IPI

Institute For Policy Innovation

IPI CENTER FOR TAX ANALYSIS

The International Components of Tax Reform:

Tax Policy that Serves the National Interest

By: Ernest S. Christian

POLICY REPORT 166

FEBRUARY 2002

The Road Map to Tax Reform™ Series

Executive Summary

Our current tax system puts U.S. companies at a disadvantage in their efforts to compete internationally. Remedies thus far have been a hodgepodge of international tax rules that often operate at cross-purposes, create perverse incentives, and incur the ire of international trade organizations. A reformed tax code including territorial taxation would better serve the vital interests of the United States.

Through a combination of historical accidents, serious policy mistakes, internal political constraints, and some fairly smart maneuvering by other nations, the U.S. administers an international tax policy that runs contrary to both logic and national self-interest. And because this policy is clearly out of step with the tax practices of most nations, the U.S. must change its basic rules so it can join the rest of the world in subsidizing exports in a treaty-legal way.

Unfortunately the U.S. still operates from a hodgepodge of international tax rules and exceptions that often operate at cross-purposes, favor large companies over smaller ones, subsidize foreign-made products over their American-made counterparts, and generally handicap U.S. companies in their pursuit of global markets.

What the U.S. needs is a system that provides an even-handed choice to both U.S.- and foreign-owned companies that sell to the U.S. market. Under this system, the total tax cost associated with selling goods in the U.S. would be the same regardless of whether a company manufactures the goods in the U.S. or overseas. With the U.S. tax the same either way, neither foreign-owned nor American companies would gain a distinct U.S. tax advantage.

Given the choice of staying home and still being able to make tax-free exports to foreign markets, most U.S. companies would probably manufacture in the U.S. And given the same choice, most foreign-owned companies would also see the wisdom of locating a plant in the U.S. and using it as a base for tax-free export sales to markets worldwide.

Such tax adjustments are not new. In fact, countries with value-added tax (VAT) systems already employ this system. Replacing America's archaic system (which taxes the income of U.S. companies from their activities outside as well as inside the country) with a model that taxes only the income from activities within the U.S. is fully consistent with international standards.

One such system under consideration is H.R. 134, a comprehensive proposal that recognizes the benefit to the U.S. economy when U.S. companies are allowed to compete and win in the global marketplace. H.R. 134 so levels the playing field for all companies engaged in the U.S. market, that for the first time in history American companies would be on equal tax footing with their competitors. And anytime U.S.-owned companies gain wealth by means of exploiting a foreign market, the nation is better off.

International tax reform can also translate into a massive tax cut for U.S. labor and capital. Currently labor and capital bear the entire burden of the U.S. income tax, and labor alone carries the weight of payroll taxes. If part of that burden could be shifted to overseas labor and capital, the U.S. would gain an additional tax base and the tax burden on Americans could be lessened by as much as $100 billion. While there are many reasons for tax reform, the most powerful may be the tax cut that is inherent in tax reform.

Direct all inquiries to:

Institute for Policy Innovation
250 South Stemmons, Suite 215
Lewisville, TX 75067

(972) 874-5139 [voice] Email: **ipi@ipi.org**
(972) 874-5144 [fax] Website: **www.ipi.org**

The Road Map to Tax Reform™

Table of Contents

The International Components of Tax Reform:
Tax Policy that Serves the National Interest

By: Ernest S. Christian

Introduction to the International Side of Tax Reform

From an international perspective, tax reform should consist of two interdependent components. The first is a *territorial rule* that excludes from tax the income that U.S. companies derive from activities conducted outside the U.S. Under a territorial rule, a U.S. company could conduct business operations in a foreign market, pay only the tax of the host country and, therefore, be on an equal tax footing with the local companies with which it must compete. The second international component is *a set of complementary border tax adjustments.* One border adjustment imposes tax when companies located *outside* the U.S. export into the U.S. market. The other border adjustment excuses tax when companies located *inside* the United States export to foreign markets.

If U.S.-owned companies that do business abroad reinvest the profits abroad, they can defer U.S. Tax.

The reformed tax system should provide an evenhanded choice to U.S.-owned and foreign-owned companies that wish to sell manufactured products in the U.S. market. They could choose to manufacture the goods in the U.S. (in which case they would pay U.S. income tax on both their manufacturing activities and their sales activities in the United States). In the alternative, they could choose to manufacture the goods abroad but sell them in the U.S. (in which case, in addition to the U.S. income tax on the sales activities in the United States, the U.S. would collect an import tax, the economic burden of which would fall back on the capital and foreign labor used to manufacture the goods abroad). Therefore, insofar as U.S. tax law is concerned, the total tax cost associated with selling the goods in the U.S. market would be essentially the same, without regard to whether the company chose to manufacture the goods in the U.S. or to manufacture them abroad. Because the U.S. tax would be the same either way under tax reform, many foreign-owned companies would decide to manufacture in the U.S. the products they sell in the U.S. Similarly, because U.S.-owned companies could gain no U.S. tax advantage by moving their plants abroad (perhaps to some so-called "tax haven") and selling their products back into the U.S. market, they, too, would tend to manufacture in the U.S. the products they sell in the U.S.[1]

When the desire is to sell manufactured products in a foreign market (instead of the U.S. market), tax reform also provides both U.S.-owned and foreign-owned companies an evenhanded choice. The company could choose to locate its plant in the United States and export to the foreign market—in which case tax reform's border tax adjustment on outbound transactions would exclude the company's export income from U.S. tax. Or, in the alternative, if the foreign market could not be fully and effectively served solely by exports from the U.S., the company could choose to locate a plant in the foreign country where the market is. In that case, under tax reform's territoriality rule, the company would be excused from U.S. tax on its foreign-source income. Therefore, without regard to whether the company chose to manufacture in the U.S. or abroad, the company's income from selling products to customers located outside the United States would be free of U.S. tax. Given the choice of staying home (with all the non-tax benefits that entails) and still being able to make tax-free exports to foreign markets, most U.S. companies would tend to manufacture in the U.S. In addition, given the choice—which tax reform definitely provides—many foreign-owned companies would see the wisdom of locating a plant in the U.S. and using it as a base for making tax-free export sales to markets all around the world.[2]

If they bring the money home for reinvestment in the U.S. economy, they will have to pay a full and immediate U.S. tax.

Tax adjustments for cross-border transactions are not some radical departure from the international norm. All countries that maintain value-added tax systems already exempt their own exports from tax and impose import taxes when other countries (including the U.S.) export to them. The only thing extraordinary about the United States making border tax adjustments is that it would do so in a way that is consistent with its own tradition of taxing income, without resorting to any of the sales-tax-type arrangements that are the hallmark of the VATs.

Replacing the United States' current worldwide taxation system (which taxes the income of U.S. companies from their activities outside as well as inside the U.S.) with a territorial system which taxes only their income from activities inside the U.S., is fully consistent with international standards. Many other countries already have territorial-type systems that exempt all or part of the income that their companies derive from business activities conducted outside the country.

Not only does the current tax code favor large companies over small companies, it favors foreign-made products over American-made.

The United States has for years been struggling to extricate itself from the clutches of its archaic worldwide taxation system—and to alleviate the tax bias against U.S. exports that is one of the defining characteristics of the current code. But because of the continuing political influence of those who view foreign trade with suspicion, the effort has been schizophrenic and largely ineffectual. Instead of forthrightly changing the basic rules that are the source of the problem, the U.S. has resorted to a series of complex and ill-conceived exceptions variously known as "deferral," "DISC" and "FSC."

The result of these struggles with worldwide taxation has been an extraordinary hodgepodge of international tax rules and exceptions that often operate at cross-purposes.[3] For example, U.S.-owned companies that do business abroad can "defer" U.S. tax on their foreign-source profits only if they reinvest the profits abroad. If they bring the money home for reinvestment in the U.S. economy, they will have to pay a full and immediate U.S. tax. In order to enjoy the benefits of deferral, companies must also forgo opportunities to minimize the amount of taxes they pay to foreign governments which, in most cases, means that the company will pay more foreign tax than is necessary. Although the price is often high, the value of "deferral" is usually worth it to the large companies whose cash flow capacities permit them to keep all foreign-source profits abroad. But to the many smaller companies that need the cash and that must repatriate earnings, deferral is not an option. They must immediately pay U.S. tax on their worldwide income.

Even among large companies, the current code causes incongruous results. For example, as already noted, a large company with the financial capacity to perpetuate deferral can build a plant abroad and sell its products in foreign markets without paying U.S. tax, but—and here is the incongruity—if that same large company were to build a plant in the U.S. and export American-made goods to those same foreign markets, it would have to pay a full and immediate U.S. tax (or a slightly reduced U.S. tax under the FSC exception). Thus, not only does the current tax code favor large companies over small companies, it favors foreign-made products over American-made products.

