Testimony before the Committee on Finance,
United States Senate
Washington, DC
September 8, 2011

Statement of James R. Hines Jr.

Mr. Chairman and Members of this distinguished committee, it is an honor to participate in these hearings on international tax reform. I teach at the University of Michigan, where I am the Richard A. Musgrave Collegiate Professor of Economics in the department of economics and the L. Hart Wright Collegiate Professor of Law in the law school, and where I serve as Research Director of the Office of Tax Policy Research in the Stephen M. Ross School of Business. I taught for years at Princeton and Harvard prior to joining the Michigan faculty, and have been a visiting professor at Columbia University, the London School of Economics, the University of California – Berkeley, and Harvard Law School. I am a Research Associate of the National Bureau of Economic Research, the Research Director of the International Tax Policy Forum, a past Co-Editor of the American Economic Association's *Journal of Economic Perspectives*, and current Co-Editor of the *Journal of Public Economics*.

U.S. international tax policy has multiple objectives that are commonly thought to be in conflict. These objectives include promoting the well-being of American workers, maintaining and enhancing the competitiveness of U.S. firms in the international marketplace, and generating tax revenue necessary to finance government operations. In fact, sound tax policy that encourages the efficient use of economic resources advances all of these objectives simultaneously, so there need be no contradiction whatsoever in attempting to pursue them all – provided that U.S. policy adheres to the principle of efficiency.

The welfare of American workers is an obvious and central concern of U.S. economic policy. In a market economy such as the United States, workers are paid according to their productivities, reflecting that firms have choices about whether or not to hire. If firms can earn profits by employing additional workers at prevailing wages, they will do so; and they will not hire workers otherwise. Since this is simultaneously true of all firms in the economy, in a competitive market economy it follows that tax (and other) policies that enhance labor productivity increase demand for American workers and thereby improve wages and job prospects, whereas policies that reduce labor productivity have the opposite effect.

This fundamental insight of labor economics carries implications for the impact of U.S. international tax policy, since tax reforms will improve the prospects of American workers if they lead to improvements in worker productivity. Worker productivity is in turn a function of the extent to which firms are able effectively to deploy labor to contribute to output. Firms that face efficient incentives are more productive than firms that do not, so to the extent that U.S. international tax policy creates efficient incentives it will increase demand for American labor.

There is a widespread, and perfectly valid, concern that international capital mobility makes it costly and difficult to attempt to tax income earned by mobile business operations. What is less readily recognized outside of the economics literature is that the theory of international capital mobility implies that the burden of U.S. taxes imposed on mobile capital is borne largely if not entirely by factors that are fixed in the United States, of which by far the most important productive factor is labor. In a setting with highly mobile capital, greater business taxes depress labor demand and therefore depress wages, the mechanism being that greater business taxes discourage capital investment, thereby reducing labor productivity and wages. Complete capital mobility implies that wages bear the full burden of business taxes, plus

the burden of any inefficiencies induced by the tax system. Consequently, workers benefit most from a system that taxes businesses efficiently.

Tax revenue is also enhanced by efficient business taxation. This is true almost by definition, since efficient taxation raises revenue with the least collateral damage to the economy, thereby making it possible to generate tax revenue at the lowest possible cost. Since it is inevitably costly to raise tax revenue, and these costs typically limit the government's recourse to tax alternatives, it follows that efficient taxation has the greatest revenue potential of all of the feasible options.

All of this begs the question of what system of international taxation promotes efficiency from the standpoint of the United States. An efficient international tax system shares some features of tax systems in many of the countries with which the United States competes, specifically in exempting active foreign business income from U.S. taxation. Exempting foreign income from taxation would promote efficient ownership of productive assets, domestic and foreign, by U.S. businesses. Such a policy would thereby contribute to the vitality of the U.S. economy, the benefits of which would be felt primarily by U.S. workers in the form of greater employment opportunities and higher wages. Efforts to move in the other direction by limiting deferral of home country taxes or limiting the extent to which taxpayers can claim credits for foreign tax payments unfortunately would have the effect of inefficiently distorting ownership of productive assets, thereby reducing the productivity of U.S. business operations and reducing the welfare of U.S. residents, primarily American workers.

