CATO HANDBOOK FOR CONGRESS

POLICY RECOMMENDATIONS FOR THE 108TH CONGRESS

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62. International Tax Competition

Congress should

- protect American fiscal sovereignty from foreign tax harmonization initiatives;
- require the withdrawal of the proposed IRS regulation that would mandate the reporting of foreign investors' interest earned in the United States;
- oppose anti-competitive legislation that would restrict companies from reincorporating abroad; and
- pursue fundamental tax reform, including substantially cutting the high federal corporate income tax rate and adopting a territorial tax system.

Individual citizens choose where to work, invest, and shop. Businesses choose where to locate research, production, and headquarters functions. In making those choices, individuals and businesses consider a range of economic factors, including the attractiveness of tax regimes. Tax competition occurs when governments respond to tax changes that occur in neighboring jurisdictions that affect their ability to attract individuals, businesses, and investment. Competition can take place between governments at the national, state, and local levels.

With more open international borders, it is easier for individuals and businesses to avoid high-tax countries, which makes it more difficult for governments to enforce oppressive tax burdens. In the past decade, cross-border investment flows have soared. As a result, U.S. policymakers need to exercise budget discipline and reduce tax rates in order to attract and retain investment.

When there is tax competition, countries have a strong incentive to move away from excessive taxes on capital, including taxes on business profits, dividends, interest, and capital gains. Businesses and investors can

quickly respond to differences in capital taxes by reallocating mobile capital income to lower-tax countries. That phenomenon occurs, for example, when U.S. companies consider moving their headquarters abroad to escape from the high U.S. corporate income tax rate and the complex "worldwide" tax system imposed by the federal government. Tax competition is a positive force because it creates pressure to reduce economically damaging taxes, such as the corporate income tax. Reductions in the corporate tax are also beneficial because it is a hidden tax that ultimately falls on individuals. Thus reducing the corporate tax moves the tax system toward more transparency and helps taxpayers to better measure the size and the cost of government.

Tax competition provides incentives to policymakers to implement more efficient budget policies and eliminate unneeded spending programs. Tax competition pushes tax rates down, allows citizens to enjoy more of their earnings, and creates a business environment more conducive to entrepreneurship and economic growth.

Tax competition is illustrated by the substantial reductions in personal and corporate income tax rates in nearly every industrial country since the U.S. tax cuts of the 1980s. The average top individual income tax rate for members of the Organization for Economic Cooperation and Development fell from 55 percent in 1986 to 41 percent by 2000, and the average top corporate tax rate for members fell from 41 percent in 1986 to 32 percent by 2000.

Also, capital gains taxes, withholding taxes, and wealth taxes have been cut in numerous countries. While politicians in many countries have become more pro-market in recent decades, they have also been pushed to reduce tax rates because investors and entrepreneurs were shifting their activities to lower-tax countries.

Although recent tax reductions have been very beneficial to the U.S. and foreign economies, tax competition has not yet reduced overall tax burdens (tax revenues measured as a percentage of gross domestic product) in most countries. Part of the reason overall burdens have remained high is that governments have taken heavy-handed measures to try to protect their tax bases. Such measures have included enactment of complex tax rules on foreign business income, efforts to limit tax competition through international pressure on low-tax nations, attacks on financial privacy, and protectionist legislation to restrict companies and taxpayers from relocating in more attractive tax jurisdictions. Congress needs to oppose such anti-competitive measures because they undermine U.S. economic strength.

Protect American Fiscal Sovereignty from Foreign Tax Harmonization Initiatives

Tax competition and lower tax rates are very good for stimulating long-term economic growth. However, many policymakers favor income redistribution over growth and, as a result, seek to undermine and halt the process of tax competition.

The European Union and OECD have been at the forefront of global efforts to stifle tax competition. In recent years, there have been a number of efforts to harmonize tax systems across countries to limit competition in the manner of a cartel. The EU has led that effort by pushing its member countries to harmonize their tax systems. The most far-reaching EU harmonization initiative has been the imposition of a minimum standard value-added tax rate of 15 percent in 1992. The EU has also tried to get member countries to harmonize income tax rates and has tried to get the United States to impose taxes on Internet sales.

At the international level, the EU and OECD have focused on indirect methods of nullifying tax competition, such as information sharing between governments. The EU is promoting a scheme known as the EU Savings Tax Directive. The OECD has pursued a policy against what it calls ''harmful tax competition.'' OECD reports in 1998, 2000, and 2001 identified ''harmful'' tax practices by OECD member countries and listed 41 low-tax jurisdictions of which the OECD disapproves.

