Tax Treaties and Tax Neutrality; A Proposal Being Considered by Indonesia

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I. INTRODUCTION

Since the abortive Communist coup in 1965, Indonesia has placed primary reliance on private investment, both domestic and foreign, to increase the productivity of its economy. These efforts to reshape its economy have been successful in some respects. Inflation has been reduced from an incredible 650% in 1966 to 9% in 19701 and both foreign and domestic investments have increased.2 Since the country's present per capital gross domestic product is only approximately $100,3 the amount of capital that

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1. See Sadli, Indonesian Investment Climate, at (ii), appearing as the introduction to Consulate General of Indonesia, Foreign Investment in Indonesia (1971) (Copy on file at MINN. L. REV.). The same article also appears in 26 FAR EAST TRADE AND DEVELOPMENT No. 5, 184-86 (May 1971). Dr. Sadli is the Chairman of Indonesia's Board of Investment.

2. Id. at (i)-(ii).

3. UNITED NATIONS STATISTICAL OFFICE, STATISTICAL YEARBOOK 587 (1968) (table 190). This figure represents an estimate of Indonesia's production at market prices expressed in Indonesian currency converted to United States dollars at the prevailing exchange rate. Id. at 590 (note to table 190). Some economists feel that statistics computed in this manner understate the value the less developed countries' product would have in the United States. Professor Hagen has made "crude adjustments" in order to "indicate to Westerners the value in Westerner's eyes of the per capita product in the low income countries." E. HAGEN, THE ECONOMICS OF DEVELOPMENT 14 (1968). He concludes that a "generous estimate" can be determined by multiplying the above figure by 3. If so, Indonesia's per capita gross domestic product would be approximately $300.

The significance of this figure from a humanitarian standpoint becomes apparent when it is realized that in 1963, when the per capita gross domestic product in the United States was $2,657, 1 in 7 of all families of two or more and almost half of all persons living alone or with nonrelatives had incomes too low ... to enable them to eat even the minimal diet that could be expected to provide adequate nutrition and still have enough left over to pay for all other living essentials. Orshansky, Counting the Poor: Another Look at the Poverty Profile, 28 SOCIAL SECURITY BULL. 3, 4 (Jan., 1965).
can be generated through domestic savings is obviously limited.\(^4\) Foreign investment, is therefore, a necessary supplement to domestic capital formation. Foreign investment also may be helpful both because it often is accompanied by a direct transfer of technology and because it adds to foreign exchange, thereby increasing the country's capacity to import equipment which utilizes technology.\(^5\) Both capital and technology are needed, if development is to proceed rapidly.\(^6\)

Representatives of Indonesia are presently negotiating the terms of a proposed double tax treaty with the United States. Tax experts in the Indonesian government recognize that tax and similar incentives should not be used indiscriminately\(^7\) and that some incentives contained in treaties\(^8\) have been criticized.

\(^4\) See generally R. Gill, Economic Development: Past and Present 92-93 (2d ed. 1967); R. Nurske, Problems of Capital Formation in Underdeveloped Countries 5 (1953); P. Samuelson, Economics 754-55 (8th ed. 1970). Surprisingly, perhaps, less developed countries managed to save an average of 15\% of their gross national products during the period 1960-1967. See L. Pearson, Partners in Development 30-31 (1969). However, it has been estimated that a country must achieve gross capital formation of between 12\% to 15\% of its gross domestic product just to keep pace with a population growth of 2\% per year. E. Hagen, supra note 3, at 275.

\(^5\) E. Hagen, supra note 3, at 328; R. Gill, supra note 4, at 94.

\(^6\) “Only two causes of economic development are of any importance. These are capital formation and technical progress.” E. Hagen, supra note 3, at 29. This is not to say, however, that other factors, often called “barriers to development,” may not restrain growth even if adequate capital and technology are present. See generally R. Gill, supra note 4, at 86-89; E. Hagen, supra note 3, at ch. 6; P. Samuelson, supra note 4, at ch. 38.

\(^7\) Dr. Sadli has indicated that tax holidays “will not be granted indiscriminately any more.” Sadli, supra note 1, at (iv). For existing incentive devices applicable to foreign firms, see Indonesian Law No. 1, ch. VI (1967) (Foreign Capital Investment).

\(^8\) Examples of provisions which appear in existing treaties—as well as some which, while negotiated, never became effective—include: the treaty between Sweden and Thailand in which the former simply exempts from tax income having its source in Thailand; the former draft treaty between the United States and Pakistan in which the United States would have allowed a credit for taxes normally imposed by Pakistan despite the fact that Pakistan waived the taxes during a tax holiday (called tax sparing, i.e., granting a credit for a waived or “spared” tax); the treaty between Germany and India in which a German lender may credit 50\% of the German tax that would otherwise have been imposed without regard to whether India imposes and then spares a tax on the interest; the former draft U.S.-Brazil Treaty in which the United States would have allowed a credit against United States tax liability equal to 7\% of the amount invested in certain types of assets in Brazil; the draft treaty between the United States and Trinidad and Tobago in which the United States would have deferred tax on any gain realized upon transfers of certain technology to Trini-
as deficient from the standpoint of tax policy. They nevertheless are considering advancing a proposal which, while not itself an incentive, is clearly intended to encourage foreign firms to invest capital in Indonesia. The United States has refused to use special incentives in treaties to encourage private investment in less developed countries, having first negotiated and then rejected several treaties containing incentives. And in light of the political climate presently prevailing in this country, it is not clear whether Indonesia will be able to persuade the United States to accept any proposal containing incentives, even if the proposal is sound from the standpoint of tax policy. This article

dad and Tobago corporations. For a general discussion of tax incentives contained in treaties see Carroll, Germany, Japan and Sweden Show the United States How to Reach Tax Treaties With South American Countries, 38 Geo. WASH. L. REV. 199 (1969).

9. For a general treatment of tax treaties with less developed countries, see Tax Treaties Between Developed and Developing Countries, U. N. Doc. E/4614, ST/ECA/110 (1969) [hereinafter cited as Tax Treaties]. For articles discussing tax sparing, see Crockett, "Tax Sparring": A Legend Finally Reaches Print, 11 NAT'L TAX J. 146 (1958); Surrey, The Pakistan Tax Treaty and "Tax Sparring", 11 NAT'L TAX J. 156 (1958). For a discussion favoring the proposal to include a 7% investment credit in the treaty with Brazil, see Sitrick, Conventions for the Avoidance of Double Taxation Between United States and Latin America: The Proposed Convention Between United States and Brazil, 45 TAXES 380 (1957). For a discussion of the provision deferring gain on the transfer of technological information to a foreign corporation, see Technical Explanation by Treasury Dep't on the Convention Between the United States and Trinidad and Tobago for the Avoidance of Double Taxation, the Prevention of Fiscal Evasion and the Encouragement of International Trade and Investment, signed Jan. 9, 1970, 2 CCH TAX TREATIES ¶ 7655.

10. Tax Treaties, supra note 9, at 41. See also notes 3 & 4 supra.

11. Perhaps the growing antipathy toward granting assistance to less developed countries is inevitable. As Stent puts it:

Onward from the first days of his infancy, [man] perceives the world in an expanding series of concentric spheres—his own person, his family, his neighborhood, his town, his province, his nation—within which, with increasing distance from him, events assume an ever diminishing emotional significance. His own toothache causes him more pain than the broken leg of his brother, which in turn causes him more pain than the death of a neighbor, of a dozen strangers, of a hundred foreigners.

Stent, An Ode to Objectivity, 228 ATLANTIC MONTHLY 125 (Nov., 1971).

12. In early 1971, the Senate Foreign Relations Committee rejected a proposed incentive because in the Committee's view the many domestic problems of the United States, including the current balance of payments deficits, are important considerations which must be borne in mind when determining whether to approve measures in tax treaties which are designed to defer taxes of United States corporations for the purpose of encouraging investment in less developed countries. 2 CCH TAX TREATIES ¶ 7656.

With roughly one half of the world's population suffering from
is not the place to speculate on political considerations, however, and the following discussion is limited to an examination of the proposal from the standpoint of tax policy.

II. THE PROPOSAL

The proposal is simple. The United States is to allow a credit against liability for the United States federal income tax for income taxes paid the Komishi Indonesia Parkenbangam (KIP—roughly the Commission for Indonesia Development). KIP, which has yet to be formed, will probably be an agency of the Indonesian Ministry of Finance, which is a department of the central government that corresponds to our Treasury Department. Since the United States generally allows a credit for income taxes paid "to any foreign country," and since for these purposes a foreign country "means any foreign state or political subdivision thereof, or any foreign political entity, which levies and collects income ... taxes," income taxes paid to KIP would appear eligible for such a credit. However, the manner in which KIP will collect income taxes and dispose of the resulting revenues will be somewhat unique.

KIP will be designed to accomplish two things: (1) to encourage firms to make those investments which otherwise would be uneconomical due to the inadequacy of existing infrastructure (e.g., roads, piers, docks and power facilities); and (2) to encourage those firms that have decided to invest in Indonesia to construct infrastructure which may be helpful to the economy generally, either by being available to others, or by lessening the burden the firm otherwise would place on existing facilities.

One of the factors tending to discourage both foreign and domestic investment in a country such as Indonesia is the inade-

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13. Int. Rev. Code of 1954, § 901(b) [hereinafter cited as IRC].

quacy of existing infrastructure. Some extreme examples can be seen in the more remote regions outside Java where investors may often find it necessary to provide, at their own expense, virtually all the facilities that normally are supplied by governments. The case is less extreme in the more developed areas of the country where existing facilities cannot meet the increased demands when industrial or similar facilities are established in the area they serve. In both cases, the lack of infrastructure may substantially increase the cost of establishing operations so that many investments are not made at all or are made in crowded areas around Djakarta rather than in the less developed regions. KIP, by sharply reducing the cost to the firm of establishing infrastructure, may be able to stimulate investment and, in ad-

15. For example, the Contract of Work Between the Republic of Indonesia and P.T. International Nickel Indonesia (copy on file with MINN. L. REV.) states:

ADDITIONAL INFRASTRUCTURE

(a) Cooperation. The Company and the Government will cooperate, together with others, in planning and obtaining financing for such facilities as may be useful to both the Project and to existing and future industries and activities in the region. For example, up-to-date living accommodations for the Company's personnel will require provision for adequate housing, food supplies, medical facilities, water, sewage facilities, pest and disease control and educational, religious and recreation facilities. Similarly, the Project's power needs will require construction of a power plant or plants, by the Company or by others, which may be hydroelectric, thermal or nuclear in design and may further entail pipelines, power lines, canals, dams, raceways and pumping stations. To the extent part or all of such requisite living accommodations and power facilities are not financed in whole or in part by others, it will be the Company's responsibility to ensure that such needs of the Project and its employees will be adequately met.

(b) Hydroelectric Power. As part of its evaluation, the Company will undertake to secure and finance, as part of the Project's costs, a feasibility study of the hydroelectric power potential of the Larona River in relation to the needs of the Project. Should such a facility prove economically feasible, the Company will be prepared as a possible aid in its financing, to enter into long term contracts on terms to be agreed with the Government, or other entity designated by the Government, to take its electric power requirements from a hydroelectric power facility in the Larona River.

(c) Regional Benefits. To maximize the regional economic and social benefits which the Project can generate, the Company will also:

(i) Endeavor to coordinate all of its studies of the Project's infrastructure studies undertaken by the Government and interest local, foreign and international public and private entities; and

(ii) Endeavor to assist and advise the Government in its planning of the infrastructure and regional development which the Company may deem useful to the Project and to existing and future industries and activities in the region of the Project.
tion, enable the government to channel investment into the more remote regions.

Reducing the cost of infrastructure also will enable KIP to meet the second objective. If the cost of constructing a facility can be lowered, firms which are investing in Indonesia may be persuaded to establish facilities they otherwise would forego, thereby providing facilities which either can be used by others or which would reduce the strain on existing facilities. If, for example, KIP can encourage a timber company to construct a pier, it will not only reduce the company's future operating costs, but also provide a facility which can be used by others. Similarly, KIP might persuade several firms investing in an area to cooperate in providing a hydroelectric or other power facility.