It may appear illogical that the way to contribute to economic activity and economic wellbeing in the United States is to lighten the taxation of foreign income. On further reflection, however, it is clear that the benefits of appropriate taxation of foreign income are simply

applications of commonly accepted (and perfectly valid) market principles that guide other economic policies. In an extreme case, it is obvious that the economic consequences of a policy banning U.S. firms from engaging in any foreign business activity would be disastrous, not only to the firms concerned but also to American workers, since modern businesses rely on foreign operations for significant fractions of their profitability, and these foreign operations contribute to the profitability of domestic operations of the same companies. If American firms were banned from foreign business activity, then they would shortly find themselves unable to compete effectively against British, Japanese, German, Canadian, and other companies not facing the same restrictions. Furthermore, even if they did not face such competition, the primary effect of such a silly ban would be to reduce their productivity and profitability, to the great detriment of everyone connected with American business.

The issue of banning foreign business activity is relevant because some of the very intuitive arguments advanced in favor of taxing foreign business operations more heavily than we do are also arguments that could be used to support banning foreign business operations altogether. We certainly do not want to do the latter, and therefore need to ask ourselves why we want to do the former. Of course these policies differ, and in fairness many of the concerns about taxing foreign business operations stem from an understandable desire to avoid subsidizing foreign business activity at the expense of domestic activity. But here is the point: exempting active foreign business income from domestic taxation is not a tax subsidy. This income is subject to taxation by foreign governments, and in order to earn foreign income, American firms must compete against other firms whose governments generally do not subject their foreign income to home-country taxation. These competitors drive down the rates of return to

investment available in low-tax foreign locations, making them not the bargain they appear from a simple comparison of tax rates.

The opportunity to earn income in low-tax foreign jurisdictions can be thought of simply as the opportunity to do business in places where a certain kind of cost – in this case, foreign tax cost – is lower. As a general matter, the United States benefits when our companies have low-cost business opportunities. If this were a different kind of business cost – the cost of a raw material, for example – there would be no discussion of the need to impose an offsetting charge on the foreign operations of U.S. companies that use low-cost materials abroad. We should think of the tax system similarly, and be appropriately wary about the desirability of subjecting foreign income to U.S. taxation in order to compensate for low tax rates in some countries.

The economic costs of a residence-based income tax system include that U.S. firms lose the opportunity to earn profits in foreign markets from which they are driven, which reduces the rate of return to domestic activities that make foreign operations otherwise profitable. It is this distortion to economic activity that produces the largest component of the efficiency cost associated with the U.S. regime of worldwide taxation. Compared to other countries, the U.S. system of taxing foreign income discourages foreign asset ownership generally, and in particular discourages the ownership of assets in low-tax foreign countries. Mihir Desai and I have estimated the net tax burden on American firms from the U.S. system of worldwide taxation to be in the neighborhood of $50 billion per year, well exceeding revenue collections, since a significant portion of the net burden comes in the form of the associated efficiency cost.

One of the striking features of U.S. corporate taxes in 2011 is that, putting aside for the moment considerations of deferral and foreign tax credits, the United States imposes a higher effective tax rate on foreign business operations than on domestic operations. The reason is that

many important credits and deductions, including the research credit, immediate expensing of equipment investment, and the domestic production activities deduction, are limited to activities that take place in the United States. It is understandable that the United States wants to encourage business activity by reducing associated tax liabilities, but it is misguided to restrict the benefits to domestic activities – for the same reasons why it would be a mistake to ban foreign business operations altogether. Instead of subjecting foreign income to higher effective tax rates than domestic income, the United States should move in the opposite direction, join the rest of the capital exporting world, and exempt active foreign business income from home country taxes.