The EU and OECD initiatives aim to give tax collectors in each country access to information about the economic activities of their citizens abroad with the aim of reducing 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. However, unconditional information exchanges raise serious issues of financial privacy and national sovereignty and undermine beneficial tax competition.

Another threat is the United Nations, which has come out in favor of restricting international tax competition. A high-level UN panel in 2001 suggested creating an International Tax Organization that would harmonize tax policy, engage in surveillance of tax systems, and push countries to ''desist from harmful tax competition.'' Such a new bureaucracy surely would have a strong bias toward tax increases. The UN report suggests creation of a ''global source of funds'' from a ''high yielding tax source.'' It also suggests study of a ''Tobin tax'' on foreign exchange transactions to finance ''global public goods.'' And it says that an ITO

‘‘could take a lead role in restraining the tax competition designed to attract multinationals.’’

Some observers think that an ITO might be like the World Trade Organization, which handles trade disputes. But while most economists agree on the benchmark of free trade, there is no such benchmark in the tax world. Proponents of broad-based income taxes and proponents of consumption-based taxes would come to vastly different conclusions about what an ITO should enforce. Fortunately, the UN has not yet acted on its proposals.

Congress 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 that preclude pro-growth tax reforms very much needed in America.

Require the Withdrawal of the Proposed IRS Regulation That Would Mandate Reporting of Bank Deposit Information on Foreign Investors

In July 2002, the IRS commissioner issued a regulation (REG 133254-02) to help foreign governments tax income earned in America. The proposal is based on a scheme that was proposed by former president Clinton three days before he left office. The IRS regulation would force U.S. banks to report the deposit interest they pay to account holders from other countries. It would target residents of 15 European nations and a few other countries such as New Zealand and Australia.

The IRS regulation is bad economic policy and disregards the intent of Congress regarding current tax policies. Interest earned on bank deposits paid to individual foreign investors has been tax-free for many years. On several occasions, Congress has debated whether or not to retain this tax exemption, and it has determined to keep it because it helps draw inflows of investment to the U.S. economy.

Note that this proposed regulation is designed, not to help the U.S. government collect taxes, but to help foreign governments collect their taxes. The IRS has not completed a required cost/benefit analysis of the proposal. Such as analysis would probably find that the regulation would have a damaging effect on the economy as foreign investors withdrew funds from U.S. banks. Figures from the U.S. Department of Commerce show that the market value of private foreign investment in the United States at the end of 2000 was about $9 trillion, with about $1.8 trillion held in bank deposits that would be vulnerable to flowing out of the

country if the regulation was imposed. Investment would be shifted to lower-tax jurisdictions that have greater privacy. It makes no sense to inflict such damage on the American economy. The IRS should withdraw this regulation.

Oppose Anti-Competitive Legislation That Would Restrict U.S. Companies from Reincorporating Abroad

Because the U.S. tax code burdens U.S. firms with high tax rates and complex and uncompetitive rules, a growing number of companies are moving their place of incorporation to foreign jurisdictions. In a transaction, referred to as an inversion, a U.S. company is placed under a newly created foreign parent company formed in a low-tax jurisdiction. That allows companies to reduce taxes paid to the U.S. government on their foreign operations. They do not typically change their actual business structure, and they continue to pay taxes on U.S.-source income to the U.S. government.

Corporate inversions are part of the broader dynamic of rising global tax competition. A 2002 U.S. Treasury report recognizes that inversions raise broad issues of business tax burdens and calls for a comprehensive reexamination of U.S. international tax rules. Yet, rather than tackle the underlying problems of an uncompetitive corporate income tax, many members of Congress are trying to hinder competitive relocations with laws that represent narrow-minded fiscal protectionism. The political quick-fix proposals introduced during the 107th Congress generally aimed to tax foreign parent companies created for an inversion as if they were U.S. companies, if they retain basically the same structure they had before inversion. Various tests would be created to determine whether particular firms should be treated as foreign or domestic.

Sponsors of those proposals claimed that companies are currently exploiting a ‘‘loophole’’ that needs to be closed. But the tax advantage that foreign companies have over U.S. companies in world markets is not a loophole. It is a systematic problem with the U.S. tax code. Indeed, the tax savings that U.S. firms gain by incorporating abroad are one measure of the excessive U.S. business tax burden.

