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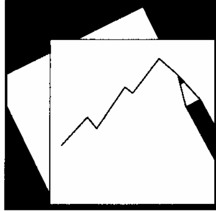

IMF Working Paper

Moving to Territoriality? Implications for the United States and the Rest of the World

Peter Mullins

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IMF Working Paper

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Moving to Territoriality? Implications for the United States and the Rest of the World

Prepared by Peter Mullins[1]

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Abstract

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This paper reviews the tax policy debate in the United States on the move of the corporation tax from its present worldwide basis to a territorial basis, and considers the implications for the United States and the rest of the world. It finds that there is no clear view on whether the move would significantly benefit the United States. Such a move, however, could have significant implications for the rest of the world in terms foreign direct investment (FDI) from the United States, the intensity of tax competition, and tax revenues.

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Author(s) E-Mail Address: pmullins@imf.org

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I. INTRODUCTION

One of the most significant recommendations of the recent report of the U.S. President's Advisory Panel on Federal Tax Reform is to move the corporation tax from its present worldwide basis (under which profits earned abroad are taxed in the United States, but with a credit for foreign taxes paid) to a territorial basis (under which profits earned abroad are exempt from tax in the United States).[2] The issue of worldwide versus territorial taxation has long been debated, but the Panel's proposals have given the discussion renewed intensity.

Although such a tax reform may have an impact on the United States, it could also have profound implications for the rest of the world in terms of their foreign direct investment (FDI) from the United States, tax revenues, and, perhaps, the intensity of international tax competition. The purpose of this paper is to provide an assessment of the current debate in the United States and to consider what the implications may be for the rest of the world.

The next section discusses international tax rules in general, the current practice both internationally and in the United States, as well as the tax reform panel's proposals. Section III considers the principles of taxing international capital flows. Section IV discusses the debate on the proposal in the United States, while Section V considers the implications for the rest of the world. Section VI concludes. Box 1 provides an explanation of some of the key concepts in international tax that are discussed in this paper.

II. INTERNATIONAL TAX RULES: KEY CONCEPTS AND CURRENT PRACTICE

It is usually accepted that the country in which profits are derived (the **source country**) has the first right of taxation on that income, although the source country may forgo that tax for its own policy purposes or under a double tax treaty. Countries in which the taxpayer resides (the **residence country**) have two broad choices for taxing foreign source income earned by their residents, the worldwide tax system and the territorial tax system. (See Box 2 for examples of the two systems.)

Under **worldwide (or residence) taxation**, foreign source income earned abroad is taxed in the taxpayer's country of residence. It is usual for a tax credit (known as a foreign tax credit or FTC) to be given for income taxes levied on the sum of income from all countries, usually up to the amount of domestic tax on the income (since foreign income could be taxed at a different rate in the source country). The worldwide system is broadly based on the concept

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[2]President's Advisory Panel on Federal Tax Reform (2005). The tax reform panel proposed two alternative reform plans—the Simplified Income Tax Plan of which the territorial system is one element, and the Growth and Investment Tax Plan which is essentially a cash-flow tax for businesses, with international transactions being taxed on a destination basis (that is, tax would be rebated on export income and expenditures on imports would not be deductible). The destination basis is different from the territorial system, in that the destination basis taxes goods and services in the country where they are consumed whereas the territorial system taxes profits in the country where they arise.

Box 1. International Tax Primer: Key Concepts

The list below explains some of the key concepts in the taxation of foreign source income.

Controlled foreign corporation (CFC) rules (known as **Subpart F rules** in the United States)**:** In those countries where foreign source income is only taxed on repatriation (whether from a subsidiary or a branch), there is often a concern with subsidiaries/branches being set up in low tax countries to shelter profits from tax in the residence country of the parent. The response to this practice has been the development of CFC rules which essentially attribute certain income of the subsidiary to the parent as though the foreign income was earned directly by the parent. Therefore, the benefit of deferral of tax until repatriation is removed. The amount attributed to the parent is usually in proportion to their interest in the foreign subsidiary. When the profits are eventually repatriated to the parent, tax relief is given to ensure the profits are not taxed twice. The profits which are subject to CFC rules are usually passive income derived by the subsidiary. Income from an active business in the foreign location is not usually taxed under the CFC rules on the basis that the subsidiary is not being used to shelter foreign source income.

Double tax treaty: An agreement between two (or more) countries for the avoidance of double (or no) taxation. Double tax treaties can determine whether the income is taxed in the source country and the rate of withholding tax.

Foreign branch: A division, office, or other unit of business of a company in a foreign country but is not a separate legal entity

Foreign source income: Income derived in a foreign country including: interest from foreign investments; royalties for the use, or right to use, intellectual property in a foreign country; rents on property located in a foreign country; capital gains on disposal of property located in a foreign country; dividends from shares in foreign companies—countries usually distinguish between dividends from a **portfolio interest** in a company (usually a small non-influential interest in a company such as, a less than 10 percent interest) or a **non-portfolio interest** in a company (a significant interest in the company such as, a more than 10 percent interest); and, profits from business in a foreign country—this can be sales income in the foreign country, profits of a branch of a company in the foreign country, or profits of a subsidiary located in the foreign country (i.e., a company in which the resident company has a non-portfolio interest).

Foreign tax credit: Tax credit for taxes paid in a foreign country. A credit is usually only given for withholding tax deducted by the foreign country. However, for corporate taxpayers a credit may be also given for underlying corporate tax—that is, tax imposed on the profits of the company out of which a dividend is paid.

Passive income: Income which is not derived from an active business in the foreign country. It usually includes income from interest, rent, royalties and portfolio dividends.

Tax sparing: A form of double tax relief in tax treaties. Where a source country provides a tax incentive to a foreign investor from a country which has a tax treaty with the source country, the residence country may give a tax credit for the tax which the investor would have paid if the tax had not been spared (i.e., given up) because of the tax incentive. The effect of the relief is that the tax incentive is preserved in the resident country.

Withholding tax: Tax on income imposed at source. A third party, usually the payer, is required to withhold tax from the payment. Withholding tax is usually applied to payments of interest, dividends, royalties and similar types of income.

