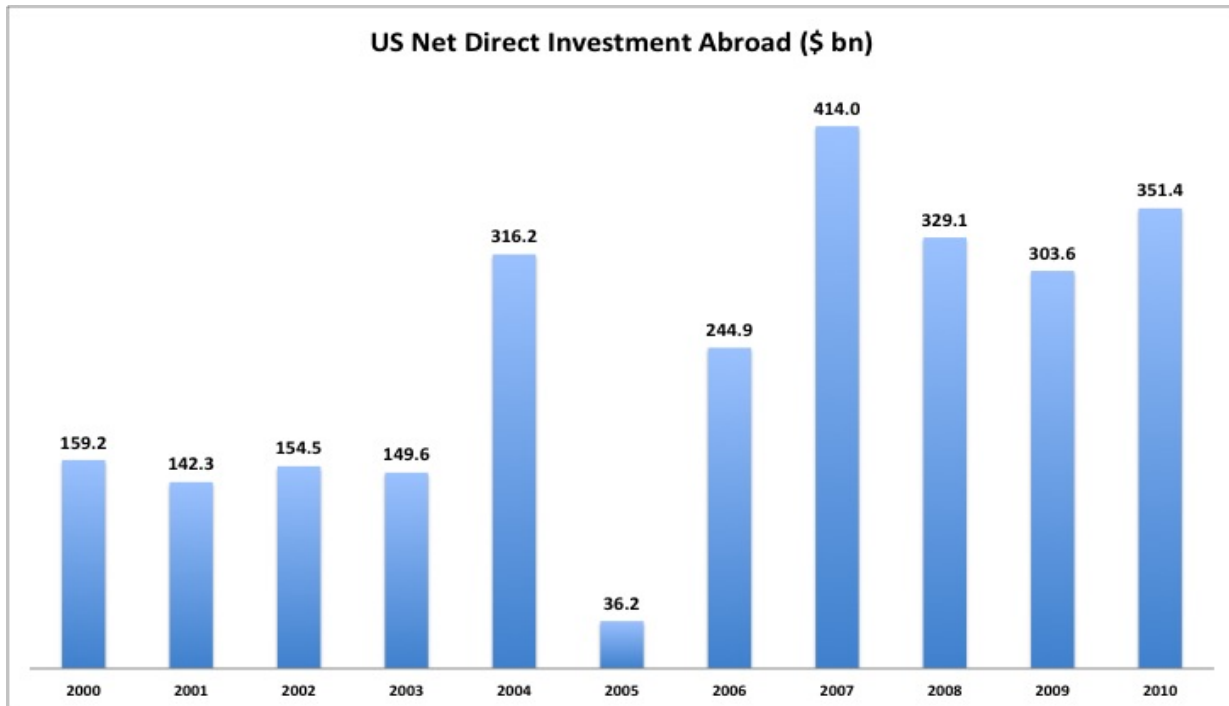


Taking American Business Back Home

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President Barack Obama has unveiled features of a new tax reform plan as part of his campaign for a second presidency, which, if implemented, could impact the developing world. Given the rising debt of the government, the resulting pressure to raise revenues or cut government expenditures and the evidence that the effective taxation of America's rich falls short of average, the tax regime was an issue that any Democratic candidate had to address. The case for raising tax revenues is strong.

But the opposition to any such increase from many among those who finance Obama's campaign is also strong. They harp on the fact that America has the highest marginal corporate tax rate in the world after Japan. And Japan is reducing its rate from April this year. So President Obama had to walk the tightrope. That he appears to have done well by making three distinctions. Between rich individuals and corporations, between a simple and cumbersome tax system and between corporations that serve America while serving themselves and those that only look to their own profits.

By making the first of these distinctions, the President proposes to tax rich individuals more while reducing taxes on corporates that create productive assets and provide jobs. He is threatening to impose the "Buffett rule" that those earning more than a million dollars a year should pay a minimum of 30 per cent of that income as tax. But to balance this, he has proposed a substantial cut in the US corporate tax rate from 35 to 28 per cent, with even lower rates for manufacturing and "advanced manufacturing". Clearly, the idea here is to highlight a push for investment, growth and jobs.

