ISSUES 2012 | No. 29 October 2012

MANHATTAN INSTITUTE FOR POLICY RESEARCH

THE MERITS OF A TERRITORIAL TAX SYSTEM

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EXECUTIVE SUMMARY

America's corporate tax rate is one of the highest in the industrialized world. Currently, the U.S. corporate tax rate is 35 percent, compared with an average of 23 percent for its industrialized competitors. Reform is becoming increasingly urgent as the gap between American and foreign rates widens. Not only are U.S. corporations at a disadvantage when they operate abroad, but high tax rates are driving American companies overseas. For example, Aon Corporation, the Chicago-based insurance company, recently relocated its headquarters to London for tax reasons.

The last major revision of the tax code occurred in 1986, and some of those reforms have been undone by rate increases. America should lower the corporate tax rate and switch to a territorial tax system. This would increase economic growth and allow corporations to compete on an equal footing with competitors abroad. Contrary to what critics assert, lowering the corporate tax rate would not deplete the domestic tax base nor would it result in a loss of American jobs.

This report begins with a brief discussion of America's current corporate tax system, and then analyzes the presidential candidates' plans for reform. The taxation of foreign income is one of the most complex parts of the Internal Revenue Code, and this report does not pretend to go into all the details. Rather, it offers an overview of some of the major issues under discussion.

Published by the Manhattan Institute

THE GLOBAL TAX SYSTEM

America's corporate tax system is exceptional. Usually, when people talk of American exceptionalism, they mean it as a compliment. But America has one of the highest corporate tax rates in the industrialized world, at 35 percent.

Furthermore, America taxes corporations on their worldwide income. Only seven of the 34 Organisation for Economic Co-operation and Development (OECD) countries do the same. This places America at a competitive disadvantage.

This problem is recognized by Democrats as well as Republicans. In June, Senate Finance Committee chairman Max Baucus delivered an indictment of the corporate tax system in a speech before the Bipartisan Policy Center, a Washington think tank.[1]

OECD Top Corporate Marginal Rate, National

Territorial Systems	Top Marginal Rate	Worldwide Systems	Top Marginal Rate
Australia	30.0	Chile	17.0
Austria	25.0	Greece	20.0
Belgium	33.0	Ireland	12.5
Canada	15.0	Israel	25.0
Czech Republic	19.0	Korea	22.0
Denmark	25.0	Mexico	30.0
Estonia	21.0	United States	35.0
Finland	24.5	Worldwide Average	23.1
France	34.4	Worldwide Average (w/o U.S.)	21.1
Germany	15.0		
Hungary	19.0		
Iceland	20.0		
Italy	27.5		
Japan	30.0		
Luxembourg	21.0		
Netherlands	25.0		
New Zealand	28.0		
Norway	28.0		
Poland	19.0		
Portugal	25.0		
Slovak Republic	19.0		
Slovenia	20.0		
Spain	30.0		
Sweden	26.3		
Switzerland	8.5		
Turkey	20.0		
United Kingdom	24.0		
Territorial Average	23.4		
OECD Average	23.3		

Source: OECD tax data

Note: This includes only the top national rates and does not take into account the effect of national tax systems that allow adjustment of national taxes based on local taxes.

Baucus said that in response to globalization, other countries have modernized their tax laws, but America has not. Washington taxes companies on their worldwide income rather than on income they generate in the United States. As a result, he lamented, we're losing revenue to tax havens and losing jobs to foreign companies.

With disapproval, Baucus pointed out: "In the past two decades, the number of U.S.-based companies on the Fortune Global 500 list has declined by 20 percent…. When it comes to international tax rules, we seem to have the worst of all worlds. We haven't kept up, and it's time to change."

A global (or worldwide) tax system is uncompetitive, especially with high tax rates, because it imposes a high income-tax rate on all income, regardless of where it is earned. If an American company operates in the United States and Switzerland, its domestic affiliate pays U.S. taxes at 35 percent. But its foreign affiliate pays U.S. taxes at 35 percent and Swiss taxes at 8.5 percent, putting it at a disadvantage vis-à-vis its foreign competitors. America allows companies to deduct the taxes paid to foreign governments from U.S. taxes owed to the Internal Revenue Service, but corporations always pay the full U.S. rate and are unable to take advantage of low-tax jurisdictions.

