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Senator Kerry on Corporate Tax Reform: Right Diagnosis, Wrong Prescription

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Summary

Senator John Kerry has proposed a major overhaul in corporate taxation, with the goal of persuading multinational companies (MNCs) to employ more workers at home and fewer abroad. Kerry has correctly emphasized that domestic production is often taxed at a higher rate than production abroad, but his prescriptions will not boost US jobs.

The core features of the Kerry plan are to cut the US corporate tax rate from 35 to 33.25 percent and to limit deferred US taxation of foreign subsidiaries of US-based MNCs. In addition, Kerry would offer a short tax holiday for MNCs to repatriate their accumulated foreign earnings at a special rate of 10 percent; the revenue would be allocated to fund a New Jobs Tax Credit.

Rewriting the US tax code to limit deferred taxation of foreign earnings would prompt a series of responses by US-based MNCs. Relocating production in the United States—Senator Kerry's goal—is unlikely to be the central response. Instead, MNCs would explore alternative ways to avoid the higher US tax burden and might well sell their operations abroad to foreign-based MNCs. Senator Kerry's plan could even spark "corporate offshoring"—reincorporating the parent firm outside the United States in order to completely avoid US taxation of non-US operations.

Under Kerry's plan, moreover, foreign-based MNCs would gain further tax advantages over US companies in worldwide markets—giving them a leg up in future expansion. Experience shows that when US-based MNCs expand abroad, they also add jobs at home. If foreign-based MNCs have a leg up, this source of US employment gains would be discouraged, contrary to Kerry's objectives.

Our analysis suggests that limiting deferral as Senator Kerry has proposed would raise a maximum of $6 billion annually. Since his proposed cut in the US corporate rate (from 35 to 33.25 percent) would cost approximately $12 billion annually, the plan would be significantly underfunded.

Likewise, the tax holiday on accumulated earnings would not raise anything like the $22 billion mentioned by a Kerry aide as the amount committed to the proposed New Jobs Tax Credit over a two-year period.

Alternative changes in US business taxation policies would better address the tax tilt that now favors investment and production abroad. Under current WTO rules, US exporters must pay on importing nations' value added tax (VAT), but foreign exporters selling in the US market are exempted from their home-country VAT. WTO rules do not permit the United States to levy its corporate income tax on imports nor to exempt its corporate tax on exports. Correcting this archaic distinction between *indirect* and *direct* taxes—by reforming the WTO rules that allow border tax adjustments for indirect taxes but prohibit them for direct taxes, a distinction that most tax experts no longer view as compelling—would significantly promote US production and jobs.

If the WTO rules were reformed, one of two outcomes would result. Either foreign governments would no longer be permitted to use border tax adjustments to encourage exports and discourage imports or the US government could impose its corporate tax on imports and exempt its exports from corporate tax. Either outcome would level the tilt in international taxation as it affects sales of goods and services in the US market. This would be a far superior response to Senator Kerry's core concern than his own tax proposals. Moreover, WTO reform would redress the root grievance underlying the 30-year tax war between the United States and Europe over the Domestic International Sales Corporation (DISC) and the Foreign Sales Corporation (FSC).

Introduction

On March 26, 2004, Senator Kerry proposed a major overhaul in the taxation of US corporations doing business at home and abroad (Kerry 2004). Kerry's proposed reforms are intended to make the United States a more competitive business location and to deter both blue-collar and white-collar offshore outsourcing by US MNCs. Our analysis indicates that the proposed reforms would do more to benefit foreign-based MNCs than to prompt US-based MNCs to relocate operations in the United States. Moreover, Senator Kerry's revenue estimates are overoptimistic: The funds raised would fall far short of the amounts required to fund his proposed corporate tax rate cut and his New Jobs Tax Credit.

The Kerry Plan

The Kerry plan is designed to be revenue-neutral, reducing corporate taxes on operations at home by increasing the corporate tax burden on operations abroad. It has six key features:

- The Kerry plan would significantly limit "deferral"—the tax practice whereby profits that foreign subsidiaries (also known as controlled foreign corporations, or CFCs) earn are not taxed until repatriated as dividends to the US parent company.[1]

- Deferral would, however, still be permitted for CFC income that was earned by producing and selling *in the country* where the CFC is based.

- The foreign tax credit would still be allowed for foreign corporate and withholding taxes paid on CFC profits and dividends. Consequently, the US Treasury would collect additional tax revenue only on nondeferred profits earned in countries where the combined corporate and withholding tax rate was less than the US effective corporate rate (currently a 35 percent statutory rate but usually a lower effective rate).[2] Kerry estimates that annual US revenue gain would be $12 billion.

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[1] In tax parlance, foreign subsidiaries are known as controlled foreign corporations (CFCs) when the US parent firm controls, directly and indirectly, more than 50 percent of voting shares or, alternatively, holds more than 50 percent of the total value of voting shares.