Investors who conclude that the existing infrastructure is inadequate for their purposes will be invited to submit to KIP proposals for the construction of the needed items. In addition, KIP may initiate infrastructure construction programs by suggesting them to one or more firms investing in the area to be served by the proposed facility. When the proposals come from firms, KIP will be responsible for determining whether the program will further KIP's objectives and may propose desired modifications in the suggested specifications. Both KIP and the foreign investor will be free to reject the proposals advanced by the other, and if agreement cannot be reached, the investor will remain free to proceed without participation by KIP. If, however, the investor and KIP are able to agree upon the specifications, they will enter into an agreement containing some or all of the following terms.

A. Agreement Terms

The agreement will identify the facility that is to be constructed pursuant to the agreement and delineate the agreed specifications. The agreement will provide that as construction of the facility progresses the investor will deposit with KIP, as prepayment of Indonesia taxes, the funds needed to meet the cost of constructing the facility and that KIP will use these funds for this purpose. The investor will agree to waive its right to benefit from tax holidays until such time as it has paid Indo-

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16. It is anticipated that frequently the infrastructure will actually be constructed by the investor with which KIP has executed an agreement. Under these circumstances, KIP will release funds to the investor as construction progresses. In other cases, the funds will be paid directly to the firm hired to construct the facility.
nesian income taxes equalling the construction cost of the facility. However, for this purpose (and only for this purpose), the investor will be permitted to treat the funds deposited with KIP as prepayments of these taxes. Upon payment of taxes in this amount, the investor again will become eligible for the benefits of any tax holiday to which it normally would have been entitled and will be permitted to enjoy these benefits for the unexpired portion (if any) of the term of the holiday.

For example, assume that KIP and an investing firm agree that the construction of a $1 million pier at a given location in Indonesia will not only reduce future operating costs of the firm, but will also contribute significantly to the economic development of the surrounding areas. Assume further that the Minister of Finance has determined that the investor would be entitled to a four year tax holiday, if no special arrangements with KIP were undertaken.

Under these circumstances, the firm and KIP might enter into an agreement pursuant to which a pier meeting mutually acceptable specifications would be constructed with funds supplied KIP by the firm as construction of the pier progresses. The agreement would also provide that the investor must pay Indonesian taxes on any Indonesian source income earned by it, notwithstanding tax holidays to which it would normally have been entitled. However, the firm would be permitted to treat the funds supplied to KIP as prepayments of this tax. Thus, if the firm generated $2 million of Indonesian source income during the first four years of operation, subject to a 50% corporate tax rate, it would be permitted to treat the $1 million paid to KIP as a prepayment of the approximately $1 million of Indonesian tax that would be imposed on this income. If it took less than four years to realize this amount of income, the firm would be entitled to the benefits of the tax holiday throughout the remainder of the four-year term. On the other hand, if the firm had not generated $2 million of income by the end of the tax holiday, it would not be allowed to credit amounts deposited with KIP against liability for taxes thereafter. Thus, amounts deposited with KIP which were not used to pay Indonesian tax would simply be forfeited.

The agreement would provide that the resulting infrastructure would belong to the government of Indonesia. When appropriate, the facility would be available for use by the government and the Indonesian public generally. It is expected that KIP will have the authority, however, to permit certain prefer-
ential use by the investor\textsuperscript{17} and to participate in construction of a facility for use by the investor only.\textsuperscript{18}

In order to be certain that no one loses sight of the fact that KIP is in a very real sense spending Indonesian government funds (and this is true notwithstanding the fact that the revenues otherwise would have been waived through tax concessions since, as will be illustrated, concessions also are an expenditure of government funds), it is anticipated that publicity and reporting requirements will be established. The plan presently under consideration requires KIP to publish in an official newspaper and file with the Secretary of the Indonesian legislature any arrangement it proposes to accept 30 days prior to the effective date of the arrangement. In addition, KIP will be required to file a financial accounting with the President and legislature annually.

B. BENEFITS TO CORPORATIONS PARTICIPATING IN KIP's PROGRAMS

The benefits to an investor participating in the program will be derived both from the use of the facilities and from the savings derived from the tax treatment given the amounts paid by the investor for construction of the facility. While the investor will have provided the Indonesian government with the funds used to construct the facility, these funds will be eligible for credit against the investor's liability for Indonesian and United States tax. Since Indonesian taxes otherwise would have been waived, it is obvious that the significant benefit will come from the United States tax treatment of these amounts. These benefits will be twofold. The first will relate to timing and the second to the amount of United States tax that will be paid.

1. The Value of Deferral

If the proposal is not in effect, an investor constructing a facility in Indonesia will recover its cost in the form of deductions for depreciation or amortization which will be taken over the useful life of the facility. To take advantage of these deductions, the firm must, of course, generate taxable income from which to deduct the depreciation, and when it does so, each $1

\begin{footnotesize}
17. For example, KIP might waive the fee it would otherwise charge for use of a pier constructed under the program.

18. An example might be a power facility used to capacity by the investor.
\end{footnotesize}
of income will be offset by a $1 deduction for depreciation, thereby saving 50 cents in tax. To the extent deductions are taken in years in which the firm is entitled to a holiday from Indonesian taxes, the benefits normally will not be felt until the firm repatriates funds to the United States.\footnote{19 Operations will normally be carried on by an Indonesian subsidiary; thus the savings of United States tax will not be felt until the investor repatriates earnings to the United States.} At this time, the deductions, by reducing earnings and profits, will reduce the United States tax on the distributions (assuming that the distributions exceed other earnings and profits).

In contrast, under the KIP proposal being considered by Indonesia, the useful life of the facility is immaterial and the investor will recover the amount paid to construct the facility (i.e., the taxes paid KIP and used by it to construct the facility) as a direct credit against its tax liability upon the generation of Indonesian source income. Again, each $1 of Indonesian source income will result in a tax savings of 50 cents (here, each $1 of Indonesian income will be accompanied by a potential tax liability of 50 cents which will be offset by a credit for the amount paid KIP). Since the credit against Indonesian tax liability will be available only during the period which the firm would otherwise have been enjoying the benefits of tax holidays in Indonesia, the tax benefits will not normally be felt until the funds are repatriated, at which time the amounts paid KIP will be creditable against liability for United States tax.

A comparison of the time value of the tax benefits can be illustrated by the following example. Assume that the facility in question (a) will cost $2 million, (b) will have a useful life of 20 years, and (c) will have a zero salvage value at the end of its useful life. Assume also that the corporation generates $1 million of predepreciation taxable income in all relevant years. If the firm constructs the facility and computes its depreciation on the straight line method, the deductions will reduce taxable income by $100,000 a year. Thus, since the project will have generated more than $100,000 per year in predepreciation income, taxes will be reduced by $50,000 a year for 20 years. The present value of saving $50,000 a year for 20 years (discounted at a very conservative rate of 6% per annum) is approximately $575,000.

On the other hand, under the KIP proposal the tax significance will depend only on the capacity of the project to develop income and not on the useful life of the facility. Thus, if the operation generates $1 million of income per year so that the firm
will have earned $2 million of income during the first two years of operation, the present value of the $1 million of tax savings will be approximately $910,000. As will be shown below, the tax savings under the present proposal will be $2 million, not $1 million; the point being made here, however, is that the difference in timing alone can result in substantial differences in the present value of the tax savings, even if the amount of tax saved is the same, as it is in the above example.

2. Credit v. Depreciation

The second advantage to the United States investor is attributable to the difference for tax purposes between a deduction and a credit. If the KIP proposal is not in effect, the cost of infrastructure, for United States tax purposes, will be recovered as deductions which reduce taxable income and earnings and profits. Assuming a 50% tax rate, each $1 of deductible cost will reduce tax by 50 cents. On the other hand, under the proposal the cost of the infrastructure will be reflected in taxes paid KIP which will be creditable against United States tax, dollar for dollar.\(^2\)

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While this statement is correct if the operations are carried on by a branch of a United States corporation, it is an oversimplification if the operations are in an Indonesian subsidiary since, under these circumstances, only 50% of the amount paid KIP will actually serve as a credit against United States tax. IRC § 902(a)(2). However, in either case, the net effect will be as stated in the text. Assume, for example, that a firm generates $4 million of Indonesian source income after having paid KIP $2 million. If the firm operates through a branch, the full amount paid KIP will be treated as taxes paid Indonesia and the firm will credit this amount directly against its United States tax liability of $2 million. Consequently, the firm's after-tax earnings will equal $2 million and there will also be a positive cash flow of this amount. The same net result will be reached if the operations are held by an Indonesian subsidiary. The $2 million paid KIP will discharge the subsidiary's Indonesian tax liability, thereby reducing its Indonesian tax earnings to $2 million. Upon repatriation of these earnings to the United States parent, a tentative United States tax liability of $1 million will arise which will, however, be fully offset by the credit. See Treas. Reg. § 1.902-3(i) (Example 2).

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\begin{align*}
\text{\$2 million (the dividend)} & \times \text{\$2 million (the Indonesian tax)} = \\
\text{\$4 million (pretax Indonesian earnings)} & \text{\$1 million}
\end{align*}
\]

Thus, after tax earnings and positive cash flow again will be $2 million despite the fact that only one half of the amount paid KIP is used directly as a credit. The two results are the same because when the business is operated by an Indonesian subsidiary the amounts paid KIP serve dual purposes. They serve to reduce earnings by the full amount paid KIP and in addition serve to shield a like amount of income from tax by being creditable against the United States tax otherwise imposed on that income.
timing, the tax benefits available under the present proposal are twice as valuable as those available from deductions for depreciation.

Again using the above example, if the firm is generating taxable income at the rate of $1 million per year, it will, by the end of the fourth year, have generated $4 million of income, thereby creating a potential tax liability of approximately $2 million. The $2 million deposited with KIP up to that time will be credited against this liability as it accrues throughout the four year period. The present value of a $2 million tax savings realized ratably over a four year period is approximately $1,720,000. This is to be contrasted with the present value of tax savings resulting from deducting $2 million of depreciation ratably over the 20 year life of a facility of approximately $575,000. Obviously, the difference is substantial.

Two further comments must be made. First, computations of the present value of eliminating future tax liabilities are premised on the conclusion that the liability would not otherwise have been postponed. If, to take an extreme example, there would have been no United States tax liability on any earnings generated during the first 20 years of operations (because no funds were repatriated to the United States, for example), the present value of all tax savings must be discounted for 20 years rather than ratably over the intervening years. Under these circumstances, the discounted cost of $1 of tax imposed 20 years from now on income earned next year is the same as the discounted cost of $1 of tax imposed 20 years from now on income earned 20 years from now. (The conclusion that the present proposal results in a credit which is twice as valuable as a deduction is not affected by this last observation, however.)

The second point is that even if the actual tax liability can be postponed for 20 years, the timing of the tax benefits will have a significant effect on the amount of earnings that are reportable for financial accounting purposes in the interim. This factor is considered further below in Part III A, where the KIP proposal is compared with an incentive device known as tax sparing.

3. Benefits to Indonesia

The benefits to Indonesia are substantial. First, for the reasons outlined above, the proposal will permit the Indonesian government to reduce the extra costs to a firm of investing in an area where facilities are inadequate far more effectively than
the government could through the use of conventional tax holidays. Second, in contrast to conventional incentives where the government simply waives taxes and receives nothing in return, the government will receive funds which will be used to provide facilities which may contribute substantially to the country's development. Moreover, the funds used for this purpose, under normal tax holiday schemes, ultimately would have been paid to the United States as taxes. In short, Indonesia can offer more meaningful assistance to investors and receive substantial benefits in return. Finally, the KIP proposal may increase the amount of tax Indonesia will collect from participating firms since firms will not be entitled to take the deductions for depreciation they would otherwise take after termination of the tax holiday.

III. UNITED STATES TAX CONSEQUENCES

As noted, the United States normally allows a credit for income taxes paid to political subdivisions of foreign governments. The question here is whether the peculiarities in the way in which KIP will conduct its affairs warrants a different result here.

