IPI Insights

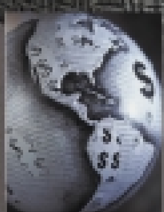
MARCH/APRIL 2002

One Arm Tied Behind Our Back:

U.S. Taxes and the International Economy

By Ernest S. Christian

Thanks to our tax code, United States companies have to compete in the global economy with one arm tied behind their backs. This handicap is partly a result of foreign envy of U.S. competitiveness, but partly a result of our own failure to make a level playing field for businesses (U.S. and foreign) within our own market. Regrettably, our tax code is biased against exports and it favors imports. It also puts a heavy burden on income that U.S. companies make abroad. This policy clearly weakens U.S. companies, and our huge trade deficit is Item #1 for the prosecution. For the economy's sake, it is time to reform the tax code, allowing U.S. businesses to compete and win in the global economy.



INSIDE: What does the government have the right to know about our finances?

ALSO: Would tax reform stimulate the technology industry?

Income Sources

How does a U.S. company make income outside the U.S.? There are basically two ways. First, it can produce goods in the U.S. and sell them abroad. This is essentially a way of expanding the *customer base* for its products. When there is a demand for goods abroad, U.S. businesses can increase production to make more sales than possible at home. The income from these exports is considered *U.S.-source income*, since all the company's work occurs in the U.S. The benefits of export sales are clear, as they provide growth for both parts of income: labor (U.S. jobs and wages) and capital (U.S. shares and dividends).

"As companies expand their operations abroad, the U.S. economy sees more (not fewer) jobs in high-paying sectors."

A company can also expand abroad by tapping into *foreign-source income*. Companies make foreign source income when they do part of their work outside the United States. For instance, a company can make goods in the U.S. and sell them to its own distributor in a foreign country. Or a company can shift all of its activity abroad: producing, distributing, and selling its goods/services outside the U.S. Sometimes this involves making the goods abroad and importing them back into the U.S. for sale.

When a company conducts some of its activity outside the U.S., it contributes to what is called *foreign direct investment* (FDI). FDI benefits the economies of both the foreign country and the U.S. Because work takes place in a foreign country, that country reaps a benefit to labor (jobs and wages). The U.S.-based company, likewise, can reap huge returns to capital investment. What's more, studies have shown that FDI leads to an increase in U.S. jobs as well as sales. As companies expand their operations abroad, the U.S. economy sees more (not fewer) jobs in high-paying sectors.

Pointing a Finger at Bad Tax Policy

In a *balance* of trade between the U.S. and other countries, the U.S. would make enough income from export sales to pay for the amount of goods we import. But that clearly doesn't happen. We've all heard of the woes (and gargantuan size) of the U.S. trade deficit. It is important to realize what enables this—how the U.S. can consistently buy more than we sell to other countries. What allows this to happen is that foreign-owned dollars are *loaned* to the United States instead of going toward the purchase of U.S. goods. Basically, we purchase a lot of imports on credit. And a large part of the debt has been accrued by the U.S. government. This can lead to serious economic (not to mention military) consequences.

If borrowing abets an enormous trade deficit, we might say that our tax code encourages the deficit. The U.S. does not spare its own companies from unequal taxation. In current policy, U.S. exports are subject to several layers of tax: *U.S.-source income* is taxed first by the corporate and personal income taxes, and further by taxes imposed in the country of destination. Furthermore, the U.S. also taxes *foreign-source income*. That income made abroad is taxed if it is reinvested in the U.S. Our tax code goes so far as to give companies an incentive to keep the money out of the States: In a provision called "deferral," companies can avoid taxes on *foreign-source income* if they keep the capital circulating abroad. The U.S. also makes them pay high taxes in the foreign country where they operate: it simply makes them less competitive.

The U.S. doesn't treat imports as harshly as it treats its own production. It spares foreign companies from taxes that U.S.-based companies pay. These same companies and their products are often subsidized by their home country. The subsidy is intended to offset import taxes—which they don't face here in the U.S.! The growth of the trade deficit is proving that other countries are increasingly benefiting from our non-neutral taxation.

