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Volume Title: Taxing Multinational Corporations

Volume Author/Editor: Martin Feldstein, James R. Hines Jr., R. Glenn Hubbard, Eds.

Volume Publisher: University of Chicago Press

Volume ISBN: 0-226-24094-0

Volume URL: http://www.nber.org/books/feld95-1

Conference Date: April 19, 1994

Publication Date: January 1995

Chapter Title: Introduction to "Taxing Multinational Corporations"

Chapter Author: Martin Feldstein, James R. Hines Jr., R. Glenn Hubbard

Chapter URL: http://www.nber.org/chapters/c7721

Chapter pages in book: (p. 1 - 6)

Introduction

Martin Feldstein, James R. Hines, Jr.,
and R. Glenn Hubbard

This growing worldwide importance of international business activities has in recent years lead to serious reexaminations of the ways that governments tax multinational corporations. In the United States, much of the debate concerns the competitive positions of U.S. firms in international product and capital markets. In addition, there are those who argue that U.S. international tax rules have become more complex and more distorting in recent years, particularly since the passage of the Tax Reform Act of 1986. Discussions in the U.S. Congress and the administration since 1992 reveal a willingness to consider significant reforms. In Europe, increased liberalization of capital markets prompted the European Commission to discuss harmonization of corporate taxation. These policy developments not only suggest dissatisfaction with certain features of modern tax practice, but also raise deeper questions of whether current systems of taxing international income are viable in a world of significant capital market integration and global commercial competition.

Academic researchers have expressed renewed interest in studying the effects of taxation on capital formation and allocation, patterns of finance in multinational companies, international competition, and opportunities for income shifting and tax avoidance. This research brings together the approaches used by specialists in public finance and international economics. The papers presented in this volume summarize the results of a research program of the National Bureau of Economic Research on the effects of taxation on the invest-

Martin Feldstein is the George F. Baker Professor of Economics at Harvard University and president of the National Bureau of Economic Research. James R. Hines, Jr., is associate professor of public policy at the John F. Kennedy School of Government of Harvard University and a faculty research fellow of the National Bureau of Economic Research. R. Glenn Hubbard is the Russell L. Carson Professor of Economics and Finance at the Graduate School of Business of Columbia University and a research associate of the National Bureau of Economic Research.

ment and financing decisions of multinational corporations.[1] As a group, the papers describe the impact of U.S. firms' outbound foreign investment on the U.S. and foreign economies. The papers offer empirical evidence documenting channels through which tax policy in the United States and abroad affects plant and equipment investment, spending on R&D, the cost of debt and equity finance, and dividend repatriations by U.S. subsidiaries. The findings of these papers, described briefly below, will be useful in discussions of reforms of international tax rules in the United States and elsewhere. The current U.S. rules for taxing international income are summarized in an appendix at the end of the volume.

According to Robert Lipsey, overseas production contributes to the ability of American multinationals to retain world market shares in the face of a long-term decline in the U.S. share of world trade, and in the face of short-term changes (such as exchange rate fluctuations). Overseas production performs the same functions for Swedish firms and, more recently, for Japanese firms. Within U.S. multinationals, those with higher shares of production overseas have higher employment at home relative to production at home. Foreign production appears to require larger numbers of employees in headquarters activities (including R&D and supervision).

Martin Feldstein shows that the credit for foreign taxes paid does not induce U.S. firms to expand their foreign direct investment (FDI) enough so that the return on FDI to the United States is less than the return on the displaced domestic investment. Feldstein argues that a typical marginal investment overseas (which has the same net return to an American multinational parent as an alternative marginal domestic investment) actually generates a higher return for the United States than would the domestic investment it displaces. In order to maximize the present value of U.S. national income, one would not replace the current foreign tax credit with a deduction for foreign taxes. Instead, one would move in the opposite direction, encouraging more FDI in general, and investments that employ substantial foreign debt per dollar of U.S. capital in particular.

Joosung Jun modifies conventional cost-of-capital measures to incorporate the impact of international tax rules. He finds that corporate taxation of foreign investment causes U.S. firms operating in major foreign markets to face, on average, about 20 percent higher costs of capital than do domestic firms in the United States. Further, U.S. firms very likely face higher costs of capital than do local firms in foreign markets. U.S. firms operating in foreign markets also may have cost-of-capital disadvantages vis-à-vis firms from third countries, in part because the U.S. tax system is not integrated and in part because U.S. tax deferral and foreign tax credit calculation rules are so strict.

1. More-technical papers appear in the companion volume edited by Feldstein, Hines, and Hubbard (1995) and in earlier volumes edited by Razin and Slemrod (1990) and Giovannini, Hubbard, and Slemrod (1993).

