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Volume Title: The Political Economy of Tax Reform, NBER-EASE Volume 1

Volume Author/Editor: Takatoshi Ito and Anne O. Krueger, editors

Volume Publisher: University of Chicago Press

Volume ISBN: 0-226-38667-8

Volume URL: http://www.nber.org/books/ito_92-2

Conference Date: June 14-16, 1990

Publication Date: January 1992

Chapter Title: The Political Economy of Tax Reforms and Their Implications for Interdependence: United States

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Chapter URL: http://www.nber.org/chapters/c8514

Chapter pages in book: (p. 97 - 116)

4 The Political Economy of Tax Reforms and Their Implications for Interdependence: United States

Charles E. McLure, Jr.

4.1 Introduction

In 1986 the United States achieved fundamental income tax reform—something that had generally been agreed to be impossible.[1] Among the most important of the changes made in the 1986 reforms were those affecting international economic relations. Because of the growing interdependence of the world economy, the changes in the U.S. income tax that have occurred during the 1980s have affected foreigners as well as Americans.

This paper deals with two topics. After a brief description of the changes made in 1981, section 4.2 describes briefly the salient features of the 1986 act and discusses the political economy of tax reform—how "the impossible became the inevitable."[2] Section 4.3 examines those aspects of recent U.S. tax changes that directly affect foreigners most strongly.[3] These include effects on international flows of trade and capital[4] and induced effects on foreign tax

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1. Break and Pechman titled their 1975 book *Federal Tax Reform: The Impossible Dream?* Perhaps the most extreme statement of the proposition that tax reform was, indeed, impossible was the following statement from Witte (1985, 380): "*There is nothing, absolutely nothing in the history or politics of the income tax that indicates that any of these schemes have the slightest hope of being enacted in the forms proposed*" (emphasis in original).

2. Birnbaum and Murray (1987, 6) write, "In the early hours of the morning of May 7, tax reform completed the transformation from the impossible to the inevitable."

3. I use the term "tax changes" rather than "tax reform" advisedly; not all the changes that have occurred qualify as reforms.

4. Jun (1989) distinguishes three ways in which a country's tax policy can affect that country's international direct investment (and the techniques affecting investment): first, by modifying the tax treatment of foreign-source income (tax rates, foreign tax credit, and deferral); second, by altering the relative before-tax profitability of investment at home and abroad (tax rates, investment tax credit, and depreciation allowances); and third, by affecting the relative cost of external financing in various countries (the deductibility of interest and withholding taxes on interest pay-

laws. It does not consider other ways in which changes in U.S. tax law have affected foreigners more indirectly: these include especially the fact that intellectual arguments for reform have been given increased attention and legitimacy by U.S. tax reform.[5] Section 4.4 draws lessons for other countries from the discussion of international issues.

4.2 The 1981 and 1986 Acts and the Political Economy of Reform

4.2.1 The 1981 Act

During the 1970s the United States suffered from historically high levels of inflation and from lagging saving, investment, and economic growth. Some have attributed poor investment performance to the interplay between inflation and an income tax that makes no provisions for inflation adjustment in the calculation of depreciation allowances. Rather than indexing the measurement of income from business and capital, however, Congress enacted an extremely generous system of investment incentives consisting of a 10 percent investment tax credit (ITC) and rapidly accelerated depreciation. In combination these incentives were roughly equivalent in real present value terms to immediate expensing (first-year write-off) of investment, at the rate of inflation prevailing at the time. Together with reductions in marginal tax rates intended to offset the effects of bracket creep resulting from prior inflation, these incentives created enormous budget deficits.

4.2.2 The 1986 Act

The 1986 reform of the U.S. income tax was far-reaching. The individual rate schedule, which had more than a dozen rates and a maximum rate of 50 percent, was reduced to four rates, 15, 28, 33, and 28 percent.[6] The corporate rate was reduced from 46 percent to 34 percent. Rate reduction was paid for by a variety of structural changes: elimination of the investment tax credit, slight deceleration of depreciation allowances, complicated provisions intended to make the timing of the recognition of income and the deduction of expenses track economic reality more closely, taxation of nominal capital gains as ordinary income, repeal of the deductions for state and local sales taxes, and a multifaceted assault on tax shelters, plus many less important

ments). For present purposes it might be useful to add a fourth category, changes in the country's tax treatment of domestic-source income attributable to foreigners; this allows us also to consider effects on incoming investment. All of these channels of influence have been active in changes in U.S. tax policy during the 1980s, for portfolio investment as well as for direct investment. In what follows they are noted in footnotes.

5. This aspect of the question is discussed in a variety of places, including the papers in Boskin and McLure (1990), Whalley (1990a), Tanzi (1987), Bossons (1987, 1988), and Pechman (1988). McLure (1989c) discusses lessons for developing countries from U.S. tax reform.

6. The peculiar blip in the rate structure results from provisions taking back the benefits of personal exemptions and the 15 percent rate for upper-middle-income taxpayers.

changes. Interestingly, many of the most important deviations of taxable income from economic income were not touched by tax reform. These include the deductions for interest on owner-occupied housing, the deduction for income and property taxes paid to state and local governments, the tax-free status of health insurance and many other fringe benefits provided by employers, and interest on securities issued by state and local governments. Unlike the provisions that were reformed, these benefit primarily middle-income households and are probably not generally viewed as loopholes.