Taxes Take a Toll

The taxes on U.S. companies take a final toll on U.S. labor and capital. The corporate income tax is supposedly a tax on businesses. But a closer look suggests something else. At whatever point a tax is imposed during the process of economic activity, the net result is that part of income is taken away by a tax. 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 it can raise prices by $10—but even that so-called "extra" $10 is not extra: it leads to an inflated price and the increase is unavailable for salary increases, etc. Thus, under either scenario–(a) constant price levels and lower wages or (b) constant wages and higher price levels—the real burden of the $10 tax is borne by labor and capital.

A Sensible Way

What is fair taxation? It would tax income equally—not putting a larger burden on select types of economic activity. It would not put an undue tax burden on investment. It would tax income only once in a simple, unified manner. Likewise, in an international economy, fair taxation in the U.S. would ensure that within our country, all products and companies (U.S. and foreign) face one equitable level of taxation. When it comes to doing international commerce, nothing is more important to U.S. businesses than neutrality.

Two steps can be taken to create tax neutrality within our borders. These steps will not necessarily give U.S. companies an advantage in the world marketplace. They are only meant to put them on an equal footing with their competitors—something that our current systems denies them. First, we need to adopt a system of *territorial taxation*: taxing only the economic activity that takes place on American soil. The work a company does in a foreign country would be taxed in that country alone. This does not encourage U.S. companies to go abroad; it only ensures that they will be able to compete. As we have seen, the capital that a company can make abroad leads to more investment in the U.S. economy—so long as the U.S. does not preclude its repatriation. It can also have a very positive effect on U.S. jobs in the high-paying sector.

The other step goes hand in hand with territorial taxation. We need to establish a system of *border adjustability*: taxing imports and exempting exports from tax. An import tax is essentially a way to expand the U.S. tax base. Companies that make sales here in the U.S. should not be exempt from the tax base. The border adjustability of taxation also ensures that a U.S. company's decision to move abroad is not influenced by our tax policy. If a company produces abroad to ship back to the U.S. for sale, it will pay an import tax and share in the U.S. tax base.

> "...when a U.S. company succeeds in a foreign market, it should be encouraged to bring its profits home, without penalty, for reinvestment in the U.S."

Let's review the net effects of these two reforms, territorial taxation and border adjustability. The total tax cost of selling goods in the U.S. would be the same regardless of whether a company was based in the U.S. or abroad: in both instances, the company's income is taxed once and in an equitable way. Also, the bias against exports and FDI would be removed. U.S. companies will be free to expand by seeking markets and production abroad. 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 see the wisdom of locating a plant in the U.S. and using it as a base for tax-free export sales to markets all around the world.

A Practical Solution

A tax reform plan that allows for competitiveness in the international economy is H.R. 134, a comprehensive proposal that includes a reformed personal tax too. First, it says that foreign-source income of U.S. persons should not be taxed. Second, in the case of an export sale, both the manufacturing and the sales profits should be treated as foreign-source income—as if the product had been manufactured and sold abroad. Third, when a U.S. company succeeds in a foreign market, it should be encouraged to bring its profits home, without penalty, for reinvestment in the U.S. Finally, the U.S. tax burden should no longer be concentrated solely on U.S. labor and 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 be required to share in the U.S. tax burden.

The Tax Dividend of Border Adjustability

An immediate benefit of border adjustments is that they would expand the U.S. tax base. Foreign companies who make income in the United States, whether by sales, distribution, or production, would contribute to tax revenues. This essentially leads to a tax cut for Americans. The dividend from tax reform is not only a level playing field for companies, it makes a fairer prospect for all American taxpayers.

Let's assume that the U.S. replaces the current corporate and personal incomes taxes with a business and personal tax similar to the model of H.R. 134. Now assume the bill imposes a 10% import tax, a good portion of which would be borne by foreign labor and capital. The model tax would raise the same annual amount for the treasury as the current income tax, and yet reduce the tax burden on Americans by at least $100 billion a year.

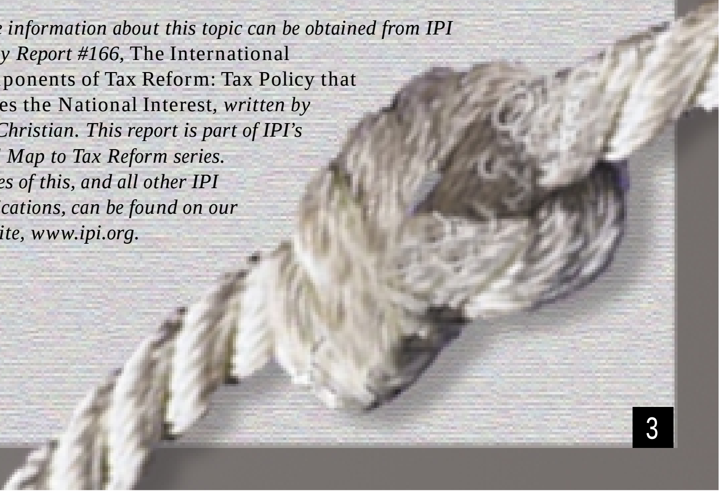
Is Tax Reform Viable in the Global Economy?

