2010

Reply to Becker and Fuest

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Available at: https://repository.law.umich.edu/articles/1689

Recommended Citation

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James R. Hines Jr.

It is an understatement to say that the appropriate taxation of foreign business income is a controversial and potentially confusing topic. One of the mysteries of international taxation has been that the prescriptions of what, until recently, was the accepted academic wisdom differs so sharply from widespread international practice. In an important contribution, Richman (1963) noted that a home government confronted with the choice of where it would prefer one of its resident taxpayers to allocate a single unit of capital would weigh the after-foreign-tax return from investing abroad against the pre-tax return from investing at home. From this observation, she concluded that countries maximize their own welfare by subjecting foreign income to full current domestic taxation, permitting only a deduction for foreign tax payments. This analysis further implies that a policy of taxing foreign income while granting credits for foreign income tax payments maximizes world welfare.

In fact virtually no countries have policies that resemble those that this framework describes as optimal and therefore individually rational. Not only do most countries exempt active foreign business income from taxation, but the small number that do not nevertheless permit taxpayers to claim credits against domestic tax liability for foreign tax payments and do not tax foreign source income currently but only when it is repatriated to the domestic parent company. Hence international practice is to tax foreign income much less heavily than these theories imply that countries should ever want to do. This difference suggests either that governments systematically — and universally — err in their taxation of foreign income, or else that these older welfare frameworks fail to capture important aspects of the problem of taxing foreign source income.

More recent analysis of international tax norms challenges the older academic paradigms by calling attention to the importance of tax-induced ownership patterns. Desai and Hines (2003, 2004), Devereux (2008), and others note that the general equilibrium impact of taxation on asset ownership — the reallocation of business ownership to tax-preferred owners — and the role of ownership in influencing productivity together carry very different implications for national tax policies. In a world characterized by shifting ownership of business assets, countries maximize their own welfares by exempting active foreign business income from domestic taxation, and maximize world welfare by

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conforming their taxation of foreign income to world norms. The purpose of the paper by Hines (2008) is to call attention to another tax policy implication of this ownership framework for analyzing international taxation, which is that the same considerations apply to domestic expense deductions that generate foreign income; specifically, countries maximize their own welfares by permitting full deduction of domestic expenses, and maximize world welfare by conforming their deductions to world norms.

The spirited comment by Becker and Fuest (2010) helps to illustrate the basis of these findings. The welfare function used in the first part of the comment is fundamentally partial equilibrium in nature, in that it does not incorporate the welfare effects of any additional domestic investment from foreigners (and domestic residents!) that would be associated with greater outbound foreign investment. This is reflected in the home government maximizing the sum of domestic tax revenue and firm profits, but failing to incorporate tax revenue from foreign investors (and new domestic investors) in the domestic economy. This is the same government objective function used in the original Richman (1963) framework, and as a result, it is not surprising that the comment draws conclusions (captured in Propositions 1 and 2) that are similar in spirit to those of Richman.

The point of the Hines (2008) paper was to consider a home country that optimally taxes foreign source income, and evaluate the accompanying optimal tax treatment of domestic expenses that contribute to the production of foreign source income. It is not possible to perform this exercise using a framework in which the home country taxation of foreign source income is not optimal. In the partial equilibrium approach used in the first part of the Becker and Fuest (2010) comment, and reflected in Propositions 1 and 2, it is not optimal to exempt foreign income from domestic taxation; this is, indeed, the standard Richman (1963) result. The Becker and Fuest (2010) comment shows that if, in this setting, the home country nevertheless exempts foreign income from taxation, then it should not permit a deduction for domestic expenses that contribute to foreign income production. This analysis is correct, but it does not address the point of the Hines (2008) paper, which is to consider a situation in which governments have chosen their taxation of foreign income optimally.

It would be fair to say that the modeling framework used in Hines (2008) is anything but transparent in its treatment of the reasons underlying the optimality of exempting foreign income from taxation; for example, capital investment and labor inputs do not appear as arguments of the firm's production function, instead being implicit — and the actions of foreign investors are not modeled at all. This might be justified on the basis of simplicity, but it carries with it the possibility of engendering confusion. In order to evaluate whether, with a given government objective function, it is optimal to exempt foreign income from taxation, it is necessary to consider a model that explicitly includes capital as an argument of the production function; the need to do this is obscured by the omission of capital from the production functions in Hines (2008). When capital is explicitly included as an argument of firm production functions, it becomes clear that exempting foreign income from home country taxation is not optimal in the setting analyzed in the first part of the Becker and Fuest (2010) comment.

Similarly including capital as an explicit argument of firm production functions in equation (9) of Hines (2008) produces the implication that home country welfare is maximized by exempting foreign income from taxation. The reason, therefore, to adopt equation (9) as the government's maximand is that it captures other features of the economic setting that must hold in order for exemption to be optimal — presumably, as other papers in the literature have analyzed, the impact of shifting ownership. Equation (9) reflects that additional foreign income production by home country firms is associated with greater home country income production by foreign investors of a roughly equivalent amount, who respond to greater outbound investment by home country firms by increasing their investment in the home country. Equation (9) omits explicit consideration of foreign firms, but includes them implicitly by dividing the foreign profits of home country firms by $(1 - \tau)$ in recognition of the tax revenue that the home government will collect from foreign firms whose operations in the home country are (increasing) functions of the level of foreign activity by home country firms.

The second part of the Becker and Fuest (2010) comment very generously explores the possibility that the results reported in Hines (2008) could be obtained in an alternative partial equilibrium model in which home country firms have the ability to sell their foreign affiliates to unrelated foreigners. In this model foreigners appear for the first time, as potential acquirers of domestically owned foreign affiliates, though not as investors in the home economy. As the comment reports in its Propositions 3 and 4, the model implies that firms should not be permitted to deduct all of their domestic expenses incurred in the production of foreign income. Again, this should not be surprising. The setting in this part of the paper does not incorporate the domestic effects of greater foreign investment, and as a result, a true exemption system is not optimal, reflecting the fact that the model fails to capture all of the benefits of additional foreign income.

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