Basic Concepts and Quantities: Things to Know about International Tax and Trade

How U.S. Companies Participate in Foreign Markets (and Foreign Companies Do Business in the United States)

U.S. companies compete in global markets in two ways. One way is to produce a product in the United States and sell it to a customer outside the United States. The product that is exported may be a manufactured item such as an automobile, or it may be an intangible such as a patent, or it may be a service such as, e.g., when an architect in Chicago creates the design and specifications for a building to be erected in Berlin. Generally speaking, these are export transactions that produce "U.S.-source" income because the activity that produces the income (e.g., the manufacture of the automobile) occurred within the territory of the United States.

U.S. companies also compete in global markets by conducting business activities abroad. The most typical case is where a U.S. company sells its American-made product to its foreign subsidiary, which then distributes the product in the foreign market. Because the business activities of the typical distribution subsidiary occur outside the territory of the United States, its income is "foreign source". Thus, a typical export transaction may result in some U.S.-source income (the manufacturing profit of the U.S. parent company) and some foreign source income (the distribution profit of the foreign subsidiary).

U.S. companies and their subsidiaries also compete around the world by producing a product in the foreign market where it is to be sold or by some combination of foreign-country production and exports from the U.S. Sometimes, the best way for a U.S. company to compete in a foreign market is to go there and conduct a full range of business activities—all the way from manufacturing the product to distributing it to customers and servicing it after they buy it. Other times, the local production may be an assembly operation using U.S.-made components. Local production may also be only the first step in the process of developing the U.S. company's share of the foreign market. For example, once the company gains acceptance for its locally made products, it may build upon that success by adding to its product line additional items brought in from its factories in the U.S. In other cases, however, local production is the only way to do business in a foreign market.[4]

Quantitative measures help to illustrate the two methods by which U.S. companies sell goods and services to foreign customers and use the proceeds to pay wages and returns on investment to the employees, shareholders and debt holders whose labor and capital produced the goods and services.

As shown in Table 1, the dollar volume of U.S. exports is large and growing:

Table 1 Growth in U.S. Exports, 1980 to 1999 ($Billions)

Category	Year		Growth
	1980	1999	
Exports of goods and services	278.9	990.2	255%
Goods	225.8	699.2	210%
Durable	133.3	504.5	278%
Nondurable	92.5	194.7	110%
Services	53.2	291	447%

Source: U.S. Department of Commerce, Bureau of Economic Analysis, *Survey of Current Business*, Washington DC, August through November 2000, "Selected National Income and Product Accounts (NIPA) Tables," Table 4.1.

Because the capital investment and the jobs are in the United States and the customers are abroad, the benefits of export trade are obvious. New customers abroad permit sales to exceed the domestic demand for consumption and investment goods. As the amount of GDP increases, so do aggregate wages and returns to capital, thereby producing, in international tax parlance, an increase in "U.S. source" income. Manufacturing jobs in the export sector are particularly high paying. Not all service jobs are necessarily high paying (many are not), but those associated with exports are typically high value-added positions that pay premium compensation.

When U.S. businesses go beyond the export trade and start producing and/or distributing goods and services abroad, they make what is called "foreign direct investment" (FDI). If a U.S. company undertakes to build a plant and to manufacture goods abroad, the amount of FDI is likely to be large. On the other hand, if its foreign operations are limited to sales administration and distribution, the amount of FDI is likely to be small.

As shown by Table 2, the amount of U.S. foreign direct investment has been increasing steadily since 1960.

Table 2 Direct Foreign Investment by U.S. ($Millions)

In	Year		
	1960	1980	1999
Canada	451	3,906	14,268
Latin America and Other Western Hemisphere	149	2,833	19,523
Western Europe	962	13,011	70,907
United Kingdom	589	4,797	29,824
Eastern Europe	—	—	1,183
Japan	18	19	10,616
Other countries in Asia and Africa	59	-1,683	17,402
All Countries	**2,940**	**19,222**	**150,901**

Source: U.S. Department of Commerce, Bureau of Economic Analysis, *Survey of Current Business*, Washington DC, October 2000, Table 10, pp. 112–117.

The amount of "foreign-source" income derived by U.S. companies is another way to measure the extent to which U.S. companies are participating in the economies of other countries. Table 3 shows foreign source income for U.S. companies in selected years.

Table 3 U.S. Income Receipts From Abroad ($Millions)

	Year		
	1960	1980	1999
Income receipts	4,616	72,606	276,165
Income receipts on assets abroad	4,616	72,606	273,957
Direct investment receipts	3,621	37,146	118,802
Other private receipts	646	32,898	151,958
US Government receipts	349	2,562	3,197
Compensation of employees	0	0	2,208

Source: U.S. Department of Commerce, Bureau of Economic Analysis, *Survey of Current Business*, Washington DC, October 2000, Table 10, pp. 112–117.

When U.S. companies conduct business operations abroad, one beneficiary is the foreign country where those investment and job-creating activities occur. The other beneficiary is the U.S. economy. The U.S. economy is made wealthier because the customer base of U.S. companies has been expanded and the amount of their foreign-source income has been increased. A U.S.-based headquarters also provides many high-paying service jobs and facilitates U.S.-based R&D. Like all income, the foreign-source income that U.S. companies derive from conducting business operations abroad will have been produced by a combination of labor and capital. Because the foreign-based portion of the work force will in most cases be composed predominantly of foreigners, the U.S. economy will not get all of the return to labor, but the U.S. economy will get the return to capital including the risk premium—which, in the case of some foreign source income, is quite high.

When U.S. companies conduct business operations abroad, the U.S. economy is made wealthier.

In addition, the U.S. economy benefits in a second and often more important way when U.S. companies make direct investments in foreign countries. A landmark statistical analysis by Edward Graham shows a very high statistical correlation between (i) a greater amount of direct investment by U.S. companies in a country and (ii) the export of a greater amount of American-made products to that country.[5]

The Graham study provides strong support for what has long been foretold by logic and borne out by experience: direct investments and operations by U.S. companies in foreign markets lead to increased exports of American-made goods and to more (not less) jobs in the high-paying sectors of the U.S. economy. This symbiotic relationship between exports *to* a foreign country and business operations *in* that country highlights the importance of having a neutral tax system that allows U.S. companies to choose the combination that will maximize sales in foreign markets to the ultimate benefit of U.S. labor and capital.

Foreign companies do business in the U.S. economy by the same combination of exports and direct investment that U.S. companies use to participate in the global market. The impact of taxes on them is, however, quite different. The income that foreign companies derive from distribution and/or manufacturing operations in the U.S. is, generally speaking, wholly or partially exempt from home-country income taxes and is not subject to value-added taxes. In addition, generally speaking, when foreign companies produce goods and services for export to the U.S., their domestic source income from home-country activities is exempt from a major portion of their home country's tax burden and is never taxed in the United States. In contrast, when U.S. companies produce goods and services for export, their domestic source income from activities in the U.S. is fully taxed by the United States and when those products enter the foreign country, the output of U.S. labor and capital is taxed again by the country of destination.

Foreign countries compete in the U.S. market primarily by exports. Their exports to the U.S. exceed U.S. exports to them by such a wide margin that the resulting U.S. trade deficit is the dominant fact of world trade today. Table 4 shows by category and, in total, the amount of dollars Americans spent in 1980 and 1999 on goods and services imported from the rest of the world. Table 5 shows for the period 1990–1999 the amount of dollars spent on imports, the amount of dollars obtained from exports and the net trade deficit (excess of imports over exports).

Table 4 Growth in U.S. Imports, 1980 to 1999 ($Billions)

Category	Year		Growth
	1980	1999	
Imports of goods and services	293.8	1,244.2	323%
Goods	248.6	1,048.6	322%
Durable	111.9	715.4	539%
Nondurable	136.6	333.2	144%
Services	45.3	195.6	332%

Source: U.S. Department of Commerce, Bureau of Economic Analysis, *Survey of Current Business*, Washington DC, August through November 2000, "Selected NIPA Tables," Table 4.1.

