Rethinking International Tax Policy

Daniel Shaviro
NYU Law School

Remarks at the NEF's Third International Colloquium,
University of Sao Paulo Law School, December 1, 2011

Worldwide state of the play

What people up north call the "U.S. approach" to taxing resident companies' foreign source income (FSI) – worldwide taxation but with deferral and foreign tax credits – used to be widespread but is now increasingly rare.

Thus, the U.K. and Japan have recently joined the march towards a more territorial approach to taxing resident corporations.

There's also been movement around the world in recent years towards lower statutory rates for corporations.

Here, as well as in having an at least nominally "worldwide" approach to resident company taxation, the U.S. is an outlier as to statutory or marginal rate (35%), though probably not as to effective or average rate.

Brazil looks a lot like the U.S. – 34% corp. rate, WW / FTC system – but with tougher FSI rules (no deferral, FTCs / tax havens, transfer pricing).

Today’s question

How should Brazil and/or the U.S. rethink their approaches to taxing foreign source income, given developments in other countries?

Note two distinct possible reasons for the rethinking:

(a) Might developments in other countries reflect new developments that we (in both the U.S. and Brazil) need to consider?

Recall the old cartoon where the fond mother watches the parade & says: “Everyone’s out of step but my Johnny!”

Rising globalization and worldwide capital mobility clearly are relevant & more important today than, say, 50 years ago.

(b) Might developments in other countries affect the U.S. and Brazil’s optimal strategic choices?

Plus, it’s always worthwhile to re-examine old paradigms, just in case we are pygmies standing on the shoulders of giants.

An international tax policy consensus?

While the U.S. export sector is not what it used to be – we've long since shifted from being a creditor to a debtor nation – one thing the U.S. still exports in bulk is *advice*.

Perhaps the market for U.S. advice isn't what it used to be, either (e.g., 1990s "Washington consensus" on domestic economic policy).

But luckily I'll be expressing my own views, not those of any U.S. consensus on international taxation.

Were it otherwise, I'd be able to choose between the "old" & the "new" U.S. consensus (the latter in 2 versions).

But as it happens, each consensus is wrong.

The "old" U.S. expert consensus

Unilateral national welfare: national neutrality (NN) – tax FSI at full domestic rate, foreign taxes just deductible.

Bad effects on cross-border activity if everyone did this, but luckily no one does. So, countries must be pursuing global, not national, welfare.

This typically is put (with wild but generally unrecognized implausibility) as a matter of national policymakers' global altruism.

You know, we're all brothers & sisters, everyone in the world counts equally, etcetera.

A compelling view ethically, but is there *any* other broad setting in which even the very same analysts adopt a global rather than a national welfare perspective?

The claim is actually about the cooperative rather than unilateral pursuit of national welfare. But this requires focusing (as the literature doesn't) on strategic interactions.

Global welfare under the “old” consensus

Under the old consensus, the pursuit of global welfare requires choosing between capital export neutrality (CEN) & capital import neutrality (CIN).

CEN: For a taxpayer w/ given residence, tax all investments the same (since taxes are a cost to the taxpayer but a transfer socially).

While most easily accomplished by having residence-based taxation only, can be achieved despite source-based taxes if residence countries neutralize these taxes with unlimited foreign tax credits (FTCs).

CIN: Tax everyone who could make a given investment the same. (For competitiveness? Efficient global allocation of saving?) Hence, source-based taxes only.

Battle of the neutralities: for various reasons, CEN usually deemed the winner.

Problems with the old consensus

Why fetishize one margin when there are many to consider? Whatever happened to tradeoffs, or to minimizing overall inefficiency?

Inadequate analysis of national welfare. E.g., why doesn't anyone seem interested in following NN? Is it just retaliation that holds them back?

Inadequate analysis of global welfare: E.g., why would we expect anyone to follow it, other than in a strategic interactions / reciprocity framework?

"Global convention" fallacy: why unilaterally follow the rule that it would be nice if everyone followed? (E.g., what global benefit from pursuing CEN if others pursue CIN?)

Two distinct issues amalgamated: tax burden on FSI; marginal reimburse-ment rate (MRR) for foreign taxes.