By contrast, a territorial tax system, common to most U.S. competitors, taxes only income earned domestically. In the example above, the American company operating in Switzerland and America would pay U.S. taxes on its domestic income and Swiss taxes on its Swiss income. In this way, companies can take advantage of low-tax jurisdictions. Business decisions can be made more efficiently, since repatriating income will not result in those profits being taxed again—thus, capital can go where it is most needed.

Critics of a worldwide system rightly assert that companies will not return income to America when profits face a high tax rate. Corporations operating under a global tax system are less competitive if their domestic tax rate is higher than their foreign tax rate, as their profits will always be subject to the higher domestic rate.

Proponents of a worldwide system, however, argue that corporations benefit from being able to headquarter in America, so taxing their global income simply amounts to "paying their fair share." The advantage to having an American headquarters is rapidly disappearing, though, as the difference between American and foreign tax rates widens. Regulations, such as those contained in the Dodd-Frank and Sarbanes-Oxley laws, are becoming more burdensome. Markets are expanding, and headquarters can be located nearer to a firm's client base. And countries such as Britain, Germany, and Japan have stable legal and financial systems, making them satisfactory headquarters for multinationals.

Taxes on foreign income are paid only upon repatriation at the high U.S. rate. This gives corporations an incentive to keep earnings abroad indefinitely to avoid being taxed in America. When the domestic tax rate is higher than the foreign tax rate, as is the case with America, a global tax system provides a major disincentive to repatriating income.

The Senate Permanent Subcommittee on Investigations has estimated that American companies hold offshore around $1.7 trillion of earnings from foreign operations. No one knows for sure how much of this would be repatriated with a lower U.S. tax rate, but corporations would surely repatriate more of it than they do now, adding to investment and employment.

House Ways and Means Committee chairman David Camp has proposed exempting 95 percent of repatriated dividends as an inducement to corporations holding significant earnings abroad.[2] Similarly, Senator Mike Lee, in his Rebuilding America Act, has proposed reducing the tax on repatriated earnings to 5 percent.[3] Even if only half the funds held abroad, $850 billion, were repatriated, this would exceed the stimulus in the 2009 American Recovery and Reinvestment Act, and the federal government would get billions in tax revenues.

THE CANDIDATES' TAX PROPOSALS

Both President Obama and his Republican challenger, Governor Romney, have proposed cutting the top corporate tax rate. Obama has called for a top rate of 28 percent, and Romney has called for a rate of 25 percent. Lowering this rate is a simple, effective measure that would bring the U.S. closer to the OECD average, making American firms more competitive.

It would make America even more competitive to lower tax rates to the levels of Germany and Canada, at 15 percent. These countries have strong rates of GDP growth: 3 percent and 2.4 percent, respectively, in 2011—compared with 1.7 percent for the United States.

Both candidates have proposed ending tax preferences—namely, deductions from gross income that reduce taxable income and therefore tax payments.

Obama has proposed reducing the deductibility of ordinary interest; ending tax preferences for oil and gas, including those that apply to other industries; ending deductions for moving overseas; and imposing a minimum tax on foreign income held abroad and not repatriated.

Obama's tax plan would make the United States an even less desirable place to invest than it is at present, with the result that more corporations would move offshore. Corporations could escape the minimum tax on foreign income and the increase in taxation on oil and gas by relocating to another country. Ending the deduction for moving overseas reduces incentives to locate in America.

Romney has proposed changing to a territorial system of taxation, with a minimum repatriation tax, and ending some tax preferences, including those for alternative energy.

Recent critics of the territorial system have argued that it would create jobs abroad at the expense of the domestic workforce. For instance, Vice President Joe Biden has criticized Mitt Romney's tax reform proposal on the grounds that "it will create 800,000 new jobs. All of them overseas. All of them."[4]

Biden was referring to a study in *Tax Notes* by Reed College professor Kimberly Clausing in which she calculated that a U.S. transition to a territorial tax system would result in 800,000 jobs being created abroad.[5] She argued that corporations would have greater incentives to move income to lower tax jurisdictions.