Table 5 U.S. Exports and Imports, 1990 to 1999 ($Billions)

Category	Year									
	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999
Exports	557.2	601.6	636.8	658.0	725.1	818.6	874.2	966.4	966.0	990.2
Goods	398.5	426.4	448.7	459.7	509.6	583.8	618.4	688.9	682.0	699.2
Services	158.6	175.2	188.1	198.3	215.5	234.7	255.8	277.5	284.0	291.0
Imports	628.6	622.3	664.6	718.5	812.1	902.8	963.1	1,055.8	1,117.5	1,244.2
Goods	508.0	500.7	544.9	592.8	676.7	757.6	808.3	885.1	930.5	1,048.6
Services	120.6	121.6	119.8	125.7	135.4	145.2	154.8	170.7	187.0	195.6
Net exports	-71.4	-20.7	-27.9	-60.5	-87.1	-84.3	-89.0	-89.3	-151.5	-254.0

Source: U.S. Department of Commerce, Bureau of Economic Analysis, *Survey of Current Business*, Washington DC, August through November 2000, "Selected NIPA Tables," Table 1.1.

Buying More from Foreigners than We Sell Them: Taxes and the U.S. Trade Deficit

Normally, the United States could not perpetually buy more from the rest of the world than the rest of the world buys from it. That is because the people who in the aggregate comprise the U.S. economy cannot as a group—absent some exogenous source of dollars—spend more to buy goods and services than the wages, interest and dividends they are paid for producing goods and services.

In a closed economy (hypothetical) where there is no trade with other nations, the people of the U.S. would themselves buy all the goods and services they produced with the money they were paid for producing those goods and services. For example, hypothesizing from 1999 data ($billions), they would be paid $9,553.2 for producing $9,553.2 of goods and services that they would purchase. In this case, the books balance: income equals expenses.

In a balanced trade situation, also hypothetical and extrapolated from 1999 data ($billions), the people of the U.S. would be paid $9,553.2 for producing $9,553.2 of goods and services. Of the total output, they would purchase $8,563.0 and sell (export) $990.2 to foreigners for which they would receive $990.2 that they would use to buy (import) $990.2 of goods and services from foreigners. In that case, the books would also balance. The American people acquired enough dollars from foreigners to pay for what they bought from foreigners.

The U.S. has been able to sustain an enormous trade deficit only because the countries of the world have purchased U.S. assets and debt.

In the reality of a trade deficit situation using 1999 data ($billions), the people of the U.S. were paid $9,299.2 for producing $9,299.2 of goods and services. They purchased $8,309.0 and sold (exported) $990.2 to foreigners, but they bought (imported) $1,244.2 from foreigners. The books did not balance. The American people had only $9,299.2 to spend (the amount they produced), but they bought $9,553.2—thereby leaving themselves short of dollars. The amount of that shortage, $254.0, is exactly equal to the amount by which imports ($1,244.2) exceeded exports ($990.2).

The United States has been able to sustain an enormous trade deficit only because the countries of the rest of the world have sent back to the United States a portion of the dollars we paid them for their exports. They have done so by purchasing U.S. assets and debt. Consequently, the deficit in the U.S. trade account resulting from a net outflow of dollars for goods and services has been offset by a surplus in the U.S. capital account resulting from a net inflow of dollars for investment. In this respect, the United States is exactly like a family that must either borrow or deplete savings in order to spend more than its current income.

When foreigners invest in the ownership of U.S. assets, the inflow of dollars appears as an adjustment in the capital account, but, in substance, the transaction is an export. Normally, an export is reflected in the trade account. That kind of export occurs when Americans sell the fruits from their tree, but keep the tree. On the other hand, when Americans start selling off land, factories, businesses, etc. in order to finance their trade deficit, they are selling the tree itself and, therefore, the transaction appears in the capital account.

The amount of direct investment in the United States by foreigners is relatively small, although it has begun to increase.[6] Tables 6 and 7 show, respectively, the dollar amounts of direct investment in the U.S., the amount income derived by foreign companies from activities in the U.S., and the amount of U.S. income tax paid by foreign companies on that income.

Table 6 Direct Foreign Investment and Payments in U.S. ($Millions)

	Year		
	1960	1980	1999
Direct foreign investment	315	16,918	275,533
Payments to direct foreign investment	394	8,635	56,098

Source: U.S. Department of Commerce, Bureau of Economic Analysis, *Survey of Current Business*, Washington DC, October 2000, Table 10, pp. 112–117.

Table 7 Foreign-Controlled Domestic Corporations, 1997, Selected Items by Selected Countries

(All figures are estimates based on samples—money amounts are in thousands of dollars)

Selected countries	Number of returns	Net worth	Total receipts	Taxable income	Tax after credits
	(1)	(2)	(3)	(4)	(5)
All countries	61,621	800,950	1,781,382	61,798	19,730
Australia	790	52,425	31,223	809	150
Canada	8,051	125,329	160,116	5,010	1,622
France	1,789	47,370	120,577	4,921	1,534
Germany	4,357	82,641	173,836	4,245	1,380
Japan	6,731	111,366	457,908	11,305	4,055
Netherlands	2,057	130,450	190,621	7,629	2,418
Sweden	494	11,674	41,191	3,387	1,105
Switzerland	1,840	35,801	97,161	3,667	1,224
United Kingdom	5,340	128,880	248,100	12,855	3,858

Source: Internal Revenue Service, "Foreign-Controlled Domestic Corporations, 1997," *Statistics of Income Bulletin*, Summer 2000, pp. 122–179.

Although foreign direct investment in the U.S. is increasing, foreigners have financed the U.S. trade deficit primarily by buying U.S. government debt. The amount of U.S. debt held by foreigners has steadily increased from less than one-quarter in the 1980s to over one-third today, pretty much in proportion to the size of the U.S. trade deficit. In the last three years, foreigners have begun to shift some of their investments into private debt and equity instruments as well.

Table 8 Major Foreign Holders Of Treasury Securities ($Billions)

Country	Holdings at End of Year [1]			As % of Total U.S. Debt		
	1999	1998	1997	1999	1998	1997
Japan	320.0	276.1	277.6	8.6%	7.3%	7.2%
United Kingdom	242.9	264.0	251.3	6.5%	7.0%	6.5%
Germany	96.8	95.1	93.9	2.6%	2.5%	2.4%
OPEC	41.3	38.9	52.4	1.1%	1.0%	1.4%
Mainland China	51.8	46.4	47.9	1.4%	1.2%	1.2%
Hong Kong	46.7	44.2	35.0	1.3%	1.2%	0.9%
Korea	26.1	18.0	5.2	0.7%	0.5%	0.1%
Singapore	30.7	43.1	35.2	0.8%	1.1%	0.9%
Taiwan	29.3	31.3	33.2	0.8%	0.8%	0.9%
Belgium-Luxembourg	28.0	31.5	26.0	0.8%	0.8%	0.7%
France	31.0	30.0	13.3	0.8%	0.8%	0.3%
Spain	22.2	41.2	51.7	0.6%	1.1%	1.3%
Mexico	17.9	21.0	19.2	0.5%	0.6%	0.5%
Canada	18.5	12.4	11.5	0.5%	0.3%	0.3%
Switzerland	26.3	33.7	28.0	0.7%	0.9%	0.7%
Netherlands Antilles	11.8	21.7	35.7	0.3%	0.6%	0.9%
Thailand	10.7	10.5	12.0	0.3%	0.3%	0.3%
All Other [2]	193.0	214.7	201.4	5.2%	5.7%	5.2%
Grand Total,	1,245.0	1,273.8	1,230.5	33.5%	33.6%	32.0%
of which is held by, Foreign Official	623.4	593.5	599.5	16.8%	15.7%	15.6%
Federal Debt Held by the Public	3,715.5	3,787.4	3,846.7	100.0%	100.0%	100.0%

Source: Department of the Treasury/Federal Reserve Board, October 31, 2000

[1] Estimated foreign holdings of U.S. Treasury marketable and nonmarketable bills, bonds and notes are based on Treasury Foreign Portfolio Investment Survey (FPIS) benchmark as of end-year 1994 and on monthly data reported under the Treasury International Capital (TIC) reporting system.

[2] Also includes repos outstanding at FRBNY with foreign official and international accounts.

When foreigners make these loans to the U.S., they are accomplishing two things. First, they are making credit sales to their customers. (Just as the U.S. could not buy more from foreigners than they buy from the U.S., absent the capital account adjustment, the foreigners could not sell more to the U.S. than the U.S. sells to them). The credit sales that foreigners make to the U.S. enable them to maintain their net surplus in the trade balance with the U.S. and, therefore, it should be no surprise that the foreigners who hold the largest amount of U.S. debt are the ones who export the most to the U.S. For example, $60 billion (24%) of U.S. net imports come from Japan and Japan holds $320 billion of U.S. debt that is 26 percent of the U.S. debt held by foreigners. Another 16 percent is held by the countries of the EU who account for 10 percent of U.S. net imports.