A. Tax Sparing

The proposal being considered by Indonesia bears some similarity to "tax sparing." Tax sparing is a credit for a "spared" foreign tax, that is, a tax normally imposed by the host country but waived during a tax holiday. Under tax sparing, the taxpayer pays a tax to neither the foreign government nor the United States. The similarity lies in the fact that both devices require the capital exporting country to grant a tax credit when it might not normally be willing to do so.\(^{21}\) There are significant differences, however. Under tax sparing both the less developed country and the United States forego the collection of tax, and the cost of any needed infrastructure (which may or may not correspond in amount to the forgiven tax) is borne by the taxpayer. Under the KIP proposal being considered by Indonesia on the other hand, a tax is paid but government funds in a like amount are used to construct a facility for the investor. The questions to consider here are whether these differences warrant reaching different results and, if not, whether tax sparing

\(^{21}\) It is not clear whether the United States would allow a credit for taxes paid KIP absent a treaty provision. See New York & Honduras Rosario Mining Co. v. Commissioner, 168 F.2d 745 (2d Cir. 1948). This problem must be clarified, however, if KIP is to serve as a reliable incentive.
should be considered unsound from the standpoint of United States tax policy.

Tax sparing has been attacked on a number of grounds.\textsuperscript{22} First, tax sparing is criticized as inequitable in that those investing capital in the United States must pay a full tax, whereas those investing in a sparing country are taxed neither by the foreign government nor the United States. If tax sparing is tied to a tax holiday of fairly short duration, this criticism is probably justified,\textsuperscript{23} because decisions concerning the quantity of capital


\textsuperscript{23} Arguments concerning taxpayer equity are often based on the (usually unstated) premise that capital invested in more heavily taxed industries will receive a lower after tax return than that invested elsewhere, as the discussion of tax neutrality in the Appendix at Part II A infra will show. However, if unequal tax burdens are allowed to persist until those affected thereby can fully adjust to them, capital will tend to receive the same rate of after tax return notwithstanding the unequal tax burdens (indeed, this is the very premise upon which the concept of tax neutrality is based). Determining the final incidence or burden of a tax (and thus, presumably, whether it is equitable) can be extremely difficult, however, and there is no agreement among economists concerning the final incidence of the corporate income tax in the United States. Mieszkowski, Tax Incidence Theory: The Effects of Taxes on the Distribution of Income, 7 J. Econ. Ltr. 1103 (1989). As the Appendix illustrates at Part II A 1 & 2, corporations in competitive industries do not bear the ultimate burden of tax but rather pass it on to consumers, shareholders or employees in the form of higher prices, lower dividends or lower salaries. Some observations concerning the ultimate burden of the tax can be made, however. For example, consumers who favor goods produced in the corporate sector suffer when a corporate tax is imposed because corporate production is lowered. Similarly, those favoring goods produced in the noncorporate sector gain under these circumstances due to increased production. In the long run, labor in the taxed and nontaxed sectors will receive the same pay for the same effort (or it will relocate) and the same is true for capital for identical reasons. But whether labor or capital will bear the burden of the tax will depend upon a number of factors. Assume, for example, that the ratio in which firms use labor and capital in the taxed sector is wholly rigid and that production is much more labor intensive there than in the nontaxed sector. Imposition of a tax on the return to capital in the corporate sector will decrease productivity and drive both labor and capital from that sector (capital will leave because it is taxed and labor must also leave because only a specific amount of labor can work with any given quantity of capital). Since more labor is used with each unit of capital in the taxed sector than the untaxed sector, the ratio of labor to capital in the untaxed sector will increase. This will tend to decrease the productivity of
to be invested and the ratio in which the firm is to use labor and capital usually will be made in light of the expected after-tax rate of return after the holiday has terminated. If so, firms will attempt to earn a rate of return which will permit them to pay the taxes that will normally be imposed and still yield a competitive return to their shareholders. It follows that if this objective is accomplished during the period the tax holiday is in effect while taxes are being paid, the firm will reap a windfall profit which might be properly be regarded as inequitable.

The KIP proposal would not appear to be subject to this deficiency, however. The firm will be able to make its investment decision knowing that the facility covered by its agreement with KIP will be provided by that agency. The firm also will have made an advance deposit which it can credit against future Indonesian income tax liability. Both long term and short term profits will be subject to tax; accordingly, the operation must be capable of producing a competitive after tax return from the outset so that no excess or windfall profits will be realized during early operations. Thus, by tying the incentive to the cost of specific facilities rather than reducing taxation on all income for a given period, the incentive should not produce inequitable excess returns.

The second objection to tax sparing is that it is "capricious" in that the benefit depends on the nominal rate of tax in the less developed country. This objection has been overcome by some developed countries through the use of a variety of techniques, and these techniques could be used here, if desirable. However, firms using the KIP proposal will pay a tax to either Indonesia or

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24. See text accompanying Appendix notes 19-21 infra.
25. Article 16(3)(b)(bb) of the German-Indian Treaty of 1959 provides that German lenders may credit 50% of the German tax that would otherwise be imposed on interest received from Indian sources without regard to whether India imposes a tax on that interest. Int'l Tax Agreements No. 28, U. N. Doc. ST/ECA/Ser. C/a (1958 current supp.). In short, India's nominal tax rate is irrelevant. Other means of avoiding capriciousness are (1) to limit the amount of foreign tax that can be spared, (2) to provide that no discriminatory rates may be imposed and then spared, and (3) to limit the amount of spared taxes to an amount equal to that imposed under rates in effect at the time the treaty is negotiated.
the United States which either equals or exceeds (because total Indonesian taxes are greater than United States taxes) the tax paid by firms doing business in the United States.

The third objection to tax sparing is that it encourages the repatriation of earnings. To the extent this is valid, it is an objection to the KIP proposal as well. However, this criticism is unsound, at least in its unqualified form. Normally, earnings can be transferred by a subsidiary to its parent, or by a parent to its subsidiary, without incurring any substantial tax liability. If a tax incentive, such as a tax holiday without tax sparing, is used by the foreign country in which the subsidiary is operating, a United States tax will be payable upon the remittance of earnings to the United States parent. The introduction of tax sparing removes this impediment to the remittance of earnings thereby restoring the normal condition of free transferability of earnings. It seems wrong to conclude that this return to the normal condition "encourages" the remittance of earnings. It seems more accurate to say that it eliminates a non-neutral impediment to this repatriation.

There are two additional less theoretical answers to this third objection. Few things are as comforting to the management of a corporation which is making its initial investment in a less developed country than the belief that the operation is capable of generating withdrawable earnings during a period of time in which, in the judgment of the many experts and nonexperts that will be consulted on this matter, the country will remain politically stable. If management knows that the earnings will be fully taxable by the United States if withdrawn, it knows that it must double pretax earnings, which often means it must double, or at least substantially extend the time that will be needed to generate these earnings. Reasonably accurate predictions of political stability may be possible for three or four years but seem almost impossible when the time is extended to six or eight years. This in no way means that the earnings will in fact be withdrawn if the investment appears sound and the situation...

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26. If both the parent and subsidiary are United States corporations, the transfer of earnings from the subsidiary to the parent will be subject to the intercorporate dividends received deduction (IRC § 243) and transfers from the parent to the subsidiary will be tax free under IRC §§ 118 & 351. With a foreign subsidiary the tax that would otherwise be paid by the parent upon the receipt of dividends from the subsidiary will be offset by the foreign tax credit (IRC §§ 901 & 903) and transfers from the parent to the subsidiary will be tax free under IRC §§ 118 & 351 (unless appreciated property is used, in which case the parent may be required to comply with IRC § 367).
The KIP proposal permits management to increase these reportable earnings by 50% of the amount paid to construct the facility.\(^2\)

A fourth objection to tax sparing is that it encourages less developed countries to enact tax incentive legislation. In light of the fact that most, if not all, less developed countries (as well as many developed countries) have enacted such legislation without the inducement of tax sparing, this criticism does not seem particularly persuasive.

The final,\(^2\) and clearly the most important, criticism of tax sparing is that it departs from tax neutrality.\(^3\) Taxes are “neutral” when taxpayers are subjected to uniform tax burdens. An

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\(^2\) See 2 CCH American Institute of C.P.A., Accounting Principles, Accounting Research Bulletin No. 51 at \(\S\) 16.

\(^3\) The cost required to obtain the use of a facility will, if written off as deductions for depreciation, reduce earnings over the life of the facility by the full amount paid less the amount of taxes saved since taxable income is reduced by deductions reflecting the depreciation of the facility. Thus, if a firm invests $1 million in a fully depreciable facility, its earnings will be reduced by $1 million in depreciation less the $500,000 of tax saved by depreciation. If the firm obtains a facility with funds treated as taxes, there is no reduction of earnings for the funds are used $1 for $1 to offset a potential liability for tax. Moreover, the increase in earnings will be reported as soon as the firm generates income and must either pay a tax or set up a reserve for the taxes that will become due when the funds are repatriated to the United States.

\(^2\) Some objections to tax sparing which are not discussed here appear in previously cited authorities. See Surrey, supra note 9; Tax Treaties, supra note 9.

\(^3\) The report of the United Nations group of experts on tax treaties between developed and developing countries notes that:

One member from a developed country using the tax credit method explained the basic concept of tax neutrality as conceived by his country, with which a tax-sparing credit would be regarded as not compatible. Tax Treaties, supra note 9, at 22.
income tax on earnings from personal services must be the same for all occupations;\textsuperscript{31} taxes paid by business firms must be imposed at the same rate regardless of the goods or services produced or the productive techniques employed; and finally, the tax paid by consumers cannot depend on the goods or services they choose to consume. On an international basis taxes must not interfere with, among other things, the choice between domestic and foreign investments.

Many who advocate adhering to a policy of tax neutrality do so because they have concluded that productivity will be maximized in certain important respects if the manner in which resources are used is determined by the free play of prices and markets. Consequently, if taxes are permitted to interfere, productivity will be depressed, thereby lowering our standard of living. These proponents of tax neutrality can point to certain assumptions and conclusions accepted by many economists regarding economic behavior which lend support to the conclusion that tax neutrality will serve to maximize consumer welfare.\textsuperscript{32}

Under this analysis, the objective, and thus the standard against which the economy’s performance is measured, is the maximization of the aggregate value of all goods and services produced by the economy. Value for these purposes means the capacity to yield utility and satisfaction to the consumers of the output\textsuperscript{33} and is measured by price.\textsuperscript{34} The objective will be met if the returns to capital and labor are proportionate to the values of their contributions to output. Put another way, the amounts paid owners of productive resources (i.e., the owners of capital or the suppliers of labor) must be proportionate to the price consumers will pay for the goods or services produced by the use of the resources, because under these circumstances efforts of resource owners to maximize their return will lead them to seek employment of these resources where the value of the goods and services they are able to produce is maximized.\textsuperscript{35}

While firms operating in perfect competition normally will

\textsuperscript{31} A tax, particularly a very high tax, may not be neutral even if it is imposed at the same rate on all earnings. For example, a person might select a low paying but more pleasant job if any additional earnings are heavily taxed. However, for purposes of this discussion, a tax will be considered neutral if it is not imposed at different rates on different investments or forms of employment.

\textsuperscript{32} A version of the underlying analysis supporting tax neutrality is included in the Appendix at Part II.

\textsuperscript{33} See text accompanying Appendix note 1 infra.

\textsuperscript{34} See text accompanying Appendix notes 1-6 infra.

\textsuperscript{35} See text accompanying Appendix notes 6-9 infra.
tend to perform in this manner, the imposition of some forms of taxes, by changing the relationship between the returns to resource owners and the value of the contrubition of their resources to output will cause them not to do so. Taxes which interfere with this relationship are said not to be "neutral." This interference can cause effects termed here as either a "factor tax effect" or an "excise tax effect." If, for example, a tax is measured by gross receipts in one or more but not all industries, it will have what is here called an excise tax effect of depressing production in that industry. If, on the other hand, the tax is measured by the return to one factor of production (e.g., a withholding tax on wages paid to labor) and is imposed in less than all industries, it will have the factor tax effect of both depressing productivity in that industry and causing firms in that industry to use too little of the taxed resource. While not all economists agree with this conclusion, it appears that the corporate income tax is a factor tax imposed on the return to capital in the corporate sector. If so, the corporate income tax is itself not neutral. Under these circumstances, proponents of tax neutrality probably will have to settle for a tax policy that prevents further distortions in the corporate sector.