In 1962, Subpart F was added to the Internal Revenue Code to end deferral for "passive" CFC income (such as interest, dividends, and royalties) when lodged in "tax-haven" countries (e.g., Bermuda, Netherlands Antilles, and the Cayman Islands). Since its enactment, Subpart F has been progressively expanded (especially with respect to the definition of passive income) and is now exceedingly complex. The Kerry plan would extend Subpart F to all CFC profits, except those earned by production and sale within the CFC's own country. For the history of deferral and other US international tax concepts, see Hufbauer (1992). Almost 30 years ago, C. Fred Bergsten, Thomas Horst, and Theodore Moran (1978, chapter 6) advocated the elimination of deferral, but at the same time they endorsed other changes that would benefit US-based MNCs. In 1978, when Bergsten and his colleagues authored their volume, US-based MNCs dominated worldwide foreign investment; of course, this is no longer true.

[2] This statement is a rough characterization of the very complicated US system of taxing foreign income. For example, due to artificial interest allocation rules, the United States sometimes collects a residual tax even when foreign taxes exceed 35 percent of earnings and profits (E&P) measured under US tax accounting standards.

• The additional revenue would be used to reduce the US corporate tax rate from 35 to 33.25 percent.[3]

• Further, the Kerry plan would give MNCs a one-year tax holiday to repatriate past CFC earnings by paying a special toll tax of 10 percent, provided the funds are reinvested in the United States and provided the repatriations are in excess of a base period amount. Senator Kerry did not estimate the amount of toll tax revenue.

• However, revenue from the special toll tax would be used to fund a New Jobs Tax Credit. The new credit would be calculated as the employer's increase in payroll tax costs on account of hiring additional workers. It would be available only to firms in "manufacturing and other industries affected by outsourcing," as determined by the secretary of the treasury.

In presenting his plan, Senator Kerry emphasized that US firms often pay higher corporate taxes than their competitors abroad—competitors based not only in current and emerging industrial powers such as the United Kingdom, France, China, India, Malaysia, Korea, Brazil, and Mexico but also in smaller low-tax countries such as Ireland, Singapore, Taiwan, and Hong Kong.[4] Kerry also emphasized that some MNCs engage in tax abuse, through "corporate inversions" (moving their headquarters to tax-haven countries such as Bermuda), "hybrid structures" (partnerships in the eyes of one country, corporations in the eyes of another), and "cross-crediting" (using the foreign tax credit on dividends from high-tax country A to shield dividends from low-tax country B against US taxation).[5]

The location and abuse problems that have captured Senator Kerry's attention are a consequence of differences in national corporate tax practices in an open world economy. Firms are not only free to produce in one location and sell in another but also have some latitude to choose where profits are booked. Tax considerations do not control most business decisions on where to produce and do not determine where most profits are booked. But taxes do have influence at the margin. Other things being equal, an MNC will prefer to produce in country A with a low tax rate rather than country B with a high tax rate. Likewise, an MNC may consider tax stratagems (such as hybrid structures, corporate inversions, and artificial transfer pricing) that enable it to book profits in country A rather than country B.[6]

Senator Kerry's proposed reforms would do more to benefit foreign-based MNCs than to prompt US-based MNCs to relocate operations in the United States.

Right Diagnosis

Senator Kerry's diagnosis—that the US corporate tax system disadvantages firms that produce in the United States—is basically correct. Moreover, US corporate tax rates are sufficiently high that some MNCs may be tempted to deploy strategies that book profits in low-tax jurisdictions.

Table 1 shows that the average effective foreign corporate tax rates actually paid by CFCs are considerably lower in a number of countries than the average effective (federal plus state) corporate tax rate paid in the United States. This is true not only of low-tax countries such as Singapore, Hong Kong, and Ireland and tax-haven countries such as Bermuda, Netherlands Antilles, and the Cayman Islands but also of major industrial competitors such as France, the United Kingdom, China, Taiwan, Mexico, and Brazil.

[3] These are federal statutory rates; the effective rate (federal and state) is currently 30.1 percent. According to GAO (2004), the majority of corporations operating in the United States report no federal tax liability at all. In 2000, 38 percent of large foreign-controlled corporations and 45 percent of large US-controlled corporations reported no tax liability. (Large corporations are defined as those with assets of at least $250 million or gross receipts of at least $50 million.) Some 63 percent of all US-controlled corporations (large and small) reported no tax liability in 2000.

[4] We define low-tax countries as those with average effective corporate rates of 20 percent or less.

[5] Most tax practitioners do not regard "cross-crediting" as an abuse. Cross-crediting is a feature of the overall, as opposed to the per-country, limit on the foreign tax credit (Hufbauer 1992). In 1978, Bergsten, Horst, and Moran (1978, chapter 6) joined other commentators in recommending a per-country rather than an overall limit on the foreign tax credit. The basic argument is that, from the standpoint of tax neutrality, it doesn't make sense to shelter production (and profits) in low-tax country B from US corporate taxation by way of foreign tax credits derived from production (and profits) in high-tax country A.

[6] Artificial transfer pricing occurs when the price charged (or costs allocated) between related members of an MNC group differ from what independent companies would charge (or allocate). Detailed Internal Revenue Service (IRS) regulations attempt to curtail artificial transfer pricing, but their success is a matter of debate.