In addition to lending Americans a portion of their savings (to make up for the low level of personal savings in the U.S.), when foreigners buy U.S. debt they are also acquiring a claim on a portion of U.S. national income (the interest charged on the loan) and a mortgage on a portion of America's assets. The sheer size of the U.S. trade deficit and the degree of dependence on foreigners to finance it is a frequently voiced concern—and rightfully so. The implied long-term decline in U.S.-headquartered manufacturing facilities has serious economic, and even military, implications.

But the trade deficit is not necessarily all bad and all parts of the deficit are not necessarily the same. Some portion of the deficit may represent the most efficient use of labor and capital between the U.S. and its trading partners. For example, it may be to everyone's benefit (including America's most specifically) for the U.S. to borrow money from foreigners, put it to a use that pays a return far greater than the interest cost, and use the profit to buy a large volume of relatively cheap goods from the lenders.

Taxes Intervene to Distort Choices, Reduce Returns to Labor and Capital, and Misallocate Resources

Some portion of the U.S. trade deficit—perhaps a very large portion—is due to government interventions that have distorted choices and worked to the disadvantage of the United States. Among those distortions are two provisions of U.S. tax laws. First, because consumed income is, under current law, taxed less heavily than saved income, Americans are encouraged to consume as much as possible.[7] Second, under current law, imports are exempt from the taxes that are imposed on the manufacturers of American-made products for sale in the U.S. or for export. The combination of a tax incentive for consumption combined with a tax subsidy for imports is almost guaranteed to produce some degree of trade imbalance. Once started, an imbalance attributable to those kinds of tax distortions tends to perpetuate and enlarge itself. For example, when Americans are encouraged to consume ever larger amounts of tax-subsidized imports, the less likely they are to save, and the more likely they are to borrow from foreigners, who can afford to lend to Americans only by continuing to sell to Americans more than they buy from Americans.

> ***Because consumed income is taxed less heavily than saved income, Americans are encouraged to consume as much as possible.***

When taxes intervene in situations where the producer is in one country and the customer is in another, the fundamentals of tax intervention are the same as when the producer and customer are all located in the same country and are all citizens of the host country. So are the consequences, generally speaking. The first thing any tax will do is reduce returns to labor (wages and salaries) and returns to capital (dividends and interest). Take, for example, the current corporate income tax or any other tax that ostensibly is imposed on businesses. For example, when an additional $10 tax is imposed on a company, the company must either reduce wages and dividends by a total of $10 or, in the alternative, it can raise prices by $10 if the government inflates the money supply sufficiently to permit that to occur. When overall price levels are inflated, everything the company's employees and shareholders buy will cost a greater number of cheaper dollars, but their wages and dividends will remain the same. Even though the company increased prices, each $10 it received from doing so was taken away by the tax increase and is unavailable for salary increases, etc. Thus, under either scenario–(i) constant price levels and lower wages or (ii) constant wages and higher price levels—the real burden of the $10 tax is borne by labor and capital.

In addition to these unavoidable impacts on the returns to labor and capital, a tax may also drastically reduce the amount of goods and services produced by labor and capital. For example, high marginal tax rates on wage income reduce the after-tax "price" employees receive for their labor, and, the lower the price they receive, the less they are inclined to sell. The same is true of capital investment. Low after-tax returns can quickly make entrepreneurial investment and innovation no longer worth the risk.

Even if tax rates are sufficiently low to permit relatively high levels of investment and work effort, a tax may still have an unnecessarily deleterious impact on output in the economy. For example, a tax (like the current federal income tax) may have a very uneven impact, taxing some sources and uses of income more heavily or lightly than others, and making distinctions between otherwise seemingly identical business transactions. As it does so, it not only reduces the rate of return (as would any tax) but it also alters the relative rates of returns among different investment choices and ways of doing business, often influencing the relative proportions of labor and capital inputs in many transactions and in the economy as a whole–both domestic and foreign.

The main differences between the one-country and the multi-country situations are threefold. First, in the multi-country situation, there is a high possibility that more than one country will tax the same transaction, thereby making the total tax destructively high. (The need to avoid double taxation is the cardinal principle of many international agreements, but that principle is often violated.) Second, when companies of different national "citizenship" are competing with one another in the same market, it is highly likely that one of them will be taxed more heavily than another. The presence of multiple tax jurisdictions with greatly different ways of taxing labor and capital (both foreign and domestic) makes it much more likely that taxes will distort, not only the competitive balance between companies, but also the way they use the labor and capital resources at their command. Third, there is the matter of "tax competition" in a direct and overt way. The winning country may deliberately use a combination of tax penalties on foreign companies and tax exemptions for its own companies as a way of gaining an advantage in international trade. Further, there is a certain amount of what might be called "comparative" tax disadvantage. In this case, the losing country may tax its nationals in a way that is perfectly reasonable when viewed in isolation, but which is highly destructive to its own interest when compared to the way other countries tax their companies in similar situations of international commerce.

The U.S. practice of taxing an American-owned company on its worldwide income is not altogether unreasonable, in and of itself, but it becomes highly disadvantageous to American interests when American-owned companies must compete against foreign companies who operate under territorial systems of taxation that permit them to exclude from their home-country tax large portions of the income they earn in the global marketplace. Similarly, it is not on its face unreasonable for the United States not to claim any tax revenue from the profits earned by foreign labor and capital when they export into the U.S. market, but when one takes into account the taxes that foreign countries impose on U.S. companies when they export into foreign markets, the failure of the U.S. to border-adjust for imports works against U.S. and interests and, thus, becomes much harder to defend.

A Bit of History and Perspective on the International Components of Reform

The worldwide reach of the U.S. tax combined with a highly restricted credit for foreign income taxes paid on foreign-source income is clearly out of step with the tax practices of most other countries.[8] So is the insistence on taxing export income—which, under current law, results in taxable "U.S.-source" income insofar as the U.S. manufacturing portion of the profit on export sales is concerned. The United States has gotten itself into this position, and remained there, through a combination of historical accidents, serious policy mistakes, internal political constraints that have prevented their correction, and lastly, some fairly smart maneuverings by other countries—primarily European—in taking advantage of misconceptions in the United States about value-added taxes, border tax adjustments, and the GATT (now WTO) rules.

European countries (and many others) routinely exempt their exporters from value-added tax and have territorial-type systems that allow their export firms to sell their products through subsidiaries located in low or zero-tax countries. For example, if a French company manufactures widgets in France, it does not pay value-added tax when it exports them to its sales subsidiary in an offshore tax haven country. Furthermore, it does not pay income tax to France on its sales and distribution profit when the subsidiary reroutes the widgets to a customer in the United States that, in turn, imposes neither an import tax nor an income tax on the French company or its subsidiary. If the situation were reversed, a U.S. manufacturer of widgets would pay income tax on the export sale to its subsidiary, pay income tax on the resale by the subsidiary to the customer in France, and pay an import tax to France when the widgets were delivered.

Some European countries have integrated corporate tax systems whereby corporate tax payments function as prepaid taxes for shareholders who are allowed a credit against their tax liability on dividends. In many cases, the result is no value-added tax on exports, no income tax on foreign-source income, and a shareholder credit for any corporate income tax prepaid on their behalf. In the United States, not only are shareholders not allowed a credit for corporate income taxes, corporations frequently are not even allowed a full credit for the tax they pay to foreign countries on top of the tax they pay to the U.S.

It is not as if the United States has been unaware that taxing exports and foreign-source income runs contrary to both logic and national self-interest.

It is not as if the United States has been unaware all these years that taxing exports and foreign-source income runs contrary to both logic and national self-interest. As far back as 1918, the U.S. tried to ameliorate the adverse impact with the China Trade Act provision. Although constricted and schizophrenic, the exception under the current code that allows deferral of tax on the foreign-source income is, itself, an attempt to blunt some of the worst aspects of worldwide taxation. Since the 1970s, when the U.S. allowed the Europeans to maneuver it into agreeing to their border adjustable VATs, the U.S. has sought to achieve a relatively minuscule subsidy for some of its own exports while continuing generally to tax exports and foreign-source income on a worldwide basis. The first artifice was the Domestic International Sales Corporation (DISC), which was enacted in 1971. After protracted GATT litigation centered on the archaic distinction between "indirect" and "direct" taxes, DISC was repealed in 1982 and replaced by the Foreign Sales Corporation (FSC). Over the ensuing years, the list of exports eligible for FSC expanded and by the time in 1999 when FSC was invalidated by a WTO panel report (affirmed on appeal), it had become a major element in U.S. export trade, heavily relied upon in the software and aircraft sectors and by a broad array of manufacturing firms—both large and small. In late 2000, after much anguishing in the Congress and the business community over the loss of the relatively minuscule benefits provided by FSC, Congress enacted the FSC Repeal and Extraterritorial Income Exclusion Act of 2000, wherein it replaced FSC with a similar provision (often referred to as FSC-II) which has also been challenged in the WTO. A final and probably negative WTO decision on FSC-II is expected in early 2002.