To summarize, under this tax neutrality theory the objective is to maximize the value of the economy's production. It will be met only if the amounts paid to resource owners are proportionate to the price consumers pay for the goods or services produced thereby. Taxes are usually considered neutral only if they do not interfere with the efforts of firms to preserve this relationship. In the United States, however, the term must be given a special meaning, for it is probable that the corporate income tax is itself not neutral. Accordingly, since most foreign investments

36. See text accompanying Appendix notes 9-21 infra.
37. See text accompanying Appendix notes 24-31 infra.
38. See text accompanying Appendix note 32 infra.
39. Some economists have concluded that corporations are able to "shift" the corporate income tax on to consumers through increased prices. See Appendix note 38 infra and preceding text. Professor Peggy B. Musgrave has concluded:
   If general shifting of the corporate income tax to the extent of the tax rate imposed by each country of source of income were a firmly established fact of life, taxation only by the country of source would be justified on neutrality grounds. P. MUSGRAVE, UNITED STATES TAXATION OF FOREIGN INVESTMENT INCOME 115 (1969). For a discussion suggesting that the corporate income tax will constitute a factor tax even if it can be shifted, see text accompanying Appendix notes 38-39 infra.
40. Appendix at Part III.
41. See text accompanying Appendix note 40 infra.
are made by corporations, "tax neutrality" for present purposes must mean requiring the total United States and foreign tax burdens to have the same distorting effect as that of the United States corporate income tax.

Neutrality is not, of course, the only objective governments seek to achieve, and not infrequently it must yield to other more important objectives. A convenient way to test a given proposal involving a concession is to ask whether the objective to be achieved by use of the incentive is valued highly enough to warrant spending the waived taxes by granting a subsidy to the firm receiving the tax relief, keeping in mind that the cost is not only the amount spent, but also the loss from the resulting distortion in resource allocation.

The foreign tax credit provisions are designed to further the objective of neutrality by equalizing the income tax burdens on capital invested abroad with that on capital invested in the United States. These provisions permit a credit for certain foreign taxes paid against liability for United States taxes, dollar for dollar. For example, if a firm pays a foreign income tax of 45% of its taxable income, its liability for United States tax will be reduced to 3% of its taxable income so that its foreign source income will be taxed at the 48% rate applicable to United States source income. The credit is available only if the foreign tax is an "income, war profits, and excess profits" tax or "a tax paid in lieu of a tax on income, war profits, or excess profits otherwise generally imposed" by the foreign government.

While it is not at all certain that Congress was aware of this fact when the credit provisions were enacted, there is some justification for refusing to allow a credit for certain taxes, at least under some circumstances. For example, if, in any given case the taxpayer's liability for the foreign tax is greater (in terms of dollar amount) than its liability for the United States corporate income tax, the allowance of a credit for the foreign tax will substitute its effect for the factor tax effect of the United States corporate income tax. This substitution will violate tax neutrality unless, of course, the foreign tax is itself a factor tax on capital.

Also, it is true that allowance of a credit for any type of tax will result in the same after credit effect of the combined taxes as that of a corporate income tax, as long as the foreign tax is smaller in dollar amount than the United States corporate in-

42. See text accompanying Appendix notes 41-44 infra.
43. IRC §§ 901 & 903.
44. See text following Appendix note 44 infra.
come tax.\textsuperscript{45} However, since the foreign tax credit provisions do not turn upon whether the dollar amount of the foreign tax is greater or less than that of the United States tax, it is arguable that the credit should be allowed only for factor taxes similar to the United States corporate income tax. The conclusion is "arguable" because it assumes that allowance of a credit for taxes which are larger than the corporate tax will have a greater distorting effect than the failure to allow a credit for taxes which are less than the corporate tax—a conclusion that might or might not be borne out by empirical analysis.

If the conclusion that the credit should be allowed only for factor taxes similar to the corporate tax is accepted, however, the question for present purposes becomes whether the Indonesian tax is such a factor tax. It appears that it is. Like its United States counterpart, the Indonesian corporate income tax is measured by gross income,\textsuperscript{46} less the cost of earning that income.\textsuperscript{47} However, no deductions are allowed for amounts paid to, or accumulated for, shareholders. As a consequence, the tax is measured by the return to shareholders. As is explained in the Appendix, this characteristic of the United States corporate income tax causes it to be considered a factor tax on the return to capital.\textsuperscript{48} The Indonesian withholding tax on dividends is also measured by the amount paid to shareholders,\textsuperscript{49} and is, there-

\textsuperscript{45} Id.
\textsuperscript{46} Article 1.1 of the Indonesian Corporate Income Tax Law provides in part:

Under the title "Corporation Tax" a tax is levied: (1st) On profits obtained by a limited liability company . . . [and] other companies or associations, the capital of which is wholly or partly divided into shares . . . .

This statute is reprinted in Sycip, Gorres, Velayo & Utomo, Indonesian Tax Laws and Regulations at 6 (1969). (Copy on file with Minn. L. Rev.). Profit is defined by Article 3 of the law to include among other things, "the sum of the net benefits derived under whatever name and in whatever form from the enterprise . . . ." Sycip, Gorres, Velayo & Utomo, supra, at 8.

\textsuperscript{47} Article 4 of the Indonesian Corporate Income Tax Law provides in part:

To compute the amount of the net benefits as referred to in Article 3, expenses for the acquisition, collection and maintenance of said benefits shall be deducted from the gross amount of said benefits.

Sycip, Gorres, Velayo & Utomo, supra note 46, at 9.

\textsuperscript{48} Appendix at Part III.

\textsuperscript{49} Article 1 of the Indonesian Tax on Interest, Dividends and Royalties provides in part:

Under the designation Tax on Interest, Dividends and Royalties, Taxes are levied on revenues, under any name or in any form, gained from . . . (b) [s]hares, profit-shares and obligations, participating in the division of profits from Lim-
fore, a factor tax as well. Accordingly, principles of tax neutrality will be furthered by the allowance of a credit for both of these taxes.

B. TAX SPARING AND THE INDONESIAN PROPOSAL

But what of these taxes if either tax sparing or the KIP proposal being considered by Indonesia is put into effect? In light of the foregoing, how do tax sparing and the present proposal fare when tested against the standard of tax neutrality?

Tax sparing appears to be wholly nonneutral. Income from capital invested in corporations doing business in the United States is subject to the United States corporate income tax, whereas income from capital invested in a less developed country having a tax sparing treaty with the United States (there are none presently), is not subject to tax in either the United States or the foreign country. Accordingly, if tax sparing is adopted, the cost of using capital in the less developed country will be approximately one half the cost of using capital in the United States and the allocation of resources will become distorted by excess investments of capital in the less developed country.

It is extremely difficult for those interested in the development of the less developed countries to accept this conclusion. Their reluctance to do so is probably attributable to a number of factors. First, the preceding discussion may be summarily dismissed as nothing more than an extreme example of dry logic leading to a conclusion which is wholly irreconcilable with observable facts. The suggestion that tax sparing, or any other tax incentive for that matter, can make capital investment “excessive” in a country where roads are built by men and women whose capital consists of the few picks and shovels they share and the straw basket each uses to transport broken rock, is hard to accept. It is probable, however, that the fault lies not with the dry logic but with confusion over the exact meaning of the word...
"excessive" when used in this context. Tax neutralists readily would concede that tax sparing would not make capital investment excessive in the sense that the amount invested in a sparing country would exceed the country's needs—or in any sense be adequate for these purposes. Capital investment would be excessive in the sense that under conditions existing in the sparing country, the additional capital that would be attracted to the country due to sparing would be less productive than it would have been were it invested elsewhere.

The second criticism is more practical than theoretical. It consists of the observation that neutrality, as previously defined, is bound to work systematically against the well being of the inhabitants of less developed countries. Investment conditions in less developed countries are, of course, generally inferior to those in the developed countries. If all governments are now to adopt policies of neutrality it is likely that most capital investment will gravitate toward the developed countries, leaving the less developed countries just that—less developed.

Third, the disenchantment of those concerned with the well being of the inhabitants of the less developed countries may be fortified by the underlying suspicion that the arguments supporting neutrality do not tell the whole story. The advantageous investment conditions in the developed countries do not result entirely (or in some cases at all) from natural economic conditions but rather from the systematic efforts of the governments of the developed countries to cause investment conditions there to be superior to those existing elsewhere. The more cynical of these observers might note that our great affection for neutrality has developed only after the United States has established a seemingly insurmountable lead in the development of the investment conditions at home. Perhaps even more important for present purposes is that even under these conditions, our adherence to neutrality extends only to the tax collection side of government activity since our government continues to spend funds in an effort to improve investment conditions in this country in what is obviously not, and is not intended to be, a neutral fashion.

Finally, if most future capital investment is channeled into the developed countries, the governments of these countries will continue to receive the revenues which they can use to improve investment conditions there, while corresponding conditions in less developed countries may progress much more slowly, stagnate, or even deteriorate.
In short: (1) even complete neutrality now would cause most capital to stay within the developed countries; (2) the developed countries have no intention of adhering to neutrality insofar as government spending is concerned—nor is it here suggested that they should do so; and (3) the cumulative effect of these two conclusions will almost inevitably mean that future investments, the revenues therefrom, and therefore the improved conditions thereby made available all will stay within the developed countries.

Most of these criticisms are aimed at the results that policies of neutrality may produce, rather than at the theoretical soundness of the analysis supporting these policies. However, these criticisms also point up a flaw in the analysis, by suggesting that neutralists who look only to taxes may be taking too narrow a view. Taxes are only half of the fiscal picture. Not only from the standpoint of the development of the less developed countries, but also from the standpoint of maximizing world-wide production, should not the concept of neutrality be broadened to cover both sides of the fiscal picture? In other words, should the objective be government neutrality rather than tax neutrality?

Stated in its extreme form, government neutrality would require the elimination of all government influence so that investment decisions will be based on “natural” economic conditions. Hence, if unequal benefits (government services and facilities) exist, they must be neutralized by unequal burdens (taxes). Anything less will distort the deployment of resources to investments which have been favored with government spending. It seems clear that government neutrality is wholly unsupportable as a domestic policy. Its invalidity is not so clear when considered in the context of international investment, however.

Government expenditures are designed, of course, to accomplish a number of ends, some of which may result in sacrificing economic efficiency to attain other national goals and some of which, although seeking generally to further economic production, may increase the attractiveness of particular potential investments much more than others. In neither case would it be sensible to offset the effect of government expenditures with tax incentives.

For example, if a highway affords a competitive advantage to service stations established nearby, it would be inefficient to provide tax concessions to a firm which locates it operations
elsewhere. Once the highway is established, economic output will be maximized only if investors take advantage of the resulting benefits. Similarly, if the government tries to encourage the young to improve their education by providing subsidies for those that remain in school, it would be counterproductive to then neutralize this effort by providing tax "relief" to high school dropouts. In the first of these examples, the tax concession would lower economic productivity. In the second, it would frustrate the government efforts to achieve an objective through its spending programs. Obviously, neither would be sensible.

When the situation is considered from an international standpoint, however, several complications are introduced since there are at least two governments either or both of which may be participating in either of two capacities. (Under tax sparing, for example, both the foreign and United States governments are taxing authorities which may be considered to have waived taxes; under the KIP proposal, the Indonesian government is a government disposing of revenues for the construction of infrastructure, while the United States is a taxing authority which has granted a credit for a foreign tax.) No longer is there a single government whose policies determine both the manner in which all government funds are to be spent and the objectives that are to be served by the system of taxation. Here the arguments against some form of governmental neutrality are substantially less clear.

Consider tax sparing for example. If tax sparing is viewed as a tax incentive granted by the United States, the arguments used against domestic government neutrality appear to be applicable. The argument would be that both past and prospective

51. On the national level the collection of taxes and expenditures of the resulting revenues are probably redistributional, not only at the personal level but at the regional level as well. R. Nurske, supra note 4, at 78-79. Nurske points out that although the "point is hard to verify" it appears that a system based on progressive income tax "tends automatically to produce transfers ... from the richer to the poorer regions within a given country." Id. at 78. His assumption is that "expenditure on public works and welfare is approximately the same per head of the population in all regions, but that taxation is proportional to income [or to make the] point ... more strongly ... progressive." Id.

This redistributional effect does not occur internationally, however. The transfer of resources from rich countries to poor countries is comparatively low. For example, the percentages of total budget expenditure of specified countries that consist of loans and grants to the less developed countries and to the multilateral agencies for the year 1965 were as follows: France: 3.74%; United States: 2.78%; Germany: 1.75%; Canada: 1.59%; U.K.: 1.43%. The External Financing
government spending by the United States reflect United States policies internationally as well as nationally. If so, tax concessions must not act at cross-purposes with, or tend to neutralize the effects of our government’s policies as reflected in the manner in which government funds are spent. Thus, if the United States government attempts to increase productivity in the United States by providing better transportation facilities and is not willing to spend a corresponding amount of funds for the construction of roads, piers or bridges in the jungles of Borneo, it should not give special tax treatment to United States firms, or their foreign subsidiaries, if they do so.

