

TCPI's 10th Anniversary Tax Policy & Practice Symposium, *Certainty in an Uncertain World? Resolving Cross-Border Tax Controversies*

*Keynote Opening by Grant D. Aldonas**

Grant D. Aldonas kicked off TCPI's Symposium by examining the challenges facing American businesses and American workers competing in a knowledge-driven, globalized world economy.

Introduction

My job in the next few minutes is to explain how our economic policies in general, and our tax policies in particular, have fundamentally failed to come to grips with the challenges that American firms and American workers face competing in a knowledge-driven, globalized world economy.

That story starts with the forces driving globalization and the challenge that competing in a global economy presents to American businesses and American workers. It explains what that challenge means for the conduct of U.S. economic policy and why our current policies fall far short of meeting that challenge.

What the story ultimately illustrates is the substantial gap between the reality of a global economy, on the one hand, and our domestic politics and economic policies, on the other.

What's Driving the Accelerating Integration of Global Markets?

Four forces have been driving the integration of world markets:

- the end of the Cold War;
- the revolution in computing, communications and shipping;

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- the dramatic expansion of global private capital flows; and
- the successful effort to reduce trade and investment barriers globally.

The Cold War's end erased political barriers that divided the world economically, as well as politically, for the better part of the 20th century. It also marked the end of any seemingly viable alternative to a market-based economic model, which led to what are now emerging giants like China, India and Brazil joining the world economy and adding over two billion workers to the global labor pool. The net effect, was not only a sharp deflationary impact (something that attends the end of any period of international conflict), but, more powerfully, the creation of a broader plane over which the rest of the forces driving globalization played out.

While the political debate over globalization tends to focus narrowly on trade policy, a far more powerful driver has been the revolution in computing, communications and transportation. The best measure of the effect of the revolution in computing, and microelectronics generally, is the off-the-cuff estimate made 20 years ago by Gordon Moore of Intel. Moore suggested that the number of circuits on a single microchip would double every 18 months.

Developments over the past 20 years have vindicated Moore's estimate. In fact, the trend is actually accelerating. The Blackberry or cellular telephone in your pocket has greater computing power than

the room-sized ENIAC computer that launched the revolution in computing 50 years ago.

We have witnessed a similar revolution in communications. The integration of satellite communications and cellular networks, combined with the shift from copper wire to optical fiber, has produced a geometric expansion of carrying capability and a parallel decline in cost. The revolution in communications has connected buyers and sellers globally, making both global markets and global sourcing a reality.

The third technological revolution involves transportation and logistics. The rapid growth of containerization dramatically increased the efficiency and reduced the cost of shipping worldwide. The same holds true of the innovations created by FedEx and UPS in terms of air transport. When combined with the revolutions in computing and communications, the revolution in shipping and air transport has produced new ways of managing global operations that have reduced costs and improved efficiency.

The best evidence of the effect that the transportation and logistics revolution has had lies in its impact on costs. In the 1960s, transportation costs represented 12 percent of the value of American exports and 10 percent of the value of our imports. Today, the cost of shipping is barely a footnote in a company's cost analysis.

The third force driving the accelerating integration of world markets involves the dramatic rise in global private capital flows. A deeper and more liquid world capital market has abetted the rise in trade as well as the rise in foreign direct investment, both inbound and outbound.

In 2006 alone, for example, foreigners engaged in \$41.1 trillion worth of purchases or sales of U.S. long-term securities. That two-way flow, which is only a small share of the global capital market, is more than three times the size of the U.S. economy, which, at roughly \$14 trillion in GDP annually, is by far the largest economy in the world.

Finally, the success of efforts to liberalize barriers to trade through the General Agreement on Tariffs and Trade (GATT) and its successor, the World Trade Organization (WTO), has contributed to globalization as well. Successive rounds of multilateral trade negotiations have dropped average world tariffs on industrial goods from 40 percent to four percent over the past 60 years. U.S. average tariffs fell from a high of 60 percent under the Smoot-Hawley Tariff Act to less than two percent today.

The fall in global trade barriers resulted in a dramatic expansion in world trade since the creation of the GATT in 1948. Global trade has grown by a factor of 17, far outpacing the six-fold increase in world production since the GATT's inception.

To date, the political debate over globalization has largely been confined to a narrow argument over trade policy. Even a brief summary of the forces driving globalization illustrates why that narrow debate completely misses the broader forces at work in the world economy.