The WTO challenges on FSC and FSC-II have been criticized as disregarding an understanding reached in the Uruguay and Tokyo Rounds, but, leaving that aside, the WTO decisions are a powerful indictment of the approach that has characterized both DISC and FSC. In holding that the FSC is an invalid subsidy to exports, the report of the WTO panel said that the U.S. could have either a territorial rule or a worldwide rule, but not a partial territorial rule that applies only to FSC exports.[9] In addition, the report went on to say "[The United Sates] is not free . . . [to] provide an exemption … specifically related to exports because it [the exemption] is necessary to eliminate a disadvantage to exporters created by the U.S. tax system itself." In effect, the report called upon the U.S. either to make changes in its basic rules sufficient to permit it to join the rest of the world in subsidizing exports in a treaty-legal way or, barring that, to reconcile itself to suffering the consequences of self-inflicted wounds, but, in all events, to stop trying by means of artifice to escape from the trap set and sprung in 1970.

In 1970, the United States made the mistake of acceding to the Europeans' argument that their emerging value-added tax systems were indirect taxes on products, as distinguished from direct taxes on firms (such as, e.g., the United States' corporate income tax), and that, therefore, they (the Europeans) should be permitted to rebate the value-added taxes to exporters. Conversely, any rebate or remission of the United States' corporate income tax to exporters would be a prohibited subsidy.

Most economists now recognize that all taxes are paid out of income and are borne proportionately by the labor and capital factors of production.

Having accepted not only the false premise that the European VATs are multi-stage sales taxes borne by the purchasers of products, and having also accepted the corollary false premise that any import tax on in-bound transfers is by definition also a sales tax borne by consumers of products in the country of destination, the United States has since then been in a box from which it has, so far, been unable to extricate itself. The U.S. allowed itself to be maneuvered into a position where—seemingly—it could subsidize its exports the way the Europeans subsidize their exports only by replacing its current income tax system with a sales tax, or some other form of transactions tax that is, at the federal level, inimical to the political ethic and culture of the United States and that, therefore, would stand no realistic chance of enactment. Meanwhile, the Europeans and many others around the world were going merrily about adopting and increasing "indirect" border-adjustable value-added taxes while relying less and less on income taxes.

Seemingly, the 1960s and early 1970s were a dark age when the principles of neoclassical economics nearly disappeared but, fortunately, those principles have now reemerged and most economists now recognize that all taxes, by whatever name called and however collected, are paid out of income (returns to labor and capital) and are borne proportionately by the labor and capital factors of production. Thus, correctly understood, the so-called "indirect" taxes—such as a VAT or sales tax—that the WTO allows to be border adjusted are not taxes on goods, but are, in fact, taxes on the income of the people who provided the labor and capital to produce those goods.

The long-standing distinction in the WTO rules between a direct tax and an indirect tax lacks any substance and ought to be abolished. It is the elimination of these kinds of fundamental artificialities that ought to be included in any new round of trade negotiations, not equally artificial distinctions between FSC, FSC-II and similar arrangements.

U.S. companies would for the first time in history be on equal tax footing with their competitors abroad.

In the meantime, even without any changes in underlying WTO rules, it is gradually becoming widely understood that under existing treaty obligations and interpretations dating back to the 1970s and before, the U.S. can make its tax system border-adjustable without having to enact a European VAT or any form of sales or transactions tax. Instead, it need only make its corporate income tax neutral as between labor and capital—an example is the business cash flow tax described in Chapter IV—in order to be able to exclude its export sales from tax, as the Europeans and others already exclude theirs. Not everyone agrees with that analysis, most particularly probably not the Europeans, but the analysis is well documented and powerful.[10]

The Structure and Policy of the International Components of Reform

A Practical Example

As an example of a tax system designed to address the international components of reform, let us consider the business cash flow tax contained in H.R. 134, which was introduced in the 106th Congress as the "Simplified USA Tax Act". H.R. 134 is a comprehensive proposal that includes a reformed personal tax as well as the reformed business tax, but, for present purposes, the focus will be solely on the business tax and its two international ingredients.[11]

The business cash flow tax in H.R. 134 recognizes the benefit to the U.S. economy that arises when U.S. companies compete and win in the global marketplace. It then sets out to equip them with the kind of tax system that will be most conducive to that success.

First, it says that the foreign-source income of U.S. persons should not be taxed. Second, it says that in the case of an export sale, both the manufacturing profit and the sales profit should be treated as foreign-source income—the same as if the product had been manufactured and sold abroad. Third, it says that when a U.S. company succeeds in a foreign market, it should be allowed—indeed, encouraged—to bring its profits home, without penalty, for reinvestment in the United States.

The business cash flow tax also says that the U.S. tax burden should no longer be concentrated solely on U.S. labor and U.S. capital as it is today. Instead, foreign companies that participate in the U.S. market should be brought into the U.S. tax base and required to share in the U.S. tax burden in a WTO-consistent way.

The business cash flow tax adopts a territorial system whereby all foreign-source income of U.S. citizens and their corporate alter egos is excluded from U.S. tax. (Thus, the deferral exception and the FSC-II provision would be repealed as superfluous). U.S. companies would be able to make direct foreign investment and operate in foreign markets, either through a branch, a U.S. subsidiary or a controlled foreign corporation without incurring U.S. tax on the profits from such investments and operations—and without regard to whether such profits are reinvested abroad or repatriated to the U.S. All foreign-source interest, dividends and royalties would be excluded from U.S. tax as well. Under the fully territorial regime contained in the business cash flow tax, U.S. companies would be subject only to the taxes of the host country where they compete in foreign markets and would, therefore, for the first time in history be on equal tax footing with their competitors abroad. Because U.S. companies would pay no U.S. tax on their foreign-source income, the foreign tax credit would be repealed.

Because the business cash flow tax classifies export income as foreign source, the model tax excludes export income from tax and, therefore, the model makes U.S. tax treatment a neutral factor in a U.S. company's decision to service a foreign market from a U.S.-sited plant or from a foreign-sited plant. Therefore, the business cash flow tax cuts the logic out from under the traditional argument that a territorial tax system would cause U.S. companies to locate their plants abroad in order to take advantage of a zero U.S. tax rate on foreign-source income.

To the extent that existing U.S. taxes may be embedded in the price of some particular exports under current law, the exclusion of export income from tax will tend to alter the terms of trade in favor of those products, but that is not the primary function of the export exclusion. In most instances, the trade effect would probably be minor. Even if it were wiped out completely and quickly by adjustments in exchange rates, the export exclusion under the business cash flow tax would still be a vital part of the international component of tax reform because it enables territoriality to be enacted and to function without any concern about "runaway" plants.

An import tax is the other part of the border tax adjustment procedure under the business cash flow tax and it, too, performs multiple functions. Like the export exclusion, the first function of the import tax is to permit the territorial system to be enacted and to function without running afoul of a version of the runway plant argument which is concerned not with plants moving abroad to serve foreign markets (the problem addressed by the export exclusion) but, instead, is concerned with U.S. plants moving abroad and then selling back into the U.S. market from some assumed "tax haven" foreign manufacturing facility. Under the business cash flow tax, if a U.S. company were to move its plant off-shore and sell back into the U.S., it would have to pay an import tax exactly equal to the U.S. business tax rate but without any deductions. Therefore, there would be no U.S. tax incentive for the company to move aboard.

The other function of the import tax has to do with the terms of trade but not in the way most of us have been accustomed to thinking. Traditionally, because import taxes have been associated with VATs, import adjustments have been thought of as some kind of tariff designed to make foreign goods more expensive—but that imaginary process is not actually the trade-related function of the import tax under the business cash flow tax regime. Rather than keeping foreign-made goods out (or causing U.S. purchasers to have to pay more for them), the primary function of the import adjustment under the model tax is to expand the U.S. tax base to include the foreign-based companies that sell into the U.S. market. Except in the case of unique products where there is no competition among foreign sellers into the U.S. market and little or no potential for competition from domestic-source products, the foreign companies who sell into the U.S. market will need to absorb all or part of the import tax and will, therefore, end up bearing part of the U.S. tax burden.[12] (The analysis by which the import tax can result in an expansion of the U.S. tax base and an implicit tax cut for U.S. labor and capital is discussed in Chapter V).

