EXECUTIVE SUMMARY

The Surprising Resilience of Globalization: An Examination of Claims of Economic Fragmentation

by Brad Setser

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Introduction

The current bipartisan doubts in the US about the value of liberal trade are shared by many populist European parties, which also question the value of deeper international economic integration. Yet for all the skeptical rhetoric—and very real steps from the US government and other advanced economies—global economic integration remains surprisingly resilient.

In this paper, Brad Setser argues that the immediate risk facing the global economy is more accurately described as unhealthy integration than as fragmentation. He specifically discusses the role of tax avoidance strategies in driving global money flows, which leads to lower US tax revenues. He also highlights that China's increasingly troubled domestic economy and its large-scale industrial policies risk leaving the US and its allies more, not less, reliant on Chinese supply in key sectors.

Setser identifies three core areas where reform could foster healthier integration: reforming pro-offshoring elements in the US corporate tax code; introducing subsidy-sharing agreements among allies to harmonize industrial policies in clean energy sectors; and renewing focus on external spillovers from China's unbalanced domestic economy.

The Resilience of Globalization

The political shift against globalization in the US and the rest of the world, along with the rise of trade restriction measures, has not led to a reduction in global trade. For example, Former President Trump's Section 301 tariffs on China, which were extended and, in clean energy sectors, expanded by the Biden administration, did not result in a drop in world trade. Rather, firms moved production to Southeast Asia. Globalization has proven to be resilient in the face of protectionist trade measures.

Furthermore, Setser observes that higher levels of globalization do not necessarily reflect more efficient markets and/or the elimination of arbitrary restrictions on cross-border flows. Setser identifies two unhealthy forms of globalization that have proven to be resilient: those driven by corporate tax avoidance strategies and persistent trade and payment imbalances with China. He also points out that some reductions in global financial flows reflect positive developments. For example, the 2017-2018 fall in Foreign Direct Investment (FDI) has sometimes been attributed to Donald Trump's populist economic policies but was in fact tied to the end of FDI linked to corporate tax avoidance.

Tax Avoidance and the Persistence of Globalization

Tax avoidance tactics, such as the "Double Irish" strategy, have allowed major companies to route profits through offshore subsidiaries to minimize tax liabilities. The OECD's 2015 base erosion and profit shifting (BEPS) reforms, aimed to curtail such practices by eliminating stateless income and zero-tax jurisdictions. The 2017 Tax Cuts and Jobs Act (TCJA) subsequently further addressed the issue of international tax avoidance by reducing the corporate tax rate from 35 percent to 21 percent, ending deferral, and introducing two new special tax rates: 13.125% for Foreign-Derived Intangible Income (FDII) and 10.5 percent for Global Intangible Low-Tax Income (GILTI).

Despite these reforms, the pharmaceutical industry in particular continues to offshore production and profits at a high rate. US imports of pharmaceuticals have more than doubled since the TCJA, with imports primarily originating from tax havens such as Ireland, Singapore, and Switzerland, as opposed to low-cost producers such as India or China. In 2023, seven of America's largest pharmaceutical companies reported losing a combined $14 billion on their US operations while earning $60 billion abroad. The absence of reported profits in the US translates directly into a loss of federal tax revenues.

The pharmaceutical sector is not the only crucial sector in which firms are moving operations globally in response to the US tax code. Applied Materials and Lam Research are US companies that make machines used in semiconductor manufacturing. Both companies have shifted manufacturing to Southeast Asia, taking advantage of low tax rates and moving intellectual property to lightly taxed offshore subsidiaries.

China's Domestic Challenges and Global Integration

The post-financial crisis decline in global trade relative to global output is almost entirely explained by China, as the country reduced its reliance on exports for growth. Recently, however, there has been a clear inflection point in the data. China's economy is now re-globalizing, and exports have recently grown much faster than China's own economy. As a share of China's GDP, exports are now up by about 3 percentage points.