Former attempts by the U.S. to "level the playing field" have been a hodge-podge of partial measures and complex allowances. Those attempts only increased the complexity of our tax code and invited the suspicion of the WTO. The WTO, in fact, has rejected or appealed different border adjustments applied by the U.S. because they cannot be consistently imposed alongside worldwide taxation. The WTO has called upon the U.S. to use either worldwide taxation or territorial taxation—not to wrestle with a mixture of both. Basic reform (territorial taxation) will permit the U.S. to join the rest of the world in making border adjustments and subsidizing exports in a treaty-legal way.

This basic tax reform is neutral: income made abroad is taxed abroad. Income that is made here (whether by U.S. or foreign companies) shares in the U.S. tax base. This allows for a level playing field that does not penalize growth and investment in the U.S. economy.

Ernest S. Christian is an attorney and tax policy consultant in Washington, DC. He serves as Chief Counsel for the Center for Strategic Tax Reform.

More information about this topic can be obtained from IPI Policy Report #166, The International Components of Tax Reform: Tax Policy that Serves the National Interest, *written by Mr. Christian. This report is part of IPI's Road Map to Tax Reform series. Copies of this, and all other IPI publications, can be found on our website, www.ipi.org.*



Preserving Privacy and Competition in a Global Economy

Yet Another Benefit of Tax Reform

by Dan Mitchell, Ph.D.

The personal income tax requires individuals to either disclose or make available upon demand almost every shred of their personal financial data to the internal revenue service (IRS). Individuals have to reveal their personal savings, their financial assets, their personal wealth, their profits and losses, and other intimate details of their existence.

This sweeping assault on privacy might be justifiable if it represented appropriate and necessary enforcement of good tax policy. This is not the case. The loss of financial privacy is caused by the fact that the internal revenue code taxes some forms of income more than one time. Indeed, the combination of the capital gains tax, corporate income tax, personal income tax, and death tax means that some income is taxed as many as four times. *(See chart on back page)*

In practical terms, this requires the tax collector to know everything—or at least have the unlimited ability to learn everything—about a taxpayer's finances. Double-taxing interest income means government must know the amount a taxpayer has saved. Double-taxing capital gains means government must know about the assets a taxpayer sells. Double-taxing dividends means government must know the amount of stock a taxpayer owns. Double-taxing at death means government must know everything about a taxpayer's personal finances.

What does the government have an unlimited right to know about under the **current system?**

Type of Income or Asset	Wages	Interest	Dividends	Sales	Stocks	Bonds	Capital Gains	Asset at Death	Foreign Economic Activity
	Yes	Yes	Yes	No	Yes	Yes	Yes	Yes	Yes

The Tax Reform Solution

Eliminating the bias against income that is saved and invested is a core feature of every major tax reform plan. Perhaps the most famous of tax reform plans, the flat tax would scrap the hundreds of forms required by the current system and replace them with two simple postcards. Households would file one postcard, and this form would be used to collect taxes on labor income—the wages and salaries people earn. The other postcard would be filed by businesses, and this form would be used to collect taxes on capital income—the interest, dividends and business income people earn.

For all intents and purposes, the flat tax is like an unlimited, back-ended (or Roth) IRA. Unlike conventional IRAs, taxpayers do not deduct the money they put in a Roth IRA. All deposits are after-tax, but all annual earnings and subsequent withdrawals are spared a second layer of tax. Under current rules, of course, Roth IRAs have so many restrictions that taxpayers do not receive any privacy benefit. But if the Roth IRA is made universal, with no age limits, income limits, or deposit limits, the government would have no need to track the money in the accounts and / or how it is invested.

What does the government have an unlimited right to know about under a flat tax system?