Overview of Territorial vs. Worldwide Taxation

The distinction between territorial and extraterritorial worldwide taxation is, of course, exactly the distinction that exists under the current code between domestic-source income and foreign-source income. The geographical location of the activity that produces the income is what counts, not the location of the customer. Thus, under current law, income from the production of goods and services in the U.S. is domestic-source even though the customer is a foreigner who pays from a foreign-sited bank. Conversely, income from the production of goods outside the territory of the U.S., and income from services performed outside the U.S., is foreign-source income.

Taxing U.S. citizens on both domestic-source and foreign-source income (worldwide) or only on domestic-source income (territoriality) produces different results only because all countries do not have the same tax system (same rates, base, etc.). If they did, the end result to all national treasuries and to all businesses would be exactly the same under either a territorial system or a worldwide system. For example, if a U.S. company earned $100 in Germany that was taxable in both the U.S. and in Germany at the same rate under a worldwide system, and if the U.S. immediately and fully allowed the company a credit for the tax paid to Germany, the result to all parties would be the same as if only Germany (not the U.S.) had taxed the $100 of income derived from the U.S. company's operations in Germany.

The geographical location of the activity that produces the income is what counts, not the location of the customer.

Absolute uniformity of taxation across national boundaries would make taxes a neutral competitive factor—not only *within* a market but across or among all markets as well—and economists would say that such a condition would maximize economic efficiency, productivity and the world's wealth.

In the imperfect world of reality where tax rates and systems around the world vary greatly, territoriality will not achieve uniformity of taxation across all markets, but it will tend to produce uniformity of taxation *within* the same market. For example, if the U.S. shifted to a territorial system, a U.S. company operating in France would pay exactly the same tax as the French companies alongside of which it competes in that market. While less than perfect, economists would say that achieving tax neutrality *within* markets by shifting to territoriality would greatly increase efficiency, productivity and wealth.

In contrast, the worldwide tax system does not achieve neutrality of taxation within a foreign market and, in fact, is not intended to do so. There is an inherent assumption in the worldwide approach that the U.S. tax rate will be higher than the tax rate of the foreign country where U.S. companies are doing business and, therefore, that U.S. companies will pay a higher rate of tax than their local competitors. For most of the post-WWII era, U.S. tax rates generally were higher than in most other countries. For example, if in 1975, a U.S. company earned $100 in Country X and paid a $20 tax, it would have been required to pay a $48 tax in the U.S. minus a credit for the $20 Country X tax, resulting in a $28 competitive disadvantage for the U.S. company.

Today, a U.S. company that operates abroad may, in some cases, encounter a foreign tax rate that is lower than the U.S. tax rate and, in other cases, a foreign tax rate that is higher than the U.S. tax rate. In theory, of course, if the foreign rate were higher than the U.S. rate, and if the U.S. allowed a full and immediate credit for the foreign tax, the U.S. company would—after credit—bear only the foreign tax (the same as under a territorial system) and taxes would be a neutral factor, but, as a practical matter, the foreign tax credit is today so limited that the U.S. worldwide tax is a non-neutral factor to the disadvantage of U.S. companies without regard as to whether the foreign tax rate is lower or higher than the U.S. tax rate.

The Theoretical Case for Territoriality

Proceeding from the correct neoclassical view that all taxes—by whatever name called and by whatever means collected—are borne by the labor and capital that produces the income with which the taxes are paid, a strong theoretical case can be made that it is only the country where the labor and capital are employed that should tax the output it produces. This argument in support of territoriality is the strongest when applied to returns to labor. Indeed, it is generally only the country of location that taxes the returns to labor at all. (For example, payroll taxes, as such, are imposed only on a payroll within the jurisdiction. Further, even under the United States' expansive worldwide income tax, a partial exemption is made for earnings from employment outside the territory of the United States.)

The foreign tax credit is today so limited that the U.S. worldwide tax is a non-neutral factor to the disadvantage of U.S. companies.

Without question, territoriality is the simplest system and permits the U.S. government the least opportunity to interfere with the way U.S.-owned companies can compete in foreign markets. (Both the foreign tax credit and deferral are creatures of the worldwide tax system and both have forced U.S. companies to conduct their business abroad in ways that have made them less competitive.)

Territoriality in Practice

Territoriality facilitates foreign direct investment and anytime U.S.-owned companies gain wealth by means of exploiting a foreign market, the nation is wealthier and everyone is better off. But that salutary effect, important though it is, is too indirect to satisfy some people. Their question is very specific: What does it do for U.S. output and U.S. jobs when a U.S. company manufactures and sells widgets in a foreign market?

There is plenty of anecdotal evidence to support the proposition that foreign direct investment by U.S. firms also enhances their U.S. operations and domestic job-creating capacities.[13] Many companies have testified before the Congress to that effect. Some of their foreign operations use U.S.-made components. Others point out that once they have penetrated a foreign market by direct investment, their export sales to that market usually increase as well. There is also important statistical evidence that foreign direct investment by U.S. companies is complementary to U.S. production and jobs, not substitutional.[14]

It is only the country where the labor and capital are employed that should tax the output it produces.

Understanding Border Tax Adjustments, Tax Incidence and Related Matters

Border tax adjustments for imports and exports are essential to a properly functioning territorial system, and provide other important advantages as well, but before they can be seriously contemplated as part of tax reform, they must first be understood and before they can be understood, they must be disassociated from the VAT and the popular misconceptions that surround that particular form of European tax.

Breaking out of the VAT Syndrome.

The principal barriers to enactment of a border adjustable tax system in the United States have been (i) the mistaken belief that only a VAT can be border adjusted and (ii) the corollary misperception that any tax that is border adjusted must be a VAT even though it is not. These two propositions stem from the peculiar idea that the VAT is some kind of cascading tax where business A pays a tax which it then passes on in price to business B which also pays a tax and then passes on the cumulative tax to consumer C who reimburses business B by paying the higher "plus tax" price that is inherent in the popular concept of "VAT".

The resulting picture of a multi-stage sales tax—where businesses pass on their tax costs to one another and finally to the consumer—is so thoroughly ingrained that one need only mention the word "VAT" and economists and others who should know better immediately suspend logic by assuming—in the above example—that business B gladly will pay business A's taxes and that consumer C readily will pay the higher tax-inclusive price, all without curtailing demand, as if the demand for all products and all substitutes were price inelastic.

A cash flow tax is, in effect, a tax on gross profit before *payments to employees, shareholders and debt holders.*

Any tax that is border adjusted is automatically classified as a regressive, consumer-borne sales tax—even though taxes without border tax adjustments are correctly understood to be borne by factor incomes, i.e., wages, gains, interest and dividends.

This logical legerdemain—engaged in as often by misguided proponents of reform as by ill-intentioned opponents—is most often accomplished by renaming border adjustable business cash flow taxes as "subtraction-method VATs."

Reality is quite different: A cash flow tax is collected from a business in direct proportion to its payments of wages (returns to labor) and dividends and interest (returns to capital). In effect, it is a tax on gross profit *before* payments to employees, shareholders and debt holders. A business cash flow tax bears no resemblance whatsoever to a sales tax—VAT or otherwise. Indeed, because it applies equally to returns to labor (wages) and returns to capital (dividends and interest), a business cash flow tax is nearly identical to the combination of the current corporate income tax (which applies only to returns to equity capital but not wages) and the current FICA payroll tax (which applies only to returns to labor but not to returns to capital).[15]

A modified form of border tax adjustment can be included in a business cash flow tax, but that does not mean it is a sales tax—VAT-type or otherwise. In fact, but for its ability to qualify for a modified form of border tax adjustment, it would never occur to any proponent or opponent of tax reform to think of a business cash flow tax as a sales tax.

Any tax that is neutral as between labor and capital—by whatever name called and however collected—can under applicable treaties be adjusted at the border for imports and exports.[16] The reason a sales tax—including the European VAT-type—can be border adjusted is because the final sales price of goods to which the tax applies includes the output of labor and the output of capital. Similarly, the reason the cash flow tax qualifies is because it, too, includes the output of both labor and capital, but at the other end of the economic process where the goods and services are produced. The tax is measured not by the amount for which the goods and services are sold but, instead, by the amount of the wages paid to employees who produce the goods and services and the amount of dividends and interest paid to owners of the capital that the employees used in the production process.

Any tax that is neutral between labor and capital can under applicable treaties be adjusted at the border for imports and exports.