The most important lesson we can draw in the face of the changing global economy is a simple one. We cannot go back, even if anyone thought that was a particularly good idea. We must recognize that our traditional approaches to economic policy, whether in tax, trade, monetary and fiscal policy or other areas, are simply no longer apposite to the challenges we face competing in a global economy. The changes in the world around us will shape our economic future and our economic policy must respond to that reality.

What Globalization Means for American Firms and Workers

The forces driving globalization have fundamentally reshaped the structure of global markets and the basis of economic competition that confronts every company represented here, no matter how large or small.

Today, less and less trade, domestic or international, involves an arm's-length transaction between independent buyers and sellers. Instead, much of world trade is driven by and takes place within the companies operating on a global basis or within their network of suppliers and distributors in a construct commonly referred to as a global supply or value chain.

There are two important facts that flow from this new global market structure. First, the elimination of political and economic barriers to trade, combined with the revolution in computing, communications and transportation, now makes it possible to organize production on a global basis without reference to underlying resource endowments. And, once it became possible to organize a global supply chain, it quickly became a competitive necessity. These global networks have become the new basis for competition among firms.

Changing the basis of global competition, and the market structure in which it takes place, has had a profound effect on the shape of firms and how they manage. We have witnessed the rise of "global," rather than "multinational," firms. Indeed, the boundaries of what we consider "firms" have themselves begun to soften.

For example, while multinational firms generally operate in separate national markets and create separate supply chains to serve those individual markets, global firms are led by a single, unified management structure operating a single global supply chain. Such

global firms source component goods and services on a global basis for production facilities that serve global, rather than individual national, markets.

Even smaller American firms and start-ups now organize themselves with these broader market dynamics in mind. They have adapted to filling a role within the supply chain of a particular global company, with all that implies in terms of their own ability to share research and development costs, help manage production and become an integral link in the flow of communication up and down the supply chain.

These changes in market structure and in the organization of firms have altered the way firms compete. What was once largely a competition for markets has become a global competition for capital, talent and ideas. The reason is that, in a knowledge-driven, globalized world economy, capital, talent and ideas represent the key factors that differentiate successful firms. That is due to the enormous scale effects they create for firms that can successfully mobilize these factors of production.

The forces driving globalization, particularly changes in technology, have had an equally profound effect on the nature of work and the employment experience for American workers. Whereas workers previously remained with a single employer in the same basic field for the bulk of their career, today they are far more likely to change both their jobs and their careers many times during their working life.

The experience of unemployment has changed significantly as well. When unemployment insurance was first introduced in the 1930s, workers found themselves out of work for a stretch, often seasonally, but were generally rehired by the same employer. Today, by contrast, workers often find themselves looking for a job with a new employer and, frequently, a new career.

While trade policy, foreign investment and outsourcing often bear the blame for these changes in the American work experience, the reality confronting American workers is quite different and, in fact, more daunting than that simplistic argument allows. The reason is intuitively obvious for anyone who has seen the changes in an automobile plant, a steel mill, a bank, a farm or any other business. Any task that can be reduced to an algorithm will be done by a machine and done with greater precision than its human counterpart.

Claudia Goldin and Lawrence Katz of Harvard made precisely that point in their recent book, *THE RACE BETWEEN EDUCATION AND TECHNOLOGY*. There, the authors point out that we experienced changes in technology at the start of the 20th century that were just as profound as those we experience today. The difference now is that

technological change is “skill biased” in ways that favor those with more education and experience.

You can see the effect of introducing greater productivity enhancing technology in the decline in manufacturing employment. Although one would never know this listening to Lou Dobbs, we produce more industrial goods than we ever did before and our manufacturing sector alone is larger than the entire Indian economy and two-thirds the size of China’s.

Total employment in U.S. manufacturing has, however, fallen sharply since the onset of the 2000 recession, from 17.3 million in mid-2000 to just 14.1 million today. Today, manufacturing employment makes up only 10 to 11 percent of the total U.S. workforce. That reflects the shift toward technologies that raise productivity, rather than some profound liberalization of our trade barriers or the efforts of individual American companies to shift employment or income abroad.

Having said that, from a worker’s perspective, this new environment presents significant challenges. In placing a higher premium on both cognitive and noncognitive skills and rewarding workers who acquire the skills that are relevant in a knowledge-driven, globalized economy, this new environment offers less to semi-skilled workers. That shift has created downward pressure on wages facing roughly 97 percent of Americans in recent years and resulted in an income distribution that has become increasingly skewed toward the top end.