While this would appear to be a perfectly reasonable position to take if sparing is to be considered as a grant by the United States of a tax concession (in which case the only relevant considerations are those of United States governmental policy), it is suggested that this is not the only, nor necessarily the proper, way to characterize sparing.

Why must tax sparing be regarded as a grant by the United States of a tax incentive? Why cannot tax sparing be viewed as tax collection by Indonesia followed by a contribution of a like amount of funds to the tax-paying firm for the purposes of inducing it to invest in Indonesia? In substance, incentives and direct expenditures accomplish exactly the same thing—the pro-

of Economic Development, U. N. Doc. E/4438 at 147 (table 40) (1968). The difference in the amounts of revenues collected and spent by the governments of the richer and poorer countries is so substantial that it is clear that the latter cannot begin to catch up or even prevent the gap from widening under existing conditions. Consider the following statistics. The per capita expenditures of federal, state and local governments in the United States totalled over 10 times the entire per capita income of those less developed countries housing over one half of the world’s population. See Statistical Year Book, supra note 3, at 81 (table 18).

52. It is not unusual for governments in the United States to contribute funds to firms they wish to establish in an area. The contribution is tax free to the recipient corporation if the items contributed to [it] by a governmental unit [are contributed] for the purpose of inducing the corporation to locate its business in a particular community, or for the purpose of enabling the corporation to expand its operating facilities. Treas. Reg. § 1.118-1 (1956). The corporation takes a zero basis in any property purchased with the contributed funds. IRC § 362(c). Under the present proposal the taxpayer never acquires ownership of the facilities and thus there are no basis questions. If tax sparing is considered the payment of a tax followed by a contribution to capital, the firm would have a zero basis in the assets acquired with the spared tax. See generally, Landis, Contributions to Capital of Corporations, 24 Tax L. Rev. 241 (1969); Note, Taxation of Nonshareholder Contributions to Corporate Capital, 82 Harv. L. Rev. 619 (1969).
vision of financial assistance by the government.\textsuperscript{53} If sparing is viewed in this manner, the desirability of providing governmental assistance to the investor becomes a question to be resolved in light of Indonesian governmental policy, not of United States policy. From a more mechanical standpoint, the United States will be considered to have granted a credit for a tax paid to Indonesia and will not be considered to have offered a tax concession to the firm. In effect, this is the substance of the KIP proposal: explicitly cause the assistance to take place at the Indonesian expenditure level so that the remaining consequences follow as a matter of course.

It is apparent that the acceptability of tax sparing and the KIP proposal depends upon whether they are appraised from the standpoint of government spending policy of the United States or that of the less developed country. If viewed from the former standpoint, tax sparing in particular, but to some extent the KIP proposal as well, appears to be a rather foolish tax concession grant by the United States for a purpose this government would not support by direct spending. If considered from the standpoint of the less developed country, tax sparing becomes a sensible tax concession grant\textsuperscript{54} for a purpose very much favored by the less developed country.

By adopting the tax credit method of avoiding double tax, this country has made the fundamental decision that the taxing jurisdiction from which income has its source shall have the first claim to tax that income and the concomitant right to spend the resulting revenues in accordance with its governmental policies. It is submitted that principles of tax neutrality do not require a different result, even if the resulting revenues are used to subsidize projects designed to further the economic development of the source country. It is submitted further that this result should obtain whether or not the subsidy is provided directly or through tax incentives.

The United States does not normally judge the wisdom of a

\textsuperscript{53} For an extensive discussion of this point, see Surrey, Tax Incentives as a Device for Implementing Government Policy: A Comparison With Direct Government Expenditures, \textit{83 Harv. L. Rev.} 705 (1970). This is not to suggest that Professor Surrey views the choice between tax incentives or direct subsidies indifferently. He argues persuasively that direct subsidies are usually far preferable to tax incentives.

\textsuperscript{54} As pointed out in note 53 supra, persuasive arguments can be made that subsidies are preferable to tax incentives. Presumably these arguments should be considered by a less developed country choosing between these two means of providing government assistance.
foreign government's spending programs when deciding whether to grant a credit for foreign income taxes. For example, taxes raised by governments who advocate and support waging war against friendly nations remain fully creditable. However, even if such an inquiry were made, subsidizing foreign (or domestic) investments does not seem objectionable. Such spending is clearly not neutral, but government spending seldom is. As noted above, the United States spends vast amounts of government funds on projects designed to further our economic development and frequently subsidizes the operations of business firms. How then can the United States object to such spending or subsidization by less developed countries? Moreover, even if one objects to some or all of the subsidies granted by the United States, it seems absurd to suggest that all less developed countries are thereby precluded from subsidizing investment in their countries. Hopefully, at least, no one will suggest that considerations of our tax policy require this result.

Since direct subsidies and tax concessions are in substance the same from the Indonesian government standpoint, why is tax sparing bad? It appears to be a non-neutral tax concession working at cross-purposes with our spending policies only if it is considered a tax waiver by the United States. If it is considered a grant of a credit for the equivalent of a tax paid to Indonesia followed by the expenditure in Indonesia of the resulting funds, it loses its status as a tax concession. This latter characterization, and only this characterization, is consistent with the conclusion that Indonesian level tax concessions and subsidies are in substance the same.

The foregoing analysis is not so much a defense of government neutrality as a use of that concept to force the analysis to focus on both sides of the fiscal picture. By doing so it can be seen that those who resist tax sparing on grounds of neutrality may be taking inconsistent positions. The first position is that a government should not spend funds through grants of tax concessions when it would not spend the funds for the same purpose directly. No distinction should be drawn between spending funds directly and spending funds through tax concessions. The second position is that a credit should be granted when foreign funds are spent directly but not when they are spent through tax concessions, which means that a distinction is being drawn between these two

forms of government spending. The first proposition is correct but the second is wrong.

However, the grant of a tax credit is not a grant of a tax concession (so that the first of the above propositions is not applicable to the present problem), but is rather simply one means of resolving the problem of conflicting jurisdictions taxing the same income. The United States government should grant a credit if the foreign country exercises its jurisdiction to tax income whether this exercise is through overt taxation and spending or through the grant of a tax concession.

III. CONCLUSION

The KIP proposal being considered by Indonesia represents an effort to attract capital and technology to that country by using income taxes paid by the investor to Indonesia to defray some of the costs of establishing Indonesian infrastructure. The principal question considered in this article is whether this proposal violates principles of tax neutrality. It has been demonstrated that taxes are neutral only if firms are subjected to uniform tax burdens so that capital investment decisions are unaffected by questions of taxation. The objective to be furthered by tax neutrality is the maximization of the economic productivity of the world. Tax neutrality should be adhered to unless other objectives are, under the circumstances in question, more important.

A convenient way to test a given proposal involving a concession is to ask whether the objective to be achieved by use of the incentive is valued highly enough to warrant spending the waived taxes by granting a subsidy to the firm receiving the tax relief, keeping in mind that the cost consists not only of the amount spent, but also the loss caused by diverting the firm's resources from the use they would pursue if influenced only by prices and markets. Since the corporate income tax in the United States is itself not neutral, neutrality can be maintained within the corporate sector only if foreign taxes influence firms in the same manner that firms are influenced by the corporate income tax.

This article set forth various objections to tax neutrality from the standpoint of less developed countries. One objection relates to the failure of tax neutrality to consider both sides of the fiscal picture. When both tax collection and government spending are considered, it appears that while tax sparing cannot
be defended on grounds of neutrality from the standpoint of tax collection, it might nevertheless be justifiable as the equivalent of non-neutral government spending. As such, it (along with other tax concessions) should be considered acceptable if, but only if, it could be justified as a direct expenditure of government funds for the same purposes.

Finally, in the international context the wisdom of spending government funds for any specific purpose and in any given manner (i.e., direct spending versus tax concessions), must be tested by the government policies of the country in which the income has its source. Thus, if the Indonesian government concludes that its policies favor spending funds to construct a given facility, the United States should not refuse to grant a credit for the tax funds used therefor on the grounds that the United States would not itself spend its funds for the same purpose.

It should be emphasized that, while tax sparing and the KIP proposal are similar in many basic respects, they should not be regarded as equivalent for all purposes. For example, as noted previously, tax sparing when tied to tax holidays of very short duration can produce inequitable excess short term profits. In addition, it seems likely that tax sparing might be used more indiscriminately than the Indonesian proposal because its costs in terms of local government funds is not so apparent. In other words, tax sparing might be used even though the government of the less developed country would not spend funds for the same purpose. For these and other reasons previously considered, the KIP proposal being considered by Indonesia is preferable to tax sparing.
APPENDIX

I. THE STANDARD: CONSUMER WELFARE

The objective, and thus the standard against which an economy's performance is measured, is the maximization of consumer welfare, which means simply maximizing the utility and satisfaction consumers derive from the economy's output.1 This probably sounds more materialistic than it is since "consumers" include not just individuals purchasing T.V. sets, but schools purchasing textbooks, universities acquiring the (sometimes) creative efforts of scholars and charities acquiring necessities for the disadvantaged.

The first step is to determine the significance of prices. This is accomplished through an analysis of consumer behavior. Economists assume that consumers seek to maximize the satisfaction they realize from the goods and services they purchase with their limited budgets. Consumers preparing budgets are unconsciously trying to adjust their spending to the point where the satisfaction gained from spending $1 more on a given good or service will exactly equal the satisfaction lost from spending $1 less on each and all other goods and services.2 That is, when a purchaser with a finite budget spends $1 for good A, he has, of course, $1 less to spend elsewhere. If upon re-examining his budget he finds that the satisfaction gained from spending one additional dollar on good A was less than the satisfaction lost by not spending that dollar on good B, he can increase his total satisfaction simply by shifting at least $1 from A to B. Only when the satisfaction gained from an increase in the amount spent for A equals exactly the satisfaction lost from an equal decrease in the amount spent on B (and all other goods) is the con-

1. Hopefully, simplifications such as this and others which follow will not, by failing to point out all the qualifications necessary to make the statement wholly accurate, lead the reader to reject the entire analysis. For example, tax neutralists are neither advocating the maximization of consumer satisfaction at the expense of our environment nor maintaining that all health and safety standards be abandoned even though this might maximize productivity. The point is rather that taxes should not interfere with the free play of economic forces unless they serve some purpose which is valued more highly than the maximization of consumer satisfaction. It follows that if the function of the tax in question is solely to raise revenue, the tax should nonetheless interfere with the free play of economic forces as little as possible.
2. J. BAIN, PRICE THEORY 164 (1952) [hereinafter cited as BAIN]; D. WATSON, PRICE THEORY AND ITS USES 87 (2d ed. 1968) [hereinafter cited as WATSON].
sumer unable to improve his position be rearranging his budget. This conclusion provides important information concerning the significance of prices.

Implicit in the foregoing is the assumption that shifts in spending will tend to eliminate the differences in satisfaction realized from the goods and services in question. Otherwise, the consumer might never reach the point where one dollar more spent on one good will yield the same increase in satisfaction as that lost from $1 less spent on other goods. Economists have concluded that a concept they call the “law of declining marginal utility” indicates that this will, in fact, occur. This concept is based on the observation that the satisfaction a person will realize from a unit of goods or service will vary depending on the quantity of that commodity he has acquired previously. Specifically, the concept holds that the greater the quantity of a good or service a consumer has in hand, the lower the value one additional unit will have to him.\(^3\) Compare, for example, the importance of a quart of water to a person allowed two quarts per day to the almost negligible value usually associated with a single quart of the relatively plentiful supply of water most people enjoy in this country.\(^4\) Declining marginal utility is said to be a common phenomenon observed by everyone in everyday life.\(^5\)

Applied to the analysis here it shows that when a consumer decreases the amount spent on good \(A\) and increases the amount spent on \(B\), each of the fewer dollars spent on the disfavored good \(A\) will yield more satisfaction while at the same time each of the more numerous dollars spent on the favored good \(B\) will yield less satisfaction. Eventually the consumer will reach the point where $1 more or less spent on each and every good or service will increase or decrease his satisfaction by the same amount whereupon no further changes in his budget should be made.