Notably absent from the 1986 act was any attempt to reduce the federal budget deficit; rather, the 1986 reforms were explicitly intended to be revenue-neutral, that is, to yield neither more nor less revenue than prior law during the first five years after enactment. Given the effects of the 1981 act described above, it is not surprising that many find this to be a major flaw in the 1986 act.[7] The requirement of revenue neutrality is explained by President Ronald Reagan's promise to veto any bill containing a tax increase.

The public policy underpinnings of the 1986 act are fairly straightforward; for the most part they reflect the conventional wisdom of a generation of advocates of income tax reform. As Henry Aaron has written (1989, 9), "The remarkable characteristic of the debate leading up to the Tax Reform Act of 1986 was how much the old concepts of equity and how little recent advances in normative tax theory were invoked not only among politicians but also among economists." The objective of tax reform, as envisaged by the authors of Treasury I, the Department's 1984 report to President Reagan, which set the terms of reference for the ensuing debate, was to tax all real economic income uniformly and consistently, without regard to its source or use.[8] It was believed that this would reduce both inequity and the perception of inequity, allow lower rates, reduce distortions of economic decision making, and even make the system simpler.[9] Contrary to the expectations of some, Treasury I did not contain a proposal to shift from the income tax to a direct tax based on consumption, the recent darling of economists. Such a proposal would almost certainly have been dead on arrival if Reagan had submitted it to Congress.

The decision to scale back investment incentives and reduce statutory tax rates, first advanced in Treasury I, has drawn criticism from some economists; they point out that this policy lowers taxes on old capital and raises taxes on new capital, thereby discouraging investment.[10] They seldom address several

7. See, for example, Shoven (1990).

8. I have explained this at length in various places; see, for example, McLure (1986c) and McLure and Zodrow (1987).

9. It should be noted that simplicity goes beyond the complexity of tax rules and the difficulty of complying with them; it includes the question of "transactional simplicity." A tax law that is complex may simplify matters on balance by preventing complicated transactions that are tax-motivated. See McLure (1989a).

10. See, for example, Shoven (1990). Shoven also decries the failure to reduce the favoritism toward owner-occupied housing, an omission that prevents the achievement of a "level playing field." Early in the tax reform process Reagan had declared the sanctity of the deduction for home mortgage interest.

key issues, including the desirability of encouraging increases in investment not matched by increased saving, the complexity and the inequities—both real and perceived—of tax shelters based on investment incentives, and the effects on the tax base of low statutory rates (to be considered below).

A very different line of criticism, associated primarily with Richard Musgrave (1987), objects to the fact that the 1986 act sharply reduces the progressivity of income tax rates paid by individuals.[11] According to this line of reasoning it would have been preferable to combine base broadening with substantially less reduction in the progressivity of rates. It seems, however, that this view is politically unrealistic, since such a proposal would never have seen the light of day if the Treasury Department had submitted it to the White House.

Moreover, the 1986 act did not reduce the progressivity of the income tax; that occurred in 1981. The 1986 act merely restored some of the horizontal equity and economic neutrality that had been lost in 1981 (and before). It did this through a distributionally neutral process of base broadening and rate reduction. The combined effect of the 1981 and 1986 act was, however, to substantially reduce the corporate income tax rate. That has international ramifications to be examined in section 4.3.

4.2.3 The Political Economy of Reform[12]

Luck—the confluence of particular circumstances and personalities—played a large role in the passage of the Tax Reform Act of 1986. First, there was a strong and popular Republican president who detested high tax rates. Whether his understanding of the objectives of tax reform went beyond rate reduction has been widely questioned. What matters is that he made tax reform the number one item on his domestic agenda. It was especially important that Ronald Reagan was a Republican, since tax reform has commonly been a Democratic issue. (See the discussion of horizontal and vertical equity below.) Republicans, especially in the Senate, were called on to support their president's plan for tax reform—and did so—even though they preferred to oppose it.

The role of congressional "brokers" has also been emphasized. Two relatively young members of Congress, Senator Bill Bradley, a Democrat from New Jersey, and Congressman Jack Kemp, a Republican from New York, both former professional athletes who had personal experience with the intricacies and insanity of the U.S. tax code, had both launched independent campaigns for tax reforms. Because of this and their expertise, they played a role in the tax reform process unusual for members of Congress with so little seniority. Moreover, they gave the quest for tax reform a bipartisan character it might have lacked.

11. This issue is discussed further in McLure (1990a).

12. On this subject see especially Birnbaum and Murray (1987) and Conlan, Bean, and Wrightson (1990).

Luck also played a role in the staffing of two important positions in the Reagan administration. When the tax reform process began, Donald Regan was secretary of the treasury and James Baker was chief of staff of the White House. Regan was willing to give the tax professionals in the Treasury Department free rein to produce a politically pure proposal that would meet the objectives of tax reform announced in Reagan's 1984 state-of-the-union address. As a result, the Treasury Department proposal set a standard against which subsequent tax reform plans would be judged. It seems unlikely that Baker, the consummate politician, would have done this had he been secretary of the treasury. In early January 1985, after the release of Treasury I, Baker and Regan changed jobs. This put Baker and his deputy secretary Richard Darman in a position to handle the delicate negotiations with Congress, something Regan could never have achieved, and gave Regan ready access to the president where he could champion the cause of tax reform—something he had a psychological interest in doing, given his role in producing Treasury I.