Table 1: Exports, FDI position, and effective and statutory tax rates, selected countries

		FDI position			
Country	**Merchandise exports, 2002** (billions of dollars)	**FDI stock from world, 2002** (billions of dollars)	**FDI stock from US, 2002** (billions of dollars)	**Average effective corporate tax rate**[a] (percent)	**Statutory corporate tax rate**[b] (percent)
Asia and the Pacific					
Japan[c]	417	60	66	48.2	57.0
India	50	26	4	32.2	35.0
Korea	161	44	12	30.1	34.0
Australia	65	129	36	21.8	36.0
Thailand	69	30	7	15.2	30.0
Taiwan[d]	144	33	10	13.7	25.0
China (Hong Kong)	200	433	36	13.4	16.0
China (Mainland)	326	448	10	11.3	33.4
Malaysia	93	57	9	8.2	28.0
Indonesia	57	56	8	0.2	28.5
Subtotal	1,583	1,315	197		
Europe					
Italy	251	126	28	40.9	41.3
Germany	604	452	65	30.5	60.0
France	331	401	44	22.7	39.3
United Kingdom	276	639	255	18.2	30.0
Netherlands	243	315	145	14.2	35.0
Subtotal	1,706	1,933	538		
Western Hemisphere					
United States[e]	693	1,351	n.a.	30.1	40.0
Canada	252	221	153	28.2	40.1
Brazil	60	236	32	16.6	32.0
Mexico	161	154	58	15.1	35.0
Argentina	26	77	11	13.6	35.0
Subtotal	1,192	2,039	254		

(continued)

		FDI position			
Country	**Merchandise exports, 2002** (billions of dollars)	**FDI stock from world, 2002** (billions of dollars)	**FDI stock from US, 2002** (billions of dollars)	**Average effective corporate tax rate**[a] (percent)	**Statutory corporate tax rate**[b] (percent)
Small, low-tax					
Bermuda[f]	1	78	69	11.6	0
Switzerland	87	118	70	10.3	31.0
Chile	18	46	12	10.0	35.0
Singapore	125	124	61	10.0	26.0
Ireland[g]	88	157	42	8.5	32.0
Panama[c,h]	1	7	20	7.0	30.0
Netherlands Antilles[i]	2	0	n.a.	5.7	50.0
Costa Rica	10	6	2	0.9	30.0
Subtotal	332	538	275		
Total listed	4,813	5,824	1,264		
World total	6,419	7,123	1,521		

n.a. = not applicable

a. Based on PricewaterhouseCoopers (2003) and on 1998 US profits tax liability (federal and state) as reported in US Census Bureau (2003).
b. Based on data from PricewaterhouseCoopers (1999).
c. Statistical discrepancy between FDI data sources.
d. Taiwan is not a member of the IMF; export data is from national agency.
e. For the United States, the federal statutory rate is 35 percent and the average state statutory rate is assumed to be 5 percent.
f. Statistical discrepancy in tax collected, possibly a result of indirect taxation by third country.
g. Inward investment to Ireland in manufacturing and some services may be eligible for a 10 or 12.5 percent statutory rate.
h. Income derived from sales in the Colon Free Zone to foreign countries is not taxed.
i. BEA does not separately report FDI position in the Netherlands Antilles. Offshore investment, holding, and finance companies are subject to a 3 percent statutory rate.

Sources: IMF (2004) for export data; UNCTAD (2003) for total FDI stock; BEA (2004) for US FDI stock; PricewaterhouseCoopers (2003) for effective tax rates in foreign countries; PricewaterhouseCoopers (1999) for statutory tax rates; and US Census Bureau (2003) for effective tax rate in the United States.

Relative Tax Rates, Then and Now

In the 1980s, after the Reagan-era tax cuts, the US corporate tax rate was lower than most of its industrial competitors—primarily Canada, Europe, and Japan. Since then, many OECD countries have slashed their corporate tax rates and introduced incentives such as rapid depreciation. Meanwhile, new industrial competitors have emerged—China, Korea, India, Mexico, Brazil, and others. While the new competitors may have high statutory tax rates, their effective rates are much lower, through the process of tax holidays and lenient enforcement (table 1).[7]

The upshot, after two decades, is that the United States has become relatively less attractive from a tax standpoint than in the mid-1980s and early 1990s. In his analysis of 59 countries, John Mutti (2003, table 2.4) found that in 1984–92, 20 of them had lower effective corporate rates than the United States and 39 had higher rates. However, by 1992–96, 43 had lower effective rates than the United States and only 16 had higher rates.

Senator Kerry's revenue estimates are overoptimistic: The funds raised would fall far short of the amounts required to fund his proposed corporate tax rate cut and his New Jobs Tax Credit.

Archaic Border Tax Adjustment Rules

The World Trade Organization (WTO) rules for border tax adjustments further disadvantage US firms. Border tax adjustments occur when a tax is imposed on imports but is not assessed (or is rebated) on exports. For example, when a US firm exports goods to the European Union, it may be hit with a 20 percent value added tax (VAT). However, when the EU firm exports to the United States, it gets a rebate on the 20 percent VAT and at most pays a small state sales tax.