Type of Income or Asset	Wages	Interest	Dividends	Sales	Stocks	Bonds	Capital Gains	Asset at Death	Foreign Economic Activity
	Yes	No	No	No	No	No	No	No	No

Some have proposed that the income tax be completely abolished and that the federal government instead rely on some form of national sales tax. Sales taxes, by their very nature, do not require individual taxpayers to divulge any information on income and assets to the IRS. Consider the following types of income and assets and the degree to which these must be disclosed in a sales tax world:

What does the government have an unlimited right to know about under a national sales tax system?

Type of Income or Asset	Wages	Interest	Dividends	Sales	Stocks	Bonds	Capital Gains	Asset at Death	Foreign Economic Activity
	No	No	No	Yes	No	No	No	No	Yes

Why Privacy Matters

The current tax code is a Byzantine contraption that requires 753 forms and instructions and 280 publications and notices. And that is just what is available on the IRS website. This avalanche of paperwork is a direct result of a complex tax code, and the complex tax code exists because lawmakers neglect principles of sound tax policy.

A direct consequence is the systemic abuse of privacy in the tax code. Taxpayers can be forced to provide almost unlimited information about their assets to the IRS. According to 1998 IRS data, 67 million taxpayers had to divulge interest income, 32 million had to divulge dividend income, and 22 million had to divulge their capital gains. None of this would be necessary in most tax reform plans. The 4 million taxpayers who will file estate and gift tax returns suffer the greatest invasion of privacy, and every tax reform plan will end their misery.

International Tax Harmonization and The Threat To Privacy

Tax reform promotes privacy by replacing bad tax law with good tax law. Yet this may never happen if international bureaucracies are allowed to rewrite the rules of international commerce and taxation.

The Organization for Economic Cooperation and Development (OECD), the European Union (EU), and the United Nations (UN) want to give high-tax governments the power to tax income earned in low-tax countries. These bureaucracies are demanding that low-tax governments emasculate their financial privacy laws and report on the financial affairs of foreign investors.

This policy, known as "information exchange," would be a blow to privacy and tax reform. The flat tax and sales tax are territorial systems. Yet the OECD and other international bureaucracies believe that territorial taxation – the common sense notion that governments only tax economic activity inside their borders – is a form of "harmful" competition. The flat tax and sales tax eliminate double taxation, but the OECD initiative is designed to help governments discriminate against income that is saved and invested.

The OECD / EU agenda is contrary to America's interests. The United States is a low-tax country and a haven for foreign investment. In large part because of our attractive tax and privacy laws, foreigners have invested more than $9 trillion in the U.S. economy. And if President Bush continues his efforts to reduce tax rates and eliminate the death tax, America is going to become an even more effective competitor in the world economy. It would therefore be self-defeating for the United States to support the OECD's attack on tax competition.

Conclusion

Policy makers should protect financial privacy. That is why tax reform is a way of killing two birds with one stone. Replacing the internal revenue code with a flat tax or sales tax would boost growth, increase jobs, and improve living standards. But tax reform also could eliminate any tax-related reason for the government to track the financial holdings of law-abiding people.

Tax reform is particularly important because it may be the best way of thwarting the anti-tax competition initiatives being pushed by Europe's welfare states. Information exchange and other tax harmonization initiatives are predicated on the view that governments should collect and share private financial data. These policies not only are a threat to privacy, but they also undermine America's competitive advantage in the global economy and they could compromise our fiscal sovereignty. Replacing today's complicated tax system with one of the tax reforms discussed above would help short-circuit international bureaucracies and preserve tax competition as a liberalizing force in the world economy.

The United States should have a tax system worthy of a great nation. Tax reform plans like the flat tax and sales tax fulfill that promise. They treat people equally and remove barriers to upward mobility. Tax reform is a way of returning privacy and control to the American people. IPI

Dan Mitchell, Ph.D., is the McKenna Senior Fellow in Political Economy at the Heritage Foundation.

More information about this topic can be obtained from IPI Policy Report #171, Tax Reform: The Key to Preserving Privacy and Competition in a Global Economy. *This report is part of IPI's Road Map to Tax Reform series. Copies of this, and all other IPI publications, can be found on our website, www.ipi.org.*

Tax Reform Would Stimulate the Tech Industry

By Bartlett Cleland

On March 9, 2002, President Bush signed into law what has commonly been called an “economic stimulus package.” This legislation included two tax provisions that will have a direct impact on the information technology (IT) sector of the economy.