The press, especially the print media, played a crucial role in tax reform. The press reaction to tax reform seems to have gone through three stages. First, for a short period the "liberal Eastern press" seemed unable to believe that something as good as Treasury I could come from the Reagan administration. Then they moved to characterizing the plan as "academic" and "intellectually pure" but "politically naive."

But as the process wore on, the press exhibited a clear if implicit view that tax reform should not die. Through its incessant ridicule of those who attempted to salvage the tax preferences that benefited special interests, the press helped turn politicians into statesmen. This is perhaps most clearly seen in two instances. First, when bank lobbyists cried, "We won! We won!" in response to a vote by the Ways and Means Committee that would have given banking an enormous new tax break, the media excoriated the committee members who had voted for the provision. Second, it began to call Bob Packwood, the chairman of the Senate Finance Committee, Senator Hackwood. Partly because of the press, no one in Congress wanted to find the dead baby of tax reform on their doorstep.

It is awkward for me to speculate on the role of tax experts in explaining the success of tax reform, given my own participation in the process; I would naturally like to believe that tax experts played a significant role.[13] I will simply quote a few statements from a recently published book.

> [T]he initial Treasury I plan was an astonishingly pure expression of expert views. Although never formally proposed as legislation, it—rather than the existing law—set the standard against which subsequent proposals were measured. . . . [T]he ideas of tax professionals were less overtly dominant

13. One is inevitably reminded of the famous passage from Keynes about the power of ideas. Once while discussing tax reform with Carl Shoup, I referred to myself as an "academic scribbler." Carl said that he thought his generation had been the academic scribblers. That raises the next question: was I one of the "mad men in authority"?

> through the remainder of the legislative process. . . . [B]y controlling the critical revenue estimates, the small band of professionals under JTC's David Brockway exercise life-and-death power over countless alternatives considered by decision makers. (Conlan, Bean, and Wrightson, 1990, 243–44)

The international context in which U.S. tax reform occurred played an important role in explaining the early success of the reformers.[14] In early 1984, just as the basic outlines of the Treasury I program were being set, the United Kingdom announced a radical reform in which its corporate income tax rate would be reduced from 52 percent to 35 percent and the expensing of capital goods would be replaced with a return to conventional multiyear depreciation allowances. The reasons given for the British reform—particularly avoiding distortion of investment decisions—were the same as those used to justify similar measures in the United States. These arguments—and especially the fact that Nigel Lawson, the British chancellor of the Exchequer, had found them convincing—were employed to assure Secretary Regan that the Treasury I strategy was sound.

The strategy followed in producing Treasury I probably also contributed to the success of tax reform. First, Treasury I was produced in secret. There is no evidence that anyone outside the Treasury Department knew until the last few weeks before its release what Treasury I would contain. This strategy, which allowed the president to claim truthfully that he did not know what would be in the Treasury proposals, helped assure the independence of the tax experts at Treasury and thus the intellectual purity of the plan. Had the White House known of the contents of Treasury I in advance, it is unlikely that purity could have been maintained; this is especially true since leaks would have brought representatives of special interests to the White House in droves to plead their cause.

The fact that Walter Mondale made the politically unwise decision to announce during the 1984 presidential campaign that he would raise taxes virtually assured that the formulation Treasury I could continue in secret. Had Mondale proposed a tax reform package patterned after that of Senator Bradley, it is likely that the president would have countered and in the process opened the public debate on tax reform before Treasury I became public. That would probably have doomed tax reform.

Historically tax reform has been advocated by Democrats to alter the vertical equity of the tax system—the distribution of taxes across income brackets—by increasing progressivity. Treasury I adopted an entirely different strategy based on horizontal equity. It took as a working hypothesis the proposition that tax reform should be distributionally neutral—that it should not affect the

14. This discussion concentrates on the role played by the 1984 reforms in the United Kingdom, which I know to have been important for the reasons stated in the text. It ignores the 1985 Canadian proposals, which were in process before the release of Treasury I but were made more urgent by it. For further discussion, see Whalley (1990b).

distribution across income classes. Thus, rather than pitting rich against poor, it pitted those who paid their fair share of taxes, and more, against those who did not. Whereas it is difficult to argue objectively that the tax system should be either more or less progressive, it is much easier to argue that everyone with a certain real economic income should pay approximately the same tax.

One component of any explanation of the success of tax reform must be the burgeoning of tax shelters that occurred after passage of the 1981 act.[15] The acceleration of depreciation allowances and the ITC provided by the 1981 act, in conjunction with the deduction for nominal interest expense bloated by inflation, created enormous tax shelter activity despite the reduction in tax rates that occurred in 1981. During the years immediately preceding passage of the 1986 act, the news media were full of stories about wealthy individuals and corporations paying little or no tax.[16]

Revenue neutrality—the proposition that tax reform should neither raise nor lower taxes in the aggregate—also proved to be politically important. It helped impose discipline on a Congress that would otherwise have used tax reform as an opportunity to bestow tax breaks, without taking back other breaks of equal value.

