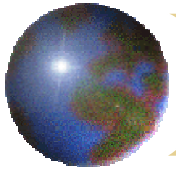


International Investment Tax Policy Lessons from the 2000s

AEI Conference on Tax Policy Lessons
Washington DC
May 2008

Mihir A. Desai
Harvard & NBER



Motivation (1)

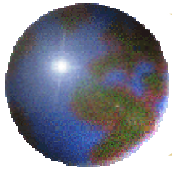
Renewed interest in significant policy changes - widely ranging alternatives: territoriality vs. formula apportionment

Corporate tax has evolved into a tax on large, public companies – international provisions more important

Significant policy changes worldwide

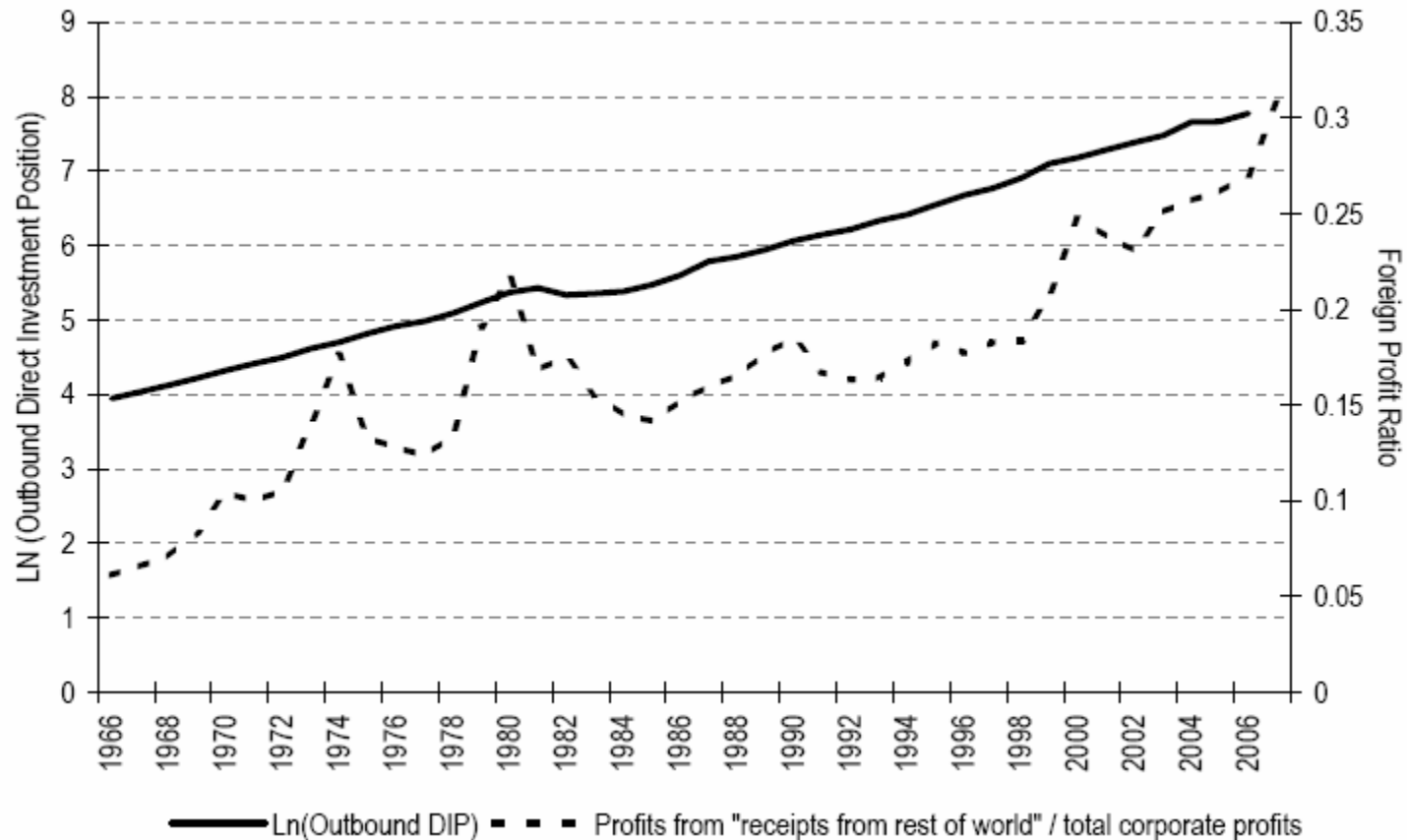
Increasing questioning of the fairness of current tax treatment – not merely inside the beltway.