What would be the consequence of exempting active foreign business income from U.S. taxation? The greater productivity associated with improved incentives for asset ownership would enhance the productivity of factors that are fixed in the United States, primarily labor, and thereby increase the returns that they would earn. Statistical evidence suggests that the associated rise in outbound foreign direct investment would not reduce the size of the domestic capital stock, but instead increase it. This evidence includes a study of my own with Mihir Desai and Fritz Foley, examining the aggregate behavior of U.S. multinational firms over a number of years, but also includes aggregate evidence for Australia, industry-level studies of German and Canadian firms, and firm-level evidence for the United States, the United Kingdom, and Germany. Mihir Desai, Fritz Foley and I find that for American firms between 1982 and 2004, 10 percent greater foreign capital investment is associated with 2.6 percent greater domestic investment, and 10 percent greater foreign employment is associated with 3.7 percent greater domestic employment. Foreign investment also has positive estimated effects on domestic

exports and research and development spending, indicating that foreign expansions stimulate demand for tangible and intangible domestic output.

Hence there are good reasons to think that exempting active foreign business income from U.S. taxation would stimulate greater economic activity, and greater labor demand, in the United States. It follows that the opposite is also true: reforms that would curtail the ability of U.S. taxpayers to defer home country taxation of foreign profits or the ability to claim foreign tax credits would reduce the productivity of U.S. business operations and thereby reduce economic activity in the United States.

The appropriate scope of U.S. international taxation is another issue, specifically concerning the standard to apply in determining whether a corporation is resident in the United States for tax purposes. The current standard is based on the site of incorporation, which has the virtue of relative legal clarity and conformance with economic principles. Countries around the world differ in the criteria that they apply to determine corporate residence, some using systems similar to that used by the United States, and others basing corporate residence on the site of active management and control.

It would be a serious mistake for the United States to adopt a management and control standard. Quite apart from the knotty issue of determining the site of active management and control, the problem with defining corporate residence in this way is that doing so effectively transforms a portion of the corporate tax from a tax on the return to business assets into a tax on active management and control. This obviously discourages firms from locating management activities in a country that uses such a standard, which is not sensible if management activities are thought to be desirable. Furthermore, even if management activities do not relocate in response to the imposition of the tax, the economic impact of the tax on management activities

can still be substantial, since an activity managed in the United States (say, if the U.S. were to adopt such a system) would have much smaller scope as a result, because by virtue of the U.S. site of management, and therefore U.S. taxation, the burden on foreign operations is thereby increased.

There is an important question of the appropriate tax treatment of domestic expenses incurred by firms with foreign income, particularly costs that are difficult to attribute directly to income produced in certain locations; important examples include expenses for interest payments and general administrative overhead. Practices differ in countries around the world, and indeed, U.S. practice has varied over time, but the current U.S. tax treatment is squarely on the side of allocating domestic expenses between foreign and domestic income based on simple indicators of economic activity. Thus, for example, an American multinational firm with 100 of domestic interest expense is not permitted to claim as many foreign tax credits as is an otherwise-equivalent American firm without the interest expense, reflecting the theory that a portion of the borrowing on which interest is due went to finance foreign investment.

Expense allocation of the variety embodied in current U.S. tax law has a decided intuitive appeal. It carries the general implication that domestic expenses that are incurred in the production of foreign income that is exempt from U.S. taxation (as is the case, for example, of income earned in countries with very high tax rates, for which foreign tax credits are available) are effectively not permitted domestic tax deductions (via an equivalent reduction in foreign tax credit limits). While there is much to be improved in the details of the current U.S. rules governing expense allocation, the general structure of expense allocation is largely consistent with the rest of the U.S. system of attempting to tax foreign income in a manner that vaguely embodies the principle of capital export neutrality.