Finally, Treasury I exhibited what might be called a whole-hog approach. With only a few exceptions (mortgage interest on owner-occupied housing and the exclusion of interest on municipal bonds) Treasury I took no hostages. That is, it attacked virtually every tax break on the books, including many sacred cows, in order to achieve as much rate reduction as possible and thereby stir the interest of the American public.

In the early stages of their deliberations, both tax writing committees attempted a different and a more traditional approach, preserving some preferences and creating others. Ultimately, however, during a now-famous long lunch, Packwood saw the basic good sense of the Treasury I approach. By being much more ambitious in its base broadening, his committee was able to achieve far more rate reduction that might have been thought possible.[17]

15. Birnbaum and Murray (1987, 10) write, "The phenomenal rise in tax shelters was a central part of the problem." Tax shelters occur when artificial accounting losses in one activity are used to offset income from other activities, such as that from employment or the exercise of a business or profession. Tax shelters result from the combination of accelerated deduction of expenses, postponement of the recognition of income, preferential taxation of income realized as capital gains, deductions of nominal interest expense, and high marginal rates.

16. Birnbaum and Murray (1987, 127) note the concern of Dan Rostenkowski, chairman of the House Ways and Means Committee, that his daughters paid more income tax than some millionaires. According to a U.S. Treasury Department study (1985), in 1983 some thirty thousand taxpayers with incomes (before deduction of tax shelter losses) in excess of $250,000 paid less than 5 percent of such income in taxes.

17. This is not to say that the 1986 act achieved a tax base that approached the comprehensiveness of the Treasury I plan. For example, whereas Treasury I would have eliminated the deduction for all state and local taxes and would have taxed fringe benefits much more heavily, the 1986 act eliminates only the deduction for sales taxes, hardly touches fringe benefits, and makes up the revenue by a truly draconian assault on tax shelters that might accurately be characterized as retroactive.

One extremely important difference between the 1986 act and its 1981 counterpart should be mentioned. In 1981 there were essentially no losers; different industries received larger or smaller tax cuts, but virtually all received some benefit. By comparison, in 1986 there were both winners and losers. Indeed, because there was a large shift in tax liability from individuals to corporations, there were some big losers. Even so, there were enough business winners that it was never possible to put together a "killer coalition" of business interests. Rather, Darman and others put together effective coalitions of industries that would benefit from reform that were strong enough to help assure the passage of tax reform.

Public perceptions about tax reform were interesting, not to say puzzling. Under the Treasury I proposal there would have been two winners for every loser, as measured by changes in individual tax liabilities. This was true in part because there was a large shift in liabilities from individuals to corporations, and the increase in corporate taxes was not attributed to the individuals that would pay them. Yet, throughout the tax reform process a majority of those questioned in surveys consistently thought they would lose from tax reform. At no time was there a public ground swell in favor of tax reform. At best, the public looked on tax reform with indifference; at worst it was hostile. Presumably this reflected some combination of ignorance of the contents of the tax reform program and distrust of Congress; it is unlikely that individuals were factoring in the increase in corporate burdens.

4.3 International Implications of Tax Reform

Most of the remainder of this paper is devoted to examination of the international implications of changes in the U.S. income tax that occurred in 1981 and 1986. The Foreign Investment in Real Property Tax Act of 1980 and the 1984 repeal of the 30 percent withholding tax on most portfolio interest paid to foreigners are discussed more briefly. Finally, I mention briefly an issue that epitomizes the problems created by international economic interdependence, though it does not involve federal tax reform; this is unitary taxation, the method some of the American states use to tax the income of multijurisdictional corporations. I end with speculations about the need for, and the prospects of, international arrangements to reduce the increased tax competition resulting from both increasing economic interdependence and the changes in U.S. tax laws discussed earlier.

4.3.1 International Implications of the 1981 Act

It seems clear in retrospect that those responsible for the 1981 act did not pay adequate attention to the international implications of what they were doing.[18] A bidding war between the Republican and Democrats, rather than

18. This argument is developed at greater length in McLure (1990b).

rational analysis, explains the generosity of the investment provisions.[19] Only later was it widely realized that an increase in investment stimulated by tax incentives that is not matched by an equal increase in saving and, indeed, is aggravated by a large increase in public dissaving, would necessarily generate an inflow of foreign capital needed to finance the excess investment.[20] The capital inflow must, of necessity, be mirrored in a deterioration of the U.S. trade balance. This would be achieved by appreciation of the dollar—a development that would make imports more attractive to American consumers and exports less attractive to foreign purchasers. In short, investment incentives would hurt the short-run competitiveness of American industry.[21] Sinn (1991, 1) states the issue as follows:

> An obvious sign of confusion is the popular belief that a policy that makes a country attractive for internationally mobile capital will simultaneously improve this country's competitiveness in international trade. Of course, with flexible exchange rates, this cannot be true since the capital import equals the current account deficit: The investors' attempt to import capital will be successful only to the extent that it leads to a revaluation and thereby to a deterioration of the current account. The confusion is shared by countries that take pride in being world export champions without realizing that they could equally well regard themselves as capital flight champions. Economists have warned of such types of irrationality.

The 1981 act clearly could not affect only the United States. Sinn (1987, 224–25) notes:

> The first half of the eighties was characterized by enormous capital imports into the United States accompanied by a strong dollar and a high world interest rate level. Most countries suffered from this situation. Europe was driven into the worst recession of the post-war period, and the developing countries were shaken by one debt crisis after another. A number of countries were unable to meet their interest obligations, and a collapse of the world banking system was avoided only by strenuous efforts. The United States alone seemed to have benefited: despite the high interest rate it enjoyed a significant consumption and investment boom.