Box 2. Example of Territorial System and Worldwide System for Companies

To illustrate the two tax systems as they apply to companies, assume a U.S. company earns profits of $100 in a foreign country via a subsidiary and repatriates those profits to the United States. Also, assume that the corporate tax rates are 20 percent in the foreign country and 35 percent in the United States. Under the worldwide system, the U.S. company would pay tax of $35—that is, $20 in the foreign country and a further $15 tax in the United States (based on an initial tax of $35 less a foreign tax credit of $20). So the total tax is at the U.S. corporate tax rate, but the actual revenue is split between the foreign country and the United States. If the corporate tax rate in the foreign country was 40 percent, then the credit would be limited to the U.S tax (i.e., $35) and the U.S. company would pay no tax in the United States (the excess tax of $5 paid in the foreign country may be used to offset U.S. tax on income from the same "foreign income basket" or it may be carried forward (back) for offset against tax on income from that basket in future (past) years).

By contrast, under the territorial system, the only tax paid by the U.S. company would be to the foreign country ($20 in the first scenario and $40 in the second), with the repatriated profits being exempt from tax in the United States. In this case, the tax rate is determined solely by the foreign country.

of **capital export neutrality**—that is, a country's residents should pay the same amount of tax irrespective of the geographic source of their income. Hence, there is no tax distortion between foreign and domestic investment, so that capital will be invested where it can generate the highest return without regard for tax considerations. The worldwide system is effectively a tax on savings.

Under **territorial taxation**—based on the **source principle** of taxation and sometimes referred to as the **exemption system**—foreign source income is exempt from tax in the taxpayer's country of residence and, therefore, is taxed only in the source country. The territorial system is broadly based on the concept of **capital import neutrality**—that is, all investors in a country face the same tax rate irrespective of the tax rates in their home countries. Hence, foreign and local investors can compete in a country on the same tax basis. The territorial system is effectively a tax on investment.

In practice, no country has a pure worldwide system or a pure territorial system. Countries with a worldwide tax system often have elements of a territorial system—for example, deferral of tax on certain foreign source income until it is repatriated to the country of residence. Countries with a territorial system often impose limitations on access to the exemption so that foreign source income falling outside those limitations is taxed in the country of residence. For example, to prevent tax avoidance, the exemption usually does not apply to passive income. Also, countries applying a territorial system usually only allow an exemption if the resident company holds a significant (non-portfolio interest) in the foreign company and may not exempt 100 percent of the foreign income. A more accurate

description of countries would be those with a predominately worldwide tax system and those with a predominately territorial tax system.[3]

In deciding whether to apply a worldwide or territorial system, countries do not necessarily apply the same system to all taxpayers and forms of income. For example, many countries apply different systems to individual taxpayers and corporate taxpayers. Most countries apply a worldwide system when taxing an individual on foreign source income from interest, royalties, rents, capital gains, or portfolio dividends, usually with a credit for any withholding tax paid in the source country. A few countries, however, such as Singapore, Hong Kong SAR and Thailand, apply a territorial system to individual income.

A. Corporate International Tax

When taxing the foreign source income of companies, countries again may not apply the same system to all types of income or corporate arrangements. For example, companies which derive foreign source income but do not have a branch or subsidiary located in a foreign country are usually taxed on a worldwide basis. Of most interest for this paper is the treatment of companies which do have a branch or subsidiary in a foreign country.

For companies with foreign branch income, the branch is not a separate legal entity. Therefore, one option is for the foreign income to simply be taxed in the same way as domestic income, but with a credit for any tax paid in the foreign country (essentially the worldwide system). However, it is also possible to apply the territorial or worldwide systems as though the branch were a separate legal entity. As a consequence, the income is treated as though it was derived in the foreign country by a separate entity, so that profits are taxed in the source country and are not taxed in the residence country until the profits are repatriated. The repatriated profits can either be taxed in the residence country with a foreign tax credit (i.e., worldwide taxation) or exempt (i.e., territorial taxation).

Profits of a foreign subsidiary are usually taxed in the source country and are not taxed to the parent in the residence country until the profits are distributed to the parent by way of a dividend. This is because the parent and subsidiary are separate legal entities and usually separate taxpayers for tax purposes. When profits are repatriated to the parent, countries must again decide on whether the worldwide or territorial system will apply in taxing the repatriated profits.

In applying the territorial system, countries will sometimes impose limitations on the exemption. These limitations include only allowing the exemption for profits from countries with which the residence country has a tax treaty (e.g., Canada) or not allowing the exemption for profits from countries with a very low tax rate (e.g., Belgium).

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[3]Countries may also have a worldwide system in their law, but the practice may be different due to the administrative difficulty in taxing residents on their worldwide incomes, for example, owing to a lack of information (often because of lack of information sharing with other countries).

In applying a worldwide system to the repatriated profits, the usual practice is to allow a foreign tax credit for both withholding tax and underlying corporate tax paid on the profits in the source country. The foreign tax credit is usually limited to the amount of domestic tax on the foreign source income, with any excess often available to be carried forward (or back) to offset tax in future (past) years. Some countries also allow foreign income of a particular type from all countries to be pooled, with any foreign tax credits relating to that income also pooled (in the United States these pools are known as "foreign income baskets"). The effect of this is that tax paid in high tax countries can be credited against potential residence country tax on income from a low tax country.[4] Some countries with a worldwide system will also allow tax sparing (see Box 1) when determining the foreign tax credit.

Tables 1 and 2 provide a list of countries with a predominately worldwide system and those with a predominately territorial system. The tables focus on the tax treatment of dividends paid from a subsidiary located in a foreign jurisdiction to a company in the relevant country. This is consistent with the focus of the tax reform panel's proposals and is of most interest to policymakers. The trend in developed countries has been towards a territorial system for corporate taxpayers, however, it appears that developing countries may not follow that trend (for example, most Latin American countries apply a worldwide system).

Table 1. Countries with Worldwide Tax Systems for Dividends
Received by Corporate Taxpayers, 2006

Country	Minimum Ownership Level for Full FTCs 1/ (in percent)	Comments
United States	10	No tax sparing.
Japan	25	Allows tax sparing in some double tax treaties.
Ireland	5	
United Kingdom	10	Allows tax sparing in some double tax treaties.

Sources: European Commission (2001); and IBFD.

1/ Full FTCs includes credit for withholding taxes and underlying corporate income tax. If the minimum level of ownership is not met, the taxpayer would usually only be entitled to a credit for withholding taxes.

[4] This is in contrast to the United Kingdom, for instance, which only gives credit relief on a source-by-source, item-by-item basis.