The idea behind border tax adjustments is to impose the tax in question on final purchases in the country imposing the tax. However, under WTO rules, recently interpreted by the Appellate Body in the FSC case, direct business taxes (such as the corporate income tax) cannot be adjusted at the border, but indirect business taxes (such as VAT) can be.[8] With the exception of the United States, most countries rely heavily on indirect business taxes for government revenue.[9] Under WTO rules, therefore, US firms incur these taxes when they sell into Europe, Canada, Latin America, and most other countries; meanwhile their competitors sell into the US market virtually free of tax.

The WTO distinction between direct and indirect taxes is based on a false premise: the assumption that the economic burden of the VAT falls totally and uniformly on the purchasers of goods and services (like an excise tax on whiskey), whereas the economic burden of US corporate income tax falls totally and uniformly on the producers of goods and services (like a tax on real estate). The analogy between the VAT and a tax on whiskey is misplaced. The VAT is nothing more than the sum of two direct taxes: a tax on labor value added and a tax on capital value added. In the absence of tax adjustments at the border, the economic burden of both the corporate income tax and the VAT tax falls primarily on the labor and capital that produce goods and services. There is no reason in principle for WTO rules to discriminate between them.

In practice, the archaic rules mean that US firms must pay high VAT taxes on their exports, while their foreign competitors can sell into the US market largely free of tax obligations, both at home and in the United States. As the US-EU dispute over the FSC and Senator Kerry's campaign promises have shown, Washington politics is highly

[7] In 1998, the average effective tax rate on CFCs doing business in India was 32 percent (table 1). However, because of tax holidays and special incentives, Indian call centers and software programming firms usually pay much lower effective rates today.

[8] See WTO case number WT/DS108, titled United States—Tax Treatment for Foreign Sales Corporations. See also Hufbauer (2002) for a detailed analysis of the FSC saga.

[9] For example, indirect taxes on goods and services comprise 30 percent of total taxes in the European Union but only 16 percent in the United States (OECD 2003, table 25).

sensitive to the role that tax differences might play in shifting jobs abroad, whether or not sophisticated economic analysis demonstrates that jobs are actually shifted.[10]

Exchange Rate Salvation?

The classic answer to national differences in corporate tax rates, and the archaic distinction between direct and indirect business taxes, is that exchange rate adjustments will eventually offset tax differences and wash away any permanent effect on business location decisions. Even if the exchange rate answer is correct as a long-run proposition, it evokes John Maynard Keynes's famous aphorism: "In the long run, we are all dead."[11]

In the here and now, moreover, exchange rate adjustments have certainly not been effective in curtailing US trade deficits. For almost a decade, a persistently strong and even overvalued dollar has led to large and increasing trade deficits, to the point where the figure now exceeds $500 billion annually, about 5 percent of GDP. With this experience, it is much harder to trot out an exchange rate answer to national tax differences.

Senator Kerry's proposal to reduce the US federal corporate tax rate from 35 to 33.25 percent is commendable, but given the fiscal realities of the federal budget, it is most unlikely that the gap between US and foreign effective corporate tax rates can be eliminated simply by cutting the US corporate rate.

[10] In a recent paper, Mihir Desai and James Hines (2002) examined panel data from 168 countries over 1950–2000 and found—after allowing for several control variables—that the countries using VAT systems actually have fewer exports. In 2000, evidence from 136 countries indicated that a 10 percent increase in VAT revenue is associated with a 2 percent decrease in exports. The authors speculate that the tendency of countries to both levy higher VAT rates on traded than nontraded goods and underrebate input taxes when goods are exported may explain these findings. Whatever the explanation for the results of Desai and Hines, the findings give little comfort to US firms.

[11] Moreover, adverse network and scale economy effects may result in the loss of industries that subsequent exchange rate depreciation cannot easily reverse.

Summarizing the Diagnosis

Senator Kerry has correctly identified two problems. Under the current tax regime, profits earned abroad are often taxed less heavily than those earned at home, so that US firms have incentive to invest abroad rather than at home. Since effective US corporate tax rates are higher than those of many other countries, business investment in the United States is discouraged. Moreover, WTO rules enable foreign VAT taxes to be imposed on US exports and excused on US imports. In the long run, exchange rate adjustments may wash out all these tax differences, but over the past decade, exchange rate relief has been invisible to US firms.

But Wrong Prescription

Senator Kerry's prescription has two main parts: lower the US corporate tax rate on operations at home and raise US corporate taxes—by limiting deferral—on operations abroad. In addition, Kerry would provide a special tax holiday for the repatriation of past earnings.

Senator Kerry's proposal to reduce the US federal corporate tax rate from 35 to 33.25 percent is commendable for improving the international competitiveness of the United States (in the context of a revenue neutral plan), even though it would only modestly narrow the gap between US and foreign tax rates (table 1).

However, Senator Kerry's prescription to level the tax field by ending deferral is wrong, for three important reasons. First, it unduly punishes MNCs for sluggish job growth in the United States. Second, it would encourage tax-driven restructuring and outright divestment to a greater extent than it would promote relocation in the United States. Third, since Kerry's plan would only affect US multinationals, it would actually tilt the tax field more steeply in favor of foreign MNCs that export to the United States and third countries. Additionally, there are serious questions whether the Kerry plan would actually raise the amount of revenue advertised.