Role of corporations and corporate tax effectively ignored. But corporate residence is not normatively meaningful, may be tax-elastic, corps can raise new equity, for distribution need to think about shareholders (SHs).

The “new” U.S. expert consensus

From 2 criticisms of old consensus: (a) for resident companies, FDI may not be a substitute for home investment; (b) Coase & multinational entities (MNEs): importance of ownership.

But this literature otherwise repeats the failings of the old consensus. Hence we get more alphabet soup:

(a) CON (capital ownership neutrality) instead of CEN & CIN.

(b) NON (national ownership neutrality) instead of NN. The goal: zero tax discouragement of outbound investment.

Proponents claim that both CON & NON favor exemption, & believe this means they don’t have to worry about global vs. national.

Others accept the analysis in theory, but not the bottom line, arguing for WW taxation of resident companies purely to backstop the source rules.

Alas, neither side grasps how wholly unpersuasive the “new” analysis is.

Problems with the new consensus

Same as with the old consensus: why fetishize one margin, failure to relate global to national welfare, global convention fallacy.

NON might make sense if, in all other respects, we had lump sum taxation & zero distortion.

But why aim for zero distortion at one arbitrarily chosen margin, when there are large distortions at other margins? (E.g., source-based tax drives a wedge between private & social return for home investment.)

A common view: We should tax FSI at zero if it's not a substitute for home investment. But this looks at the wrong margin – the effect on *home investment* of taxing FSI. What matters is the effect on *FSI* of taxing it.

Suppose resident MNEs' FSI was completely inelastic – would they still propose taxing it at zero? Don't relative elasticities matter?

My facetious extension of NON: "bus drivers' work neutrality" or BWDN (tax bus drivers' wages at zero if not a substitute for other income).

A better way forward

Issues raised by taxing resident companies' FSI are not fundamentally different from other tax policy issues – so use standard analytic approaches rather than alphabet soup.

The only special features of the international setting are (a) possibility of strategic interactions between sovereigns (e.g., treaties or tit-for-tat); (b) countries' limited market power in a global economy (cf. tariffs).

Three issues to consider:

(a) ***Why*** tax FSI? (Which is not to prejudge whether we should; the question is what purposes it might serve.)

(b) ***How*** tax FSI? (I.e., how should a tax with a positive rate be structured.)

(c) ***How much*** tax FSI? (I.e., what tax rate, including zero, should it face.)

(1) **Why** tax FSI?: the corporate residence issue

Corporate residence (unlike that of individuals) is neither meaningful nor normatively significant; an abstract legal entity doesn't "live" anywhere.

But even apart from the possibility that it might serve as a proxy for taxing resident individuals, the key thing about corporations that can colorably be defined as resident is that one *can* tax them on FSI.

E.g., suppose the U.S. &/or Brazil wanted to tax all income earned in Germany (since it avoids the domestic source-based tax). Can only get away with this re. corporate "residents."

The fact that one *can* tax "resident" companies on their FSI is enough to establish that one should at least think about it – even if corporate residence is nonsensical, & there are no other relevant difference between "home" and "foreign" companies.

Why tax FSI?: distributional issues

Distributional issues only apply to individuals, not legal entities – so need to think about SHs, who may be either domestic or foreign.

Domestic SHs: WW taxation of companies helps back up WW taxation of individuals. Cf. corporate income taxation generally; note what people in the U.S. might call the "Bill Gates – Mark Zuckerberg problem."

If resident individuals were taxed directly on corporate income, strong case for WW taxation without deferral. Quid-pro-quo deals might yield FTCs, but more likely reciprocal exemption from source-based taxes.

Foreign SHs: not included in national welfare calculus, so taxing them is really an efficiency issue. If no burden on domestic individuals, the optimal fee is whatever yields the most revenue.

Even with tax incidence shifts & other domestic deadweight loss (DWL), the optimal fee may exceed zero. Taxing FSI is admittedly an odd fee structure, but might be the best (or only one) available.

Why tax FSI?: efficiency issues

Upside of taxing FSI: Incentive problem re. source-based taxes, which drive a wedge between TP return & social return.