But this form of globalization is also unhealthy, as it is the result of faltering domestic demand in China, which has led the country to rely again on exports and global demand to support its economic growth. China's export-led growth model is driven by extensive government support to favored sectors, mostly through the provision of cheap equity and cheap debt financing. These informal subsidies have tilted the playing field to

China's advantage in several specific cases, including in the production of EVs, semiconductors, and aircrafts. In addition, Chinese households save too much, and the country thus relies heavily on exports to offset its own limited internal demand. Its national savings rate is close to 45 percent of GDP, an outlier even among Asian countries that historically have high savings rates. This high level of savings creates internal imbalances in the United States and the eurozone, fueling bubbles and bad debts.

The high savings rate also contributes to fragility in the Chinese economy. The Chinese property sector has long absorbed the excess savings, but property construction is expected to normalize at about half its level during the boom. Weak domestic property investment, coupled with low levels of household consumption, creates pressure on China to return to an export-driven growth model.

Policy Considerations

Setser offers three concrete steps which would start to define a path toward a healthier form of globalization.

1. US Corporate Tax Reform

The US tax code should be reformed to reduce profit shifting and realign incentives for US multinational corporations. First, Setser calls for reforms to limit offshoring, including increasing the GILTI rate from 10.5 percent to a minimum of 15 percent. Second, when US firms shift intellectual property supported by the R&D tax deductions to their offshore subsidiaries, they should be limited in their ability to deduct R&D expenses from their taxes. Finally, he advocates for the US to make the sale of a firm's intellectual property from one international subsidiary to another a taxable event, making it harder for companies to shift intellectual property internationally to limit global tax liabilities.

In 2022, US firms reported around $370 billion in annual profits in the major centers of corporate tax avoidance, so the potential revenue gains are substantial. Improving the taxation of such easily identifiable profit streams could generate, at the low end, $30 billion annually in new tax revenue.

2. Subsidies Sharing Among Allies

The US and the EU have introduced subsidies for EV purchases, but such policies lack coordination. The US subsidies contain "Buy North American" requirements that largely

exclude purchasing European EVs, while Europe's subsidies include those imported from China. If the EU introduces a "buy European" provision into its subsidies, the US and EU could enter a subsidy-sharing agreement, where European-made EVs would get full access to US EV subsidies and American-made EVs would get full access to EU subsidies. This approach would expand market size and reduce costs.

Setser further advocates for increased US-EU coordination on steel production and imports to address the challenges posed to the global market by China's enormous steel production capacity.

3. Addressing China's Internal Imbalances

US policymakers should find effective ways to pressure China to change its current export-led growth model. He suggests that the IMF should be pressured to take global trade imbalances more seriously. They should also more forcefully encourage China to clean up the property sector and provide more substantial support for household demand. The US and other trading partners can help accelerate the needed internal shift by making it clear to China's leaders that they will resist new forms of unbalanced integration

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Brad W. Setser is the Whitney Shepardson senior fellow at the Council on Foreign Relations (CFR). His expertise includes global trade and capital flows, financial vulnerability analysis, and sovereign debt restructuring. He regularly blogs at "Follow the Money". Setser served as a senior advisor to the United States Trade Representative from 2021 to 2022, where he worked on the resolution of a number of trade disputes. He had previously served as the deputy assistant secretary for international economic analysis in the U.S. Treasury from 2011 to 2015, where he worked on Europe's financial crisis, currency policy, financial sanctions, commodity shocks, and Puerto Rico's debt crisis, and as a director for international economics on the staff of the National Economic Council and the National Security Council. He is the author of "Sovereign Wealth and Sovereign Power" (CFR, 2008) and the coauthor, with Nouriel Roubini, of "Bailouts and Bail-ins: Responding to Financial Crises in Emerging Economies" (Peterson Institute, 2004). His work has been published in "Foreign Affairs, Finance and Development",

"Global Governance" and "Georgetown Journal of International Law", among others. Setser was a senior fellow at CFR from 2016 to 2020, a fellow from 2007 to 2009, and an international affairs fellow in 2003. He also has been a visiting scholar at the International Monetary Fund. He holds a BA from Harvard University, a master's from Sciences-Po Paris, and an MA and PhD in international relations from Oxford University.

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