Taking as a premise that capital export neutrality is an unsatisfactory basis for taxing foreign income, and that the United States would instead prefer to join virtually all other capital exporting countries in exempting foreign income from taxation based on capital ownership considerations, then what kind of expense allocation regime properly accompanies the exemption of foreign-source dividends from domestic taxation? The answer is that domestic expenses must not be allocated at all, but instead permitted to be fully deducted in the country in which they are incurred.

A tax system that allocates expenses has the effect of distorting ownership by imposing a tax cost on foreign investment, since greater foreign asset ownership, or business activity, reduces the deductions a taxpayer is entitled to claim. The only sense in which this tax differs from a more conventional tax on foreign income is that it does not vary with the rate of foreign profitability. The fact that a simpleminded expense allocation rule acts just like a tax on foreign investment might at first suggest that those who design policy should seek alternative expense allocation systems that do not create these incentives. Unfortunately, there is no clever solution available to this problem: any system that allocates expenses based on a taxpayer's behavior will have the effect of influencing that behavior, in the same way that a more conventional tax would. An alternative system of tracing expenses, in which taxpayers determine and report the uses to which deductible expenses are put, does not have this feature but creates ample opportunities for tax avoidance. Hence policies designed to avoid taxing foreign income necessarily must forego allocating expenses incurred domestically.

This implication of foreign income exemption seems to run afoul of obvious objections from the standpoint of tax arbitrage. Why should the United States permit taxpayers to borrow in the United States, using the proceeds to invest abroad, and thereby earn income that is exempt

from U.S. tax while claiming deductions against other U.S. taxable income for the cost of their borrowing? Even the observation that this is exactly what many other countries do has the feel of not fully addressing this issue. The answer lies in the fact that greater foreign investment triggers added domestic investment, so from the standpoint of the U.S. tax system, the borrowing does not simply generate uncompensated interest deductions, but instead a domestic tax base that is equivalent to (quite possibly greater than) the tax base that would be forthcoming if the borrowing proceeds were invested domestically by the same entity that does the borrowing.

If the goal of a tax system is properly to raise revenue while offering appropriate economic incentives, and these are understood to include efficient incentives for capital ownership, then the simple exemption of foreign income from taxation is insufficient without accompanying expense allocation rules. Exempting foreign income from taxation gives taxpayers incentives to allocate their resources to maximize after-local-tax profits only if there is no unwinding of these incentives through expense allocation that depends on where income is earned or where other expenses are incurred. Permitting full deductibility of domestic expenses need not be viewed as a daring step. The same logic that underlies the efficiency rationale behind exempting foreign income in the first place also implies that expenses should be deductible where incurred.

There are sure to be both revenue concerns and other concerns associated with a reform that exempts foreign income from taxation and permits deduction of domestic expenses. Removal of U.S. taxation of active foreign business income would increase the importance of effective enforcement of the transfer pricing rules and other rules designed to protect the U.S. tax base. It would, however, be a mistake to maintain the current regime of taxing foreign income simply out of concern over base erosion of this type, given that there are many ways of

addressing these issues. For example, elimination of U.S. taxation of active foreign business income might be accompanied by allocating significant additional resources to the Internal Revenue Service for use in international enforcement. Given the alternatives before us, it would be a serious mistake to think that enforcement concerns alone dictate the maintenance of an inefficient system of taxing worldwide income.

The inefficiencies associated with the current U.S. system of international taxation include not only distortions to the ownership of productive assets, but also the financing of firm operations. It has been widely documented that the current system of repatriation-based taxation discourages repatriations, as a result of which firm financing is less than optimal, to the detriment of productive management of operations. In a very real sense the U.S. system of taxing international income can be viewed as a tariff on international transactions, with all of the distortions and inefficiencies for which tariffs are known. Economic growth in the modern era, the prosperity of the country and its prospect for future prosperity, relies on international transactions, impediments to which reduce national income, and reduce the prospects for American workers.