International Taxation in an Age of Deglobalization

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Abstract

Over the past thirty years, a common refrain in the literature on international taxation has been that the regime for taxing multinational corporations (MNCs) has become obsolete due to globalization, and especially to increased cross-border capital mobility. However, over the last decade, the progress of globalization has slowed or even reversed, with many observers characterizing the current era with respect to world trade and other cross-border activity as an age of deglobalization. This paper addresses the implications of deglobalization for international taxation. After briefly surveying the evidence for deglobalization (including the resurgence of tariffs) in the international trade literature, the paper develops a simple conceptual framework for understanding MNCs' cross-border activity and the effects of taxes imposed by source and residence countries. This framework is used to draw three main conclusions. The first is that – as a substantial fraction of world trade is within MNC affiliates – tariffs (in addition to the well-known deadweight costs to which they give rise) also represent a particular burden on MNCs that distorts global patterns of firm ownership. This burden is analogous to that of a repatriation tax (i.e., a residence country tax on dividends from foreign affiliates to the MNC parent, as imposed by countries with "worldwide" tax systems). Second, in certain common circumstances, tariffs make MNC profit shifting via transfer pricing less of a concern. Third, when tariffs are taken as exogenously fixed, eliminating distortions to MNC activity would require a negative repatriation tax. Wider implications for international taxation are also discussed.

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Extended Abstract

Over the past thirty years, a common refrain in the literature on international taxation has been that the regime for taxing multinational corporations (MNCs) has become obsolete due to globalization. The international tax regime took shape in the 1920s, and is manifested in countries' domestic tax law relating to international activity and in an extensive network of bilateral tax treaties. These treaties - and international norms - require countries to alleviate double taxation by one of two methods: the exemption of the foreign income of resident MNCs (known as territorial taxation), or the granting of a foreign tax credit for taxes paid abroad by resident MNCs (known as worldwide taxation). The international tax regime also allocated taxing jurisdiction among source countries (i.e., countries where business operations are undertaken) and residence countries (where MNCs are headquartered).

Starting around the early 1990s – in what is often viewed as the age of globalization – this system came under increasing pressure. Scholars of international taxation frequently lamented the impact of globalization and capital mobility on the ability of governments to effectively tax MNC activity. Leading examples include Avi Yonah (2000), who emphasizes the role of capital mobility among firms and tax competition among governments in creating a "fiscal crisis of the welfare state." More recently, Avi Yonah and Kim (2024, p. 1) succinctly state this argument as follows:

> "[S]ince the advent of globalization in the 1980s and digitalization in the 1990s, the original [international tax regime] has ceased to function as intended. The main problem is the increased mobility of capital related to increased intangibility and digitalization, in conjunction with a relaxation of capital controls and increased tax competition."

Importantly, this view has led to a number of important multilateral initiatives – such as the Base Erosion and Profit Shifting (BEPS) initiative of the Organization for Economic Cooperation and Development (OECD) and the more recent OECD-led proposal for a global minimum tax on MNCs.

This view, however, has not taken into account the slowdown and reversal of globalization in the last decade. For instance, Goldberg and Reed (2023) document that world trade has been declining as a fraction of global GDP since around the global financial crisis of 2008. While the quantitative evidence in the trade data for deglobalization is – to date – fairly limited, Goldberg and Reed point to a shift in ethos. Evidence from linguistic analysis suggests that the policy and intellectual environment with respect to international openness has changed. Notably, the influence

of economists on trade policy has declined, and even some economists have sought to question the benefits of globalization by focusing on the labor market effects of globalization in developed economies. Perhaps the most dramatic manifestation of deglobalization is represented by the tariffs introduced by the United States in 2018 (e.g., Amiti et al., 2019) and 2025.

The wider costs and benefits of globalization are not central to the arguments made here, but it is worth noting some basic background facts. While within-country income inequality apparently increased during the age of globalization, global inequality declined (Milanovic, 2013), suggesting that globalization was associated with the rise of a relatively widely-shared prosperity. These achievements now appear to be threatened by deglobalization. There is no consensus on the causes of deglobalization, in particular on its relationship to the global decline of democracy ("dedemocratization") over the same time period. These issues remain the subject of extensive ongoing research across multiple academic disciplines.

To explore the consequences of deglobalization – and especially the imposition of substantial tariffs – on the taxation of MNCs, a simple conceptual framework that captures the insights of the "Reading School" of international business studies (and in particular its focus on the concepts of ownership, location, and internalization (OLI)) is helpful. Assume a continuum of firms with mass 1 in a foreign (i.e., non-US) country F. Each firm is assumed to have a fixed value D under domestic ownership. These firms, however, have varying values V_{US} under the ownership of a US MNC (there is assumed to exist only one US MNC, for simplicity). In particular, $V_{US} > D$ for some firms and $V_{US} \leq D$ for others. The latter would presumably not be acquired by the US MNC, but there are social gains from the acquisition by the US MNC of the former. Value under US ownership is assumed to be bounded from above at a finite value $\overline{V}_{US}$ - i.e., $V_{US} \leq \overline{V}_{US}$.