=> Have we reached a tipping point?

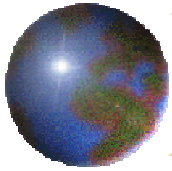


Motivation (2)

Figure 1: The Evolution of U.S. Outbound FDI, 1966-2007

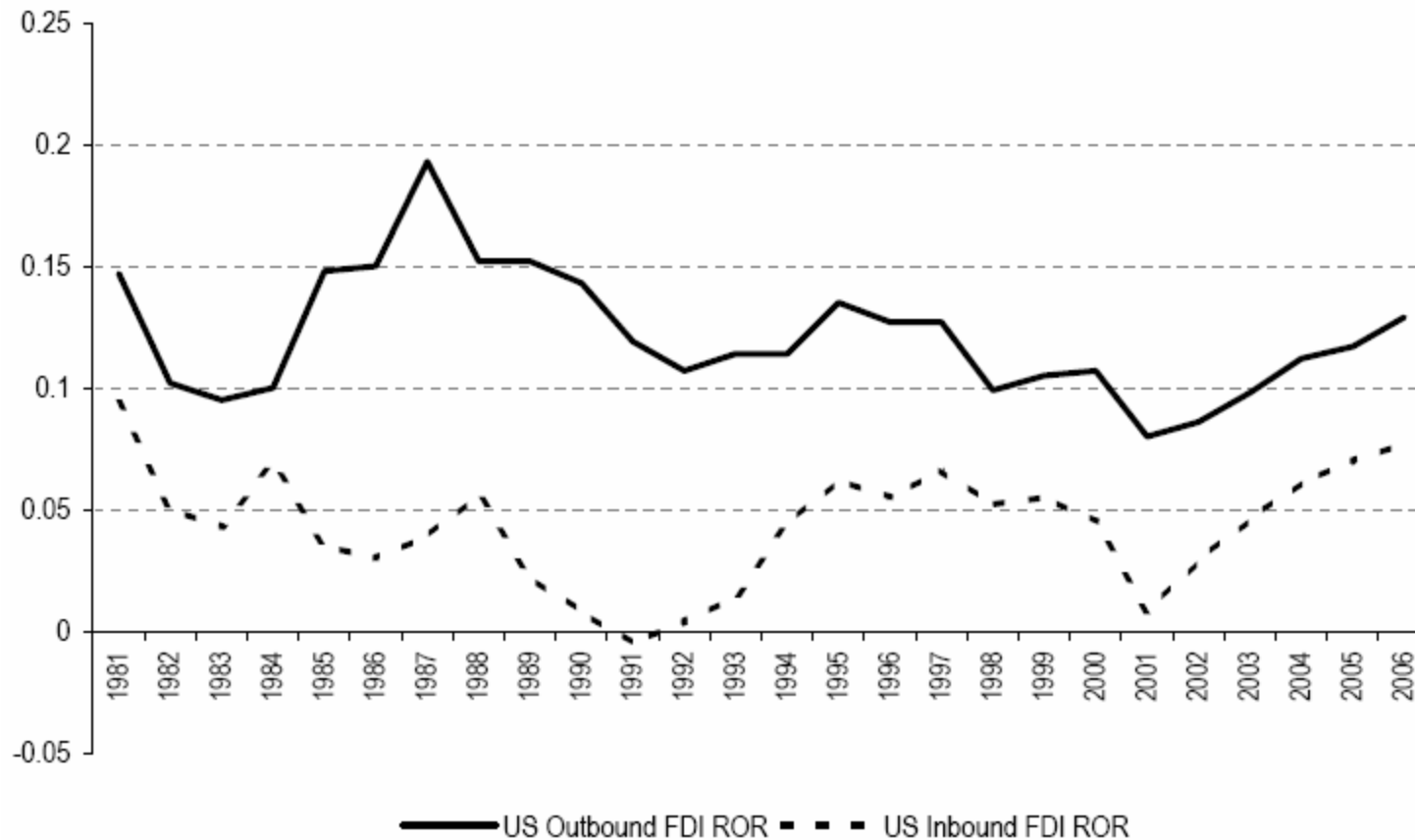


Continued, rapid growth in overseas activity with no signs of growth abating

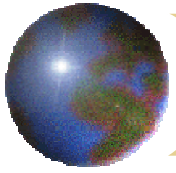


Motivation (3)

Figure 2: U.S. Outbound and Inbound FDI Rates of Return, 1981-2006



Continued, very high levels of profitability for overseas activity relative to inbound FDI



Three Sources of Lessons

New Policy developments

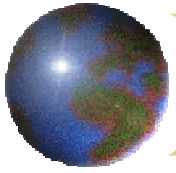
Check-the-box regulations, FSC/ETI-WTO, AJCA

Changing regimes and rates around the world

Multilateral efforts – OECD, ECJ

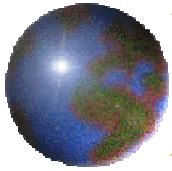
New Micro-Data Sources – Treasury/BEA/Bundesbank

New Links to Other Literatures/Disciplines – Accounting,
International Trade, Corporate Finance/Organizational
Economics