This can affect real locational choices &/or where income is reported.

Given this problem, it would clearly be desirable (if feasible) for a given country to tax ALL companies in the world on ALL of their WW income.

Since unfeasible, the question is what net benefit remains from so taxing only a subset (i.e., companies classified as domestic residents).

This may preserve some of the benefit, but note, e.g., clientele effects & corporate residence electivity / elasticity.

This in turn may create domestic DWL from taxing FSI only when earned by “resident” companies.

(2) **How** tax FSI?

Standard tax policy mantra is "broad base, low rates." But all countries with WW tax systems use FTCs; most use deferral.

The view that one must *either* grant FTCs *or* exempt FSI reflects the fallacy that "double taxation" *as such* is a problem.

But double taxation is a purely formalistic concept, scoring each tax system's impact as "1 / 0" without regard, e.g., to high vs. low taxes.

And who cares? I would rather be taxed twenty times at 1% each time than once at 34 or 35%.

What **is** of genuine normative interest is heavy vs. light taxation at a given margin, equal vs. unequal taxation at two margins.

So there is no inherent reason to prefer, say, a 34 or 35% tax with FTCs to [placeholder]-neutral lower rate plus mere foreign tax deductibility.

Foreign taxes vs. domestic taxes

From a domestic standpoint, they're fundamentally different – "we" don't get the money from foreign taxes!

Need *reciprocity* for treating the two as equivalent to make any sense.

But there is no reciprocity in practice. Even in treaties, can use either FTCs **or** exemption.

Exemption is an implicit deductibility system, since the MRR for foreign taxes (0%) equals the MTR (0%).

This may initially sound like a cute semantic point – but in fact it's an important substantive point.

Foreign taxes vs. domestic taxes

In a deductibility system (be it exemption or NN), TPs try to maximize after-foreign tax income, & treat $1 of foreign tax liability as equivalent to any other $1 outlay or foregone receipt.

By contrast, in a pure credit system (w/o deferral or FTC limits), TPs try to maximize pre-foreign tax income & are indifferent to foreign taxes paid.

E.g., if fully creditable I ought to be willing to pay someone else's $1B foreign tax bill in exchange for a $1 side payment.

From a unilateral domestic standpoint, deductibility is clearly correct. Thus, e.g., we should want companies owned by resident individuals to invest in low-tax, not high-tax countries (all else equal).

But no implication whatsoever re. what should be the tax rate on FSI. Note that exemption (w/ 0% rate) & NN (with full domestic rate) are identical at this margin.

Adding deferral to the picture

Deferral creates further horrible incentives, & hence is dominated by a [placeholder]-neutral alternative (as in Grubert-Altshuler 2008).

But note that FTCs & deferral each have the beneficial side-effect of curbing each other's bad incentive effects.

Deferral makes domestic corps foreign tax cost-conscious, since $1 reimbursement in 10 years (or never) is worth less than $1 of tax today.

Likewise, FTCs can reduce the "lock-out" of foreign earnings that may result from deferral, since it makes repatriation cheaper (or even tax-free).

But systems with both inevitably have a horrific ratio between (a) tax planning and compliance costs and (b) revenue raised.

The U.S. is case in point. Brazil: worth examining whether lack of deferral makes FTCs "worse."

Conventional tax policy wisdom about broadening the base & lowering the rate should apply to FTCs as well as to deferral.

(3) **How much** tax FSI?

Conceptually, a 2-step process: (a) repeal FTCs & deferral (if applicable) in [placeholder]-neutral combination with a lower tax rate for FSI; (b) suitably adjust the tax rate for FSI.

Obviously, (b) is the hard part. While I don't claim to know the right answer (for the U.S. or Brazil), I do have a view re. how to think about it.

An important public economics concept is the *marginal efficiency cost of funds* (MECF), defined as (taxes + tax planning costs & other DWL borne by domestic ind'ls) / tax revenues raised net of gov't administrative costs).

The lower the better, from an efficiency standpoint. E.g., it's 1.0 for a lump sum tax, & potentially less than 1.0 for a well-designed Pigovian tax (such as a pollution tax).