This conclusion helps explain the significance of prices since it demonstrates that when a consumer spends $20 on good \(A\), and $10 on good \(B\), each one of the $20 spent on good \(A\) will be yielding the same satisfaction as each one of the $10 spent on good \(B\). Accordingly, the consumer has placed a value, in terms

\(^3\) G. Stigler, *The Theory of Price* 51 (3d ed. 1966) [hereinafter cited as Stigler]; Watson, supra note 2, at 60.
\(^4\) Stigler, supra note 3, at 51; Watson, supra note 2, at 63. Diminishing marginal utility is the reason demand curves commonly slope downward from left to right. Watson, supra note 2, at 66.
\(^5\) Watson, supra note 2, at 62, 63.
of capacity to give satisfaction, on good $A$ which is twice the value he assigns to good $B$. In short, price is a direct reflection of capacity to yield consumer satisfaction. Since consumers are considered fungible, it follows that the goal of maximizing consumer satisfaction can be realized if and only if the value, in terms of the price consumers will pay, of the economy's output is maximized.

The next step is to see how resource owners respond to prices. Here again the key is each individual's desire to increase his material welfare. If a given productive resource (the labors of a single individual for example) can produce good $A$ in less than twice the time it can produce good $B$, it will help maximize the economy's output by doing so in a situation such as the above example in which consumers will pay $20 for good $A$ and $10 for good $B$.

Happily, the resource owner will also maximize his income by doing so, for since it takes less than twice the time to produce good $A$ for which he will be paid $20, than it does to produce good $B$ for which he will be paid $10, he obviously will maximize his income if he produces $A$ rather than $B$—at least if it is assumed that the resource owner receives that which the consumer is willing to pay. Just as it was earlier assumed that consumers will seek to maximize the enjoyment they realize from their purchases, it is here assumed that resource owners (includ-

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6. Some may object on the ground that the price only shows the value to consumers of the 999th quart of water, for example, since price reflects the trade-off value consumers place on one quart of water after they have obtained 998 quarts. Put another way, price does show the value of the first and second quarts of water which must be consumed each day to sustain life.

These are accurate observations. However, consumers trying to maximize satisfaction (and, therefore, policy makers trying to maximize total consumer satisfaction) should not permit this to influence them. Consumers must take the economy as they find it. They are offered 999 quarts per person at a tiny fraction of a cent per quart. They are also being offered a pair of shoes which costs $40 per pair. Consumers would be foolish to conclude that since they value their lives more than warm, dry feet they should spend $20 or more for water. Rather, they should conclude that as long as they are offered 999 quarts of water at a fraction of a cent per quart, they should spend two or three cents for the 999 quarts. If the quantity offered at a fraction of a cent per quart drops, and particularly if it drops to two or three quarts per day, they must of course increase the amount they are willing to spend for water.

A policy maker is in substantially the same position. The relevant question is, in light of the circumstances as they presently exist, how will increases or decreases in the quantity produced of various goods and services affect consumer satisfaction?
ing individuals capable of performing services) will try to maximize incomes. In short, resource owners seeking to maximize their return will pursue the highest prices obtainable. Since price is a direct reflection of the capacity to yield satisfaction, it follows that by doing so resource owners will be producing those goods which maximize consumer satisfaction.

The economy is not, of course, as simple as the foregoing would suggest because most resource owners do not sell their services or the use of their capital directly to the public. Rather they sell to firms which, in turn, use the capital and labor they purchase to produce goods and services for the public.

Probably most, but certainly not all, economists assume that firms seek to maximize profits. Watson states that "[t]he assumption of profit maximization for firms is symmetrical with the assumption of utility maximization for consumers." The important question for present purposes is whether firms seeking to maximize profits equate the price consumers pay for the goods and services produced by the firm with the amount paid for the use of the resources which produced the goods or services. Economists have concluded that firms do. Their conclusion is based upon their analysis of how firms respond to the two major problems that confront them: (1) what quantity of goods or services to produce; and (2) the method of production, including the appropriate proportion of men and machines.

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7. This is an oversimplification, of course. For example, working conditions and prestige associated with various positions affect labor's choice of employment and risk affects the investment of capital. See Stigler, supra note 3, at 257-63 (discussing the former). See also A. Harberger, The Incidence of the Corporate Income Tax, 70 J. Pol. Econ. 215, 217 (1962); P. Samuelson, Economics 595-96 (8th ed. 1970) [hereinafter cited as Samuelson] (discussing the latter). In addition, resource owners may be unaware of many opportunities or may not have the mobility needed to take advantage of them. Nevertheless, it is thought that the dominant force motivating labor to work and owners of capital to invest is the expectation of compensation and that the principal criterion used in selecting the place of investment or employment will be the rate of return.

8. Of course, the economy will never reach this condition. Consumers' tastes are constantly changing. New products and productive techniques are constantly being developed. The important thing is that the economy is constantly adjusting toward this end.

9. Economists refer to all forms of business organizations—proprietorships, partnerships, corporations, etc.—as "firms." Watson, supra note 2, at 146-47. For an economic discussion of the various forms a business organization may assume, see Samuelson, supra note 7, at 77-95.

10. Watson, supra note 2, at 147. A brief look at firms which pursue objectives other than profit maximization will be undertaken later.
To maximize profits a firm should select that level of production at which any increase in the quantity produced will cost exactly that which it yields (in the language of economists, marginal cost must equal marginal revenue). That is, as long as increases in output generate more additional revenue than additional cost, the firm will increase its profits by expanding output. Only when the firm reaches the point where any increase in production increases revenues by exactly the same amount that it increases costs will expansion no longer be justified.

This simple observation appeals to common sense, but there are certain complications which underlie it. First, what is meant by “cost”? Cost must, of course, include amounts paid others for the labor or capital they supply. Wages to the firm’s employees, interest to banks, and rent to lessors are all included. Also included, however, is the return the owners of the firm could have received if the capital or labor they have invested were invested elsewhere. Assume, for example, that the firm is a sole proprietorship and that corporate stocks which represent the same risk to an investor as ownership of the firm represents to the proprietor are yielding 10%. Under these circumstances, the “cost” to the proprietor of investing his capital in the firm is the amount lost by not investing in corporate stock. It follows that the cost of capital includes that which one normally considers a firm’s profit. To some extent this is a matter of semantics. One could say that the “cost” of capital includes a normal or competitive rate of return to capital. On the other hand, one could say that capital supplied by the owner of the firm has no cost but that the firm must earn a normal profit for its owner. The former approach is preferable since it assigns the amount that must be earned to compensate the owners for the use of their capital directly to the use of that capital. For ex-

11. BAIN, supra note 2, at 143-44; WATSON, supra note 2, at 257-58. If price stays above average cost, new firms will enter; if it falls below, some will leave. BAIN, supra note 2, at 143-44. As the industry expands or contracts, industry costs may rise or drop. See id. at 147; SAMUELSON, supra note 7, at 450-52; STIGLER, supra note 3, at 151, 166-67. Price may react similarly. BAIN, supra note 2, at 139. Finally, average costs will reach price and no “excess” profits will exist. Id. at 156, 162; SAMUELSON, supra note 7, at 446, 448. As Samuelson describes it, equilibrium will be reached when long-term marginal costs equal average costs and these in turn equal price. SAMUELSON, supra note 7, at 446.

12. As will be shown below, a firm which earns more than the amount needed to meet its costs will be said to be earning an “excess” profit. See also note 11 supra.
ample, the rule for profit maximization could not be stated so simply if the cost of capital were not explicitly recognized.

The second complication underlying the profit maximizing rule is the assumption that as output expands costs will rise relative to the price at which goods will sell. In an industry in which perfect competition prevails, the firm will be faced with prices which remain constant regardless of the quantity of goods or services produced by the firm. However, the cost of producing each additional unit will rise as the quantity of output increases. Under these conditions, the firm should set the level of production at the point where any increase in the quantity produced will increase cost by exactly the amount it will increase revenues. This is common sense. If a firm goes beyond that point by hiring labor which cost it $1.01 more in wages, for example, by hypothesis the increased production will increase revenues by less than $1.01. Similarly, if the shareholders invest an additional $10.10, they will, if their capital gains would yield a 10% return if invested elsewhere, have given up a return of $1.01. Yet the firm’s revenues will increase less than $1.01. Both steps will, by costing more than they yield, reduce profits and thus should be avoided. On the other hand, if the firm reduces production, again by hypothesis, it will have reduced revenues by more than it reduced costs. Obviously, this too will reduce profits and similarly should be avoided.

If a corporation is able to generate “excess” profits (a return which exceeds the amount foregone by shareholders by not investing elsewhere), the excess will go the shareholders as the owners of the residual interest in the firm. The shareholders will earn not only the 10% return available elsewhere, but an additional profit as well. If this occurs, others with capital will be attracted to this industry by its higher return. Accordingly, they will invest capital in the industry and expand industry output. The declining marginal utility to consumers of the increased industry output will reduce its price until finally the point is

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13. See Samuelson, supra note 7, at 39, 67-68, 450; Watson, supra note 2, at 117.
14. See note 10 supra; Bain, supra note 2, at 132; Stigler, supra note 3, at 181; Watson, supra note 2, at 238. More precisely, if long term marginal costs of firms do not rise, the industry will not be competitive. Various reasons why costs may rise are set forth in Stigler, supra note 3, at 155-58.
15. See note 11 supra.
16. See note 11 supra.
17. Id.
reached at which no firm is earning an excess profit.\textsuperscript{18} At this point, the link between resource owners and consumers has been partially established. The ultimate objective is to cause resources to be employed in producing those goods and services which yield the maximum satisfaction to consumers. In a simple economy each resource owner will seek to invest his resource where it will receive the highest monetary return consistent with the risk incurred. Since the return to the resource owner is the price being paid by the consumer, and since this price reflects the capacity of the item to yield satisfaction to him, the resource owner must maximize consumer satisfaction if he is to maximize his return. It is essential, therefore, that each $1 paid by consumers represents $1 received by the resource owners who produced the good or service.

This analysis illustrates that a firm will produce at the level where the cost of producing one additional unit is exactly equal to its price, and that if a firm earns an excess profit, other firms will enter the industry and eliminate the profit. This means that the amount the firms are receiving for the sale of their goods or services will exactly equal the cost. Thus, in the aggregate, the objective has been reached since, if all resources employed by a firm are lumped together, the amount resource owners are receiving for producing a good or service will be exactly equal to the amount consumers are paying therefor.

But what if a firm’s resources are not lumped together? Is it not possible the firms are using resources in the wrong proportions so that the wages paid by the firm may exceed the value of labor’s contribution, while the cost of capital may be less than capital’s contribution to production? The question seems to invite an esoteric discussion of the relative contributions to productivity of labor and capital, but fortunately it need not.

An example may be helpful. Assume that firms X and Y are both producing at the profit maximizing level. Assume also that firm X is using capital and labor in such proportions that firing a unit of labor costing $1 will decrease the value of production by $.90 whereas decreasing the amount of capital spent by $1 will decrease the value of production by $1.10. Assume also that firm Y is in just the opposite position so that cutting back labor costing $1 will decrease the value of production by $1.10 and cutting back on the use of capital by $1 will decrease the value of production by $.90. If this were to occur (and it is likely that

\textsuperscript{18} Id.
similar situations arise all the time) total production in the economy could be increased by shifting one dollar's worth of labor from X (thereby decreasing the value of production by $.90) to Y (where it will increase the value of production by $1.10), and shifting capital costing $1 from Y to X (with the same effect). Happily, both firms in pursuing their individual efforts to maximize profits, will be changing the proportions in which they used capital and labor. Firm X can increase its total profits by $.20 by spending at least $1 more for capital and $1 less for labor. (The additional dollar spent for capital will increase the value of production by $1.10, whereas the decrease in the use of labor will decrease the value of production by only $.90.) Similarly, firm Y can increase the value of its output $.20 by substituting labor for capital. Thus, each firm, acting in pursuit of its own self interest and without conscious regard to the impact of its actions on the economy as a whole, will be seeking an exchange of resources which will maximize the value of the economy's output.