Table 2. List of Countries with Territorial Tax Systems for Dividends Received by Corporate Taxpayers, 2006

Country	Level of Exemption 1/	Minimum Ownership Level	Other Conditions
Australia	Full	10 percent	
Austria	Full	10 percent	
Belgium	95 percent	10 percent (or €1.2 million)	Holding must not be in a tax haven or country with a substantially lower tax rate.
Canada	Full	10 percent	Dividend must be paid out of active exemption income from a treaty country.
Denmark	Full	EU parent-subsidiary directive standard for all countries 2/	Not a foreign financial company subject to a substantially lower tax burden compared with Denmark.
Finland	Full	EU parent-subsidiary directive standard or, if the directive does not apply, 10 percent for treaty countries	
France	95 percent	5 percent	
Germany	95 percent	None	
Italy	95 percent	None	Distributing company must not be in a country with a privileged tax regime.
Luxembourg	Full	10 percent (or €1.2 million)	Comparable tax in the source country (i.e., rate of tax at least 11 percent).
Netherlands	Full	EU parent-subsidiary directive or, if the directive does not apply, 5 percent non-portfolio investment	Profits subject to tax in source country, whatever the rate.
Portugal	95 percent	10 percent (or €20 million) for EU affiliated company	Dividends from a non-EU affiliated company are taxable with a full credit under a double tax treaty.
Spain	Full	5 percent	Profits must be: subject to tax in the source country at a comparable rate; from a tax treaty country; or, 85 percent from active business (not from a tax haven).
Sweden	Full	10 percent	

Sources: European Commission (2001); and IBFD.

1/ A number of countries only allow 95 percent exemption as a proxy for disallowing expenses relating to exempt income.

2/ The EU Parent-Subsidiary Directive (which seeks to eliminate tax obstacles in profit distributions within groups of companies in the EU) requires a holding of at least 20 percent but this is being reduced to 15 percent for the period January 1, 2007 to December 31, 2008 and to 10 percent from January 1, 2009.

B. Present U.S. Worldwide Tax System

In the United States, subject to some important exceptions, all domestic and foreign source income of resident corporations is subject to income tax in the United States with a credit given for any taxes paid on that income in other countries. The two key exceptions are the deferral of tax on certain income until repatriation and the foreign tax credit limitations.

Under the deferral rules, foreign source income earned by a foreign subsidiary of a U.S. resident corporation is not subject to U.S. tax until the income is repatriated to the United States as a dividend or on sale of the stock. The deferral is only available for dividends paid from active business income and does not apply to branch income. The parent company must have at least a 10 percent interest in the foreign company and U.S. shareholders must hold at least a 50 percent interest in the company. The effect of the deferral rules is that the worldwide tax system may be avoided altogether if the corporation is willing to leave the profits abroad. The law also includes controlled foreign corporation rules in Subpart F that are essentially rules to prevent abuse through deferral (for a discussion of these rules, see Box 1).

The main limitation on the foreign tax credits is that the credits cannot exceed the U.S. tax on the foreign source income. In applying tax to foreign source income, the United States allows corporations to pool their worldwide income (and related foreign tax credits) into nine foreign income baskets.[5] The main basket is the "general limitation" basket in which most active business income is placed. In determining the U.S. tax on that income, there are rules for allocating deductions, such as interest expenses, to the income. Excess foreign tax credits on an income basket cannot be applied to reduce U.S. tax on another income basket, but can be carried forward or back to offset tax on the same income basket in other years.[6] The effect of the foreign tax credit is that it averages the rates of tax a company faces on income in a basket from different countries.[7]

C. Tax Reform Panel's Proposal

The tax reform panel proposes that the United States adopt a territorial system for taxing foreign source income.[8] Active business income earned by foreign affiliates (branches and

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[5]The number of baskets will be reduced to two—a passive income basket and a general limitation basket (essentially all other income)—from January 1, 2007.

[6]Excess foreign tax credits can be carried back for one year and carried forward for 10 years.

[7]For example, assume a company derives a $100 profits in one country with tax paid of $40 (a corporate tax rate of 40 percent) and $100 profits in another country with tax paid of $20 (a corporate tax rate of 20 percent). The profits are from active businesses in the source countries. Under the U.S. worldwide system, the profits would be pooled in the same foreign income basket and tax imposed at 35 percent with a credit for the sum of the taxes paid in the foreign countries. Therefore, the net tax paid in the United States would be $10 (i.e., ($200 x .35) - $60). The example shows that the basket approach averages the rates of tax imposed by the two foreign countries.

[8]President's Advisory Panel on Federal Tax Reform (2005), pp.103–05 and 132–35.

controlled foreign subsidiaries) would be taxed on a territorial basis so that dividends paid out of such active foreign earnings would be exempt at the corporate level in the United States. However, passive and highly mobile income such as royalties and interest from foreign affiliates would be taxed in the United States when earned (that is, there would be no deferral but foreign tax credits would continue to be available). Also expenses, such as interest, incurred in the United States in generating exempt foreign source income would not be deductible. Unlike some territorial systems, the proposal does not require the source country to have a tax treaty with the United States or a minimum rate of tax in the source country to access the exemption—although certain active business income which is not likely to be taxed in any jurisdiction would be treated as mobile income.

III. Issues of Principle

Optimal tax theory suggests that, if the collective (across-country) interest is considered, the residence principle is an appropriate guiding principle for international tax as an implication of the Diamond and Mirrlees (1971) theorem on the desirability of production efficiency.[9] This is the proposition that, under certain conditions, any Pareto-efficient tax structure leaves production decisions undistorted, which in an international context requires that there be no distortion in the international allocation of capital. The residence principle is consistent with global production efficiency because the tax system does not discriminate between capital according to where it is located. However, the conditions required for the Diamond-Mirrlees theorem are not trivial, such as the requirement that pure profits be fully taxed. Also, when national governments face distinct budget constraints—meaning in particular that lump-sum transfers cannot be made between them—then moving around the world's second-best utility possibility frontier may require introducing production inefficiencies (such as source-based taxes) as a means of reallocating resources internationally.[10] Importantly, the Diamond-Mirrlees theorem also assumes that countries can enforce residence based taxation which is difficult in practice without extensive information sharing between countries.