The first of the two allows for a three-year accelerated depreciation on business purchases, also called “bonus depreciation.” This provision will allow businesses to write off purchases of computers, software, telecommunications, as well as other equipment at an accelerated rate, a rate that reflects the modern business environment and the true length of use of equipment. These reasonable depreciation schedules are even more critical during a period of economic weakness, when companies must invest to make operations more efficient and to provide increased security for their property, their data, and their people. Such a provision will stimulate corporate investment and keep people working, two current weak spots in our recovering economy.

The second provision extends the “carry back” for net operating losses (NOL). Many companies are currently in a NOL position, that is, their expenses are greater than their revenues. Extending the current NOL carry back will put cash in the hands of companies that have none, which will enable them to invest in new equipment and to keep their employees on the job.

These changes are a good start, but many other tax reforms are needed. For example, the research and development (R&D) tax credit is perhaps the best example of a credit that cannot be fully utilized because of the Congress’ penchant for short-term extensions of the credit rather than making it permanent. The R&D tax credit provides businesses with a tax credit for certain R&D-related expenditures. The credit is intended to spur innovation and economic growth by promoting private sector investment in R&D.

If the credit is not made permanent or extended, the R&D credit will expire in 2004. This environment of uncertainty precludes tax planning. The credit was first enacted in 1981 and provides companies with a 20 percent credit for incremental R&D expenditures. Extensions of the credit have resulted in three gaps in coverage, two of which were retroactively filled.

While society clearly benefits from innovation, companies engaged in R&D face high risks and oftentimes fail to reap the full rewards of their investments. In fact, experts believe that up to 80 percent of R&D projects end in economic failure. Historically, government assumed much of this risk by performing a majority of R&D projects. In the 25 years between 1970 and 1994, the government’s share of total R&D spending dropped 24 percent. Given the economic necessity of increasing innovation in the face of substantial investment risk, the credit becomes a critical incentive to increase private sector R&D expenditures.

On the other end of the spectrum are taxes that have been on the books and never seem to end, despite having far outlived their purposes. For almost 104 years the federal government has imposed a 3 percent “luxury tax,” or federal excise tax (FET), on telecommunications, which is to say on the phone bill of every American. Originally, this tax was levied to fund the 1898 Spanish-American War. At the time the tax was imposed, only 2,000 phone lines were operational in America. Today, 94 percent of American households have telephone service.

Although the Spanish-American War lasted just under six months, the FET remains in effect. While this tax does generate revenue for the federal government, it makes all communications more expensive.

These taxes simply highlight the importance of any tax reform to the high-tech sector of the economy. In some cases, the IT industry faces consequences unique to the sector, and in other cases, the impact is the same as for all companies. Regardless, the IT industry must figure importantly in any tax reforms. IPI

Bartlett Cleland is the director of the IPI Center for Technology Freedom.

For nearly 30 years, generally income from stock option plans has not been subjected to employment taxes. Recently, the Internal Revenue Service (IRS) seems to have changed its view on this matter. The IRS now seems to believe that beginning in 2003 taxes should be withheld from individual paychecks when stock options are exercised under these plans. Currently, employees pay capital gains taxes on options if a profit is realized when the options are sold.

In reaction, H.R. 2695 states that that its goal is to clarify the existing law of tax policy as it affects incentive stock options and employee stock purchase plans. Incentive stock options and employee stock purchase plans are valuable tools utilized across several industries, including high tech, to attract and retain high quality, highly skilled workers. These plans create individual ownership and equity in companies, and are valuable to boosting our economy. The IRS’s arbitrary change would likely result in workers forgoing their options.

The House Ways and Means Committee agreed on March 14th to include this legislation in pension reform legislation. The House is expected to vote on the pension reform bill in April.