Once again, two unstated premises underlie the foregoing analysis. The first is that resources can be used in different proportions. That is, firm X in the above example can substitute capital for labor. Economists are satisfied that productive resources usually can be used interchangeably to a degree. This is a matter of technology and, while it is true that some capital equipment may be indispensable in some industries (e.g., air transportation and radio broadcasting), it is undoubtedly possible to use more men and fewer machines in some facets of the operation even in these industries.

The foregoing example also assumes that substituting capital for labor will tend to equalize the productivity of these two resources. Economists have concluded from everyday observations that this will in fact occur. For example, hiring one man adds more to the productivity of a firm whose assets are a single shovel and a single acre of land if he is the first rather

19. Stigler, supra note 3, at 115, 117-18; Watson, supra note 2, at 177.

20. If, in a given industry, technological conditions are such that resources cannot be substituted for one another, the separate cost of each resource becomes insignificant to the firm and the economy as a whole. Under such circumstances, neither capital nor labor taken separately can make any contribution to production in the industry. Thus, since their contribution to production is joint, the sole question is whether one dollar spent on hiring them jointly builds a product worth one dollar.
than the tenth man; the latter would probably just get in the way.\(^\text{21}\) Therefore, it appears that the firm can usually substitute capital and labor for one another and that as it does so each unit of the resource which is being added will add progressively less to production and each unit of the resource which is being removed will reduce production by progressively greater amounts. Return to firm X in the above example as it shifts from labor to capital; the former will become more, and the latter less, productive. Firm X will find that substituting capital for labor will continue to be advantageous until the value of the additional output resulting from spending $1 more on capital is equal to the value of the decreased production resulting from $1 less on labor.

The link between resources and consumers is now complete. Each firm must select the level of production at which the cost of producing one more unit will equal its price. Excess profits will be absorbed by competitive firms entering profitable industries and losses will be eliminated because some firms will abandon distressed industries. Consequently, the resource owners, in the aggregate, will be paid exactly the price the firm receives for the output. In addition, each firm must use capital and labor in such proportions that increasing or decreasing the amount spent on each by $1 will either increase or decrease the value of output by the same amount. It follows that the amounts being paid to resource owners are directly proportionate to the contribution of that resource to the firm's production. Finally, since the entire value of the firm's production is paid to resource owners, it follows that each resource owner receives the value to consumers of that portion of the firm's output its resource produces.

In brief summary, the objective is to maximize consumer welfare, that is, maximize the satisfaction consumers realize from the goods and services produced by the economy. An analysis of consumer behavior discloses that price can be ac-

\(^{21}\) Economists refer to this phenomenon as the "law of diminishing returns." As Professor Samuelson puts it:

The Law of Diminishing Returns: An increase in some inputs relative to other fixed inputs will in a given state of technology, cause total output to increase; but after a point the extra output resulting from the same additions of extra input is likely to become less and less. This falling off of extra returns is a consequence of the fact that the new "doses" of the varying resources have less and less of the fixed resources to work with.

Samuelson, supra note 7, at 25. See also Bain, supra note 2, at 101-04; Stigler, at 122; Watson, at 160-65, 168-69, 171.
accepted as a direct reflection of the capacity of goods to yield consumer satisfaction. A study of the probable actions of resource owners indicates that their efforts to maximize their return will encourage them to produce goods which yield the highest price and therefore the maximum consumer satisfaction. Consumer welfare will be maximized, therefore, if a direct link can be established between the amount consumers will pay and the amount resource owners will receive so that the former receive that which the latter pay. Finally, an analysis of profit maximizing firms operating in perfect competition shows that these firms will establish this link.

This then is the case for tax neutralists: The economy will tend to maximize consumer welfare if economic forces are allowed free play; taxes should not, therefore, be permitted to interfere with these forces. In other words, taxes must remain neutral.

II. THE REAL WORLD

The previous section speaks of rational, calculating, fully-informed, unemotional factor owners, managers and consumers, each moving with the deliberate precision we all hope is possessed by skilled surgeons. These conditions are hardly those we have learned to expect in the world. A more realistic description of economic life would characterize the actions of the participants as a process of "groping."22 Certainly most people will at some time stupidly, ignorantly or stubbornly refuse to take advantage of an opportunity which economists expect them to seize. But any system must accept these and other human failings. More to the point perhaps is the fact that even though some distortions creep in due to these deficiencies, there is no reason to introduce other distortions through bad tax legislation.

The importance of the above analysis is that it demonstrates that economic pressures on each individual (whether he is a factor owner, a firm manager or a consumer) seeking to advance his self interest will lead him to act in a manner which tends to maximize the general welfare of all. Each person in pursuing his self interest, when and to the extent he recognizes an opportunity to improve his position by receiving a higher return, increasing profits, or heightening his satisfaction from consumption, will act in furtherance of the general welfare when he

22. This is Walras' characterization. Watson, supra note 2, at 272-75.
attempts to seize the opportunity. It is not, therefore, necessary for tax neutralists to assume that only if all persons act in the calculating and deliberate manner attributed to them in the preceding discussion will the economic system function.

With these conclusions in mind, it is now possible to consider the effect of taxes on the behavior of firms.

A. TAXES

The following traces the impact of certain taxes on the allocation of resources. Some taxes have no effect on the behavior of firms and the allocation of resources. If the measure of a tax is noneconomic (e.g., a tax imposed at a uniform rate on everyone living on a given date), it will not affect economic decisions. Such a tax is neutral. In addition, some taxes whose measures are economic (e.g., an income tax imposed uniformly on all forms of income) will not affect the allocation of resources even though they may affect work-leisure or investment-consumption decisions. The neutrality of such an income tax is apparent from the discussion below concerning the distorting effect of income taxes which are not imposed on all forms of income. For present purposes, a tax which does not affect the allocation of resources among competing forms of employment will be considered neutral even though it may affect work-leisure or consumption-savings decisions.

There are taxes, however, which do affect the allocation of resources in one of two ways. These effects on resource allocation will be categorized as (1) an excise tax effect and (2) a factor tax effect.

1. Excise Tax Effect

For present purposes, an excise tax is defined as a tax “imposed upon the production or sale of [some, but not all] commodities or related groups of commodities.” If no excise tax is imposed, all firms will be equating total costs with total revenues and they will not therefore be able to absorb a tax without operating at a loss. Firms must therefore either increase prices or decrease costs.

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23. The phrase “allocation of resources” refers to the manner in which the labor and capital in the economy are employed and invested.
24. THE ROLE OF DIRECT AND INDIRECT TAXES IN THE FEDERAL REVENUE SYSTEMS, A CONFERENCE 3 (1964). A somewhat different definition has been adopted by some commentators:

Excise—a hateful tax levied upon commodities, and adjudged
Since firms operating in perfect competition cannot increase price, they must concentrate on reducing costs. Since costs rise as the quantity of output is increased, the first reaction to the imposition of an excise tax may be a reduction of output in an effort to reduce costs to the point where amounts paid to resource owners, when added to the tax, will equal total revenues. A reduction by each individual firm of its output will soon be reflected in a reduction of industry wide production. As this takes place, the marginal utility of each unit of the now decreased quantity will increase and consumers will be willing to pay a higher price per unit. Accordingly, while the imposition of an excise tax will not in itself increase consumer demand, it will induce firms to reduce the quantity of output in order to reduce costs which in turn will cause consumers to bid up the price of the more scarce commodity. Firms and consumers will, to use Walras' phrase, grope back to the point where the new and higher price (which represents the value to consumers of the new and smaller quantity) which, when added to the tax, will equal the new and lower cost of producing the new and smaller quantity of output.

It is logical to conclude that an excise tax distorts the allocation of resources. The preceding discussion demonstrates that

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not by the common judges of property but wretches hired by those to whom excise is paid.

Samuel Johnson

25. See note 4 supra.
26. See note 5 supra.
27. See text accompanying notes 3-5 supra. Two responses are likely. As the quantity available decreases, some consumers who did not value the commodity highly will simply discontinue its consumption. Others will discontinue the least important uses (in terms of capacity to yield satisfaction), but will pay a higher price rather than discontinue all uses. The net effect will be that the higher price paid for the lower quantity will represent a higher value to consumers.
28. It is possible that consumer demand for some commodities is wholly “inelastic;” that is, consumers will pay any price for the same quantity of output. This unusual case and the case of the wholly “inelastic” supply are not considered here.
29. Watson, supra note 2, at 274.
30. As Samuelson puts it:
A tax will raise the price to the consumer and lower the price received by the producer, the difference going to the government. At the higher price a smaller quantity will be bought by consumers. This is as it should be, because producers are also supplying a smaller quantity at the lower price which they receive. Thus the amounts willingly bought and sold out balance where the new supply and demand schedules intersect, and there will be no further change in price.
Samuelson, supra note 7, at 368. See generally Stigler, supra note 3, at 183-84; Watson, supra note 2, at 251-52.
resource allocation is optimized when producers receive the amount consumers are willing to pay for their good or service. It also demonstrates that firms can serve as the conduit through which these payments flow from consumer to resource owner. But an excise tax intervenes between the resource owner and consumer, thereby preventing the resource owner from receiving the full amount paid by consumer. Importantly, the tax will intervene only in the taxed sector, leaving the untaxed sector undisturbed. Whereas before the tax, firms in both sectors were equating the amount paid for productive resources with the price the firms received for their output, only the untaxed firm will be doing so after the tax is imposed. Thus, the product value to consumers for each dollar’s worth of capital used in the taxed sector will be greater than each dollar’s worth of capital used in the untaxed sector. Consumer welfare therefore could be increased if productive resources moved from the untaxed to the taxed sector. However, since costs will have been increased in the taxed sector, firms producing there will not seek to hire additional resources. This distorting effect is called an “excise tax effect.”

2. Factor Tax Effect

A factor tax will mean here a tax which is imposed on the return to one, but not all, resources and which is imposed in one or more, but not all, industries. A corporate income tax is probably such a tax. It is imposed on the return to capital but not on the return to labor and is, of course, imposed only in the corporate sector. This conclusion is central to the subject at hand and will be examined more fully below. Perhaps a clearer example would be a tax which is withheld from wages paid only by firms producing certain commodities. Such a tax meets the description of a factor tax since it need not be withheld from the return to owners of capital and is not imposed on firms which are not producing the commodities in question.

Both the level of a firm’s output and the proportions in which it uses labor and capital will be affected by a factor tax, for a factor tax affects not only the quantity of output but the techniques of production as well. A factor tax’s effect on the level of output is the same as that of an excise tax. Like an ex-

31. Watson, supra note 2, at 94–96.
32. Such a tax might be called a “one industry factor tax” or a “one sector factor tax” since the above definition covers only taxes on the return to factors used in less than the entire economy.
cise tax, a factor tax increases the firm's total costs. For the reasons set forth in the discussion of an excise tax, a factor tax will, therefore, reduce output in the taxed sector. Unlike an excise tax, however, a factor tax increases the cost of using one productive resource (e.g., labor) but does not increase the cost of using the other. Since labor will not be willing to accept a lower after tax return in the taxed sector than its untaxed return in the untaxed sector, firms in the taxed sector, when a 50% withholding tax is imposed, will be required to double the total amount paid for the use of each unit of labor. However, the tax will have had no effect on the cost of capital. Both taxed and untaxed firms must use capital and labor in such ratios that their costs are directly proportionate to their contribution to production. Since the cost of labor now has doubled for the taxed firm, it must increase the ratio of capital to labor until the law of diminishing returns causes the productivity of capital to decline (and the productivity of labor to rise) to the point where the costs of capital and labor are once again proportionate to their productivity.

It is apparent that (1) the quantity of production in the taxed sector will decline as a result of the imposition of the tax, and (2) firms in that sector will be using far more capital intensive techniques of production. Labor will be much more productive in the taxed than in the untaxed sector so that total productivity in the economy thus could be increased by shifting labor from the untaxed to the taxed sector. However, as a result of the increased cost of using labor in the taxed sector, firms will have no incentive to make such changes despite the beneficial effect the changes would have on the economy as a whole.

III. UNITED STATES CORPORATE INCOME TAX

The next question is to determine the effect of the corporate income tax in the United States. Specifically, does this tax have an excise tax effect, a factor tax effect or, perhaps, some third effect yet to be identified?

Most who are familiar with the corporate income tax in the United States probably would conclude instinctively that it is a factor tax. The tax, of course, is imposed only in the corporate sector thereby satisfying one criterion of a factor tax. In addition, it appears to be imposed on the return to capital owners but not to labor owners; it is imposed on and reduces corporate profits; corporate profits are accumulated for the benefit
of, or are paid to, shareholders; everyone knows that shareholders are capitalists.