MNCs and US Jobs

MNCs are frequently criticized for shifting US jobs overseas—or in the words of Lou Dobbs, "exporting America." Such assertions rely on anecdotes of employment growth overseas and contraction in the United States, whether or not there is a causal link between the two and whether or not taxes are the driver. For example, Jonathan Weisman, reporting

in the *Washington Post*, observed that Merck shed 3,200 US jobs in 2003 while adding 1,300 foreign jobs and booked an additional $3 billion of deferred foreign earnings.[12]

In some cases, links surely exist between jobs at home, jobs abroad, and taxes. However, systematic studies indicate that expanded MNC activity abroad, on balance, creates jobs in the United States. In a recent report, Matthew Slaughter (2004) presents some revealing statistics. Between 1991 and 2001, CFCs increased the number of foreign employees from 6.9 million to 9.8 million, a gain of 2.9 million workers. Meanwhile, their US parent firms *increased* the number of US employees from 18 million to 23.5 million, a gain of 5.5 million workers. The rate of job expansion abroad was faster than at home. Even so, the US parent firms increased their share of total US employment by 1.2 percent (from 16.6 to 17.8 percent). On balance, these statistics do not suggest that MNCs by and large have a record of shifting jobs abroad. Further, in a detailed econometric analysis of US employment experience, Slaughter and his colleagues show that expansion abroad is not the enemy of employment at home (Hanson, Mataloni, and Slaughter 2003).[13] Moreover, econometric analysis by Edward M. Graham (2000, appendix B), among others, demonstrates that foreign investment by MNCs tends to attract (not replace) US exports of goods and services. As a generalization, the perennial complaint that MNCs "export jobs" is simply wrong.

Unhelpful Outcomes

The second reason Senator Kerry's prescription is misguided involves the mechanics of his plan. If deferral is ended (except for in-country CFC sales), and if the additional tax bite is substantial, MNCs will consider four alternatives:

• First, as Senator Kerry hopes, some MNCs may relocate their production activities in the United States or at least choose US rather than foreign sites for future expansion.[14]

• Second, they may turn to their tax lawyers and accountants to create new structures for distributing out-of-country CFC sales. As just one example, they might sell their entire output to foreign-owned wholesale firms in the host country. Those firms would then handle the distribution to other countries, including the United States. That way, the CFC's entire earnings would count as in-country profits, still eligible for deferral. Alternatively, the CFC might price its out-of-country sales to related firms at bargain basement prices and claim that the bulk of its earnings was derived from in-country sales.[15] If all other avenues were closed off, then "corporate inversion" would represent the nuclear option. By moving corporate headquarters overseas, former US parent firms could entirely escape the US tax net for their non-US operations. Senator Kerry's plan could inadvertently spur "corporate offshoring" on a grand scale.[16]

Senator Kerry's plan for limiting deferral could inadvertently spur "corporate offshoring" on a grand scale.

• Third, if detailed tracing rules, transfer pricing rules, anti-inversion taxes, and other regulations prevented the sort of response considered in the second alternative, the MNC might simply sell a majority of its CFC shares to a foreign partner. Once non-US parties own 51 percent of the foreign subsidiary, it ceases to be a CFC (no more US control) and thus escapes the US tax net.[17] Alternatively, the MNC might just sell out entirely to a foreign com-

[12] See "US Firms Keep Billions Overseas, Kerry Plan Spotlights Huge Untaxed Earnings," *Washington Post*, April 2, 2004, A1.

[13] On the connection between jobs and FDI, also see Lipsey, Ramsterrer, and Blomstrom (2000).

[14] From the US national standpoint, this seems like the best possible outcome. However, if relocation in the United States entails higher costs, even this outcome has its disadvantages. The affected MNCs will have fewer funds to carry out research and development, capital investment, and other expansion activities that would otherwise generate additional US employment.

[15] If Senator Kerry's plan were reduced to legislative language, antiabuse provisions would attempt to eliminate deferral when the CFC sold to a third party in the expectation of out-of-country sales. Likewise, the transfer pricing rules would be invoked against bargain sales. However, in practice, it seems doubtful that the IRS could keep up with the ingenuity of private lawyers and accountants.

[16] For a discussion of the corporate inversions hotly debated in 2002, see Hufbauer and Assa (2003). Unlike the tax incentives that inspired Stanley Works and Tyco International to engage in "paper" inversions, the Kerry plan might prompt "real" inversions, with the actual movement of headquarters personnel to foreign locations. Tax practitioners would certainly suggest that newly formed companies incorporate and locate their headquarters abroad, so as to stay clear of the US tax net.

[17] In 1986, after the United States repealed deferral for shipping income, several US firms sold a majority interest in their shipping CFCs.

petitor. After all, if an MNC's production in Ireland is going to be taxed at the US average effective rate of about 30 percent (table 1), while a competing foreign firm can produce the same product and pay the Irish effective rate of only 8.5 percent, the MNC may not be able to stay in game. The US-based MNC might decide to sell out and withdraw from the business.