Clausing's study has serious flaws.[6] Clausing admitted that she looked only at the effect of changing from a worldwide to a territorial system, and not from changing to a territorial system with a lower rate. A combination of a lower rate with territoriality would drive fewer jobs offshore. Most proposals to move to a territorial system are accompanied by reduced corporate tax rates.

Furthermore, lower rates and a territorial tax system would attract jobs back to America. Corporations such as Aon, which left America earlier this year in search of Britain's lower 24 percent tax rate, would have fewer reasons to leave. Other corporations would be likely to return to the United States.

Peterson Institute for International Economics fellow Gary Hufbauer, responding to Clausing's article, concluded that "10 percent greater foreign investment by multinationals triggers 2.2 percent *additional* domestic investment" (emphasis in original).[7]

Clausing cautions that because of the weak economy, "these new low-tax country jobs could displace jobs at home."[8] In reality, there is little correlation between foreign investment and the level of domestic employment.[9] The implication of Clausing's study is that jobs abroad necessarily replace those in America. However, the academic economic literature suggests that productivity gains abroad are generally firmwide and that job creation abroad is accompanied by domestic job creation.[10]

For instance, a study by the Tax Foundation, a Washington, D.C., tax research organization, notes that "a permanent policy of discouraging the movement of U.S. firms abroad would not appreciably alter the economy's overall level of employment."[11] The creation of jobs abroad often encourages growth domestically because of firmwide productivity gains that translate into lower prices and higher demand. Just one example: if Apple's iPhone 5 had to be produced solely in America, it would be unaffordable.

Clausing fails to acknowledge that incentives to locate offshore—specifically, a high top U.S. marginal rate compared with that of competitors and taxation of foreign income when repatriated—are already embedded into America's tax code. As Harry Grubert, a senior interationaleconomist at the U.S. Treasury, and Rosanne Altshuler, a Rutgers University economics professor, note in a recent paper: "The present system raises little revenue, is complicated, [and] creates incentives for aggressive income shifting."[12]

Policymakers are concerned about the $1.7 trillion of undistributed earnings that remain abroad and that contribute little to the U.S. economy. These funds could return to America and be used for capital projects, consumption, and job creation, or paid out as dividends or share repurchases—all of which would boost a weak economy. A territorial system would allow earnings to be repatriated with minimal taxation.

Some have proposed a temporary reduction in the repatriation tax rate, known as a "tax holiday."[13] Although tax holidays provide a temporary stimulus, they increase the incentive to hold capital offshore. Corporations will wait for the next "holiday." Tax holidays, like other temporary measures, make the tax code more complex and less efficient.

With a minimal repatriation tax to reduce income shifting and tax avoidance, American companies would be able to compete on an equal footing with foreign competitors. This long-run benefit would allow companies to grow faster and become more productive—domestically and abroad.

Under the status quo, firms have every incentive to keep profits abroad and little incentive to repatriate earnings.[14] A territorial taxation system would allow for a more efficient distribution of capital. As an added benefit, businesses would incur fewer economically inefficient expenses from trying to avoid taxes. As Altshuler noted in testimony before the Senate Budget Committee: "[A]rranging affairs to avoid taxation of foreign earnings is costly…. The result is a system that distorts business decisions, treats different multinationals differently, and encourages wasteful tax planning."[15]

A territorial tax system with low rates would attract capital back to America, increasing economic activity and employment. In the wake of the slowest recovery in postwar history, improving the competitiveness of U.S. firms and making domestic investment more attractive is critical to sustainable future growth.

CONCLUSION

Under fundamental corporate tax reform, America would reduce the top rate to bring it in line with our major competitors and broaden the base by eliminating some tax preferences.

- Reduce the corporate tax rate to a top rate of 15 percent, below the OECD average and equivalent to that of Germany and Canada.[16]

- Switch to a territorial tax system for earned income. The territorial tax systems of the majority of OECD countries reduce America's attractiveness as a location for a global headquarters.[17] Besides the economic benefits detailed earlier, the influx of billions of dollars of capital would do much to spur economic growth.