Even if anti–corporate inversion legislation passes, the basic tax advantage of foreign firms would remain. As a result, foreign firms will continue to acquire U.S. firms at a rapid pace. U.S. firms will continue to be at a cost disadvantage in world markets and will have less cash available to hire U.S. workers and pay U.S. shareholders. Also, a growing number of

forward-looking U.S. start-up firms may decide to incorporate abroad to enjoy long-term tax savings without having to go through the complex and costly process of inversion.

Anti-inversion legislation offers no economic benefits; it simply raises tax costs for U.S. companies and complicates the tax code. Congress should reject protectionist anti-inversion legislation and stop putting off long-overdue business tax reforms.

Engage in Fundamental Tax Reform by Substantially Cutting the Corporate Income Tax Rate and Adopting a Territorial Tax System

Secretary of the Treasury Paul O'Neill has noted, ''If the tax code disadvantages U.S. companies competing in the global markets, then we should address the anti-competitive provisions of the code.'' Policymakers can begin right away with two basic steps:

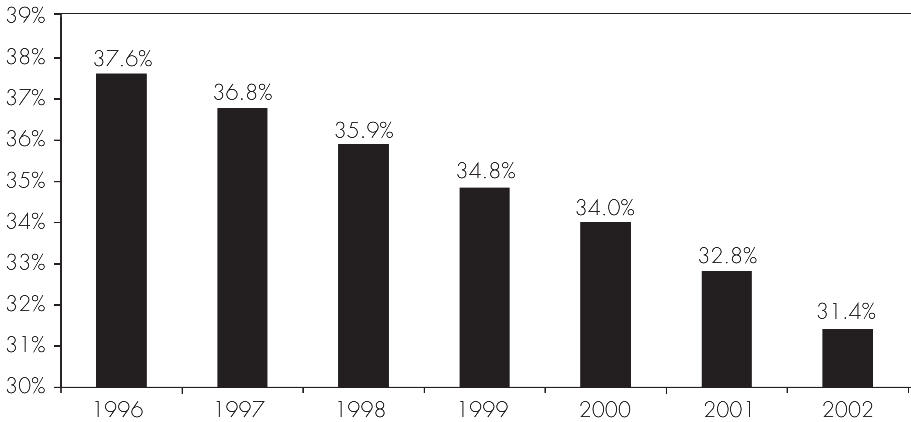
Cut the Corporate Tax Rate

The recent rise in corporate inversions is a warning that the U.S. corporate tax has become dangerously uncompetitive. When the United States led the world in 1986 by cutting the corporate rate from 46 to 34 percent, most major countries followed suit and some surpassed us by cutting even further. But the United States then raised its rate to 35 percent and piled ever more complex tax rules on international businesses. At 40 percent (federal plus the state average), the U.S. corporate income tax rate is the fourth highest in the 30-country OECD (Figure 62.1).

A substantial cut in the corporate tax rate would greatly reduce the inversion problem and other corporate tax avoidance problems that have concerned policymakers. For example, there has been concern about ''earnings stripping,'' which occurs when foreign parent firms lend excessively to their U.S. subsidiaries in order to reduce U.S. taxable income with large interest deductions. Lowering the statutory tax rate would reduce the incentive for earnings stripping.

In a global economy with 60,000 multinational corporations and trillions of dollars of investment funds searching for good returns, the high U.S. corporate tax rate is not sustainable. Unless the United States substantially cuts its tax rates, wasteful tax avoidance will increase, complex and uncompetitive legislative responses will ensue, and the performance of the U.S. economic engine will suffer.

Figure 62.1
Average Top Corporate Income Tax Rate in the OECD



SOURCE: Cato calculations based on KPMG data. Unweighted averages.

Adopt a Territorial Tax System

Along with a lower rate, the United States should adopt a territorial tax system. That would eliminate the need for corporate inversions and allow U.S. firms to compete on a level playing field in foreign markets.

A territorial system would be much simpler than the complex worldwide system that has been built piecemeal over decades without a consistent foundation. As the Treasury study notes, ''The U.S. rules for the taxation of foreign-source income are unique in their breadth of reach and degree of complexity.'' Many of those rules would be done away with under a territorial system. The ultimate solution is to replace our income-based tax system with a low-rate territorial system that has a consumption base. That way, global corporations will be encouraged to move their operations and profits into the United States rather than flee to lower-tax climates.

Suggested Readings

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