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''Basket cases'': Tax incentives and international joint venture participation by American multinational firms

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Abstract

This paper examines the impact of the U.S. Tax Reform Act of 1986 (TRA) on international joint ventures by American firms. The TRA mandates the use of separate ''baskets'' in calculating foreign tax credits on dividends received from each foreign corporation owned 50% or less by Americans – which greatly reduces the attractiveness of joint ventures, especially those in low-tax foreign countries. Since the effect of the TRA on joint ventures varies with foreign tax rates, the country-level pattern of subsequent joint venture activity illustrates the sensitivity of organizational form to tax considerations. The evidence indicates that American participation in international joint ventures fell sharply after 1986, particularly in low-tax countries. Moreover, joint ventures in low-tax countries use more debt and pay greater royalties to their American parents after 1986, reflecting their incentives to economize on dividend payments.

Keywords: Joint ventures; Foreign tax credit; Foreign direct investment; Organizational form

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1. Introduction

There is increasing evidence of the importance of organizational form to business operations and of the influence of government policies on the forms that

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businesses take. Tax systems often give firms incentives to adopt certain organizational forms at the expense of others. For example, the U.S. corporate income tax must be paid by corporations but not by unincorporated businesses. This, together with other U.S. tax provisions, appears to influence the organization of domestic business,[1] though its effect on international business is still poorly understood.

The purpose of this paper is to examine the effect of the U.S. Tax Reform Act of 1986 (TRA), which introduced new tax costs for American firms with international joint ventures. Since the 1986 law raises the cost of U.S. participation in joint ventures in some countries more than it does in others, the country-level pattern of responses after 1986 reflects the degree to which firms substitute one organizational form for another. Passage of the TRA coincides with a dramatic shift in the level and pattern of U.S. participation in international joint ventures, suggesting that the tax change significantly reduced American joint venture activity. The character of joint venture activity changes at the same time and in a way that is consistent with the incentives created by the legislation.

A growing body of literature documents the effect of tax policies on the location and behavior of multinational firms.[2] The experience of American joint ventures in the years after 1986 offers additional evidence that tax policies influence not only the magnitude but also the nature of international business activities.

Until the 1980s, there were increasing numbers of joint ventures between American multinational firms and foreign firms. Such arrangements offer American firms the prospect of obtaining footholds in rapidly growing markets while avoiding some of the market risks associated with wholly-owned ventures. International joint ventures are particularly popular in high-technology industries in which different firms may have proprietary assets – such as patents, trademarks, and know-how – that are complementary in production. International joint venture activity is limited by the moral hazard costs associated with split ownership, but in spite of this limitation, some observers forecast its continued expansion.[3]

The TRA contains a number of important new tax provisions, including a change to the taxation of dividends received from international joint ventures owned between 10% and 50% by Americans. This reform increases the tax cost of

[1]See the evidence presented in Gordon and MacKie-Mason (1994), Gentry (1994) and MacKie-Mason and Gordon (1997).

[2]See, for example, Slemrod (1990), Grubert and Mutti (1991), Hines and Rice (1994) and Hines (1996). This literature is reviewed by Hines (1997).

[3]See, for example, Hladik (1985), who documents the growth of international joint ventures between 1951 and 1984, Anderson (1990) and Geringer and Hebert (1991). Bleeke and Ernst (1993, p. 269) offer that, ''Organizations of the future have to seek partners who can share costs and swap skills and access to markets. In the fluid global marketplace, it is no longer possible or desirable for a single organization to be entirely self-sufficient. Collaboration is the value of the future. Alliances are the structure of the future.''