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Research Report

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United States corporate tax reform and global FDI flows*

by
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The US is the largest source of FDI, accounting for 24% of the world's outward stock. Now that Congress and the new presidential administration are putting forward plans for reforming the corporate tax regime, and especially the way multinational enterprises (MNEs) are taxed on their foreign earnings, we should consider the effects of these plans on FDI flows and the behavior of MNEs.

At the moment, US MNEs face income tax liabilities for the profits of their foreign affiliates, with a deduction for the taxes paid in host countries. Since payment is deferred until the income is returned to the US—and because the corporate tax rate in the US (35%) is higher than in most other countries—companies tend to accumulate earnings abroad to avoid a large tax bill at home. By the latest estimates, US companies hold US$2.343 trillion abroad in "reinvested foreign earnings."[1] Half of these have been reinvested in productive assets, as is common practice for MNEs anywhere;[2] but half of that sum is estimated to be kept in liquid assets in low-tax territories.[3]

A reform that addresses this distortion should have short-term and long-term effects on FDI flows. To begin with, there are plans to bring back the earnings accumulated abroad by substituting the tax liability for a one-off toll.[4] If companies perceive this offer as time-limited, as it was the case with the American Jobs Creation Act (AJCA) in 2004, the amounts repatriated could be very high. For instance, assuming that the final deal only attracts half of the reinvested foreign earnings kept in liquid assets (or 25% of the total), the repatriation would be US$600 billion, double the average annual FDI outflows from the US over the past few years. The reform should try to spread this repatriation across several years, but the annual US FDI flows (and those of some other countries) would still be severely distorted.[5]

What will parent companies do with this one-off inflow? The objective of the reform is to increase investment in the US. But most of the accumulated foreign earnings are owned by large information technology and pharmaceutical companies that can already access as much capital as they want in the US.[6] It is more likely that the funds will be used to reduce debt, pay dividends or

engage in large share buy-backs. It may also increase the appetite for domestic acquisitions, already high among technology firms. Regulators and market players should be aware of potential disruptions that a sudden inflow could create in financial markets.

In the long term, the reform is likely to reduce the incentives to keep future foreign earnings abroad, bringing the reinvestment rate of US foreign affiliates in line with those of the rest of the world. This should affect mostly the type of reinvested earnings kept in liquid assets in low-tax territories. But even a marginal impact on the decision to reinvest in productive assets would be felt in some host countries: reinvested earnings by US MNEs account for 19% of total FDI inflows in Mexico, for example.[7] These effects also may be seen between two non-US economies, as foreign affiliates of US MNEs have less capital to invest in other countries.

A second aspect concerns the effect on the global efforts to prevent tax avoidance by MNEs through profit shifting. If the reform brings the US corporate rate more in line with that of other large economies, it will reduce a significant distortion in the global corporate tax system. But unless the corporate tax is eliminated, US companies (like those of other countries) will still have an incentive to shift profits to tax havens.

Overall, US corporate tax reform is likely to generate large FDI flows, as companies unwind their stocks of reinvested foreign earnings. Lower corporate tax may increase investments in the US in the long-run, but little of the repatriated foreign earnings will be invested in productive capacity However, if it reduces the incentive that US companies shift profits abroad, this reform could help to harmonize international tax regulations and discourage aggressive tax planning. The US and other governments should seize this chance to continue the cooperation on this agenda.

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[1] *See* Jessica McKeon, "Indefinitely reinvested foreign earnings still on the rise," *Audit Analytics*, http://www.auditanalytics.com/blog/indefinitely-reinvested-foreign-earnings-still-on-the-rise/.

[2] *See* UNCTAD, *World Investment Report 2016* (Geneva: UNCTAD, 2016), p.7.

[3] Jennifer L. Blouin et al., "The location, composition, and investment implications of permanently reinvested earnings," July 8, 2014, https://ssrn.com/abstract=2154662.

[4] The previous Administration suggested a 14% rate for this toll, but the new proposal may be lower. *See 2015 Economic Report of the President* (Washington, D.C.: Council of Economic Advisors, 2015), p. 219, https://obamawhitehouse.archives.gov/sites/default/files/docs/cea_2015_erp_complete.pdf.

[5] Repatriated earnings are counted as negative FDI outflows in home countries (a credit in the financial account of the balance of payments) and as negative FDI inflows in host countries (a debit).

[6] In AJCA's experience, only firms that were capital constrained used the repatriated funds to increase investment. *See* Michael W. Faulkender and Mitchell A. Petersen, "Investment and capital constraints: repatriations under the American Jobs Creation Act," NBER Working Paper no. w15248, August 2009, https://ssrn.com/abstract=1454981.

[7] Secretaría de Economía, Mexico, http://www.gob.mx/se/acciones-y-programas/competitividad-y-normatividad-inversion-extranjera-directa?state=published.

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