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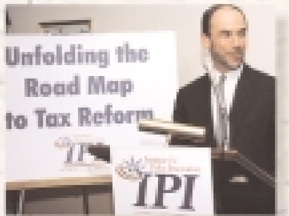
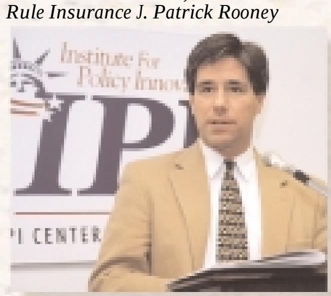


White House Chief Economist Dr. Douglas Holz-Eakin

House Majority Leader Dick Armey with IPI author Allan Carlson

Rep. David Dreier speaking at press conference

Lone Star Foundation President David Hartman, IPI President Tom Giovanetti, IPI Senior Research Fellow Steve Moore, Former Ways and Means Committee Chairman Bill Archer, Chairman Emeritus of Golden Rule Insurance J. Patrick Rooney



IPI author Dan Mitchell

IPI Unfolds Road Map

Earlier this year, IPI hosted a daylong Capitol Hill event highlighting the results of a two-year research project entitled, "The Road Map to Tax Reform." IPI's Road Map project is the most comprehensive effort ever undertaken on fundamental tax reform and includes over seventeen policy reports from national tax experts. Many of the key U.S. Representatives that work relentlessly to push tax reform to the top of Congress' agenda helped kicked off this IPI's event. Speaking at IPI's press conference were **Representatives David Dreier *(R-CA and House Chairman of the Zero Capital Gains Caucus)*, Jim DeMint *(R-SC)*, Mike Pence *(R-IN)* and John Linder (*R-GA*).**

Former Ways and Means Committee Chairman Bill Archer reinforced the necessity of fundamental tax reform to the audience during his keynote address at IPI's policy luncheon.

Project authors addressed the results of this comprehensive investigation over the course of three intense panel discussions. Discussing the intellectual, moral and economic arguments for overhauling the nation's tax code, the authors suggested *how* tax reform will solve many of our most difficult public policy problems, and *why* it should be a priority for Congress and the Administration.

The Road Map project brought together many of the most respected authorities on tax reform from around the country. Road Map authors participating in this event included: John Berthoud, *National Taxpayer Union Foundation,* Allan Carlson, *Howard Center for Family, Religion & Society*, Ernest Christian, *Center for Strategic Tax Reform,* Chris Edwards, *Cato Institute,* Stephen Entin, *Institute for Research on the Economics of Taxation,* JD Foster, *U.S. Department of the Treasury*, David Hartman, *The Lone Star Foundation,* Dan Mitchell, *The Heritage Foundation,* Stephen Moore, *IPI*, Dan Pilla, *Tax Freedom Institute, Inc.*, Aldona Robbins, *IPI* and *Fiscal Associates,* Margo Thorning, *American Council for Capital Formation,* and Grace-Marie Turner, *Galen Institute.*

Margaritas and Moore

On Jan. 31, 2002, the Institute for Policy Innovation had a "Margaritas & Moore" reception to announce that well-known economist Steve Moore was joining the IPI Center for Economic Growth as a Senior Research Fellow.

Steve has a long and distinguished record of shaking up both the policy and political establishments. His pro-growth tax and economic policies have consistently challenged both Democrats and Republicans to cut taxes and eliminate disincentives to work, saving and innovation. And as president of the Club for Growth (which continues to be his primary job), he puts money where his policies are —supporting candidates who stand up for pro-growth policies.