If, on the other hand, the national interest is considered, a small capital importer—meaning one that takes as given the required rate of return—acting in its national interest, should not levy a source-based tax on capital income (ignoring, for a moment, the tax system of the country in which the recipient of the income resides). Assuming capital is mobile, the burden of such a tax will be passed on to immobile factors (the leading candidate being labor), with a deadweight loss caused by distortion towards labor intensive methods. Thus, it is better to tax labor income directly. If, however, the residence country provides a full credit for tax in the source country, that country could tax up to the residence country tax rate; but if the residence country exempts the income, then the source country should do likewise.

In contrast, a small capital exporter, acting in its own national interest, should tax after-tax foreign income and domestic income at the same rate. From a national perspective a foreign

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[9]For a fuller discussion of these issues see Gordon and Hines (2004).

[10]Keen and Wildasin (2004).

tax is a cost like any other cost of doing business in the foreign country. This implies that foreign taxes should be allowed as an income tax deduction.[11]

A large country, relative to world capital markets, has an incentive to take advantage of its market power and hence should set taxes to restrict capital movements to advance its national interest. This implies taxing residents on foreign source income if the country is a capital exporter, and levying a source-based tax on capital income if the country is a capital importer.

These simple principles suggest that a country such as the United States, acting in its national interest, should adopt a worldwide tax system with a deduction for foreign taxes. This raises the question why do countries such as the United States give a credit rather than a deduction. One reason put forward by Gordon (1992) is that a large capital exporter acting as a Stackelberg leader has an incentive to provide a tax credit as a way of inducing others to set high tax rates and thereby stem the capital flight to low tax countries. As the United States was the dominant capital exporter during much of the post-war period, it may have been the Stackelberg leader with regard to capital income tax policy.[12] Altshuler and Goodspeed (2002) find that, for the period 1968 to 1996, European countries behaved as if the United States was indeed a Stackelberg leader in setting corporate taxes after the U.S. 1986 Tax Reform but not before.

Recently an alternative guiding principle for international taxation, known as national ownership neutrality and capital ownership neutrality, has been proposed. Desai and Hines (2003) suggest that international tax differences influence the ownership of capital assets around the world. They argue it is important that the most-productive owners control the right assets.[13] Differences between tax systems create inefficient ownership patterns. World welfare is maximized if the identities of capital owners are unaffected by tax system differences—a condition they refer to as "capital ownership neutrality". This can be achieved by harmonizing the taxation of foreign source income among capital exporting countries (using a worldwide or territorial system) but not necessarily applying the same tax rate. "National ownership neutrality" maximizes national welfare if the tax system promotes the after-tax profitability of domestic firms which is best achieved by exempting foreign income from tax. In a world of shifting ownership, the United States does not lose tax revenue when a U.S. company invests abroad, since its domestic investment is replaced by new inbound

[11]For a discussion of this theory, see Musgrave (1969) and Feldstein and Hartman (1979). To illustrate the deduction for foreign tax, assume a U.S. company earns profits of $100 in a foreign country and repatriates those profits to the United States. Also, assume that the corporate tax rates are 20 percent in the foreign country and 35 percent in the United States. The U.S. company would pay tax of $20 in the foreign country. The income would also be taxed in the United States with an income tax deduction for the tax of $20 paid in the foreign country. Therefore, the tax in the United States would be $28 (i.e., ($100-$20) x .35).

[12]Until the 1980s, the United States was a significant capital exporter, but that has changed so that the United States is now a capital importer.

[13]Desai and Hines (2003) claim that the literature on FDI and the available data indicate that ownership, and its attendant costs and benefits, are likely to be central to explaining the determinants of multinational investment.

FDI. The ownership neutrality concept is not universally supported, however, with opponents, for example, criticizing the assumption that U.S. investment abroad will not effect production elsewhere, and arguing that tax rate and tax base differences could lead to inefficient investments. [14]

IV. Territorial or Worldwide? The Debate in the United States

The merits of a territorial system in the United States have been debated for some time. An impetus for this debate has been a desire to find ways to maintain the international competitiveness of U.S. firms in response to World Trade Organization rulings that a succession of U.S. export tax credit schemes—the Domestic International Sales Corporation scheme (DISC), the Foreign Sales Corporation scheme (FSC), and the Extraterritorial Income exclusion (ETI)—constituted export subsidies.[15]

The main reasons put forward by the tax reform panel for proposing a territorial system were the following: reducing complexity; moving further toward capital import neutrality, meaning an increase in the competitiveness of U.S. firms in foreign markets; removing the distortionary incentive to retain profits offshore, with repatriation to the United States increasing domestic investment in the United States; and, eliminating more favorable outcomes for taxpayers which are available under the current system compared to the territorial system.[16] The announcement of the tax reform panel's proposal intensified the debate on the merits of a territorial system.

A. Supporters of Territorial System

One of the key arguments for the territorial system is that it would move the U.S. tax system in the direction of capital import neutrality and hence make U.S. companies more competitive in foreign markets (assuming the tax rates of other countries are not the same as the U.S. rate). This is especially so if competitor countries are adopting a territorial system which supposedly makes their companies more competitive then U.S. companies in third markets, suggesting the United States should review its tax treatment of foreign source income.[17] However, there is little evidence to assess the impact of U.S. taxes on the

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[14]Grubert (2005)and Fleming and Peroni (2005).

[15]The effect of each of these schemes was essentially to exempt from tax all or part of export earnings of firms operating in the United States.

[16]The tax reform panel does not expand on the more favorable outcomes. However, in the January 2005 paper prepared by the staff of the Joint Committee on Taxation, "Options to improve tax compliance and reform tax expenditures," it states that "... the present-law worldwide system actually may yield results that are more favorable to the taxpayer than the results available under the territorial exemption systems used by many U.S. trading partners, as these systems generally fully tax foreign source royalties and portfolio-type income, and often exempt less than 100 percent of a dividend received from a subsidiary, as a proxy for disallowing expenses allocable to the exempt income."

[17]For example, Pamela Olsen, former Assistant Secretary for Tax Policy, U.S. Department of Treasury, before a Senate Committee on July 15, 2003, when referring to the U.S. worldwide system in relation to the territorial

(continued…)

competitiveness of multinational corporations in foreign markets, and especially the extent competitiveness is affected by the use of the worldwide system.