• Fourth, MNCs might decide to absorb the increased tax costs (an increase that their foreign-based competitors do not bear) by raising prices, accepting lower after-tax profits, or both. If they raise prices, they will lose global market share. If they accept lower profits, the market value of their shares will decline, harming pension funds, employee stock ownership plans, and individual shareholders.

Our estimate of a $5 billion revenue gain from the tax holiday is highly speculative; a $22 billion revenue gain—as mentioned by a Kerry aide—is almost inconceivable.

Our guess is that the second, third, and fourth alternatives would dominate MNC responses rather than a decision to relocate production to the United States.

Damage to US Competitive Position

The second, third, and fourth alternatives are not the responses Senator Kerry has in mind. None of them would benefit US workers or shareholders. All would damage the US competitive position in world markets. Tax-driven restructuring (the second approach) would entail legal, accounting, and transaction costs. Genuine divestment (the third approach) would deprive the United States of associated exports (both components and final goods) now sold through CFCs. It would deprive the US parent firm of a profitable stream of royalty, interest, and dividend income. The research findings of Hanson, Mataloni, and Slaughter (2003) suggest that divestment would probably dampen the rate of US employment growth by US parent firms. Finally, if MNCs simply absorbed the increased tax costs (the fourth approach), then they would be placed at a competitive disadvantage compared with foreign-based peers.[18] The disadvantage would show up either in prices charged in world markets or in the MNCs' equity valuations.

A Boon to Foreign Multinationals?

Senator Kerry intends to discourage both blue-collar and white-collar offshore outsourcing by US multinational companies. However, ending deferral will do nothing to discourage the US importation of software programs from India or semiconductors from China *when the exporter is a foreign-owned company*. IBM and Texas Instruments may be discouraged from producing in India or China and selling in the United States or third-country markets, but SAP of Germany and Toshiba of Japan will not be.[19] The SAP and Toshiba corporate groups are organized around parent firms based, respectively, in Germany and Japan. Hence their foreign subsidiaries are *not* controlled by US persons and consequently are not CFCs from the standpoint of US tax jurisdiction.

As table 1 shows, US MNCs are far from alone in the world. In fact, they account for only one-fourth of world foreign direct investment (FDI) in countries other than the United States. Plenty of competitors are willing and able to take their place if, for tax reasons, US-based MNCs are no longer able to competitively produce goods and services abroad for sale in the United States or third-country markets.

Realistic Revenue Estimate?

Senator Kerry has estimated that ending deferral would generate about $12 billion of additional US tax revenue annually. How reasonable is this estimate? The undistributed earnings and profits (E&P) of CFCs based in low-tax countries increased from $180 billion in December 1998 to around $340 billion in December 2003.[20] The annual E&P increase was thus about $32 billion. The average effective

[18] Even if they relocate production in the United States, US-based MNCs may incur a competitive disadvantage, since costs (including taxes) are almost certainly higher than in the alternative foreign location.
[19] Of course, IBM and Texas Instruments would still make extensive sales in the US market based on production in the United States and other high-tax locations.
[20] The Kerry plan cites the Congressional Research Service for an estimate that CFCs had $639 billion of retained E&P in December 2002. However, about half of this E&P was retained in CFCs based in countries where the combination of corporate tax and withholding tax on repatriations would substantially offset (via the foreign tax credit).

foreign tax rate (both corporate profit and withholding taxes) on these earnings is about 11 percent. Since the US effective rate is 30 percent, these figures suggest that ending deferral would generate additional US tax of about 19 percent (after the foreign tax credit), or about $6 billion. The Kerry plan might generate additional revenue from undistributed E&P of CFCs based in other countries, but it's very hard to see another $6 billion—the amount necessary to reach a total annual revenue gain of $12 billion.[21]

There are collateral reasons for thinking that the $12 billion figure is high. The Joint Committee on Taxation (JCT)—a House-Senate committee charged with estimating the revenue effects of tax legislation—has estimated that ending deferral for all CFCs on all their operations would only yield $6.9 billion of additional revenue in 2005.[22] However, Kerry's plan will allow companies "to defer the income they earn when they locate production in a foreign country that serves that country's foreign market." This means that the change will not affect the majority of CFC sales (especially in mid-sized and large countries), since host-country markets account for 65 percent of total affiliate sales.[23] Of the sales that would lose deferral, most are exports to third countries (some 24 percent of total CFC sales are exports to third countries, while only 11 percent is destined for the United States).[24] Taking these caveats into account, we think that $6 billion represents the top end of annual revenue that might be generated from Kerry's plan to limit deferral.

Spending the Revenue

The $12 billion (Kerry's estimate) raised from limiting deferral is intended to pay for a cut in the federal corporate income tax rate from 35 to 33.25 percent. According to the *Economic Report of the President*, federal corporate income taxes are projected to reach $230 billion in 2005 (CEA 2004, table B-80). A cut in the rate by 1.75 percentage points (5 percent of the base level) works out to $11.5 billion. That part of Kerry's arithmetic is correct. However, if limiting deferral does not generate more than $6 billion annually (our top estimate), then the corporate tax rate cut would be seriously underfunded.