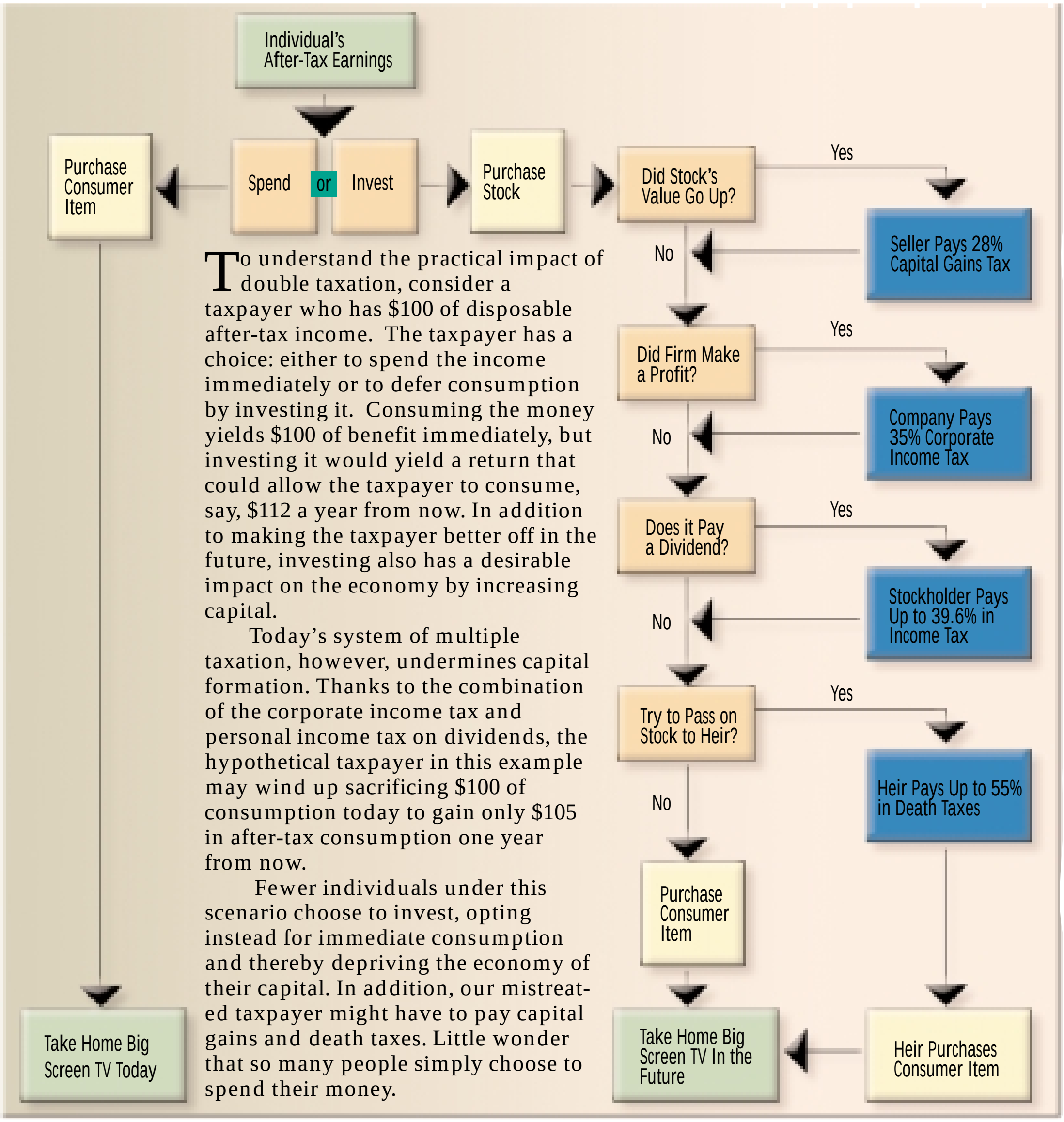
At the Jan. 31 reception, held in conjunction with the American Conservative Union's annual Conservative Political Action Conference, more than 150 people joined IPI to congratulate Steve on his work and the new relationship.

Tom Giovanetti with Becky Norton Dunlap from the Heritage Foundation

Americans for Tax Reform President Grover Norquist, Steve Moore, Science and Environmental Policy Project President S. Fred Singer, and Eric Schlecht from the National Tax Payers Union

President of NOVECAN Dr. Richard Rahn, IPI Fellow Gary Robbins and Steve Moore

Savings and Investment Can Be Taxed Up to Four Times— Message to Taxpayer Is "Spend Now"



To understand the practical impact of double taxation, consider a taxpayer who has $100 of disposable after-tax income. The taxpayer has a choice: either to spend the income immediately or to defer consumption by investing it. Consuming the money yields $100 of benefit immediately, but investing it would yield a return that could allow the taxpayer to consume, say, $112 a year from now. In addition to making the taxpayer better off in the future, investing also has a desirable impact on the economy by increasing capital.

Today's system of multiple taxation, however, undermines capital formation. Thanks to the combination of the corporate income tax and personal income tax on dividends, the hypothetical taxpayer in this example may wind up sacrificing $100 of consumption today to gain only $105 in after-tax consumption one year from now.

Fewer individuals under this scenario choose to invest, opting instead for immediate consumption and thereby depriving the economy of their capital. In addition, our mistreated taxpayer might have to pay capital gains and death taxes. Little wonder that so many people simply choose to spend their money.

Source: IPI Policy Report #171, *Tax Reform: The Key to Preserving Privacy and Competition in a Global Economy* by Dan Mitchell, Ph. D.

IPI Insights

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