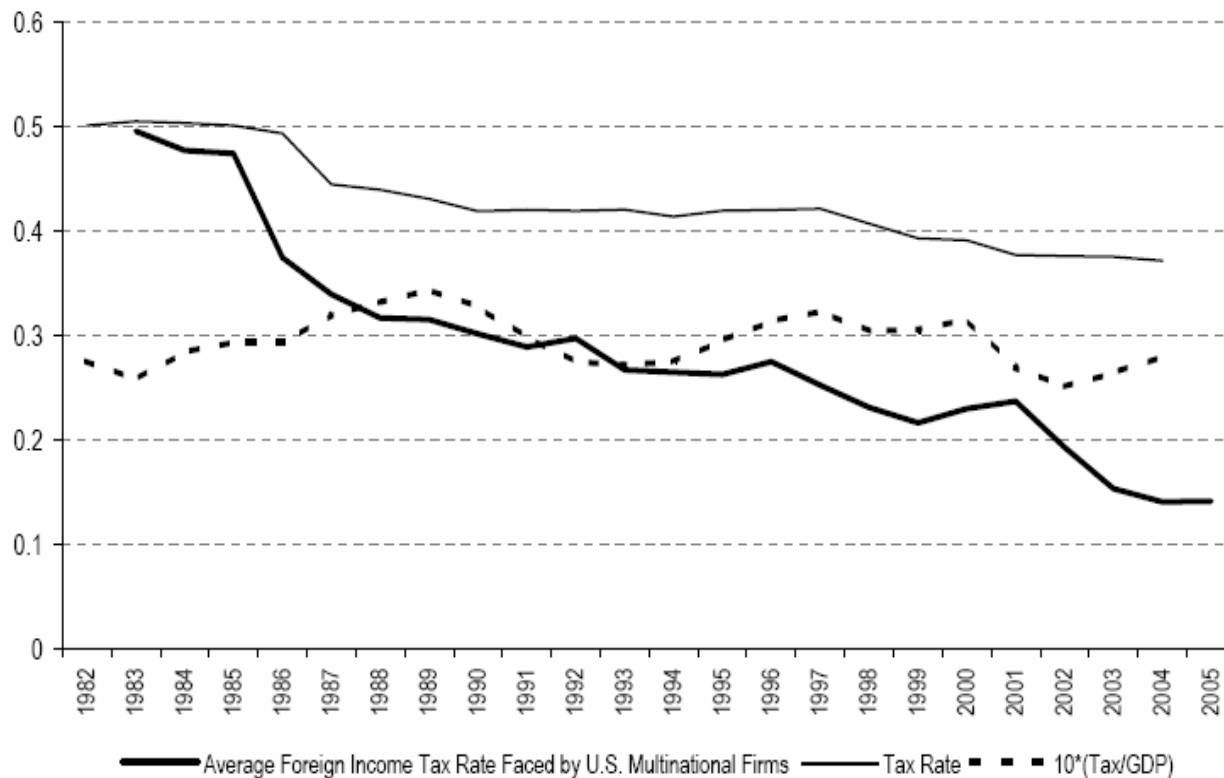
Three Primary Lessons

- i) Changing Responsiveness - Increased levels and new margins of responsiveness => what is less clear is why
- ii) New understanding of reforms – Explicit proposals and changed understanding of what firms do indicate the promise of reform
- iii) Changing nature of capital flows – FDI is decreasingly important - the rise of FPI creates new interactions and can constrain policy choices



Changed Responsiveness (1) – Evident in the aggregate

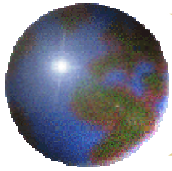
Figure 4: Average Foreign Tax Rates, 1982-2005



Comparing different measures of tax burdens across time

- i) Declining average tax rates
- ii) Reduced MNC tax exposures relative to national averages
- iii) Stable revenue shares

How do these fit together?

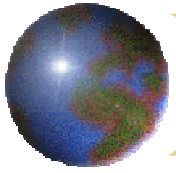


Changed Responsiveness (2)

Figure 3: Payout Ratios of Foreign Earnings, 1982-1998 annual, 1999-2007 quarterly



AJCA response exceeded all expectations



Changing Responsiveness

Historic questioning of sensitivity to taxes has been made obsolete

Traditional margins appear to have become more responsive

- Investment – greater measured elasticities

- Repatriations

New margins

- Affiliate capital structure

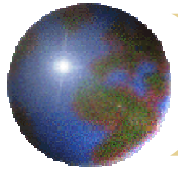
- Transfer pricing on trade balances

- Ownership shares

- Chains of ownership

- Domicile location - inversions

- Domicile location – mergers

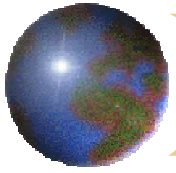


Changing Responsiveness – But why?

Understanding the sources of these changes

Several alternative explanations:

- i) Changing relative tax rates
- ii) Regulatory changes – eg: check-the-box
- iii) Secular changes in underlying determinants of responsiveness
Evidence on havens
- iv) Changed incentives for tax avoidance
Private firms, accounting considerations



Lessons on Reform Alternatives (1)

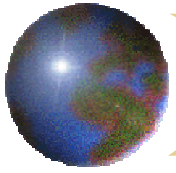
First serious evaluation of territoriality – G&M – shaped subsequent debate

But it was a very particular form of territoriality that was a revenue-raiser...how?

Led to confusion about current system and revenue and burden consequences of current system

Recent UK version of territoriality has been greeted with similar reactions...