Roger Gordon and Jeffrey MacKie-Mason examine possible explanations of why industrial countries tax the overseas income of their domestic multinational firms in the ways that they do. Many economists argue that it is inefficient to use corporate income taxes to raise revenue in open economies. If capital is internationally mobile, the burden of corporate taxes falls largely on other immobile factors (such as labor), and the tax system would be more efficient if these other factors were instead taxed directly. Not only do governments use corporate taxes, however, but corporate tax rates are also roughly comparable with top individual tax rates. Some theories predict that multinationals based in countries with residence-based tax systems should not invest in countries with low corporate tax rates, since those multinationals must pay sizable surtaxes when they repatriate their profits. This tax obligation imposes on these multinationals a competitive disadvantage, yet there is a significant amount of such FDI. Gordon and MacKie-Mason suggest that the abilities of firms to shift income (through aggressive transfer pricing) may explain the use of corporate income taxes, as well as the observed pattern of FDI. Countries may use corporate taxes as backstops to labor income taxes in order to discourage individuals from converting their labor incomes into otherwise-untaxed corporate income. The authors explore how those taxes might be modified to deal with cross-border income shifting.

Andrew Lyon and Gerald Silverstein examine some of the ways that U.S.-based multinational corporations may be affected by the corporate alternative minimum tax (AMT). In 1990, more than half of all the foreign-source income was earned by corporations subject to the AMT. Consequently, when U.S. firms plan their foreign activities, the tax incentives created by the AMT may be at least as important as those created by the regular U.S. corporate tax. The AMT creates a relative incentive for AMT firms to invest abroad rather than in the United States, and the AMT offers a temporary timing opportunity that allows repatriation of income from abroad at a lower cost than if the firm were subject to the rules of the regular U.S. tax system. These two different incentives have an ambiguous effect on U.S. domestic investment overall, if repatriated income is retained by the parent corporation in the United States. The AMT may provide an opportunity for firms to repatriate income from certain foreign locations with poor reinvestment opportunities, and at the same time to reinvest funds abroad in alternative foreign locations that have better investment opportunities. There appears to be an ambiguous net effect of these two incentives on the total volume of capital invested outside the United States.

James Hines asks first whether R&D activity by multinational firms is sensitive to local tax conditions, and second whether imported technology and R&D are complements or substitutes. He finds that R&D responds to local tax rates, and that it is a substitute for imported technology. Firms appear to react to high royalty tax rates by paying fewer royalties and performing additional R&D locally. To the extent that royalty payments reflect actual technology transfer

(rather than adept accounting practices), the behavior of multinational firms suggests that local R&D is a substitute for imported technology.

Rosanne Altshuler, Scott Newlon, and William Randolph recognize that repatriation taxes on dividends may vary over time, providing firms with incentives to time repatriations so that they occur in years when repatriation tax rates are relatively low. The authors use information about cross-country differences in tax rates to distinguish the effects on dividend repatriations of permanent tax changes (as typically occur when statutory tax rates change) from the effects of transitory tax changes. Using data from U.S. tax returns for a large sample of U.S. corporations and their foreign subsidiaries, the authors find that permanent tax changes have much smaller effects than do the transitory tax changes. This finding suggests that repatriation taxes *do* affect dividend repatriation decisions, but only to the extent that taxes vary over time.

Jason Cummins and R. Glenn Hubbard use panel data on FDI by subsidiaries of U.S. multinational firms to measure the effect of taxation on FDI. The results cast significant doubt on the simplest notion that taxes do not influence U.S. firms' overseas investment decisions. Taxes appear to influence FDI in precisely the ways indicated by traditional neoclassical economic models of investment behavior. Specifically, it appears that the annual rate of overseas investment falls by 1–2 percentage points for each percentage point rise in the cost of capital for outbound FDI. This effect, which is of a magnitude similar to those recently estimated for domestic investment by U.S. and European firms, implies that changes in foreign corporate tax rates and depreciation rules, or in the foreign tax credit status of parent firms, significantly influence overseas investment by U.S. subsidiaries.

Kenneth Froot and James Hines examine the impact of the change in the U.S. interest allocation rules that followed passage of the Tax Reform Act of 1986. The 1986 act significantly limited the tax deductibility of the U.S. interest expenses of certain American multinational corporations. This tax change increased the tax liabilities of certain American multinationals and made additional borrowing more expensive for these firms. Froot and Hines find that the change in interest allocation rules discouraged borrowing and new investments. Firms that were unable to deduct all of their interest expenses against their U.S. tax liabilities issued 4.2 percent less debt (measured as a fraction of total firm assets) and invested 3.5 percent less in property, plant, and equipment during 1986–91 than other firms did. This is consistent with other evidence that suggests that the Tax Reform Act of 1986 significantly raised the borrowing costs of some American multinational firms.

Jason Cummins, Trevor Harris, and Kevin Hassett analyze the two accounting regimes that govern reporting practices in most developed countries. "One-book" countries, such as Germany, use their tax books as the basis for financial reporting. "Two-book" countries, including the United States, keep tax and financial reporting books largely separate. Firms in one-book countries may be reluctant to claim certain tax benefits if reductions in their taxable incomes can

be misinterpreted by financial market participants as signals of lower profitability. The authors' estimates suggest that the interaction of tax systems and accounting regimes significantly influences domestic investment patterns, both within and across countries.

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