Supporters also argue that a move to the territorial system will increase repatriation of profits earned abroad and hence increase investment in the United States, which they suggest is good for the U.S. economy. It is argued that an increase in repatriation is likely if the exemption of foreign earnings is associated with other proposed changes—namely, the full taxation of royalties (due to the removal of foreign tax credit offsetting against royalty income) and the non-deductibility of interest expenses allocated to exempt foreign source income (currently a deduction is available for overhead and interest expenses incurred in the United States in earning foreign source income). These changes will presumably reduce the tax differential between investing in the United States and investing in low-tax countries.[18] It is also suggested that the increased investment, due to an increase in repatriation, and the associated tax changes will lead to an increase in tax revenues.[19]

Evidence that there is a disincentive to repatriate to the United States under the current system may be found in the recent substantial increase in repatriation associated with the temporary one-year reduction in the tax rate on repatriated dividends, under the American Jobs Creation Act of 2004.[20] Recent analysis shows an almost five fold increase in dividends from foreign companies since the measure was introduced ($244 billion in 2005 compared to $50 billion in 2004).[21] This outcome is consistent with research which has found that there is a negative relationship between dividend repatriation taxes and dividend payout rates.[22]

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system of other countries, said: ‘We must write tax rules that take into account what other countries are doing. If what they are doing is inconsistent with improving their own international competitiveness, then we should not follow. But if they appear to be moving in ways that will improve their ability to compete, then we must reconsider the extent to which our rules impede the flow of capital of U.S. businesses, necessitate inefficient business structures and operations, and leave U.S. companies and workers in a less competitive position.’

[18]For example, Althuser and Grubert (2001) find that under the current system an investment with an effective local tax rate of 7 percent faces an overall (residence plus home country) rate of only 5 percent (due to the allocation of domestic overhead expenses to reduce taxable foreign income). If the same firms were unable to claim a tax deduction for overhead expenses allocated to exempt income under a territorial system, the same investment would face an overall tax rate of about 9 percent. Therefore, investment in low-tax countries would not be encouraged compared to the current system.

[19]Grubert (2001) estimates that the increase in revenue could be around $9 billion a year, based on 1996 data.

[20]The tax measure effectively provides companies with a tax rate on repatriated dividends of 5.25 percent compared to the corporate tax rate of 35 percent. The reduced rate is available for one year, either the 2004 or 2005 year at the taxpayer’s option.

[21]Analysis by the IMF Research Department based on (U.S.) Bureau of Economic Analysis (2006) data. The data also shows that corporate tax collections have increased by 39.5 percent over the same period. This is greater than the increase in pre-tax corporate profits (16.4 percent) suggesting that the increase in tax is partly due to taxes on repatriated dividends.

[22]See Desai and Hines (2001) who find that repatriation taxes reduce aggregate dividend payouts by 12.8 percent. But also see Sinn (1990) who suggests dividend taxes should have no effect on payouts.

However, there is an alternative argument which is that for mature subsidiaries (i.e., those retention-financed at the margin) it is not the repatriation tax itself that is distortionary (it cannot be avoided, since if a company does not repatriate now it will have to in the future), but the distortion comes from changes in the rate of tax on repatriation (which does affect repatriation decisions). This suggests that the repatriation tax does cause a distortion but probably not to the same extent as suggested by the recent evidence from the temporary tax measure.

Support for a territorial system is also found in proponents of national ownership neutrality and capital ownership neutrality who argue that exempting foreign source income enhances both national and global welfare. (see the discussion in Section III.)

B. Opponents of Territorial System

One of the main arguments put forward by opponents of the territorial system is that it will encourage U.S. firms to invest and/or locate abroad rather than in the United States, in pursuit of the highest after-tax rate of return. They argue this could weaken the U.S. economy with increased capital outflows aggravating the current balance of payment deficit, reducing tax revenues, and slowing the growth of domestic employment.[23] The tax reform panel dismissed this argument in their report suggesting that there was no definitive evidence that location incentives would be significantly changed and, in any case, companies can effectively exploit the current deferral rules to achieve virtual exemption. Some support for the panel's view can be found in research by Grubert and Mutti (1995) who have estimated that the average U.S. corporate tax rate on foreign source income is only 2.7 percent, which suggests that a change to a territorial system will not significantly affect U.S. multinational companies.[24]

There also does not appear to be much evidence of the supposed simplification benefits of a territorial system. The benefits appear to be limited as many of the current complex rules such as controlled foreign corporation, expense allocation, and foreign tax credit rules (at least for non-dividend foreign source income) will still apply. In fact, it is argued that a territorial system could place pressure on transfer pricing rules—as companies seek to convert taxable passive income into tax-exempt dividends, or shift profits from the United States to low-tax countries—leading to further complexity.[25] This may also have implications for the administration of the tax system, with greater pressure on the Internal Revenue

[23]For example, see Joseph (2005).

[24]Grubert and Mutti suggest the main reasons for such a low rate is the deferral of tax until repatriation as well as problems in measuring foreign and domestic income (for example, due to the incorrect allocation of income and expenses to domestic or foreign sources).

[25]For a discussion of the simplification issue, see Fleming and Peroni (2005).

Service monitoring of international transactions and potentially greater need for double tax treaties to ensure the source of income is clear.[26]

C. An Alternative?

While most opponents agree that the U.S. tax treatment of foreign source income is in need of reform, some suggest that it would be better to retain the worldwide system but reform it, in particular by removing the deferral and limiting cross-crediting. This would move it closer to capital export neutrality. Such a move would reduce the incentive to shift income to low tax jurisdictions and reduce the incentive to invest abroad. While it may encourage corporate inversions,[27] this problem could be overcome with taxes on inversion or through ownership tracing provisions.[28] However, such an approach would seem to have implications for the administration of the tax system as it would require extensive information sharing between countries.

D. Should the United States Adopt a Territorial System?

The divergent views outlined above illustrate that a definitive conclusion on whether the United States should adopt a territorial system is not easy. Corporate tax is very complex and similarly firms' responsiveness to tax law changes are complicated. The main point of contention appears to be whether the move to a territorial system will make U.S. firms more competitive while at the same time increasing investment in the United States or instead will simply facilitate the flight of U.S. companies and capital out of the country. The effect of the proposal on the competitiveness of U.S. firms and their domestic investment is inconclusive. In any case, the overall competitiveness of U.S. firms also depends on factors other than tax (for example, exchange rates). It also seems that the simplification benefits are likely to be limited. This inconclusiveness suggests that there may be merit in considering further the alternative proposal to retain the current worldwide system but without deferral.