Territoriality is not a unitary system and can be shaped in many different directions – as can any system



Lessons on Reform Alternatives (2)

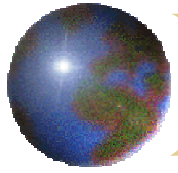
Disappointment with traditional welfare metrics

Building on the insights of other branches of economics
on what MNCs do

Questioning implicit assumption of substitutability

CON/NON: Territoriality can be rationalized through a
welfare metric that allows for imperfect
substitutability of foreign and domestic investment
and differential productivity of owners

Empirical evidence is increasingly suggesting that
complementarity is more likely than substitution



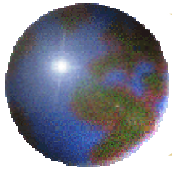
Lessons on Reform Alternatives (3)

Two previews of a multilateral future – the OECD and the ECJ

OECD effort quietly morphs from emphasizing harmful tax competition to financial transparency

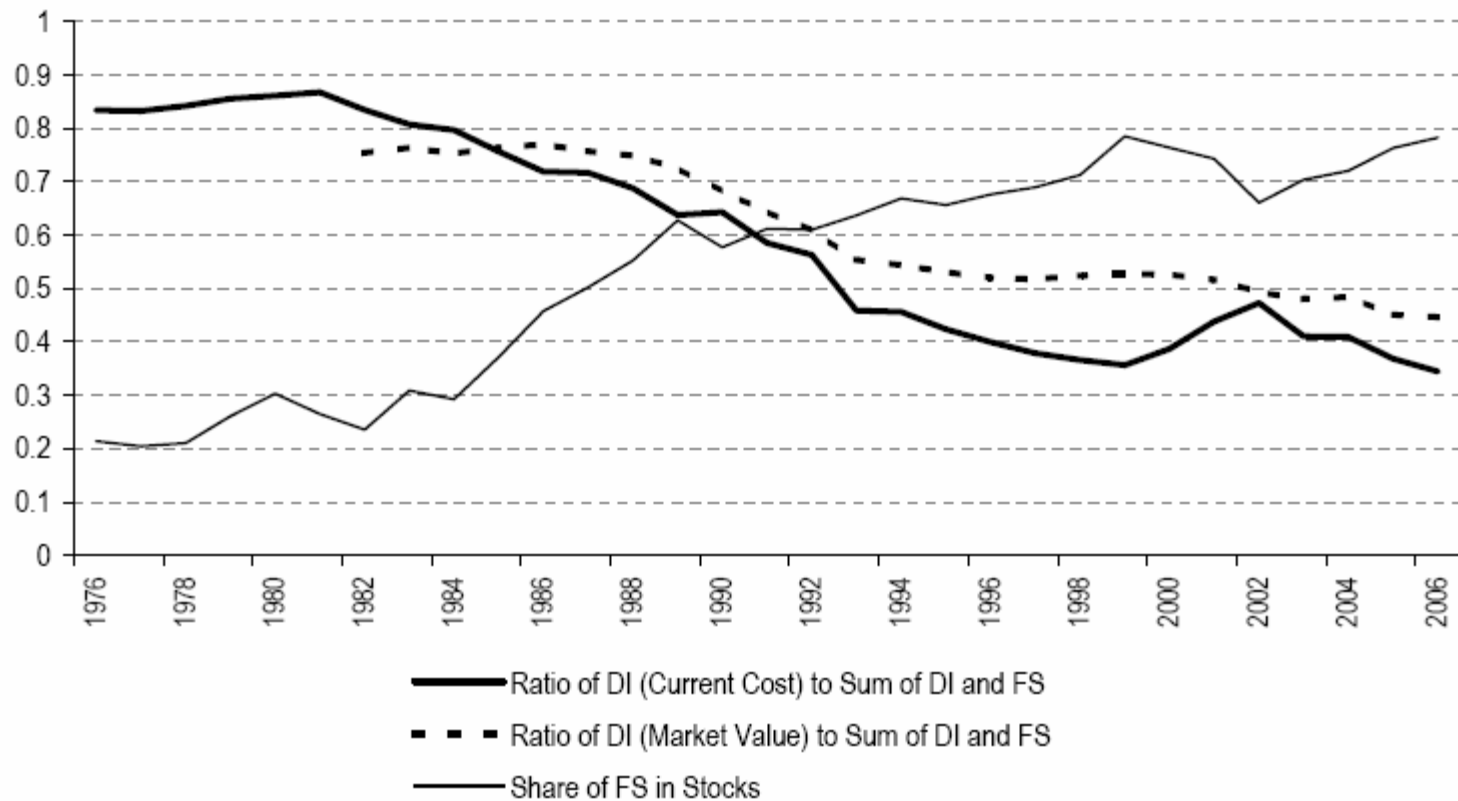
ECJ, on the other hand, is highly effective...