Although generally sound, this reasoning is deceptively simple. As noted, a corporate tax reduces corporate profits and thereby reduces the earnings of shareholders. As will be seen below, the important feature of the corporate income tax is not only that it reduces the amount of shareholder earnings, but that it is measured by this amount as well. For present purposes, however, it is sufficient to note that the tax reduces shareholder earnings.

What does this have to do with the productive resource capital? In the preceding sections the terms “labor” and “capital” have been used to describe productive resources, and when used in this sense, the terms usually bring to mind men and machines. The answer lies in part at least in the fact that shareholders supply more than money. To be more specific, shareholders supply the time value of money. That is, they permit firms to use their money over periods of time without charging interest. The time value of money is the means by which physical capital (as distinguished from money capital) is acquired. A plant, machine or tool must be purchased before, and often long before, the revenues it generates will be at hand. In the interim, the firm must have money invested in the productive asset. The time value of money serves as the bridge between payment for physical capital and realization of the revenues it will eventually produce.

There are a number of items that a non-economist might not consider capital goods but which require firms to tie up money for periods of time. Inventories of supplies (growing timber is an extreme example), or finished products (aging wine) may tie up quantities of the time value of money that exceed that invested in machines or tools in an industry. Economists, however, categorize these items as capital. For example, Professor Samuelson describes capital this way:

33. In a leading article on the incidence of the corporate income tax, Chicago's Professor Harberger states:

In the very short run, the [corporate income] tax will necessarily be borne out of the earnings of fixed capital equipment in the affected industry [i.e., the corporate sector] . . . .


34. It was Marx's failure to recognize the contribution to production of the time value of money (as distinct from depreciation of physical capital) that led to his conclusion that capitalists were receiving more than they were contributing and were therefore exploiting labor. K. Marx, Capital 95 (Modern Library ed. 1932).
Capital goods consist of a great variety of things: machines of various kinds, plants and houses, tools, raw materials and goods in process (seed grain, growing wheat plants, harvested wheat, flour, dough, warm loaves, wrapped and delivered bread), and canned and frozen edibles.\textsuperscript{35}

A prominent example of an asset that may tie up vast quantities of the time value of money is land. While the traditional definition of capital is limited to produced assets, as distinct from natural assets,\textsuperscript{36} there is a current trend towards including land as capital.\textsuperscript{37}

For now, it is sufficient, and important, to note that in the context of the corporate income tax, the term "capital" includes all assets which represent the investment of the time value of money, and this includes assets which may have been produced entirely through the use of labor. Similarly, "capital intensive" techniques of production are those involving the intensive use of the time value of money. It is still accurate to conclude that the use of a high proportion of plant, machine and tools per unit of labor is a capital intensive technique of production, but it must be kept in mind that holding substantial inventories of supplies and finished goods can be similarly described. Firms use capital when it appears that its use will increase production. Ignoring debt, a firm will obtain the time value of money made necessary by use of capital from its shareholders. The assets it acquires with these funds (a tool or aging wine) will increase the firm's productivity, thereby providing additional revenue with which the firm can compensate its shareholders. In short, the time value of money becomes the means by which the firm obtains the use of such items of physical capital as tools or machines; the use of the tools or machines enables the firm to increase productivity; the revenues from this increased productivity become the compensation to the shareholders; consequently, a tax on the return to shareholders is a tax on the compensation paid for supplying physical capital.

Earlier it was suggested that it is not just that the return to shareholders is reduced by the corporate income tax that is important, but rather that the tax both reduces and is measured by that return. A corporate income tax will reduce the return to shareholders simply because it reduces after tax profits, and this is, after all, the source of the return to shareholders. However, the same is true of a number of taxes. For ex-

\textsuperscript{35} Samuelson, \textit{supra} note 7, at 719.

\textsuperscript{36} See, e.g., Samuelson, \textit{supra} note 7, at 46.

\textsuperscript{37} See, e.g., Watson, \textit{supra} note 2, at 158.
ample, before a firm can fully adjust to an excise tax, it too will reduce the firm's after tax profit and thus the return to shareholders. This does not mean, however, that the two taxes are the same. The measure of the tax is important because it determines the effect of the tax on the cost of labor or capital. A tax measured by the amount paid to labor (e.g., a withholding tax on wages) increases the cost to the firm of using labor but not capital. A firm subject to such tax, for example, could double the amount paid for the use of capital without increasing the amount of tax. Whereas, if it doubled the amount paid labor it would double the tax as well. By like reasoning, a tax, such as a corporate income tax, which is measured by the amount paid to, or set aside for, the use of capital will increase the cost of using capital but not labor. Finally, a tax such as an excise tax which is measured by the value of goods or services sold will leave the costs of using labor or capital unaffected although it will increase total costs—or reduce total revenues, which is the same thing.

The immediate effect of all three taxes might be to reduce corporate profits and, therefore, the amount paid to or set aside for shareholders. An employer who is subject to a withholding tax might not reduce wages by the amount of the tax for fear of losing its employees. Similarly a firm subject to an excise tax might not raise the price of the goods or services it sells for fear of losing its customers. But when the firm seeks to adjust to the tax, it must look to its measure to determine whether it has increased the cost of using either labor or capital. If either is increased the firm must change the ratio in which these factors of production are used in order to re-establish equality between the cost of each factor and its contribution to the value of production.

It may be objected that this analysis simply proves that a corporate income tax is a factor tax affecting the cost of capital by a scrambled redefinition of terms: First, see what productive processes are affected by the corporate tax (those using the time value of money), define those as capital, and then observe with amazement that the tax is a factor tax affecting the cost of capital. But the important conclusion is that the corporate income tax changes both techniques of production and the quantities in which goals and services are produced. The fact that affected capital intensive techniques or production include such processes as aging wine does not detract from the conclusion that these and other capital intensive productive techniques are made
more expensive by the tax so that firms in the corporate sector are induced to favor more labor intensive techniques of production.

Some economists have concluded on the basis of statistical studies that corporations are able to "shift" the corporate income tax to consumers. That is, due to noncompetitive conditions firms are able to raise prices by the full amount of the corporate tax. Indeed, one study indicates that firms shift 135% of the tax. While at first it might appear that the ability of firms to recoup the entire amount of tax through increased prices will destroy the tax's effect as a factor tax, this is probably not the case. Even if a firm can increase its revenues by an amount equal to its corporate income tax liability, it should continue to employ capital and labor in such proportions that the contribution to the value of production by each equals its cost to the firm.

Consider, for example, a monopoloid firm whose management has concluded that its salaries are tied more closely to the volume of sales than the level of profit. Before imposition of the tax, this firm will be generating profits equal to the amount its shareholders can realize from alternative investments of like risk. Thereafter, the firm will use its monopoloid position to maximize the volume of sales. The imposition of a 50% corporate income tax will reduce the return to shareholders by one half. The firm can (assumed here that it will) immediately adjust prices upward, thereby shifting the tax forward to consumers. There will be some pyramiding—50 cents of every dollar raised to offset $1 of tax must itself be paid as tax so that revenues must then be increased by an additional 50 cents etc.—and the increased prices may lower the total volume of sales. Nevertheless, the firm can, if it so chooses, limit its response to the tax to increasing prices until the after tax rate of return to capital is once again at its pretax level so that the tax appears to be borne solely out of increased revenues.


39. If the increased price reduces demand and thus output, the tax can be said to have been shifted in part "back" onto labor and capital in that less of these factors of production will be employed by the firm. This response to the facts is similar to the industry wide response to an excise tax in a competitive industry. The latter is discussed in this Appendix at Part II A 1 supra.
If that is the firm's sole response to the tax, the tax will not have the factor tax effect of changing the proportions in which the firm uses labor and capital. But should this be the firm's sole response? Clearly not. Before the tax the firm was using labor and capital in such proportions that any increase or decrease in the amount paid shareholders or laborers by $1 would increase or decrease revenues by $1. But for every dollar the firm now pays capital, it must also pay $1 in tax. Accordingly, if it decreases the amount paid shareholders by $1, it will also decrease its tax liability by $1. Consequently, the firm can substitute two units of one productive resource (i.e., an amount of labor costing $2) for each unit of the other resource (i.e., an amount of capital for which shareholders will be paid $1), thereby increasing production without increasing cost. Presumably, a management committed to maximizing sales will do so, for what could be more likely to induce a sales maximizing firm to take action than the ability to increase the volume of output without increasing total costs?

In short, if a firm regards the maximization of sales as a worthwhile goal, it can be expected to pursue this goal systematically, in which case it will change the ratio of capital to labor in response to the tax. If a firm is simply trying to avoid excess profits in order to escape antitrust charges or to avoid attracting competition, and if any method of keeping profits down (including the inefficient use of resources) will suffice, tax neutrality becomes a dead word. On the other hand, if it is assumed that firms pursue their objectives rationally and systematically, the ability to shift a tax forward in the form of higher prices does not prevent the tax from becoming a factor tax.

IV. SUMMARY

The proposition that considerations of consumer welfare require the mechanisms for taxing foreign income to be used in a manner which achieves tax neutrality loses some of its persuasiveness when it is realized that the corporate income tax is probably not neutral. This is particularly so when it is realized that most investment of capital abroad takes place in the corporate sector so that the present system probably is biased against foreign investment.\footnote{40} Under these circumstances, pro-

\footnote{40. Within the corporate sector, there may be a bias in favor of investments in countries where the cost of labor is substantially less than it is in the United States. As noted, the corporate tax induces...}
ponents of tax neutrality will probably have to be content if the system of taxing foreign and domestic income does not create additional distortions which influence the choice between investing in United States or abroad. Hereafter, it will be assumed that the objective is to equalize the cost of capital employed by corporations in the United States with its cost when employed by corporations abroad.

United States tax laws rely principally upon the foreign tax credit provisions to achieve neutrality between domestic and foreign investment. The Internal Revenue Code allows a domestic corporation a credit for certain foreign taxes imposed on income received from foreign sources. The credit may be used to discharge the corporation's liability for United States corporate income tax and directly reduce the amount of tax payable to the United States. The credit is allowed only if the foreign tax is an "income, war profits, [or] excess profits tax" or a tax imposed "in lieu of a tax on income, war profits, or excess profits otherwise generally imposed by any foreign country . . . ." If the objective is to neutralize the foreign tax and thereby equalize the cost of using capital abroad with its cost when used in the United States, it might seem strange that only income taxes qualify for the credit. Should not any tax that may distort resource allocation be eligible for credit? Yes and no. As the following demonstrates, a foreign tax should be eligible for credit if it is smaller than the United States corporate tax but not if it is larger, unless it has a factor tax effect identical to that of the United States corporate income tax.

Consider the following example. Assume that Indonesia imposes a production tax equal to 20% of a firm's gross income for which the United States allows a credit. If this tax is smaller firms to use more labor intensive techniques of production than would be used in the absence of the influence of the tax. It would seem to follow that under these circumstances the cost of obtaining a unit of labor would be of greater significance to a firm than it would be if less labor were used so that there would be a greater inclination to seek the services of cheaper labor abroad.

41. A domestic corporation is one "created or organized in the United States or under the law of the United States or any State or Territory." IRC § 7701(a)(4).
42. IRC §§ 901-06.
43. A deduction reduces taxable income and therefore the amount of tax by 50%—assuming a 50% rate. A credit is twice as valuable since it reduces the amount of tax itself. Taxes which are not eligible for credit may be taken as deductions. IRC § 164(a).
44. IRC §§ 901 & 903.
than the United States corporate income tax, the sale of one unit more or less of output brings a firm the full price consumers pay for the unit of output, since any increase or decrease in production tax will be wholly offset by an increase or decrease in the credit. Allowance of a credit therefore permits the firm to ignore the production tax completely. Conversely, if the production tax is the larger of the two, the sale of one unit more or less of output will net the firm the price less the production tax. The reason is that since the production tax already exceeds the income tax, the additional tax credit resulting from the additional production tax has no income tax against which it can be applied. Consequently, the additional production tax simply constitutes an additional cost to the firm. Similar reasoning can be used to show that only the larger tax will be considered by a firm when it is determining the relative cost of capital and labor. It follows that a credit for such a tax is not neutral if it is larger than the corporate income tax.