Sinn goes on to observe: "A potential explanation of the development of the world economy that fits all of the facts mentioned could be the Accelerated

19. See Rudder (1983, 205–6) and Witte (1985, 221–35). This experience is summarized in McLure (1989a).

20. This case is an example of the second of the channels of influence identified by Jun (1989). It appears that Summers (1988) is one of the first explicit recognitions of this proposition, so obvious in retrospect; see also Bernheim (1988, 3–5). Sinn (1987, 224–31) provides a masterful exposition of this proposition.

21. The concept of competitiveness used here, the ability to compete with imports and to export, is a crude one that does not necessarily make much sense; but it is the one that seems to permeate discussions of public policy. Slemrod (1991), besides noting the faults of this definition, argues for defining competitiveness as the ability to maintain (or increase) a nation's level of real income in the presence of competition from abroad.

Cost Recovery System (ACRS) introduced by the Reagan Administration in 1981." He concludes: "[T]here cannot be much doubt that ACRS caused one of the most severe disturbances of the world economy ever induced by a tax reform."

4.3.2 International Implications of the 1986 Act

Like the 1981 act, the 1986 act has had important effects on international trade and capital flows. Moreover, it has induced foreign governments to alter their tax policies. By eliminating the investment tax credit and reducing the speed with which depreciation allowances can be taken, it has reduced incentives for investment in the United States.[22] This may tend to reverse the excess of investment over saving, capital inflows, depreciation of the dollar, difficulties exporting, and competition from imports noted earlier.

It is interesting to note that discussions of the international effects of tax reform that occurred during the two years preceding passage of the 1986 act reflected only a rudimentary and incomplete understanding of such effects. Those arguing in favor of retention of investment incentives contended that such incentives were necessary to maintain the competitiveness of American industry. They seemed not to understand that, if saving cannot be increased, encouraging investment undermines the competitive position of U.S. industry in the short run, for reasons outlined above, no matter how positive the effects might be in the long run.

Several provisions of the 1986 act, most notably the reduction in corporate rates, the change in "sourcing" rules, and the tighter limitations on the foreign tax credit, can be expected to have extremely important international implications.[23] The reduction in corporate rates has converted the United States into a tax haven in some respects. In particular, multinational firms based in many countries employing the territorial principle will find it attractive to invest in the United States or to manipulate transactions to attribute as much of their income as possible to the United States, in order to have it taxed at the rate of 34 percent, which is one of the lowest in the world. Even corporations based in countries employing residence taxation with foreign tax credit limitations calculated on an overall basis may find it attractive to attribute income to the United States, in order to be able to average low-tax U.S. income with high-tax income earned in other countries.[24]

Multinational corporations may also have an incentive to shift borrowing from the United States to other countries, in order to benefit from interest deductions at the higher rates prevailing there, rather than the lower U.S.

22. This is an example of Jun's second channel of influence.

23. These are examples of Jun's first channel of influence.

24. Slemrod (1991) notes that Japan has enacted provisions intended to restrict the possibility of offsetting high-tax income against low-tax income under its system of overall limitation on the foreign tax credit.

rate.[25] Such a shift could have important effects on the distribution of tax revenues among nations. This has apparently been an important determinant of Canada's decision to reduce its corporate tax rate in response to the American rate reduction.[26]

The United States has long been worried about the incentive effects created by the use of an overall limitation on the foreign tax credit.[27] The overall limitation can create an incentive for corporations to move business to low-tax jurisdictions, in order to offset taxes paid in high-tax jurisdictions. Alternatively, if they have adequate low-tax income, they can invest in high-tax jurisdictions without actually bearing the burden of such higher taxes.[28] Those responsible for U.S. tax reform realized that the proposed rate reductions would aggravate this problem: rate reduction would reduce the ability of U.S. corporations to take full credit for tax paid to foreign countries, and thus increase incentives to shift income to low-tax jurisdictions.[29]

Various approaches have been proposed to deal with this problem. For example, the U.S. Treasury Department (1984, 2:361) and President Reagan's 1985 tax reform proposals to the Congress (p. 389) recommended shifting to a per-country limitation on the foreign tax credit. The 1986 act took a different approach. It retained the overall limitation but expanded the use of separate "baskets." In particular, there are separate baskets for ordinary operating income, for passive income, and for income that is commonly subject to low rates, such as that from financial services and shipping income. Moreover, it provided for a "high-rate kick-out"; interest income subject to high gross withholding taxes cannot be comingled with passive income subject to low tax rates. These rules have greatly increased the complexity of the tax system for U.S. multinational corporations.[30] Most will be forced to classify their income into at least three baskets, operating, passive, and high-tax interest.

The reduction in rates, tighter sourcing rules, and greater use of separate baskets will have important international ramifications. In particular, many more American firms will have excess foreign tax credits—taxes paid to for-

25. This is an example of Jun's third channel of influence. It involves a change in the relative cost of funds resulting from changes in the tax rates at which deductions are taken.