Tax Holiday and Job Credit

The Kerry plan has a second component, with no revenue estimate. It provides a tax holiday for repatriated prior year CFC earnings, above a base level of repatriations, with a toll tax of 10 percent. The money raised would be spent on a New Jobs Tax Credit to help industries adversely affected by outsourcing.[25]

As a matter of urgency, the United States should demand an end to the archaic WTO distinction between direct and indirect business taxation.

Any Revenue?

As proposed, the tax holiday is not likely to generate much revenue. Based on recent experience, US parent firms pay an average US tax of less than 4 percent on repatriated dividends from their CFCs (see, for example, Altshuler and Grubert 2003). Since the decision to repatriate is elective, both under present law and the Kerry plan, it is not clear why US parent firms would suddenly decide to repatriate additional funds and pay a 10 percent toll tax, when they have customarily paid less than 4 percent.[26] Although Kerry has not proposed it, one possible incentive would be the retroactive elimination of deferral on past CFC earnings and profits, to the extent the US parent did not elect the special tax holiday. To be as

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[21] Undistributed E&P from CFCs, other than those based in low-tax countries, amounts to about $47 billion annually. However, the combination of foreign corporate tax and withholding tax on these earnings would very likely reduce US corporate tax to 5 percent or less of that portion derived from out-of-country sales. Since out-of-country operations are about 35 percent of total sales, the implied US revenue from ending deferral on this E&P might be less than $1 billion annually.

[22] This is the tax expenditure estimate for "deferral of active income of controlled foreign corporations" and "deferral of certain active financing income" (JCT 2003, table 1).

[23] In 2001, total sales of US affiliates was $2.5 trillion, of which $1.6 trillion was to the local country, $272 billion to the United States, and $604 billion to third countries (BEA 2003, table III.F.1).

[24] According to one of Senator Kerry's aides, the plan would eliminate deferral on 75 percent of E&P. This estimate is inconsistent with the proposal that in-country sales (65 percent of the CFC total) would still be eligible for deferral. See "Kerry Goes After Outsourcing with Tax Plan," *Asian Wall Street Journal*, March 29, 2004, A1.

[25] The flavor of tax credits targeted to adversely affected industries troubles some commentators and editorialists (e.g., "John Kerry, Supply-Sider?" *Wall Street Journal*, March 29, 2004, A18). They detect a perverse industrial policy for sunset industries.

[26] Presumably, but unstated in the Kerry plan, no foreign tax credit would be allowed for the tax holiday repatriations.

Box 1: Revenue Estimate Based on the Homeland Investment Act of 2003

The Homeland Investment Act of 2003 (H.R. 767, also known as the HIA), sponsored by Congressman Phil English (R-PA), is similar in spirit but different in result to the tax holiday component of Senator Kerry's plan.[1] The HIA provides, for one year, an elective US corporate toll tax at the rate of 5.25 percent (as opposed to 10 percent in the Kerry plan) on qualifying dividends repatriated by US parent firms from their controlled financial corporations (CFCs). Qualifying dividends are those so designated by the US parent firm in excess of a base period dividend amount. The foreign tax credit on qualifying dividends would be disallowed to the extent of 85 percent (Kerry does not mention the foreign tax credit, but we presume he intends total disallowance).

The Joint Committee on Taxation (JCT) has scored the HIA with a revenue cost of $4.4 billion over 10 years, projecting that lower revenues in future years will more than offset the tax holiday windfall. The minutia of tax scoring is too arcane for this policy brief, but we believe that the JCT score has the wrong sign and that the HIA should be scored with a revenue gain of around $2 billion over 10 years. However, a higher toll tax (Kerry's 10 percent rather than HIA's 5.25 percent and total disallowance of the foreign tax credit compared with 85 percent disallowance) would, in our opinion, dramatically lower the amount of additional repatriations.

We estimated $200 billion additional repatriations under the HIA.[2] Given the less attractive terms of the Kerry plan (an effective tax rate more than twice as high), we believe it cannot hope to attract more than $50 billion. A 10 percent toll tax on $50 billion of new repatriations (above the base amount) would generate an immediate $5 billion of additional US revenue in the tax holiday year. Ignoring lower revenues in the future, we use this figure as a generous upper bound on the revenue that the Kerry tax holiday might generate.

[1] We endorse the HIA. Other bills with the same tax holiday spirit include S. 596 (Jobs and Growth Tax Relief Reconciliation Act of 2003) and H.R. 2896 (American Jobs Creation Act of 2003).

[2] The $200 billion figure is expressed on a "grossed-up" basis and consists of $178 billion of net CFC dividend repatriations plus attributed foreign taxes (the so-called gross-up) of $22 billion. On a grossed-up basis, at the end of 2003, undistributed earnings and profits in low-tax CFCs was about $380 billion. Our estimate for the HIA assumes that US parent firms would distribute more than half of this amount.

optimistic as possible, we assume that the Kerry tax holiday will spur an additional $50 billion of CFC repatriations based on the analysis of the Homeland Investment Act of 2003 (box 1). We think the extra $50 billion would, at most, yield a revenue boost of $5 billion.