...but significant questions remain as to the intellectual coherence of any effort to neutralize all differences

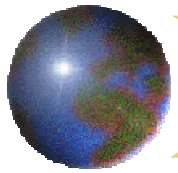


Changing Nature of Capital Flows (1)

Figure 5: The Changing Nature of International Investment, 1976-2006



The preoccupation with FDI is misplaced



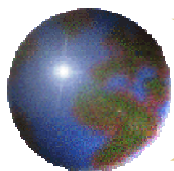
Changing Nature of Capital Flows (2)

Now, FPI and FDI are alternative means of accessing diversification opportunities

The U.S. corporate tax regime effectively makes FPI a preferred vehicle for diversification in low-corporate tax countries

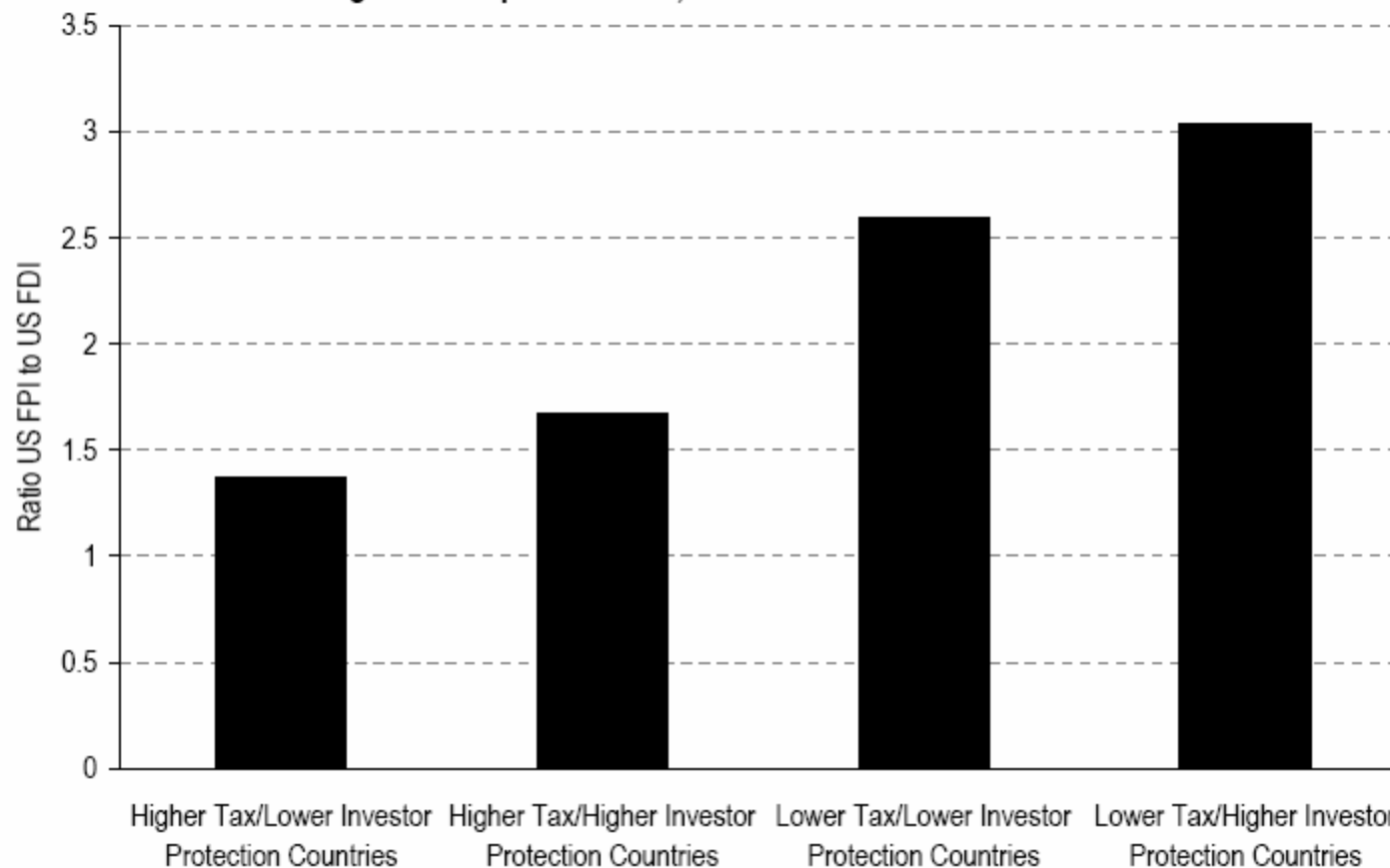
Similarly, FDI may be preferred in countries with weaker investment protections...

