treaty statuses confirms that foreign investment does increase significantly.[2] Subsequently, the cross-border activities of large multinational enterprises open a channel for aggregate shocks in one country to be transmitted to the host country.[3] Furthermore, the evidence confirms that the shocks transmitted by multinational enterprises can indeed have large aggregate consequences.[4]

To further detail the potential for US international tax reform synchronize international business cycles, we offer the following facts. The evidence suggests that the transmission of economic shocks is much greater between G7 nations, and that the effects of certain international fiscal coordination policies in promoting business cycle synchronization is also larger for G7 nations. However, this does not preclude the transmission of other aggregate shocks outside of the G7. For non-G7 nations in the OECD, the evidence suggests that greater fiscal coordination between nations better facilitates

[2]See Blonigen, Oldenski & Sly (2014) *The Differential Effects of Bilateral Tax Treaties* American Economic Journal: Economic Policy 6(2) pp 1-18

[3]See Kleinert, Martin, & Toubal (2014). *The Few Leading the Many: Foreign affiliates and business cycle comovement*, American Economic Journal: Macroeconomics.

[4]Cravino & Levchenko (2014) *Multinational firms and international business cycle transmission* mimeo University of Michigan.

the transmission of shocks to nations' GDP trends, rather than shorter-run business cycle shocks.

Our aim in this letter is not to offer normative policy recommendations, but rather to provide the Committee with evidence on the potential consequences of international tax reform that may better inform the policy debate. Although international tax rules affect only domestic agents that have global economic interests, there is substantial evidence that international tax policy rules influence domestic aggregate economic fluctuations. We feel that these facts are of first-order importance to the policy debate on international tax rules. If the members of the Committee would like further details about these, or related, issues we will gladly respond to such a request.

Sincerely,

Nicholas Sly
*Economics*
*University of Oregon*
*sly@uoregon.edu*
*541.346.4676*

Caroline Weber
*Economics*
*University of Oregon*
*cweber5@uoregon.edu*
*541.346.4677*