- Exclude 95 percent of foreign dividends from U.S. taxation, leaving an effective rate of 0.75 percent upon repatriation to guard against tax avoidance.

Corporate tax reform would do much to spur economic growth, increase U.S. competitiveness, and reduce unneeded regulatory burdens.

ENDNOTES

[1] Transcript of Chairman Baucus's speech, June 11, 2012, http://www.finance.senate.gov/newsroom/chairman/release/?id=7f75cb4c-d83f-405b-8063-b1d7c1d2ea88.

[2] House Ways and Means Committee, "Technical Explanation of the Ways and Means Discussion Draft Provisions to Establish a Participation Exemption System for the Taxation of Foreign Income," October 26, 2011, http://waysandmeans.house.gov/uploadedfiles/final_te_--_ways_and_means_participation_exemption_discussion_draft.pdf.

[3] The Rebuilding America Act, November 9, 2011, http://www.lee.senate.gov/public/index.cfm/2011/11/the-rebuilding-america-act.

[4] Transcript of Vice President Biden's speech, September 6, 2012, http://www.realclearpolitics.com/articles/2012/09/06/joe_bidens_acceptance_speech_at_the_democratic_national_convention_115377.html.

[5] Kimberly A. Clausing, "A Challenging Time for International Tax Policy," *Tax Notes*, July 16, 2012.

[6] These flaws have been documented by Peterson Institute senior fellow Gary Clyde Hufbauer, in "800,000 Jobs Shipped Overseas? Check the Math!," *Tax Notes*, August 6, 2012.

[7] Ibid., p. 719.

[8] Clausing, "A Challenging Time for International Tax Policy," p. 283.

[9] Harry Grubert, "Foreign Taxes and the Growing Share of U.S. Multinational Company Income Abroad: Profits, Not Sales, Are Being Globalized," *National Tax Journal*, February 2012.

[10] Mihir A. Desai, C. Fritz Foley, and James R. Hines Jr., "Foreign Direct Investment and the Domestic Capital Stock," NBER, January 2005; and David M. Marchick and Matthew J. Slaughter, "Global FDI Policy Correcting a Protectionist Drift," Council on Foreign Relations, June 2008.

[11] Tax Foundation, "Global Perspective on Territorial Taxation," August 16, 2012, p. 8.

[12] Harry Grubert and Rosanne Altshuler, "Fixing the System: An Analysis of Alternative Proposals for the Reform of International Tax," Office of Tax Analysis, U.S. Treasury, September 14, 2012, http://www.sbs.ox.ac.uk/centres/tax/symposia/Documents/2012/Grubert%20Altshuler%20Fixing%20the%20System%20Oxford%20Version.pdf.

[13] Laura D'Andrea Tyson, Kenneth Serwin, and Eric J. Drabkin, "The Benefits for the U.S. Economy of a Temporary Tax Reduction on the Repatriation of Foreign Subsidiary Earnings," New America Foundation, fall 2011, p. v.

[14] The exception here is capital-constrained firms. A capital-constrained firm is one that is incapable of financing all its positive Net Present Value (NPV) projects. Capital-constrained firms are less sensitive to the repatriation rate because of their constraints. However, there is a reverse effect as well: capital-constrained firms may choose to avoid repatriation altogether if the NPV of their domestic projects (due to taxes reducing net profits) is negative or lower than the NPV for projects abroad—in this instance, they would be more sensitive. See Michael Faulkender and Mitchell Petersen, "Investment and Capital Constraints: Repatriations Under the American Jobs Creation Act," NBER, April 2012.

[15] Testimony of Dr. Rosanne Altshuler before the Senate Committee on the Budget, February 2, 2011, http://budget.senate.gov/republican/public/index.cfm/files/serve?File_id=a4330db5-ec0e-4669-bb12-4392321a5c62.

[16] The focus on OECD countries is warranted because these are very similar countries, economically speaking.

[17] Leora Klapper and Inessa Love, "Entrepreneurship and the Financial Crisis," World Bank, 2010, http://siteresources.worldbank.org/INTFR/Resources/475459-1222364030476/WBGES_2010_presentation.pdf. These results confirm that a higher tax rate has a negative correlation with the number of business registrations.