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## Musgrave: United States Taxation of Foreign Investment Income: Issues and Arguments

W C. Brewer Jr

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## BOOK REVIEW

United States Taxation of Foreign Investment Income: Issues and Arguments. By Peggy B. Musgrave. Cambridge: International Tax Program, Harvard Law School, 1969. Pp. V, 171.

Taxation in most of the world is still concerned with raising sufficient money from a reluctant populace to meet the payroll and purchase a bit of military hardware. But in the United States and a few other wealthy countries, with revenue and compliance at a tolerable level, attention has increasingly turned to the economic and political ends which taxation may serve, rather than to the problems of raising revenue. While some tax philosophers have regretted this subliminal policy-making, the temptation to do indirectly by fiscal measures what might never be done directly seems overwhelming. Nowhere is this more true than in the field of foreign investment income.

Much discussion over many years has been directed to the role taxation ought to play in the encouragement or discouragement of foreign investment. Much has missed the mark. This is understandable, since the mark is elusive, both the statistical records and the governing economic principles being inaccessible to many in the tax and business community.

Mrs. Musgrave, a scholar working under the auspices of the International Tax Program at Harvard Law School, has tried to remedy this lack of background material. In a monograph based on trade and investment statistics available as of the end of 1965, she has sought to isolate the economic context in which tax policies directed at foreign transactions must function, to create a set of standards by which such policies can be judged, and to test existing tax laws by these standards.

Systematic economic analysis is rare as a prelude to legal studies, in most cases because the writer is not competent to deal with it, but Mrs. Musgrave knows her economics. In four commendably brief chapters she traces the statistical footprints left by United States foreign investors during the years 1961 through 1965. An attempt is made to judge the real impact of such investments by a variety of indices, including domestic investment levels, foreign trade, employment, and balance of payments. Four remaining chapters are then addressed to the tax issues: What economic goals should be served by tax policy? What policies are suitable to achieve these goals? How do our current tax laws measure up? On these points the author does not hesitate to express her opinions, which are perhaps less valuable to the reader than her explanation of the path through the economic thicket by which she has reached them.

An evaluation of foreign tax policy must deal with the distinc-

tion between the interest of the United States and the interest of private investors. It is now clear that what is good for General Motors is not always good for the rest of us; what is not clear is how far the government can wisely go in deciding what in fact is good for the rest of us. Little attempt is made to regulate the direction of domestic investment by corporations, even though economists might feel, for example, that such investment should be channelled into one region of the United States rather than another, or that mining investment should take priority over manufacturing, or that investment funds should be made available to the capital market by payment of increased dividends rather than by internal expansion. Decisions on these issues are essentially private decisions, not always made in the public interest. The freedom of enterprises to make financial decisions which may to some extent work against the public interest is, at least in the United States, felt to have certain long-term values. And, in fact, our understanding of the social and political aspects of business investment leaves much to be desired.

An ample measure of humility is therefore required when deciding to replace private with public decisions on foreign investment policy where the interests of the United States are intertwined with those of the world community. It is true that one can ascertain a number of relatively simple economic consequences of foreign investment: the effective rate of return on manufacturing investments outside the United States is not significantly greater than in the United States; tax revenue, employment, and national efficiency will be greater if a dollar is invested in the United States than if it is invested abroad; even under the most favorable conditions it is six years before the average United States investor earns the equivalent of his investment. These and similar consequences are quite clearly demonstrated by the author. And, whether one agrees or not, it is helpful to have set out the economic evidence supporting tax policies which would encourage the repatriation of foreign earnings, discourage new foreign investment, and in general cause United States business to turn its eyes away from any foreign venture other than exports.

Yet, having read the evidence, one is left an uneasy sense that something is lacking. If taxation is the instrument by which major changes are to be effected in the habits of investors, then not only is great care required in determining the direction these changes will take, but political and social value judgments must be weighed equally with economic indices.

In the United States, the free movement of investment capital across territorial boundaries was for many years an important element of our foreign economic policy, as reflected in the FCN treaty series, even though it has been frequently limited by stress of war or adverse economic circumstances. Free movement of capital can be expected to benefit the public at large, through lower prices and improved living standards, as well as the investors themselves. Such movement is an

essential ingredient of a large territorial market. It is difficult to believe that the advantages of scale offered by the United States or the European Economic Community could exist if their territorial subdivisions were inclined—or permitted—to place any substantial tax burden on “foreign” investment.

It is this intuitive faith in the beneficial quality of the free movement of investment capital that is disturbed by some of Mrs. Musgrave’s conclusions. Common sense, untrained in economics though it may be, suffers a light but perceptible affront when told that the public is better off when investors stay home. A phrase frequently used by the author, and indeed a favorite in high places where tax policy is made, is “tax neutrality.” But neutrality, like peaceful coexistence, is not always what it seems. The prime example of tax deferral, which is to say non-neutrality, is the use of foreign corporations to defer United States tax on income until it is distributed to the United States shareholder. Conversely, neutrality would consist of taxing all such profits as earned, regardless of distribution.

To the businessman, and indeed to most lawyers, this puts things upside down. It may be that in a proper fiscal world income should be passed through corporate shells and taxed to the shareholder. But it is not done in the United States, and rarely done elsewhere. To tax the United States parent on undistributed income of foreign subsidiaries, while others are not so taxed, may be desirable, but it is hardly neutrality.

Can foreign subsidiaries of United States companies remain competitive if they bear a higher tax burden than their foreign counterparts? The question is a very old one, but Mrs. Musgrave has some fresh thoughts on the subject. She concludes that income taxes are not a significant factor in remaining competitive, first because a profits tax is by definition not a cost and therefore not an element of price which need be shifted to the consumer, and second because, even if the tax does reduce after-tax profits available for reinvestment, other factors, such as superior technology or the greater availability of funds to the United States corporation, make this reduction insignificant. The first point depends upon the assumption that the United States investor will accept a net return on the foreign venture which, assuming equal profitability, is less than his foreign counterpart. This may in fact be true if the return can be judged roughly fair by United States standards.

At times a curtain of misunderstanding seems to hang between the author and the business spokesmen whom she quotes and whom she has made a serious attempt to understand. Decisions to invest abroad are made, after all, for roughly the same complicated network of reasons that give rise to investment at home. Thus, when a representative of an international chemical company says that “tax benefits alone have not and would not cause any major foreign investments if the normal operation of market forces did not indicate that investment was desirable,” Mrs. Musgrave comments that the statement

seems "to indicate that tax differentials, at least in their present magnitudes, do not affect the decision to invest abroad." From this and other evidence she draws the conclusion that world capital will be used most productively when each country's supply of capital is taxed at one rate, which should be the rate of the source country.

Using this standard, the author's conclusions about appropriate tax policy are not surprising. All foreign income should be taxed to the United States investor; only a deduction for foreign taxes should be allowed; use of the foreign tax credit "represents a clear concession by the country of residence to international tax neutrality and world efficiency;" while use of the credit plus deferral, our present policy, "clearly exceeds the bounds of rational behavior."

Whether the reader agrees with these conclusions, he at least is exposed, perhaps for the first time, to a probing analysis of certain long-held views about foreign investment. Therein lies the merit of this tightly-written book. It is a very considerable contribution in a field where views are more frequently found than facts.

W. C. BREWER, JR.  
*Instructor in Law, Boston College  
Law School; Partner, Hill &  
Barlow, Boston, Massachusetts*