Raising tariffs or changing our tax laws to try to deter American firms from going abroad would do nothing to alter that picture. In fact, such changes would make the situation far worse. What is needed is a far greater investment in human capital than has been the case in the past and a set of complementary economic policies that recognize that a highly educated and highly productive work force is essential to our long-term competitiveness.

Implications for U.S. Economic Policy

There is, of course, an extraordinarily practical reason for encouraging American firms to pursue international markets, whether through trade or investment. That is where the growth is. In 2005, for the first time, the developing world surpassed the industrialized economies in terms of their share of global GDP. More importantly, they accounted for considerably more than 50 percent of the growth in global GDP.

What is really telling, though, is the fact that China and India represent only one quarter of that growth.

In other words, the story of emerging markets—and growth potential for American firms—lies increasingly outside our borders and outside our traditional export markets. American firms need to be engaged in these markets if they are going to grow and produce jobs and a rising standard of living here at home.

Our economic policy, including our tax policy, should be designed to reinforce their ability to do so, rather than questioning their patriotism, as currently seems to be the case. More profoundly, however, the question we need to answer is the following: Given the nature of changes under way in the global economy and in our own, what policies should we adopt to ensure growth, rising productivity, a rising standard of living and broadly shared prosperity?

The starting point is the recognition that globalization has also proven to be enormously beneficial, particularly for those at lower income brackets. In the aggregate, our engagement in the global economy boosts GDP by \$1.4 trillion annually. That amounts to an additional \$10,000 every year for a family of four at a median income, or 20 percent of their earnings. Further liberalization would yield an additional \$500 billion in GDP annually, which would offer a raise of \$3,500 to \$4,000 per year for that same family of four.

Any effort to deter U.S. companies from engaging in the global economy, whether through the tax code or by raising trade barriers, puts those benefits at risk. Our economic policy, including our tax policy, ought to be geared toward preserving and expanding those gains for American firms and American workers, rather than undercutting them.

Adopting policies that encourage our competitiveness requires a fundamental shift in our perspective towards economic policy—one that understands that openness to the global economy is the key to our future prosperity. Our economic policies should be geared to continuing to attract investment by globally engaged firms, whether domestic or foreign-based, for precisely that reason.

Some might ask why, given the other economic challenges we are confronting, we should care about investment by globally engaged firms? It is true that companies in the United States that are part of a multinational firm account for barely one in four private sector jobs. On the other hand, these firms account for over 30 percent of our GDP, one-third of our capital investment, one-half of all trade in goods and almost 80 percent of our investments in research and development.

The reason they add that kind of value is precisely because they are the best in their industries in mobilizing the key factors that define success in the global

economy—capital, talent and ideas. They mobilize the sorts of investments that drive productivity, which is essential to raising our standard of living. Those investments also create jobs—not only by virtue of their own operations, but also due to the supply chain they organize around their own economic activities.

What that suggests is the need to think about what sorts of economic policies would reinforce the attraction of the U.S. market to investment by such firms. In that regard, we hold one enormous ace in the hole. The quality of our institutions (*i.e.*, property rights; freedom of contract; legal framework that fosters investment; protection of intellectual property, *etc.*) is extraordinarily high. The same can be said about the relative flexibility of the U.S. economy (*i.e.*, the ability to shift capital investment from one use to a more productive application at a very low cost relative to other countries) and the adaptability of our workforce.

But we also have considerable deficits, all of which start with choices we make here at home. In a world where talent matters and the rewards to both cognitive and noncognitive skills are rising, we have a declining high school graduation rate and a declining rate of college attendance. In a world where ideas matter, we are investing less in terms of research and development, particularly in basic science, than we have in the past. And, most relevant to our ability to compete for investment by globally engaged firms, we have the second highest corporate tax rates among the industrialized economies and we impose a variety of rules that penalize companies for taking the steps they must to remain competitive.

Tax policy, of course, is more than a question of rates; the structure of the tax code matters as well. Consider the relationship among firms participating in a global supply chain. The company that creates and manages the supply chain demands that every participating company share in the risk associated with developing new products. That implies a broad sharing of the research and development function and its cost. It often involves daily interactions up and down the supply chain among those executives and workers engaged in the R&D effort.

The IRS's rules regarding the allocation of R&D expenses, which think of such spending as "located" in one nation or another rather than being located within a global value chain, simply do not capture the complex reality of that interaction. Indeed, from the perspective of attracting investment in high-end research and development in the United States, they penalize it. That cannot be the result we want in a knowledge-driven, globalized world economy that pays a premium for talent and ideas.