As such, the ratio of FPI to FDI should reflect these considerations...

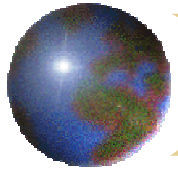


Changing Nature of Capital Flows (3)

Figure 6: Corporate Taxes, Investor Protection and FPI



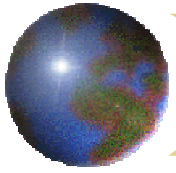
A simple double-sorting on tax rates and investor protections reveals basic patterns consistent with these effects



Changing Nature of Capital Flows (4)

A 10% decrease in a foreign country's corporate tax rate increases US investors' equity FPI holdings by 21%, controlling for effects on FDI

JGTRRA's treatment of international dividends provides opportunity to assess general sensitivity of FPI to taxes



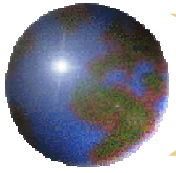
Policy Implications of new capital flows (1)

Welfare evaluations, such as D/G&G, try to incorporate FPI into CEN/CIN frameworks

G&G: NN logic – residence taxation with deduction

Need for new welfare metrics that emphasize unique aspects of FPI

- diversification benefits
- absence of control/governance
- capital gains vs. dividends



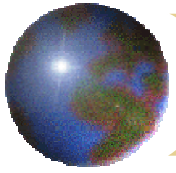
Policy implications of new capital flows (2)

Asymmetric treatment of divs and cg's

Constraints on domestic policies - decline and likely demise of imputation

Integrating excess returns and exorbitant privilege into tax analysis

Treatment of SWF, remittances



Conclusions (1)

Greater responsiveness than ever

- Increases sensitivities

- New types of responses

- The puzzle of why

Lessons about reform

- The many varieties of territoriality

- A logic for territoriality

- Questionable future of multilateralism

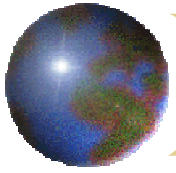
Changing nature of capital flows

- Misplaced attention on FDI

- Interactions between FDI/FPI taxation

- Need for optimality frameworks

- Question re new types of capital flows and investors



Conclusions (2)

Very significant reform alternatives have now surfaced

Territoriality of varying stripes

Formula apportionment

Revenue neutral repeal of deferral

Any reforms must accommodate these high levels of responsiveness, reflect the lessons of recent efforts on reforms, and incorporate the role of alternative capital flows.