The reason the existing corporate income tax does not qualify for border tax adjustment is because it applies only to the equity capital portion of the production process. Therefore, unlike the business cash flow tax and the sales tax which—while at opposite ends of the economic spectrum are neutral as between labor and capital—the current corporate income tax applies only to some capital income and not at all to labor income and is, therefore, non-neutral.

When the drafters of the GATT allowed so-called "direct" taxes to be forgiven on exports, they had the European VAT-type tax in mind as the primary then-existing example and, furthermore, consistent with the highly mechanistic approach to taxes that tended to prevail at that time (especially in Europe), they probably also viewed the VAT as being in economic substance exactly what its statutory structure implies: a retail sales tax collected at the final consumption end of the economy with an aggregate base equal to the total value of goods and services produced and sold. None of this means, however, that some other tax that has exactly the same base (although measured at the opposite end of the economy where goods and services are produced and expressed as the total amount paid to labor and capital for that production) cannot also be forgiven on export. Nor does it mean that everyone—most especially the Congress and President of the Untied States—must accede to some archaic, highly mechanistic approach to economic incidence and characterize business cash flow taxes and all other border adjustable taxes as regressive levies borne by consumers in proportion to retail purchases when—in fact—according to the most basic principles of economics, common sense and the modern view of tax incidence, all such taxes (including the VAT itself) are ultimately borne by labor and capital income.

The question of tax incidence (who actually bears the economic burden) is quite simple. A tax many be collected at any of three points in the economy: when goods and services are produced and sold by businesses, when employees and capital owners receive the wages, dividends and interest paid to them by businesses for their labor and the use of their capital in producing the goods and services, or, lastly, when consumers purchase the goods and services for their own use and benefit. Properly calculated, the tax base is the same in each case, i.e., the dollar amount of goods and services produced and sold is equal to the dollar amount of goods and services purchased and both are equal to the dollar amount of the returns to labor (wages) and returns to capital (interest and dividends) for producing them.

By taxing the U.S. producers of goods and services destined for Europe, the member countries of the European Union have managed to shift a large portion of their tax burden off their own citizens.

The Extended Reach of Cross-Border Adjustments for In-Bound Transactions

When a country imposes a tax on in-bound transfers of goods and services (an import tax), it extends its jurisdiction to apply to the income of noncitizens and foreign corporations from activities outside its own borders. This fact seems to have escaped the attention of most commentators in the U.S., but it is known to the Europeans and others who have—by means of border taxes—been taxing the “U.S.-source” income of U.S. citizens and companies for many years.

Under the false rubric that their import taxes are taxes on the purchasers of imported products, the Europeans and others have been able to maintain the fiction that—when they impose tax on imports—they are doing no more than taxing their own citizens in a way of their own choosing. In fact, however, when, for example, the Europeans impose tax on imports of goods manufactured in the United States, they are not just taxing their own citizens and companies who purchase those U.S.-origin products. Instead, for the most part, the economic burden of the import tax will fall on the U.S. labor and capital that produced the imported product, and, thus, when Europeans impose import taxes on American-made products, they are, in reality, taxing the income of Americans as well.

Viewed from the standpoint of a U.S. company engaged in export trade with Europeans, the overall situation is as follows: Its U.S.-source income must bear the burden of both the U.S. income tax and the European import tax for which it will get no credit for U.S. purposes. Once understood, this extraterritorial reach of border taxes gives new and realistic meaning to the “destination” principle that confused lawyers and economists are so fond of in trying to explain the artificial distinction between direct taxes and indirect taxes. By, in effect, taxing the U.S. producers of goods and services destined for Europe and using the revenues to pay for welfare programs in their own countries and/or to hold down the level of their internal budget deficits while not increasing taxes on their own citizens and companies, the member countries of the European Union have managed to shift a large portion of their tax burden off their own citizens.

Importing a Tax Base and Cutting Taxes for Americans

In addition to the many other benefits to be derived therefrom, tax reform could produce a result that is—in effect—a massive tax cut for U.S. labor and capital.

At present, with only immaterial exceptions, U.S. labor and capital together bear the entire burden of the current U.S. income tax—and U.S. labor alone bears the economic burden of U.S. payroll taxes—but if part of that tax were to be replaced by an import tax that is primarily borne by foreign labor and capital, the United States would, in effect, have imported an additional tax base consisting of the wages, interest and dividends received by foreigners who produce (outside the United States) the goods and services that they export into the U.S. market to the tune of $1,244.2 billion each year.

Assume, for example, that the United States replaced the current income tax, corporate and personal, with business and personal taxes similar to the ones in H.R. 134 that, among other things, imposed a 10 percent import tax. The H.R. 134 tax would raise the same $1,086.6 billion of annual revenue for the Treasury as the current income tax, but, in the case of the H.R. 134 tax, $124.4 billion would come from an import tax (10% x $1,244.2 imports) and a good portion of that import tax would be borne—not by Americans, but, instead, by foreign labor and capital. If, to be generous, it is assumed that as much as 20 percent of the import tax would be borne by Americans, that would still leave $100 billion (80%) to be borne by foreigners. The result is to reduce the tax burden on Americans by at least $100 billion per year.

There are many other reasons for tax reform and, perhaps, many better ones, but the most politically powerful may be the "tax cut" that is inherent in tax reform.

Endnotes

1. International tax reform of the type described is a clear and unassailable move toward making taxes a neutral factor, and, without question, neutrality is the universally accepted first principle of sound tax policy, but this is also a case where "doing the right thing" redounds heavily to the benefit of the United States. To benefit, the U.S. need not seek some tax advantage over others in the global marketplace. Merely leveling the playing field by correcting the present tax disadvantages under which U.S. companies and their employees have long labored is sufficient.
2. *Ibid.*
3. Under the current code, the general rule is worldwide taxation, expanded to include not only the worldwide income of U.S. corporations but also the worldwide income of foreign corporations controlled by U.S. persons. Thus, U.S. companies must pay U.S. tax on their domestic-source income and, if they directly or indirectly participate in foreign markets, they must pay U.S. tax on their foreign-source income as well. When a U.S. company manufactures a product in the United States and sells it in an export sale, the profit from manufacturing in the U.S. is treated as domestic-source income and is taxed. When a U.S. company manufactures a product in the U.S. and sells the product to its foreign subsidiary which markets and sells the product abroad, the "sales profit" derived by the subsidiary is treated as foreign-source income and is taxed. If a U.S. company causes its foreign subsidiary to both manufacture and distribute the product abroad, the entire profit from the transaction is treated as foreign-source income and is taxed. The effect of worldwide taxation is ameliorated somewhat by allowing U.S. companies to credit against their U.S. tax on foreign-source income the amount of tax they have paid to foreign governments on that income. The foreign tax credit is, however, so constrained by limitations that many companies are not allowed a credit for all the foreign taxes they pay. For example, foreign tax paid on a particular category of foreign-source income may not be allowed as a credit against the U.S. tax on some other particular category of income. The impact of worldwide taxation is also ameliorated somewhat by the deferral exception—which allows U.S.-controlled companies to defer tax on some foreign-source income under some circumstances—and by the Foreign Sales Corporation provision which, until repealed in December 2000 under pressure from the World Trade Organization, operated, generally speaking, as follows: If a U.S. parent company complied with a series of special rules and set up a Foreign Sales Corporation (FSC) in a low tax foreign country and paid that sales subsidiary a commission to market and promote the parent company's exports abroad, the U.S. parent company would still have to pay U.S. tax on the "manufacturing profit" from the export, but only about 65 percent of the of the FSC's sales commission would be taxed in the U.S. When that preferential treatment of the FSC was combined with the U.S. parent company's deduction for the commission paid the FSC, the real corporate tax rate on export income channeled through a FSC was reduced to about 29 percent.
4. U.S. brand soft drinks (and other similar products where the ratio of weight to price is high) are marketed all around the world, but they are normally produced locally using a formula and technologies that are of U.S. origin. Construction firms and mining companies also, by definition, compete on site in the foreign country where they are working—although in many cases much of the equipment and materials they use is of U.S. origin.
5. Erick Wada and Edward M. Graham, Appendix B, "Is Foreign Direct Investment a Complement to Trade," *Fighting the Wrong Enemy,* Edward M. Graham (Washington, DC: Institute for International Economics, September 2000). *See* also "Foreign Direct Investment Outflows and Manufacturing Trade: A Comparison of Japan and the United States," in Dennis Encarnation, editor, *Japanese Multinationals in Asia: The Regional Operations of Japanese Multinationals* (Oxford and London: The Oxford University Press, 1997) and "U.S. Direct Investment Abroad and U.S. Exports in the Manufacturing Sector: Some Empirical Results Based on Cross Sectional Analysis," in Peter J. Buckley and Jean-Louis Mucchielli, editors, *Multinational Firms and International Relocation* (Cheltenham, England: Edward Elgar, 1997).
6. One alarming aspect of foreign investment in the U.S. is the extent to which U.S. companies are being merged into foreign companies and are reemerging as controlled subsidiaries of foreign parent corporations whose headquarters and dominant stock ownership is outside the United States. Some of those mergers that were originally thought of as synergistic combinations of equals spanning the global market may

have been old-fashioned raids that may lead to the end of the American company. Other combinations of major U.S.-based and major foreign-based firms seem to be genuine mergers, but even in those cases, the consistent pattern is that the headquarters (and the control) is outside the U.S. There may be many reasons for this, but the U.S. tax law cannot be dismissed as irrelevant. Take, for example, the much publicized DaimlerChrysler transaction. From a tax standpoint, it would have been highly ill advised to have exposed Daimler-Benz's worldwide income to the United States' worldwide tax system. Given that Germany has a territorial-type tax system that limits German tax on income from sources outside of Germany, there was a strong tax-related case for the headquarters of the combined company being in Germany.

