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# Protectionist Pitfalls in U.S. Tax Reform

By James R. Hines Jr.

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The magnitude of current and projected U.S. budget deficits makes it appropriate for the government to cast its net wide in seeking new revenue sources. In doing so, however, there is the danger of misconstruing the role of domestic taxation in a global economy, and thereby designing a tax reform proposal with significant protectionist elements.

Movements to impose heavier taxes on Americans earning active income abroad would undermine the vitality of the U.S. economy and its ability to generate tax revenue. A much sounder and more sustainable tax reform course would be to increase the country's reliance on expenditure-based taxes, which is the direction most of the world has taken in response to the competitive pressures faced by all economies.

Active foreign income earned by American businesses is taxed by foreign governments and, to a lesser extent, by the U.S. government. U.S. taxes typically apply to that income only when it is returned to the United States and after taxpayers have been allowed to claim credits for foreign tax payments. The resulting low ratio of U.S. tax collections to annual foreign income gives the system the appearance of treating foreign income more generously than domestic income and thus makes it an attractive target of reform efforts designed to raise tax revenue.

In fact, the United States taxes foreign income far more heavily than any other major capital-exporting country. Efforts to increase the U.S. tax burden by limiting deferral or reducing foreign tax credits would only increase the obstacles facing American firms attempting to compete in global markets and thrive at home.

The question for reformers is whether current U.S. taxation of foreign income is excessive, or alternatively whether the absence of full U.S. taxation of foreign profits is tantamount to an unwarranted subsidy. The burdens are easily identified: American firms are at a significant disadvantage in low-tax foreign markets compared with all of their foreign counterparts. Competition with investors from countries that exempt foreign income from taxation raises acquisition prices and other costs of operating abroad, thereby effectively pricing Americans out of foreign markets despite the benefits of low tax rates.

Far from being unconscionable loopholes, the limited ability to claim credits for foreign taxes and the deferral of active foreign income do not permit American businesses to compete effectively against investors from any other country in the world. As a result, American firms lose the productivity benefits that would otherwise contribute to their worldwide profitability.

Efforts to increase the U.S. tax burden on foreign income are motivated by the understandable concern that foreign investment by American firms comes at the expense of domestic investment and employment. While there are examples of American employers substituting foreign production for domestic production, there are also hundreds of American companies whose domestic profitability depends in part on their foreign operations. The net effect of foreign investment on domestic economic activity by American firms therefore depends on the relative magnitudes of the substitution and productivity considerations — and the evidence suggests that the productivity effects dominate.

American firms expanding foreign operations generally expand domestic operations at the same time. The most recent statistical evidence indicates that a 10 percent growth in a firm's foreign employment is accompanied by a 3.7 percent growth in domestic employment. Recent evidence for British, Canadian, German, and other firms displays similar patterns.

The more general point is that the desirability of greater domestic economic activity does not imply that greater foreign activity is undesirable. On the contrary, every nation can benefit — and the United States certainly does benefit — from expanded international trade and investment. When Americans invest abroad, they not only undertake greater domestic investment

themselves, but also encourage foreign investment in the United States. As a result of international exchange, business assets are held by the most productive owners, regardless of nationality, to the benefit of all economies.

It does not follow from this logic that the U.S. tax system should subsidize foreign investment; rather, the United States should follow the policies of virtually every other nation in exempting active foreign income from taxation. Doing so promotes efficient ownership of business assets and generates more total tax revenue than a policy that discourages cross-border ownership. The alternative viewpoint — that a failure to tax active foreign income is equivalent to a subsidy — is itself little more than a protectionist fallacy. The reality is that foreign governments tax that income, and competition from foreigners whose home governments exempt foreign income from taxation removes the need for the United States to tax the income directly.

Expenditure taxes such as excise taxes and VATs are attractive alternatives to corporate and personal income taxes in a globally competitive world. Expenditures have clear geographic associations, reducing the potential for international tax avoidance and greatly reducing the mobility of the tax base compared with income tax options. There is ample opportunity to deepen our reliance on expenditure taxes.

The United States is one of the few countries with no VAT, and the U.S. ratio of excise tax collections to total tax revenue is the lowest in the OECD. Historically, small countries with the most open economies have relied most on expenditure taxes, because the personal income tax — and in particular the business income tax — alternatives have been much more costly. But economic developments are rapidly turning all countries, including the United States, into small countries.

Fair and efficient tax policies do not tax all income that governments can identify. Instead they are selective, reflecting the potential mobility of the tax base and the circumstances in which income is earned. Americans earn foreign income in environments that are made highly competitive by the actions of investors that are not taxed by their home countries. In seeking new revenue sources, it would be a serious mistake to increase U.S. taxation of active foreign income, particularly compared with expenditure tax alternatives. ■