The foreign country's tax rate τ_F is normalized to zero (without significant loss of generality, as long as τ_F is lower than the US corporate income tax rate). The density of firms over the range $[0, \overline{V}_{US}]$ of possible values v under US ownership is given by the pdf $f(v)$, with corresponding cdf $F(v)$. To derive simple illustrative closed-form solutions, we use the uniform pdf $f(v) = \frac{1}{\overline{V}_{US}}$ and corresponding cdf $F(v) = \frac{v}{\overline{V}_{US}}$. However, the main results below hold for general distributions.

The model assumes a single US MNC that faces no financial constraints (i.e., it can make all of the acquisitions that it wishes to make and to which domestic owners accede). The timing –

shown in Figure 1 – is as follows. At time 1, the US MNC can make take-it-or-leave-it (TIOLI) offers to domestic owners to acquire firms. As a domestically-owned firm always has a present value of *D* under its current ownership, this entails that the US MNC pays *D* to acquire a foreign firm.

In this framework, global welfare can be characterized as:

$$W_{Global} = \int_{D}^{\bar{V}_{US}} vf(v)dv + \int_{0}^{D} Df(v)dv$$

and US national welfare as:

$$W_{US} = \int_{D}^{\bar{V}_{US}} (v - D)f(v)dv$$

Both global and US national welfare are maximized when the US MNC acquires all country F firms for which $V_{US} > D$. This is illustrated (for the case of a uniform distribution $f(v) = \frac{1}{\bar{V}_{US}}$) in Figure 1.

Now suppose that the US imposes a repatriation tax at rate of τ. That is, dividends paid by the foreign affiliate to the US parent now face a tax τ. If the affiliate cannot defer dividends (for instance, if the US parent requires cash to pay out to its shareholders), then this repatriation tax will burden the US MNC's foreign operations. Anticipating the repatriation tax, the US MNC will only acquire F firms for which $V_{US} > \frac{D}{1-\tau}$. This gives rise to an ownership distortion: some firms that would be more valuable under US ownership remain under domestic ownership.

Suppose that instead of a repatriation tax, the US imposes a tariff. Under certain conditions, the tariff is equivalent from the MNC's perspective to a repatriation tax. For instance, suppose that the F affiliate produces output at a cost of $90 and sells this output to the US parent for $100. With a tariff at a rate of 2%, the MNC would be subject to a tariff payment of $2 to the US. With a 20% repatriation tax, the MNC would be subject to an identical a tax payment of $2 to the US. The two types of taxes are equivalent when that tariff rate *t* is:

$$t = \frac{\tau D}{(1-\tau)R}$$

where *R* is the foreign affiliate's revenue. Even when precise equivalence does not hold, the more general point is that - as a substantial fraction of world trade takes place within multinational enterprises - tariffs represent a particular burden on MNCs that distorts global patterns of firm

ownership. This is an efficiency cost of tariffs that is distinct from – and in addition to - the familiar deadweight costs of tariffs that are very familiar.

In the example above, the MNC may be tempted to reduce its tariff burden by engaging in strategic transfer pricing – for instance, instead of selling the output at a price of $100, it may choose a transfer price of $90. This would reduce the tariff payment from $2 to $1.80. However, this increases income reported in the US by $10 and decreases income reported in F. When the US tax rate is higher than that of country F, this will typically increase the MNC's global income tax burden. Under typical circumstances, there is thus a tradeoff between setting transfer prices to reduce income taxes and setting transfer prices to reduce tariff payments. This tradeoff has not – to date - been a major theme of the transfer pricing literature, perhaps because tariffs were very low in the age of globalization. However, it now looms larger, and suggests that in a deglobalized world characterized by substantial tariffs, profit shifting via strategic transfer pricing is less of a concern. This may not apply, however, to other forms of profit shifting, such as the strategic use of inter-affiliate debt.

Finally, suppose that tariffs are in place and cannot be eliminated. Then, how should international tax policy be set optimally? For instance, what is the optimal repatriation tax τ? Arguably, this question may not be completely coherent, given that optimal policy would typically involve eliminating the tariff. The policymaker who imposed the tariff is very unlikely to impose the optimal repatriation tax. While not meaningful as advice to the policymaker who imposed tariffs, the optimal repatriation tax is still valuable as a normative benchmark. It turns out that the optimal repatriation tax in these circumstances is negative:

$$\tau = -\frac{tR}{V_{US}}$$

That is, in the presence of a tariff, the US should *subsidize* MNC activity, to counteract the tariff-induced distortion to global ownership patterns.

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Figure 1: Efficient Outcome