26. This has been emphasized in Bossons (1987, 1988). See also Whalley (1990b).

27. The United States allows U.S. multinationals credit for taxes paid to foreign governments, but only up to the amount of U.S. tax that would be paid on such foreign-source income. It employs an "overall limitation," under which the income earned in all foreign countries and the taxes attributed thereto are combined in calculating the limitation on the credit.

28. See the example in U.S. Department of the Treasury (1984, 2:360–61), and *The President's Tax Proposals* (1985, 387).

29. See *The President's Tax Proposals* (1985, 387). Because the 1986 act contains a 34 percent corporate rate, there is an enormous shift of tax burden from individuals to corporations. Under an alternative reform that would have left corporate liabilities unchanged, the corporate rate might have been reduced to as low as 28 percent. See Birnbaum and Murray (1987, 59). Under such a change excess foreign tax credits would be even more prevalent.

30. On the complexity of the post-1986 U.S. taxation of multinational corporations, see Tillinghast (1990).

eign governments in excess of what can be credited in the United States. As long as the United States had relatively high tax rates and liberal sourcing and averaging rules, foreign governments could operate under an umbrella created by the U.S. foreign tax credit: they could, on average, levy tax rates as high as those in the United States without fear that U.S. taxpayers investing within their jurisdiction would actually bear the burden of local taxes. Now that many more U.S. multinationals are in an excess credit position, the umbrella is shredded; it will be much more common that the investors, rather than the U.S. Treasury, will pay taxes levied by source countries. The result is that conditions now resemble more closely what they would be if the United States employed a territorial system.

One obvious result of this change in U.S. tax policy has been pressure on foreign governments to reduce their own tax rates. Explicit recognition of this is nowhere expressed more clearly than in the Colombian income tax reform passed at the end of 1986. Article 44 of that law provides the government the power to change the tax rates applied to income of foreigners in the light of changes being made in the income taxes of resident countries of foreigners investing in Colombia (the most important of which is the United States); the provision mentions specifically changes in the availability of foreign tax credits. This power has since been exercised; whereas the withholding rate was initially raised from 20 percent to 30 percent when the income tax rate was reduced from 40 percent to 30 percent (producing a combined rate of 51 percent on income distributed to foreigners, compared to 52 percent under prior law), it has since been reduced to 20 percent.

There may be few cases as clear as this one. But there is no doubt that tax rates have been falling around the world. Table 4.1 reports tax rates before

Table 4.1 Tax Rates in Selected Countries, before and after Tax Reform

Country	Top Marginal Rate for Individuals (old/new)	Corporate Rate (old/new)
Australia	60/49	46/39
Canada	34/29	36/28
Colombia	49/30	40/30
Indonesia	50/35	45/35
Israel	60/48[a]	53/48
Japan	70/50	42/37.5
Mexico	55/40	42/36
Sweden	75/50	56/30
United Kingdom	80/40	52/35
United States	70/28 (+5)[b]	46/34

Source: Charles E. McLure, Jr., "Appraising Tax Reform," in Boskin and McLure (1990, 282).
[a]Assumes scheduled elimination of surcharge at the end of 1989.
[b]The additional 5 percent represents a surcharge faced by upper-middle-income taxpayers.

and after tax reforms in selected countries. Whalley (1990a) also documents the movement toward lower tax rates.[31] Sinn (1990, 1) writes, "The current world economy seems to be going through a phase of increased tax competition." Of course, it has been necessary to expand tax bases, often by reducing investment incentives, in order to lower rates without sacrificing revenues. Thus it seems that U.S. tax reform has helped encourage the tax reform movement that has swept the world in recent years.

Though this is undoubtedly a welcome development to many of those involved in the process of U.S. tax reform, especially the conservatives in the Reagan White House, there is little reason to believe that worldwide tax reform was a conscious, high-priority objective of those most responsible for advocacy and design of the U.S. reform. They were primarily interested in improving the American system; the reform of other systems is an unexpected if welcome bonus.

4.3.3 Other Tax Changes

The Repeal of Withholding on Interest[32]

During the early 1980s substantial American attention was focused on treaty shopping, the unanticipated and improper use of treaties between the United States and another country to gain the benefits of the treaty for a resident of a third country. Primary attention focused on the Netherlands Antilles, where American corporations would establish finance subsidiaries that would borrow in the Eurodollar market and then relend to their American parents without paying the withholding tax on interest that would be due in the case of direct borrowing from Europe.

The degree of international interdependence is shown by the fact that the United States did not merely repeal its treaty with the Netherlands Antilles or amend it to outlaw this abuse. Rather, the United States repealed its withholding tax on most portfolio interest paid to foreigners.[33] (There had long been no withholding tax on interest on bank accounts.) This route was chosen because of fears that simply repealing the treaty would cause an unacceptable increase the cost of funds to American corporations. This, in turn, is true because there is very little source-based taxation of interest in Europe.[34] Of course, the virtual elimination of source-based taxation of interest by the United States makes it even less likely that any other country will attempt such

31. Whalley (1990a) notes that New Zealand reduced its top individual rate from 66 percent to 33 percent and its corporate rate from 45 to 33 percent.

32. This section draws on McLure (1989d).

33. This is an example of Jun's third channel of influence.

34. When West Germany attempted to introduce a modest withholding tax on interest in 1989 there was such a large exodus of capital to other European countries that the measure had to be repealed. This episode provides evidence that the taxation of interest income is being evaded, since the withholding tax would have been creditable against final liability.

taxation; indeed, it increases the likelihood of further reductions of such taxes by other countries.