Of course, equity considerations count as well & must in principle be amalgamated with it (ME**E**CF?).

Features of MECF

Significantly related to tax-elasticity (potential revenue / actual revenue, where the numerator is reduced by tax planning responses).

This reflects that TPs will presumably bear up to $1 of tax planning costs & other DWL to avoid $1 of tax liability.

Particular tax instruments (e.g., tax on domestic income, tax on FSI, audit rate) tend to have rising MECF as their rate or usage level increases.

In principle, efficiency maximized (at a given revenue level) by equalizing *marginal* MECF for all instruments.

Akin to Ramsey taxation (optimal commodity taxation), with its inverse elasticity rule. E.g., tax milk at a higher rate than orange juice if milk-drinkers are less price-responsive than orange juice-drinkers.

Applying MECF

While any two tax instruments can be paired in an equalize-MECF analysis, doing so may make especial sense re. the tax rates for domestic source income & FSI.

Note, e.g., political perceptions in the U.S. re. taxation of the "corporate" or "business" sector.

2 points that seem clear: (a) Tax rate of X% on domestic & 0% on FSI is likely to be dominated by lowering the former & raising the latter.

Note, e.g., U.S. evidence of still-limited tax elasticity of resident-company outbound investment & FSI.

(b) At least for the U.S., optimal tax rate for FSI likely to be lower than that for domestic source income.

U.S. probably has far more market power re. all domestic economic activity than re. use of U.S. resident entities to invest abroad.

Problems with the proposed solution

WW taxation without FTCs (or deferral) & a lower tax rate for FSI than domestic source income may be hard to enact given intuitive aversion to "double taxation."

It also may be unstable in a political economy sense, & clearly violates treaties. Might it encourage foreign retaliation?

If so, & if MECF is bound to be prohibitively bad for an FTC system (with or without deferral), then a case for exemption after all?

But in that case, countries that previously used deferral should address resident MNEs' windfall gain by enacting a transition tax on unrepatriated foreign earnings. (E.g., via a "timely deemed repatriation" rule.)

Brazil: Might this rationale apply to FSI that has accrued economically but not as yet been recognized for tax purposes?

Source rules under a territorial (and also a worldwide?) system

Exemption would raise the stakes re. improving source rules.

Strong case for a WW "unitary business" approach without regard to whether a domestic company is at the top of the global group.

Thus, ignore intra-group debt payments & which member of the group engaged in third-party borrowing. Also ignore intra-group risk allocations and the like. (But might use formulary elements based on location, not entity lines.)

Some "territorial" countries, such as Japan, continue to tax income that is earned in countries that tax at below a specified tax rate.

This is part-good and part-bad, but on the whole misdirected.

What foreign source income to tax under a "territorial" system

When income arises in a tax haven, that may be a good predictive "filter" suggesting the relative likelihood that it may actually have arisen at home.

But – there is no reason to want domestic companies to pay *more*, rather than *less*, foreign tax.

Plus, minimum foreign tax rates for exemption can be exploited, both by taxpayers and by other countries.

There might be better filters – e.g., income from intellectual property, or located in countries where the taxpayer lacks significant productive resources, might remain taxable when one shifts to exemption.

Such changes may be desirable even if one has a WW / FTC system and does not otherwise change it.

E.g., the U.S. could redefine foreign royalties (deductible abroad) as domestic income that's ineligible for FTCs.

What implications for Brazil?

I should probably just *ask* this of today's audience, rather than purporting to answer it.

But an important issue concerns Brazil's degree of market power over outbound investment by Brazilian taxpayers.

Is the tax-elasticity of using domestic incorporation / HQ when one invests abroad higher or lower than for the U.S., EU countries, Japan, etc.?

How willing are Brazilian individuals to invest abroad through non-Brazilian corporate entities? How do Brazilian companies bid for foreign assets?

Other distinctive features here: don't similarly allow deferral; fewer tax treaties than many other countries; tougher FTC & transfer pricing rules.

Can / should anti-tax haven rules, without being weakened, be reformulated?

Key issue: what tax planning techniques do Brazilian taxpayers currently use in response to the national tax treatment of FSI?