In Defense of Tax Havens

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Unlike almost all of their foreign competitors, American companies face a tax penalty when they compete for market share around the world. But this penalty is not imposed by protectionist foreign governments. Instead, this discriminatory tax--known as worldwide taxation--is imposed by American politicians.

Congress and the Obama administration now want to make the penalty even more severe, even though that will further tilt the playing field in favor of companies from other countries.

The U.S. is one of the few nations in the world to impose worldwide taxation. This means that American companies are taxed not only on the income they earn in the U.S., but also on income they earn in other countries. That is a problem since any money earned abroad by American companies already is subject to all applicable taxes in those other countries. That's not too surprising. After all, the IRS taxes foreign companies that earn money in America.

Yet if two countries tax the same income, that is an unambiguous form of double-taxation. Even the politicians in Washington realize that two layers of tax would cripple American companies trying to earn market share abroad. As such, American companies with foreign income are allowed a credit for corporate income taxes paid to foreign governments.

That's certainly better than nothing, but now we come to the second problem, and its a biggie. The U.S. has a 35% corporate tax rate, much higher than most other countries. This high corporate tax rate, combined with worldwide taxation, is a huge liability for American companies.

Let's say an American company is competing around the world against a Dutch company. Both companies have manufacturing divisions in Ireland, servicing divisions in Hong Kong and financing divisions in the Cayman Islands. And to keep our example simple, let's assume each division generates $100 million of profit.

Now let's add taxes to the equation. The Irish government imposes a 12.5% corporate tax on both companies. The Hong Kong government imposes a 16.5% tax on both companies. And the Cayman government imposes zero tax on both companies.

But the U.S. has a worldwide tax system, and the Netherlands has a territorial tax system. This means that the American company owes tax to the IRS on the $300

million earned in the three jurisdictions, but the Dutch company does not need to pay any additional tax on its $300 million. And even if the American company is allowed full credit for taxes paid to the three foreign governments, its total tax bill will be more than $100 million--more than three times higher than the tax bill for its Dutch competitor.

In a competitive global economy, this is a huge disadvantage for an American company. This is why politicians, in an unusual display of common sense, created a policy known as "deferral," which allows

American companies--in some circumstances--to delay the extra tax. U.S. businesses still don't get to compete on a level playing field, but deferral does significantly reduce the self-imposed tax discrimination caused by America's worldwide tax system.

Ideally, policymakers would try to fix this competitive disadvantage by lowering the corporate tax rate or shifting to territorial taxation (the commonsense notion of only taxing income earned inside national borders). In the strange world of Washington, however, moving in the right direction does not seem to be an option. President Obama has proposed to make America's tax system even less competitive by restricting deferral.

You're probably asking yourself, "Why would Obama want to hamstring American companies in the global marketplace?" There are two explanations. First, politicians love tax revenue, and the president's budget claims that this portion of his tax plan will collect as much as $210 billion. In reality, it won't collect anywhere near that much because of Laffer Curve effects, but that's no obstacle to politicians. They'll assume the money will materialize, and further increase the burden of government spending.

The second explanation is that some people in Washington think deferral is a subsidy "to move jobs offshore." They argue that if an American firm can earn money in Ireland and only pay 12.5% tax, this gives them an incentive to close down factories in America and ship them overseas.

Since nearly 90% of what American companies produce overseas is sold overseas, according to Commerce Department data, there's not much evidence that this is happening. But there's actually some truth to this argument. If a company can save money by building widgets in Ireland and selling them to the U.S. market, then we shouldn't be surprised that some of them will consider that option.

But this does not mean the president's proposal might save some American jobs. If deferral is eliminated, that may prevent an American company from taking advantage of a profitable opportunity to build a factory in some place like Ireland. But U.S. tax law does not constrain foreign companies operating in foreign

countries. So there would be nothing to prevent a Dutch company from taking advantage of that profitable Irish opportunity. And since a foreign-based company can ship goods into the U.S. market under the same rules as a U.S. company's foreign subsidiary, worldwide taxation does not insulate America from overseas competition. It simply means that foreign companies get the business and earn the profits.

If deferral is curtailed or eliminated, several bad things will happen. American-based companies will become less competitive since they will face a higher tax rate. Those U.S. companies also will lose market share around the world since foreign companies will have an even bigger tax advantage. America will have fewer exports, since a big chunk of our exports are the goods that American companies sell to their foreign subsidiaries. And American workers will have fewer jobs because of the reduction in exports.

Sadly, politicians either don't understand or don't care. All that matters to them is that they get more money to spend.

Added to www.cato.org on May 6, 2009

This article appeared in Forbes on May 6, 2009.