The current economic downturn makes it all the more difficult to realign the economic incentives in our economy in ways that would make us more competitive globally. At moments like these economically and politically, we risk acting reflexively, rather than reflecting on the underlying challenges we face and addressing our economic policies to those challenges.

Will we be wise enough, even amidst the current downturn, to make the policy choices that will secure our long-term future? That depends on our politics, which is what we turn to next.

Measuring the Gap Between Our Politics and Economic Reality

Given the challenges we face in remaining competitive in a rapidly changing global economy, we often seem to pursue policies that are fundamentally at odds with our ability to succeed in the global economy. The question is, why?

There are two separate answers to that question—one political; the other practical. The political answer is that the downward pressure on wages and increasing job insecurity has led to a significant populist shift in our politics. Repeated polls have shown a serious erosion of public support for trade liberalization and other policies reflecting an openness to the global economy.

That shift affects both parties, but it manifests itself differently. For Democrats, the issue is trade; for Republicans the issue is immigration. But both issues reflect an instinct to build walls around our prosperity. That, of course, is destined to fail. But that fact does not deter politicians from exploiting those sentiments for electoral advantage.

Those sentiments have, in fact, already shaped our politics in significant ways. In the midst of the recent presidential campaign, for example, it became necessary for Democratic candidates to promise to abandon the North American Free Trade Agreement, even though it was signed over 15 years ago and any effect it had on the shape of our economy or on shifts in employment have long since filtered through. Equally, for Republicans, the primaries became a contest to see who could sound tougher on illegal immigration, completely leaving aside the fact that reasonable immigration reforms might reduce the incentives to illegal immigration far more than building a fence along our southern border, as well as create incentives for talented, well-educated individuals to come to the United States and add to our productivity.

Even more telling, it became fashionable to question whether the law of comparative advantage continued to apply in the face of globalization despite all the evidence to the contrary sitting in New York harbor and the Port of Los Angeles/Long Beach. This is the sort of ill-informed view, which, if left unrebuted, will shape our politics and our economic policies in profoundly negative ways going forward. The “Buy American” provisions of the recently passed stimulus bill represent only the first such example. They will not, unfortunately, be the last.

These sorts of misconceptions (and the mistaken policies they yield) and the fact that Congress, the Obama administration, the media and, indeed, the American public are operating from a frame of reference that is roughly 40 years out of date. They think that the United States market represents a larger share of the world economy than it actually does and that access to our market offers us greater leverage than we actually wield.

That is not surprising in one sense since very few members of Congress or the Obama administration have any hands-on experience in the sorts of enterprises, large and small, that drive economic growth in the United States. They simply do not have an accurate picture of the challenges that firms face in global markets, much less what shapes their investment decisions.

I want to be clear, however, that this is not entirely their fault. Business leaders, particularly those engaged in global business, have had the luxury in some respects of focusing on business since the onset of deregulation in the late 1970s under Jimmy Carter. The Reagan revolution and much of the economic policy since that time produced 30 years of unprecedented economic growth. But, in the process, those of us in the private sector lost the ability to speak in an idiom that people in government can understand. We have lost the ability to see the economic equation from their perspective and the perspective of their constituents.

At its best, politics involves a delicate balance. On a daily basis, in 100 different ways, members of Congress must practice the art of mediating between the aspirations of their constituents and the reality of the economic challenges we face.

Their challenge should inform our efforts to explain the competitive reality with which the global economy confronts American firms and American workers. To get that point across will require us to develop a new lexicon—one that speaks to the interests of both America’s firms and America’s workers and to the challenge that the administration and members of Congress face in choosing the right course.

In closing, I want to underscore the importance of starting a long-overdue conversation about how, as a nation, we respond to the challenges of competing in a global economy. We will not make progress in addressing those challenges without an open and serious discussion about what is driving the integration of world markets and what that means for American firms and for American workers.

What we are engaged in is, in fact, the renegotiation of a social contract that has served us well as a nation for many years. To succeed in that effort will require good

will on all sides and an honest dialog among business, the administration and Congress. It is essential to our future economic success as a nation, and I am glad, by your attendance here, that you have indicated a willingness to be a part of it.

Thank you.

ENDNOTES

- * This speech took place at the 10th Annual Tax Policy and Practice Symposium, *Certainty in an Uncertain World? Resolving Cross-Border Tax Controversies*, held on February 25–26, 2009. Mr. Aldonas' comments were edited, annotated and augmented prior to publication.

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