The second distinction, between a complex and simple tax system, is made to argue that the reduction in the corporate tax rate needs to be accompanied by a simplification of the tax system, which eliminates multiple concessions that introduce distortions. The most obvious of those distortions is that while the US has among the highest marginal corporate tax rates in the world, the corporate tax to GDP ratio in the US is among the lowest among OECD countries. The US-based Center for Tax Justice has found that the US has the second lowest corporate tax to GDP ratio in the developed world, falling only behind Iceland. A study by research firm Capital IQ for the New York Times found that of the 500 companies included in the Standard and Poor's stock index, 115 were subject to an effective total (federal and other) corporate rate of less than 20 per cent during the five years ending 2010. Yet, over time corporate tax revenues in the US have fallen from 4 per cent of GDP in 1965 to just 1.3 per cent in 2009. To justify a corporate tax rate reduction in this context, President Obama has proposed a rationalisation of the tax system that puts an end to tax breaks given, for example, to the oil and gas industry and the private equity business, and benefits such as accelerated depreciation, which permits companies to write off assets against tax at a faster rate than they actually depreciate in economic terms.

Finally, the third distinction, between profits brought back home and those retained abroad, is made to argue that the President intends to end the discrimination against firms that provide Americans jobs by investing profits at home as opposed to retaining them abroad. It is here that the President was strident: "Our current corporate tax system is outdated, unfair, and inefficient. It provides tax breaks for moving jobs and profits overseas and hits companies that choose to stay in America with one of the highest tax rates in the world...It's not right and it needs to change." US firms earning profits abroad and choosing to retain them there are not taxed in the US on those profits. But if they choose to bring them home then they are subject to the US corporate tax regime. This does encourage US corporations to retain and invest their profits abroad, especially in countries where the effective tax rate is significantly lower than in the US. Obama now wants to give up this "territorial" system of taxing profits of US multinationals and impose a minimum tax that needs to be paid on overseas profits, whether repatriated or not.

It is not clear how effective such a system of reducing the differential tax on repatriated and retained profits would be. But there is evidence that when tax concessions are offered on profits repatriated back to the US, corporations do respond. As the accompanying Chart shows, US net direct investment abroad, which ruled high in the latter part of the last decade, registered a dramatic decline in 2005. The drop in 2005 reflected the decision by U.S. parent firms to reduce the amount of reinvested earnings going to their foreign affiliates, in order to repatriate profits home and take advantage of one-time tax provisions in the American Jobs Creation Act of 2004 (P.L. 108-357). That act allowed U.S. companies that received dividends from foreign subsidiaries during a specific period (calendar year 2004 or calendar year 2005) to be taxed at reduced rates, on the condition that they worked out a domestic reinvestment plan for the dividends granted that benefit. Many companies chose to use that opportunity in 2005, when much of such dividends were paid out, because the act was signed into law only late in 2004.

If a similar, more long-term, consequence were to follow the implementation of the proposed reduction in the tax rates on reinvested as opposed to repatriated overseas profits of US MNCs, US business may at the margin choose to return home. In this they would also be encouraged by the fact that in at least one of the countries that is their favoured destination, viz. China, there are signs of labour shortages and a rise in wages, besides currency appreciation, which erode its competitiveness as a location. According to The New York Times, a report recently released by

the Chinese government argues that this year's post-Spring Festival labour shortage was more pronounced than in earlier years and also longer and wider in scope. There are other reports that the migrant worker pool on the basis of which industry in China's export-oriented zones grew is shrinking. An important reason is that the government's effort to improve rural well-being and reduce the rural-urban imbalance is delivering results and encouraging workers to stay back in their rural homes.

This in itself may not ensure the return home of American business. Many produce in China because it is the Chinese market that they are targeting. Others may choose to shift, but to other low-wage locations rather than back to the US. But the evidence suggests that Obama's ploy to justify tax concessions to corporations in a country where they are effectively undertaxed may end up working.

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