V. Rest of the World's Perspective

While much of the debate on the move to a territorial tax system is focused on the impact in the United States, such a move may also have significant implications for the rest of the world. This aspect has received little attention in the debate in the United States. Some of the issues being debated, such as the simplification benefits of the reform, are unlikely to be of concern to other countries. However, there is likely to be interest in the impact of a territorial tax system on U.S. investment abroad. Even if a territorial system is beneficial for the United

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[26]The monitoring of international transactions may increase the importance to the United States of the OECD project on information exchange between tax authorities.

[27]A corporate inversion is where a parent company is moved offshore to a low-tax jurisdiction with usually no change in shareholding of the parent.

[28]For a discussion of the arguments in support of a worldwide system without deferral rather than a territorial system, see Gravelle (2004) and Fleming and Peroni (2005).

States, the consequences of such a move may or may not be so for the rest of the world. If not, then the U.S. gains may come at the expense of the rest of the world, although to the extent that the current system creates inefficiencies, any U.S. gains may outweigh the rest of the world's losses. Even if the rest of the world gains overall, some countries may be winners and others losers. For example, developing countries may gain but non-U.S. developed countries lose as their multinationals may lose competitiveness.

In providing a framework for considering the implications for the rest of the world, four key questions can be asked:

(i) Will the territorial system change the level and/or location of U.S. FDI?

(ii) Will the territorial system encourage other countries to more aggressively pursue tax competition (i.e., lower rates or increase tax concessions) to attract U.S. FDI?

(iii) Will other countries follow the United States lead and move to a territorial system?

(iv) Will there be an impact on the tax revenues of other countries?

These questions assume that the main interests of the rest of the world are in attracting U.S. FDI and ensuring a country's own tax revenues. FDI is an important source of capital for a country that also provides spillover benefits, such as technology transfers and management expertise, which can enhance the productivity of domestic firms and improve economic growth.[29] The rest of the world may have other interests in the move to a territorial tax system. For example, a non-U.S. multinational company, and possibly foreign governments, may be interested if the proposal would make U.S. companies more competitive in the same foreign market (that is, it may affect the relative competitiveness between U.S. and non-U.S. multinationals). Also, another country may be interested if they are benefiting from tax planning by U.S. multinationals to overcome the current U.S. tax system (e.g., affiliates of a U.S. company may be locating in another country to access a territorial system in that country). For the purposes of this paper, the main focus is on the impact of the proposal on U.S. FDI and tax revenues of other countries.

There is no doubt that U.S. FDI is significant. Table 3 provides a summary of FDI outward stock for 2004, and shows that the U.S. FDI was around US$2 trillion or 20.7 percent of worldwide FDI. The United States is the leading country as a source of FDI, with the next largest source of FDI being the United Kingdom. However, in terms of FDI outward stock as a percentage share of home GDP, the United States lags behind the major European countries.

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[29]For a summary of the literature on positive spillovers from FDI see Lim (2001).

Table 3. Summary of FDI Outward Stock for 2004

Country/Region	FDI Outward Stock (in US$ billions)	Share of Worldwide FDI Outward Stock (in percent)	FDI Outward Stock as Share of GDP (in percent)
United States	2,018	20.7	17.2
United Kingdom	1,378	14.2	64.8
France	769	7.9	38.1
Germany	833	8.6	30.8
Japan	371	3.8	7.9

Source: UNCTAD (2005).

The average FDI outflow from the United States is around $152 billion per year (based on the years 2001-2004).[30] Most of U.S. FDI is invested in developed countries, with 29.5 percent of FDI outward stock (in 2003) being invested in developing countries, a ratio which is greater than other major sources of FDI. Table 4 compares the location of U.S. FDI outward stock with other major investing countries, including the regional location of FDI to developing countries. Most of the U.S. FDI in developing countries is located in the Latin America/Caribbean region and in the Asia-Pacific region. However, almost half of the Latin America/Caribbean region FDI outward stock is in the low tax countries of Bermuda, Bahamas and the British Virgin Islands, suggesting that these could simply being used as conduits for capital which is ultimately invested in other locations.

The implication of the data on the size and location of U.S. FDI is that even a small change in the level of FDI could have a significant impact for host countries. Similarly, a change in location of U.S. FDI could have a significant affect for those countries in which the United States is a significant investor. This includes countries such as Canada, where U.S. investment represented around 64 percent of inward FDI stock in 2003, and Mexico, where U.S. investment represents around 73 percent of inward FDI stock in 2002.[31] It also includes regions such as Central America where in some of the countries, such as Costa Rica and Panama, the United States is almost the only source of inward FDI stock.

A. Impact on Level and Location of U.S. Foreign Direct Investment (FDI) Abroad

The first question is whether a move to a territorial system will affect a U.S. company's choice on the level and/or location of investment. There may be a perception that a move to a territorial system will mean U.S. companies will seek to invest in low tax countries on the basis that the final tax liability on foreign source income only depends on the tax rate in the source country. The answer to this question will depend on the extent to which tax affects such decisions.

[30] Bureau of Economic Analysis (2006) and UNCTAD (2005).

[31] UNCTAD (2006).

Table 4. Summary of Location of FDI Outward Stock for 2003
(as a percent of overall FDI outward stock)

Home Country	Developed Countries	Developing Countries 1/	Share of FDI Outward Stock to Developing Countries: Central and Eastern Europe	Africa	Latin America and Caribbean	Asia-Pacific	Central Asia and Middle East
United States	70.5	29.5	2.5	2.9	57.6	33.2	3.8
United Kingdom	90.3	9.7	11.2	8.2	34.3	44.3	2.1
France	93.3	6.7	31.2	9.3	28.4	27.7	3.5
Germany	86.3	13.7	43.0	1.6	22.4	29.8	3.1
Japan	73.0	27.0	1.3	1.1	24.3	72.4	1.0

Source: World Investment Directory On-Line (2006).

Note: 1/ A developing country is based on the UNCTAD definition.

On the issue of whether tax affects the decision to invest locally or abroad, the evidence is varied. For example, Devereux and Freeman (1995) conclude that tax is not a significant factor in the allocation of investment between domestic and foreign locations, but is significant in the allocation between foreign locations implying no change in total FDI but a change in location across countries. However, Gropp and Kostial (2000) find that tax is an important consideration. Hines (1996) concludes, based on a survey of studies, that it is difficult to determine if there is a tax-induced substitution between domestic and foreign investment. This may be partly explained by an 'attachment to home'—that is, a bias for investing in the home country.