Foreign Investment in Real Property Tax Act

American response was quite different in another area, the taxation of capital gains on U.S. real estate. In 1980 the United States enacted the Foreign Investment in Real Property Tax Act (FIRPTA). It modified the normal tax treatment of capital gains realized by foreigners—exemption—to treat gains on real estate as taxable income.[35] This legislation reflected a variety of political pressures, most notably the concern that foreign investors benefiting more from favorable tax treatment than did Americans were bidding up the price of U.S. real estate.

Comparison

It is fascinating to compare the American reaction to greater economic interdependence in these two areas. In the case of interest, source-based taxation was reduced in order to avoid repelling capital inflows or raising the cost of capital to American business. In the case of real estate the stance of public policy was just the opposite; taxes on capital gains were raised in order to prevent capital inflow—or at least make it less attractive. Whether this objective is realized depends on the treatment of such gains and taxes thereon in the country of residence of the foreign investor (territorial, residence with credit, etc.).

Unitary Taxation[36]

The states in the United States employ formulas to apportion the income of multistate corporations among themselves. If several affiliated corporations are deemed to be engaged in a unitary business, their incomes and apportionment factors are "combined" by some states for purposes of determining the income attributable to the state. The idea is that "separate accounting" applied to the activities of the individual corporations cannot adequately determine the division of income between the firms, and thus the geographic source of income. This is true because of the possibility that transfer prices are manipulated and because economic interdependence may be so great that it is conceptually impossible for separate accounting to give an accurate division of income between affiliated firms. In some states this approach is carried to its logical conclusion in "worldwide unitary combination," under which the income and economic activities of all affiliated firms deemed to be engaged in a unitary business are combined, no matter where the firms do business.

This approach has proven to be extremely unpopular with foreign governments, as well as with both domestic and foreign multinational corporations.

35. This is an example of the fourth channel of influence added to Jun's list.

36. This section draws on much of my work on unitary taxation, the most important of which is published in McLure (1986a).

There has thus been a general retreat to "water's-edge combination," under which only U.S. source income is apportioned.

This result is somewhat ironic, given the growing interdependence of the world economy. One would expect that as economic integration proceeds in Europe the economic interdependence of affiliated corporations will become so great that formula apportionment will be needed.[37] Of course, there is no reason to expect that worldwide combination would be attempted.

On the other hand, it is entirely possible that the growing economic interdependence of the world will make separate accounting increasingly untenable everywhere. It is said that the determination, defense, and policing of transfer pricing is imposing a rapidly increasing burden on corporations and tax administrators in the United States. While the United States may be able to cope with these problems satisfactorily, many countries cannot; this is especially true of LDCs. It would not be surprising to see a movement to the use of formulas to divide income among nations.[38]

4.4 Lessons

This review of the international implications of U.S. tax policy provides two kinds of lessons. The first are lessons for other countries acting unilaterally and in their own interest. The lessons for individual countries are fairly straightforward and have been anticipated by the foregoing discussion; they are simply stated with little elaboration, except to note that they would be modified if there were greater international tax cooperation. By far the more interesting implications are those for the international community of nations; they involve the need for greater cooperation in tax policy. I deal with them at greater length, but not really satisfactorily.

4.4.1 Lessons for Other Countries

Countries that wish to compete effectively in world markets would do well not to increase investment more rapidly than saving; this is something that economists working in developing countries have known for years, but the United States learned only in the 1980s, if at all.

Countries that want to attract investment from the United States would be well-advised to pay attention to the foreign tax credit position of potential investors. If such firms have excess foreign tax credits, the taxes of the source country will burden the investor, as under a territorial system, and not be borne by the U.S. Treasury. In general, countries would do well to keep their statutory corporate tax rates below the American corporate rate, and that may not even be low enough, due to the working of the overall limitation on the foreign tax credit.

37. For a more detailed statement of this position, see McLure (1989b).

38. For discussions of this possibility, see Carlson and Galper (1984) and Kopits and Muten (1984).

The elimination of U.S. taxation on virtually all interest income suggests that other countries may be well advised to reduce their own taxation of income from business and capital, in order to prevent capital outflows. At the very least, it might be appropriate to exempt interest income of residents from tax.[39] A more extreme approach would be to replace the income tax with a direct tax based on consumption.[40] Of course, that policy involves questions that go far beyond the scope of this paper.[41]

Multinational companies have opportunities to chose where to borrow and to manipulate transfer prices in order to minimize their taxes. This also suggests that other countries will do well to avoid statutory rates above the U.S. corporate rate. Moreover, it suggests that they may even want to think of using a form of unitary taxation, both to prevent abuses and to get around the problems inevitably posed by economic interdependence with a group of affiliated firms—problems that will become even more acute for tax administration as international interdependence increases.

4.4.2 Lessons for the Community of Nations

The picture painted above—including the lessons for countries acting unilaterally—is not a pretty one; it is one of intensified tax competition that can be prevented only by international cooperation. As Razin and Sadka (1989, 4) wrote in a recent NBER working paper, "If there is not sufficient coordination with the rest of the world to allow each country to tax its residents on their income from capital in the rest of the world, then tax competition leads to no tax whatsoever on capital income."

