

International Implications of Corporate Tax Rate Reductions

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Corporate tax rates and all that

- What are the international implications of potential U.S. corporate tax rate reductions?
- That would depend, of course, on exactly what additional provisions, including revenue enhancing base broadeners, are included along with any corporate tax reductions.
- Evidence from OECD tax changes from 1980-2004 is that half the time corporate statutory rate changes are accompanied by base changes, though more often than not tax rate reductions are imposed along with base narrowing.
- For now, however, consider only rate changes.

International responses, part 1

- Lower statutory tax rates will stimulate greater levels of FDI in the United States and greater levels of FDI from the U.S. to other countries.
- Studies consistently show that FDI is sensitive to taxation, with elasticities that commonly exceed 2. Lower U.S. tax rates encourage inbound FDI.
- Since the U.S. worldwide tax system effectively imposes a tax on repatriated foreign earnings equal to the difference between the U.S. and foreign tax rates, a lower U.S. rate means that foreign income is taxed more lightly.

International responses, part 2

- A lower U.S. tax on foreign income leads to greater outbound FDI.
- Higher levels of inbound and outbound FDI are linked, in that they tend to rise and fall together.
- A lower U.S. tax rate will imply that more U.S. firms have excess foreign tax credits, which carries implications for where firms invest: this increases the attractiveness of low-tax foreign jurisdictions.
- Consequently, lower tax rates encourage significantly greater investment everywhere, particularly low tax countries.

International responses, part 3

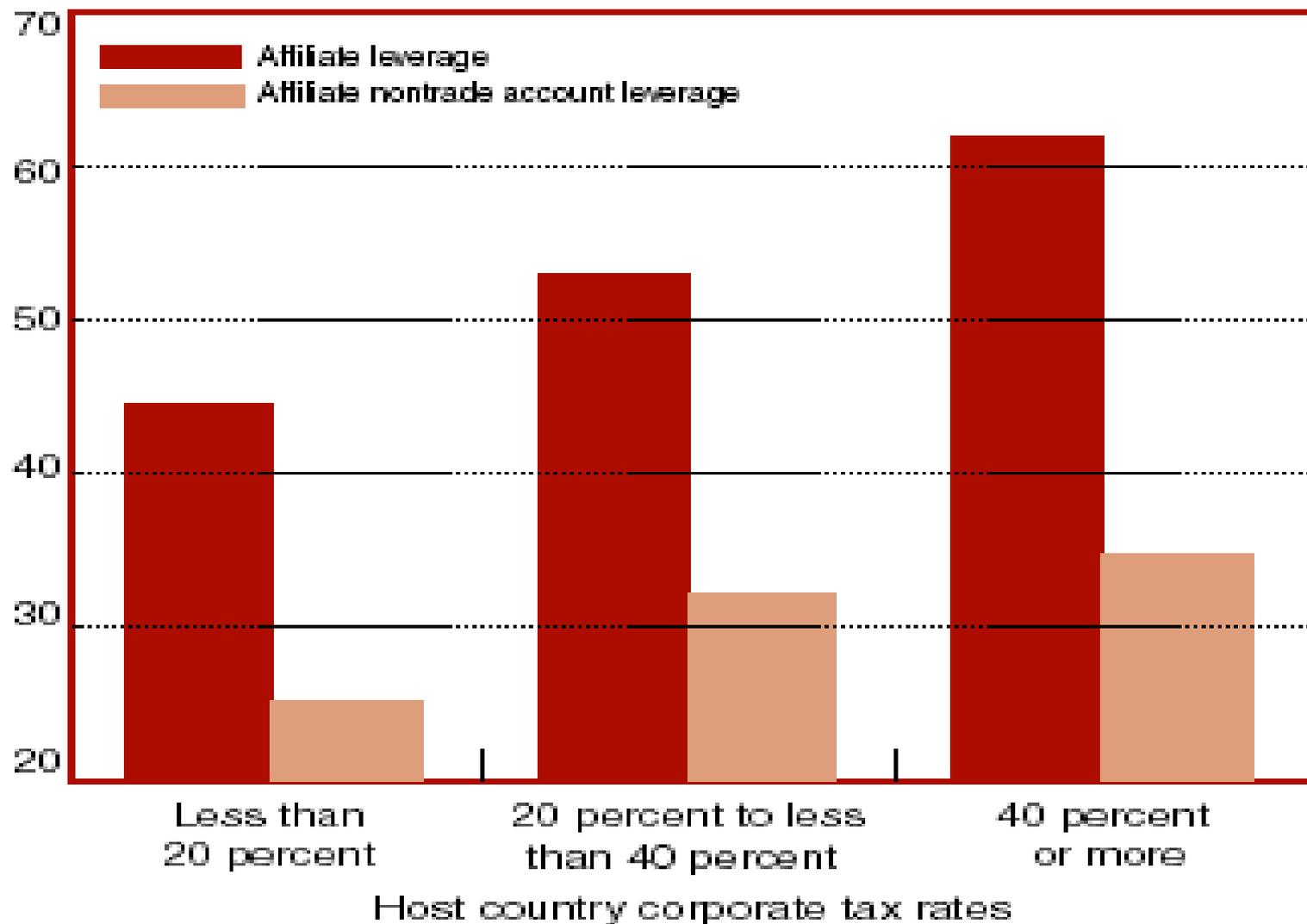
- A lower U.S. tax rate would remove some of the (current) disincentive to repatriate foreign earnings.
- Active foreign business income is taxed only upon repatriation, with credits for foreign taxes.
- It appears that a great deal of foreign profits are kept abroad these days, due largely to the tax that would be owed if the funds were repatriated.
- Evidence from firm variation and the aggregate response to the 85% repatriation holiday in 2005 (when repatriations increased sixfold) suggests that modest tax rate reductions would increase repatriations, but probably not dramatically.

International responses, part 4

- Statutory tax rate differences encourage firms to reallocate taxable income from high-tax to low-tax jurisdictions.
- This can potentially be done in several ways, including through the adept choice of prices used in transactions between related parties.
- A more straightforward, and likely more common, method of reallocating taxable income entails the use of financing arrangements that generate deductible interest expenses in high-tax locations (and possibly interest receipts in low-tax locations).
- There is ample evidence that firms are more apt to have high borrowing expenses in high-tax countries than they are in low-tax countries.

Chart 2. Affiliate Capital Structure and Host Country Tax Rates, 1994

Leverage



Foreign-domestic linkages

- What is the effect of all of this on economic activity in the United States?
- There is evidence that greater foreign business activity by U.S. firms is associated with greater domestic business activity as well: that foreign operations are complementary with domestic operations.
- Greater FDI in the United States is also apt to be associated with greater U.S. economic activity.
- That said, greater numbers of U.S. firms with foreign tax credits will find that they are unable to deduct fully some U.S. expenses (such as R&D or administrative expenses), thereby discouraging activity.

What about base broadeners?

- The international implications of lower statutory tax rates could be entirely reversed by the imposition of certain base broadeners intended to raise revenue or otherwise influence business decisions.
- For example, FDI is influenced not merely by statutory tax rates but instead by the whole portfolio of tax burdens that businesses face.
- One of the attractive features of statutory tax rate reductions in an international setting is that they reduce incentives to reallocate taxable income elsewhere, but this is only one aspect of the whole problem.
- International implications are important, and they need to be evaluated in the context of the entire tax system.