7. Americans are encouraged to consume as much of their income as possible as fast as possible because income that is consumed immediately is taxed less heavily than income that is saved and consumed later. The tax bias against income that is saved is easily illustrated by a simple example: Mr. Jones earns $100, pays a $40 income tax, and has $60 after-tax income left over. If he uses the after-tax $60 to buy a car to drive to work (in lieu of paying bus fare), he will not have to pay tax on the value of the transportation services the car provides him; nor should he. After all, he has already paid tax on the $60 once. On the other hand, if instead of buying the car, Mr. Jones saves the after-tax $60, he will have to pay bus fare (having no car) *and* he will have to pay tax on the interest earned by the $60 of savings.
8. See note 3 *supra* for general discussion of the severely limited tax credit allowed for taxes paid to foreign governments on income also subject to U.S. tax.
9. The language of the WTO decision on FSC and the subsequent debate in Congress has perhaps led to some blurring, in the minds of some, of the otherwise clear distinction between the manufacturing profit on an export sale which is U.S.-source income and, on the other hand, the distribution profit which is foreign-source income. Adoption of a territorial system would exclude foreign-source income from U.S. tax, and would, therefore, exclude from U.S. tax the distribution profit on an export sale, but territoriality would not exclude the manufacturing profit on an export sale that is U.S.-source income. Only a qualifying border tax adjustment would exclude that export income. The blurring of the distinction—which has misled some into believing that adoption of a territorial system would put U.S. exports on an equal tax footing with other countries' exports—apparently arose because the WTO held that FSC was an illegal subsidy to exports because the U.S. did not generally exclude foreign-source income from tax but did so only for the foreign-source distribution profit on export sales conducted through a FSC.
10. A business-level tax that includes both the labor factor and the capital factor would, in general, qualify under international agreements. *See* Gary C. Hufbauer and Carol Gabyzon, *Fundamental Tax Reform and Border Tax Adjustments* (Washington, DC: Institute for International Economics, 1996). The authors of this analysis specifically examined the question whether differences in terminology, statements and characterization in political debates, and other reflections of a particular country's traditions and culture would significantly alter the "GATT-ability" of a tax. They concluded not.
11. The main features of the Simplified USA Tax in H.R. 134 are (a) a simple personal income tax with progressive rates up to about 30 percent, a universal savings account patterned after a Roth IRA but without the income limits and dollar caps, and a credit for the employee-paid OASDI payroll tax; and (b) an 8 or 10-percent cash flow tax imposed on incorporated and unincorporated businesses. In lieu of a deduction for compensation paid, businesses are allowed a credit for the employer-paid OASDI payroll tax. The business cash flow tax is territorial. Export income is excluded from tax. A tax is imposed on imports at the same rate as the business cash flow tax.
12. The usual, and generally incorrect, way of looking at an import tax is the same as the usual, and generally incorrect, way of looking at a retail sales tax. The false premise is that if the import tax is 10 percent, U.S. purchasers of imported products will pay 10 percent more for all imports—such as, for example, autos. But, in fact, if foreign auto companies could charge 10 percent more for autos shipped into the U.S. market, and still maintain market share, they would already be doing so. Remember, the U.S. market is the world's largest: it is a price setter, not a price taker. Thus, the truth is that most companies who sell into the U.S. market would have to adjust their pre-tax price downward to accommodate to the import tax so that the total cost to the U.S. purchaser, including the import tax, would generally be about the same as if there were no import tax. The only exception would be unique products—where the forces of market competition do not apply—and products such as petroleum where the domestic supply is insufficient to meet demand. Sales taxes, import taxes, income taxes and all other taxes end up having the same incidence. They are borne by the labor and capital income factors of production. *See* Gary and Aldona Robbins, "How the Current Tax System Works," *Institute for Policy Innovation, Policy Report 155,* July 2000. In the case of an import tax imposed by the U.S., the economic burden of that tax would be borne primarily by the owners (capital) and employees (labor) of the foreign corporation that sells products into the U.S. market.
13. There are far too many examples of U.S. companies successfully investing abroad to repeat here, and there is no real point in doing so. The important thing is the logical principle involved and one of the best and most familiar illustrations of the principle does not even involve U.S. companies. Instead, it involves the large amount of "foreign direct investment" that Japanese auto companies have made in the U.S. Japan has gained a large market share by a combination of exporting autos to the U.S. and assembling autos in the U.S.
14. See *supra,* n. 5.
15. The similarity between the business cash flow tax, on the one hand, and, on the other hand, the current corporate income tax in combination with current employer payroll tax, is obvious and can easily be illustrated by assuming that the corporate tax rate is 7.65%, the same as the OASDHI employer payroll tax rate. This hypothetical corporate income tax would apply a 7.65% tax only to capital income (wages being deductible), but the companion employer payroll tax would apply a 7.65% tax to wages. The result is exactly the same as in the case of a business cash flow tax that allows no deduction for wages, and, therefore, taxes both capital income and wages at 7.65%, but then allows a credit for the 7.65% payroll tax on wages.
16. See *supra,* n. 10.

About the Author

Ernest S. Christian is an attorney and tax policy consultant in Washington, DC. He was former Deputy Assistant Secretary (for Tax Policy) and Tax Legislative Counsel of the Treasury Department, and served on President Reagan's Tax Transition Team. Mr. Christian is author of numerous books and articles on taxes and tax reform, and a longtime advocate of a simpler tax system that is not biased against saving and international competitiveness. He serves as Chief Counsel of a privately funded nonprofit corporation, the Center for Strategic Tax Reform, that was established in 1991, to develop a series of options for fundamental tax restructuring that serve the strategic interests of the United States in a world economy.

About the Roadmap to Tax Reform™ Series

The Road Map to Tax Reform™ is a series of studies published by the Institute for Policy Innovation (IPI) and produced in cooperation with participating organizations. The purpose of this project is not to promote a particular tax reform plan or proposal, but to provide research, analysis and argument in service of fundamental tax reform toward a neutral federal tax system, and to work with all proponents of such reform. The series consists of topical investigations by leading experts, with the goal of creating a corpus of research that makes a truly comprehensive case for a neutral, transparent, and simple tax code.

About the IPI Center for Tax Analysis

The IPI Center for Tax Analysis is the tax policy arm of the Institute for Policy Innovation, a nonpartisan public policy organization. The IPI Center for Tax Analysis recognizes that changing tax policy affects incentives to work, save, and invest. These changes in economic behavior are frequently ignored in static government forecasts, resulting in policy decisions that negatively affect economic growth, capital formation, employment, and local, state, and federal revenues. The IPI Center for Tax Analysis publishes *Economic Scorecard,* a quarterly newsletter, as well as additional commentary on tax policy.

About the Institute for Policy Innovation

The Institute for Policy Innovation (IPI) is a nonprofit, nonpartisan educational organization founded in 1987. IPI's purposes are to conduct research, aid development, and widely promote innovative and nonpartisan solutions to today's public policy problems. IPI is a public foundation and is supported wholly by contributions from individuals, businesses, and other nonprofit foundations. IPI neither solicits nor accepts contributions from any government agency.

IPI's focus is on developing new approaches to governing that harness the strengths of individual choice, limited government, and free markets. IPI emphasizes getting its studies into the hands of the press and policy makers so that the ideas they contain can be applied to the challenges facing us today.

Nothing written here should be construed as necessarily reflecting the views of the Institute for Policy Innovation, or its directors, or as an attempt to aid or hinder the passage of any bill before Congress.