Another indicator of the likely response of the level of U.S. FDI abroad is to consider the evidence of FDI from countries which already have a territorial system. There is some evidence that countries with a territorial system are more likely to have higher levels of outbound FDI then countries with a worldwide system. Gropp and Kostial (2000) find that FDI flows abroad are greater in exemption countries (2.3 percent of GDP) than in countries with a worldwide system (1.5 percent of GDP). Their research also shows that countries with a worldwide system had a higher rate of investment from retained earnings than countries with a territorial system. This suggests that investors from countries with a worldwide system may undercapitalize initially so as to retain earnings and avoid repatriation, which suggests that, as discussed above, taxes affect repatriation decisions for immature subsidiaries.

The alternative argument is that the introduction of a territorial tax system will increase repatriation to the United States of profits earned abroad and hence increase investment in the United States, most likely at the expense of FDI abroad. If the repatriation taxes do have a negative effect on dividend payout rates, then it can be expected that more earnings will be repatriated to the United States under a territorial system (although an increase in investment in the United States will depend on whether the profits are invested or consumed). The case for increased repatriations is strengthened if the exemption of foreign earnings is associated

with the full taxation of royalties and the nondeductibility of interest expenses allocated to exempt foreign source income.

Once a decision is taken to invest abroad, it is clear that tax does affect the location of FDI. While other factors, such as market size, labor costs, infrastructure, and a stable economic and political environment, are likely to be more important, research shows that tax has a small but statistically significant effect on FDI. De Mooij and Ederveen (2003) review the empirical literature on the impact of company taxes on the allocation of FDI and find that the mean value of the tax rate elasticity in the literature is around -3.3—that is, a 1 percentage point reduction in the source country tax rate raises FDI in that country by 3.3 percent.[32] Recent research also shows that other tax factors may be important in the location decision, including (somewhat surprisingly) the level of indirect taxes, and complexity and uncertainty in a country's corporate taxes—such as, multiple tax rates, unclear language in the tax law, and inconsistent changes in the law. [33],[34] It follows that U.S. companies may seek to change the location of their FDI to low-tax jurisdictions if a territorial system were adopted.

However, there is an alternative argument that suggests a move to the territorial system will not affect the level and location of U.S. FDI abroad, or may even reduce the level of U.S. FDI abroad. It is argued that the existing deferral of tax until repatriation and foreign tax cross-crediting provides U.S. companies with virtual exemption. This virtual exemption together with the proposed changes to interest deductibility and taxation of royalties, will decrease the after-tax return in low tax countries making investment less attractive.

The tentative evidence that outward FDI is higher from countries with a territorial system may provide some hope for countries seeking an increase in U.S. FDI abroad if the United States moved to a territorial system. However, the uncertainty over the importance of tax as a factor in the decision to invest locally or abroad, the impact of other tax changes associated with the move to a territorial system, and the possibility that even if the United States increased its FDI it will simply replace non-U.S. FDI, make it unlikely the hoped for increase in aggregate FDI will happen. More likely there will be changes in the location of United States. FDI abroad. Based on de Mooij and Ederveen (2003) that the elasticity of FDI to a change in tax rate is -3.3 percent, any change, even small, may still have implications especially for countries in which the United States is a significant investor, such as Canada, Mexico, and Central American countries.

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[32]Also see Hines (1999) for a summary of the research on the relationship between FDI and after-tax rates of return.

[33]Desai, Foley and Hines (2004) examined FDI by U.S. multinational firms and found that a 1 percent lower indirect tax rate is associated with 0.71 percent greater affiliate assets (which is a similar effect to lower income tax rates). Indirect taxes include value added taxes, excises, property taxes, import and export duties and similar taxes.

[34]See Edmiston, Mudd, and Valev (2003).

B. Impact on Corporate Tax Competition

Corporate tax competition is the non-cooperative strategic tax setting in which countries set their taxes in response to the taxes set by other jurisdictions. The fall in corporate statutory tax rates around the world over the past 10 years (by an average of around 8-10 percent) suggests that tax competition is occurring. Evidence also suggests that the fall in rates has been accompanied by base broadening in developed countries but less so in developing countries.[35] The concern with tax competition is the 'race to the bottom,' ending in a situation in which tax rates are generally too low in terms of the collective interest. Although, all countries may not be worse off—for example, the literature suggests that small countries are likely to be better off than they would be under schemes of cooperation without side payments, because in setting low tax rates they have little to lose from their domestic tax base but much to gain from attracting foreign investment and tax base.[36] Some in fact see competition as being good, in that it provides a discipline on the size of governments.

The benefits of a country aggressively pursuing tax competition are somewhat offset if the investor is resident in a country with a worldwide tax system. One argument against countries pursuing tax competition by offering tax concessions to foreign investors is that, if the investor is from a country with a worldwide system (especially the United States), there is simply a transfer from the source country government to a foreign government. The benefit of the concession is simply clawed back by the residence country. This is consistent with the theory that a small capital importer should tax up to the residence country tax rate of the investor if the residence country of the investor provides a full credit for tax in the source country. In practice, whether a tax transfer takes place is debatable considering the evidence cited earlier that the average rate of tax on U.S. foreign source income is only 2.7 percent, which suggests that the transfer to the U.S. Treasury is not significant.[37]

A move to a territorial system may affect tax competition if the tax transfer argument is true, and/or if countries believe it to be true. A country which believes the tax transfer argument may be inclined to reduce rates or introduce new concessions on the basis that the tax benefits will not be clawed back in the United States if a territorial system was introduced. Countries may feel under pressure because they can no longer set their tax rates to soak up U.S. foreign tax credits.

The extent of the response to a U.S. move to a territorial system may be limited, however, if the country has already responded to the territorial systems of other countries in which large investors are located. For example, many EU countries have a territorial tax system (see Table 2) and are active investors. Although U.S. FDI may be important to a country, investment from other countries may be equally or more important. As mentioned earlier,

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[35] Keen and Simone (2004) and Devereux, Griffiths, and Klemm (2002).

[36] For example, see Kanbur and Keen (1993).

[37] Grubert and Mutti (1995).

there is some evidence which suggests that territorial countries invest a greater share of GDP than countries with a worldwide system, although the United States continues to be the largest single source of FDI outflows. The countries which may respond most are those in which the United States is a significant investor.

The other factor to consider is the extent to which countries have already responded to tax competition. The evidence suggests that countries have been responding to tax competition for some time—for example, by cutting corporate tax rates. So the potential change in the United States may not make a difference especially if the country has already responded and is unwilling or unable to compete further (for example, because of revenue constraints).