New Jobs Tax Credit

How far would $5 billion go in paying for the New Jobs Tax Credit—the employer's portion of payroll tax for firms in certified industries? In 2001, the employer's portion worked out, on average, to $2,100 per employee.[27] Arithmetic suggests that $5 billion would thus cover the payroll tax for about 2.4 million job years.

By contrast, an aide to Senator Kerry claimed (on March 26, 2004) that the New Jobs Tax Credit would provide a payroll tax benefit of $22 billion over two years.[28] We think this figure was reached by calculating a payroll tax benefit of $2,200 per employee for Senator Kerry's goal of creating 10 million new jobs. Our estimate of a $5 billion revenue gain from the tax holiday is highly speculative; a $22 billion revenue gain is almost inconceivable.

Better Prescriptions

Senator Kerry's diagnosis—a tilted tax field—is correct but not for the reasons that hold his attention. Tax differentials are not the main reason for offshore outsourcing, nor are they the main reason for the trade deficit. However, policy can and should address market distortions caused by tax imbalances. For the reasons summarized in this policy brief, Kerry's prescription is misguided. It is unlikely to raise the revenue necessary to finance a cut in the corporate tax rate from 35 to 33.25 percent—though

[27] Calculated by authors using data from US Census Bureau (2003, table 541).

[28] See "Kerry Targets Job Outsourcing with Corporate Tax Overhaul," *Wall Street Journal*, March 26, 2004, p. A1.

a cut in the US corporate rate would be laudable. Limiting deferral would also almost certainly make US firms less competitive in world markets.

The solution to the tax tilt lies not in jiggering with the taxation of US business abroad, however much that speaks to the political mood of the moment, but in fundamentally changing the taxation of US business at home. The day has long passed (if it ever existed) when the United States could change the way foreign countries structured their tax systems. But the United States can certainly change the way it taxes business at home and how it taxes imports and exports of goods and services.

We have already applauded Senator Kerry's proposal to cut the statutory US corporate tax rate to 33.25 percent. Any measure that closes the gap between US and foreign effective corporate tax rates is a step in the right direction. But given the fiscal realities of the federal budget, the gap is unlikely to be eliminated simply by cutting the US corporate rate.

Thus, as a matter of urgency, the United States should demand an end to the archaic WTO distinction between direct and indirect business taxation. In the WTO Doha Round of trade negotiations, the United States should insist that the WTO rules be rewritten to either:

• Abolish border tax adjustments altogether (on both imports and exports), with a limited exception for sumptuary excise taxes ("sin taxes");[29] or

• Allow border tax adjustments for direct business taxes (exemplified by the corporate income tax) as well as indirect business taxes (VAT and its cousins).

The first outcome would level the tax field to a far greater extent than Senator Kerry's proposals, since VAT and similar taxes are much higher, per unit of final sales, than corporate income taxes.[30] US firms would no longer pay foreign VAT on their exports, and foreign competitors could no longer sell into the US market free of their home-country VAT obligation. Since VAT rates are typically around 15 percent of final sales, the abolition of border adjustments would substantially improve the competitive position of US firms, assuming no exchange rate offset.[31]

The second outcome would pave the way for the United States to impose its own corporate tax on imported goods and services. Mechanically, this could be achieved, in a rough and ready fashion, by disallowing a portion of the business deduction for goods or services purchased from foreign suppliers.[32] Eliminating the WTO distinction between direct and indirect business taxes would also enable the United States, if it so decided, to exempt export earnings from the corporate tax base. As long as the United States runs a trade deficit in the range of $500 billion annually, border adjustments (both imports and exports) for corporate income tax would generate around $15 billion of tax revenue, enough to pay for Senator Kerry's cut in the US corporate tax rate.[33]

Either solution to the archaic WTO rules would go a great deal further to level the international tax field than Senator Kerry's proposals. Moreover, WTO reform would redress the root grievance underlying three decades of tax wars between the United States and Europe.

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[29] Sin taxes are exemplified by very high taxes on alcohol, tobacco, and perfume.

[30] When profits are 10 percent of final sales (a high figure for most firms), a 30 percent corporate profits tax amounts to 3 percent of final sales. By comparison, VAT systems typically impose tax at rates between 10 and 20 percent of final sales. See OECD (2001).

[31] Abolition of border adjustments would, however, require the US states to refrain from imposing use taxes on purchases from out-of-state suppliers. It would also require the states to collect their sales taxes on goods sold out of state. Both changes would be contentious.

[32] More exact, but administratively much more complex, border adjustments could be designed for imported goods and services. If WTO rules are rewritten to permit border adjustments for direct taxes, the new rules should permit approximate as well as exact calculations.

[33] In 2000, gross domestic product originating in the private sector amounted to $8,606 billion, and corporate tax liability amounted to $259 billion. Roughly, federal corporate taxes amount to 3 percent of private-sector value added. Applying this figure to a trade deficit of $500 billion indicates that the net revenue from border adjustments would be roughly $15 billion.

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