Some would find this development to be a positive one; presumably most advocates of consumption-based direct taxes would fall in this camp, as would less-principled advocates of greater capital formation. This is not the place to enter that debate. I will simply take as given the need to prevent wholesale tax competition, for whatever reason, and ask what kinds of cooperation would be needed to achieve this end.[42] The discussion that follows reflects the last three lessons for individual countries given above.[43]

39. I do not consider the possibility that residence countries will adopt the worldwide taxation of interest where it does not now exist; I consider that a futile gesture in the absence of far-reaching international cooperation of the type discussed below.

40. McLure (1989d) suggests this approach. McLure et al. (1990, chap. 9) and McLure (1990a) discuss whether the United States would allow foreign tax credits for such a tax, noting that the development of excess foreign tax credits by many American multinationals reduces the importance of the issue.

41. See, however, McLure et al. (1990, chap. 9) or Zodrow and McLure (forthcoming).

42. On the costs of international tax competition, see Musgrave (1990), Slemrod (1990), and Sinn (1990). The primary reason for favoring the taxation of income from capital is the regressivity of failing to do so. Musgrave relies heavily on the view that source countries are "entitled" to taxes on income, whereas Sinn notes an insurance motive for preventing tax competition. The need to end tax competition is especially grave for LDCs and for countries in the process of emerging from socialism. It may be worth noting explicitly that I have advocated tax competition among subnational governments as a way of assuring that citizens get something of value from their governments; see McLure (1986b).

43. For similar suggestions, see Slemrod (1990, 21–22). Bird (1988) and Bird and McLure (1990) also deal with this issue.

First, it would be appropriate to keep statutory corporate tax rates within a fairly narrow band—or at least above an agreed lower bound. This would protect all countries from destructive tax competition. Second, withholding taxes should be levied on all passive income paid to foreigners. Such taxes could be final taxes, with revenues retained by the source country, or creditable against tax liability in the taxpayer's country of residence (in which case revenues would be remitted to the residence country); alternatively, revenues could be split between source and residence countries. Third, countries not agreeing to the above two rules of the game would be designated as tax havens. Amounts paid to persons residing in them (including "letterbox persons") would be subject to full withholding, without the benefit of crediting. The fourth possible lesson is even more controversial than the above three. It involves the adoption of some variant of unitary taxation, at least within the EC, and perhaps by all countries.

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Comment Toshiaki Tachibanaki

This is a very valuable survey paper on the experience of the U.S. tax reform and its implication for the other countries. Obviously, the United States is the most influential country in the world. Thus, it has a special value for the other countries. One interesting and useful element of this paper is that Charles McLure presents his personal opinions in several cases. This reflects the fact that McLure was at one time an insider of the U.S. tax reform. Therefore, readers can learn some insider stories. My comments are largely addressed to his opinions.

First, McLure attributes the big increase in investment to investment tax credit (ITC) and accelerated depreciation allowances in the 1981 tax reform. In other words, tax reform was quite effective for increasing investment activity in the United States. This opinion was advocated by Hans-Werner Sinn, and McLure supports the opinion to a greater extent. No serious empirical evidence, however, is described in this paper. It is possible to guess that there

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must be some other important reasons for explaining the increase in investment, such as sales increases, profit increases, and others. It would be necessary to report some empirical support of the investment behavior in the United States in view of McLure's emphasis on the increase in investment due to tax policy.

Second, McLure suggests that the big increase in investment is the main cause of the U.S. investment-savings imbalance. I do not deny the effect. It seems to me, however, that excess consumption (or lower saving) of the American people and/or huge government deficits have been more responsible for the U.S. investment-savings imbalance than the increase in investment. This is my personal opinion.

Third, McLure says that tax may affect the degree of competitiveness of the industry. Some people propose that a decrease in the corporate tax rate or an increase in ITC is recommended in order to improve competitiveness. According to the careful international comparison among four countries, namely the United Kingdom, Sweden, West Germany, and the United States, performed by King and Fullerton,[1] the correlation between productivity (or investment activity) and tax burden is inverse. In other words, countries that levy higher taxes have higher productivities or investment activities. Thus, it may be difficult to believe a strong effect of tax on competitiveness. Competitiveness is determined by factors other than the tax factor. This may be again my personal opinion.

Fourth, McLure points out the necessity of international tax coordination particularly in the field of corporate tax rates, the "sourcing" rule, and the limitation of the foreign tax credit. I agree with him because it is important to avoid tax competition or tax war among nations. In other words, a country should learn from the experience of other countries. McLure points out the possibility of broadening the tax base in the United States, namely, a shift to a tax based on consumption rather on income. However, tax reform in the United States failed to have such a shift. In view of the experiences in most of the industrialized nations where a VAT or a tax based on consumption was introduced, the United States may have to learn from the experiences in the other industrialized countries. Otherwise, the United States may be isolated from the world trend. If tax coordination is important as suggested by McLure, the time has come to consider such a tax in the United States.

The comments here were largely my personal reactions to the opinions addressed by McLure. Needless to say, they do not dispute the quality and usefulness of this paper at all.

1. Mervyn A. King and Don Fullerton, eds., *The Taxation of Income from Capital* (Chicago: University of Chicago Press, 1984).