C. Impact on International Tax Systems of Other Countries

Some countries may look to the United States for leadership in tax system design, for example some of the Central American countries which may rely on the United States as a significant source of investment and trade. Any move by the United States to a territorial system may encourage other countries to move in the same direction. This could have negative revenue implications for a country if they have not properly considered the potential revenue loss of exempting certain foreign source income. The other danger for developing countries in moving to a territorial system is that the authorities may not be able to adequately administer the anti-avoidance rules usually necessary to prevent abuse under a territorial system (although this is less of an issue if the country has little FDI abroad).

The other international tax issue to consider is the implication of a territorial system on double tax treaties. Many countries have treaties with the United States and others are in the process of negotiating such treaties. These treaties are based on the concept of two-country taxation with revenue splitting. Under a territorial system, revenue splitting will not apply to most dividends of multinational corporations with tax only being collected by the source country. Therefore, countries may feel under pressure to reduce their tax rates under a treaty with the United States in order to attract U.S. FDI.

D. Revenue Implications

The main concern with a change in level and location of U.S. FDI abroad, an increase in tax competition, and changes in the international tax systems of other countries, is the effect on tax revenues, in particular in developing countries. Table 5 provides a summary of the foreign tax paid by corporate taxpayers on foreign source income for the 2001 year. The total tax paid in developing countries on foreign source income taxed in the United States was US$13.8 billion (compared to $30.7 billion in developed countries). This is not necessarily the total tax paid for the year by foreign affiliates (foreign subsidiaries and branches) in foreign countries, but is rather the tax on foreign source income that is taxed in the United States in that year (for example, it will not include unrepatriated profits derived and taxed in the foreign country in the 2001 year). However, it is still an indication of the size of the revenue collected by foreign countries on U.S. corporate investments abroad.

Table 5. Summary of Foreign Tax Paid by U.S. Corporate Taxpayers on Foreign Source Income for the 2001

	Foreign Tax Paid (in US$ millions)	Share of Total Foreign Tax Paid (in percent)
Total	44,505	100.0
Developed countries	30,741	69.1
Developing countries	13,764	30.9
Countries in which highest amount of tax was paid:		
United Kingdom	7,047	15.8
Japan	4,549	10.2
Canada	4,067	9.1
Norway	3,681	8.2
Switzerland	1,756	3.9
Spain	1,743	3.9
Netherlands	1,700	3.8
Mexico	1,585	3.6
France	1,238	2.8
Germany	1,226	2.8
Brazil	1,012	2.3
Australia	939	2.1
Low income or low-middle income countries in which highest amount of tax was paid: 1/		
Indonesia	900	2.0
Thailand	497	1.1
Philippines	201	0.5
Egypt	184	0.4
India	155	0.3

Source: Luttrell (2005); and IMF staff compilation.

1/Low-income and low-middle income based on World Bank definitions.

The data also show that the effective rate of tax on foreign source income from low tax countries which was taxed in the United States for the 2001 year is generally less than the U.S. corporate tax rate. For example, taxable foreign source income from Ireland was US$4,451 million and the tax paid in that country was US$248 million, an effective rate of 5.6 percent. This suggests that there may be some truth to the argument that if a source country applies a low corporate tax rate there is simply a transfer of tax from the source country government to a foreign government, in this case the U.S. Treasury. However, the actual U.S. rate of tax paid on that income may not be the difference between 35 percent and 5.6 percent due to pooling of all foreign source income of a similar type into 'foreign income baskets', and the ability to pool foreign tax credits from high tax and low tax countries and offset those credits against tax on all income in the basket.

Based on the amount of tax paid by U.S. affiliates (i.e., foreign branches and subsidiaries) to foreign countries, the impact on tax revenues from a move to a territorial system is potentially sizable, but somewhat complex. To the extent that U.S. FDI abroad increases (and does not simply displace FDI from elsewhere), revenue in other countries would tend to increase as a consequence of a move to a territorial system (assuming the source country tax rate is unchanged). This increase will depend on the elasticity of U.S. FDI abroad to a change from a worldwide to a territorial system.

Theory would suggest, however, that if a residence country exempts foreign source income, then a small capital importer should do likewise. This would mean that all the corporate tax revenue currently being collected from U.S. affiliates in the source country would be lost. In practice, a country is unlikely to reduce its rate to zero as the corporate income tax may serve other purposes, such as a backstop to the personal income tax. The country may reduce its tax rate, however, especially in response to tax competition.

Further downward pressure on corporate tax rates may result in a worsening of a usually tight fiscal position in developing countries unless alternative revenue sources can be found. The ability of developing countries to recover any loss of revenue from a reduction in corporate tax rates appears limited, based on the evidence for developing countries that the fall in corporate tax rates over the past 10 years has been accompanied by a decrease in corporate tax revenues as a share of GDP.[38]

VI. Conclusion

At this time, it is unclear whether the U.S. authorities will implement the tax reform panel's recommendations on international tax reform. Based on the debate in the United States, deciding on the best system for the United States is not easy to resolve, since there is no clear answer on whether the supposed main benefit of a territorial system, making U.S. firms more competitive in foreign markets, will happen. There are, however, likely to be significant implications for the rest of the world.

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[38]Keen and Simone (2004).

If the United States decides to move to a territorial tax system, the evidence would suggest that there is unlikely to be a significant increase in U.S. companies' overall FDI abroad, resulting in little overall benefit for the rest of the world. If, however, the move to a territorial system did increase U.S. FDI abroad, then there are likely to be benefits, especially if that investment went to developing countries. Owing to the size of U.S. FDI abroad, even a small increase could have significant implications for countries in which the United States invests. These implications are likely to be more acute for countries whose inward FDI is sourced predominantly in the United States, such as Canada, Mexico, and the Central American countries.

The evidence also suggests that a move to a territorial system may lead to some change in the location of FDI as companies pursue better after-tax rates of return. Such a shift is likely to result in winners and losers, which could lead to more aggressive tax competition, especially since the final tax liability would be based on the source country tax rate. Past experience suggests that further reductions in tax rates owing to tax competition is likely to affect developing countries more than developed countries, with the main impact being a reduction in much-needed tax revenues. It is the impact on tax revenues that is likely to be the biggest concern for the rest of the world, especially for developing countries.

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