



Statement of Todd McCracken

on behalf of

The National Small Business Association

regarding

International Issues relating to Tax Reform

September 8, 2011

My name is Todd McCracken and I am the president of the National Small Business Association (NSBA), America's oldest small-business advocacy organization.<sup>1</sup> The NSBA is pleased to provide its perspective on international issues relating to tax reform.

The NSBA strongly believes that the present tax system is irretrievably broken and constitutes a major impediment to the economic health and international competitiveness of American businesses of all sizes. To promote economic growth, job creation, capital formation, and international competitiveness, fundamental tax reform is required.

To promote the international competitiveness of U.S. businesses, we believe that tax reform, whether fundamental or incremental, should:

- reduce compliance costs and simplify the tax system;
- place foreign and domestic manufacturers on an even footing and remove impediments to exporting;
- reduce marginal tax rates;
- provide for a neutral tax treatment of savings and investment;
- eliminate provisions in the tax law that provide artificial incentives to undertake particular kinds of economic activity; and
- remove tax impediments to the free flow of capital and to repatriating profits earned abroad to the U.S.

This statement also examines proposals to move to a territorial tax system, consumption taxes generally and the FairTax in particular.

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## **Reduce Compliance Costs and Simply the Tax System**

Compliance costs are the costs that businesses incur complying with the tax system. In the case of small businesses these costs include the time of small business owners and their accounting staff devoted to collecting necessary information and filling out IRS forms and the costs incurred hiring outside accountants and lawyers for advice about how to comply with the tax law. In general, small business compliance costs relative to income or revenues are disproportionately high.

There will always be some compliance costs in any tax system. But today these costs are very high. And if there is one thing the NSBA membership is almost universally agreed on, it is that the current compliance costs are too high and that the tax system needs to be simplified.

Estimates by economists vary as to the magnitude of compliance costs. In general, compliance costs seem to be in the neighborhood of 9 to 14 percent of the revenues raised. These high costs do nothing to further a societal interest. We should aim to raise the revenue needed by the federal government in the least costly way. The costs of the current system represent a huge waste of resources that could be better spent growing businesses, creating new products, conducting research and development, or purchasing productivity enhancing equipment.

These costs also represent a significant drag on the international competitiveness of U.S. businesses. Compliance costs must be recovered by businesses in the sales price of their goods or services. Otherwise, the businesses will fail. Reducing these costs is within our control and it should be a priority of Congress. Furthermore, there is strong reason to believe that U.S. costs are substantially higher than those of most other developed nations.

## **Place Foreign and Domestic Manufacturers on an Even Footing and Remove Impediments to Exporting**

An origin principle tax system taxes goods and services based on where they were produced or originated rather than where they were purchased or consumed. In an origin principle tax system, the production of goods and services in the taxing country is taxed no matter where the goods and services are sold, used or consumed. In a destination principle consumption tax, goods consumed in the taxing country are taxed whether the goods or services were produced domestically or abroad. Exported goods are not taxed.

The individual and corporate income tax and payroll tax raise well over 90 percent of the revenue collected by the federal government. These taxes are origin principle taxes. Most consumption taxes (including sales taxes<sup>2</sup>, European style credit-invoice type value added taxes, Canadian and Australian goods and services taxes<sup>3</sup> and proposed business transfer taxes<sup>4</sup>) are

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<sup>2</sup> Including U.S. state sales taxes and proposed national sales tax such as the FairTax.

<sup>3</sup> GST is essentially just another name for credit-invoice type VAT.

<sup>4</sup> These are subtraction method value added taxes.

destination principle taxes. The Flat Tax and various proposed consumed income taxes<sup>5</sup> are, however, origin principle systems.

It is a common fallacy that having a destination principle tax like a VAT or a GST helps domestic exporters and hurts foreigners importing goods into the taxing country. This is not the case because both domestic and foreign goods are subject to the same tax when consumed domestically. This is why VATs and GSTs are legal under World Trade Organization rules.

What **will** help U.S. producers and impose a greater effective tax burden on foreigners importing goods into the U.S. would be to **replace** the current origin principle taxes with a destination principle consumption tax. There are two reasons for this. First, exports will no longer bear a U.S. tax burden and imports, for the first time, will bear the same tax burden as U.S. goods. Second, as discussed below, a consumption tax reduces the U.S. user cost of capital and will increase the U.S. capital stock and hence the productivity of U.S. businesses.

The current tax system taxes U.S. producers whether they are selling in U.S. or foreign markets and imposes no appreciable tax on foreign producers selling goods into the U.S. It, therefore, places U.S. producers at a considerable disadvantage.<sup>6</sup> Were the U.S. to replace the current tax system with a destination principle consumption tax (such as the FairTax) then, for the first time in nearly a century, the U.S. government through its tax system would no longer be according a major advantage to those who produce goods abroad over those that produce goods in the U.S.

### **Reduce Marginal Tax Rates**

The tax base should be broadened and marginal tax rates on business reduced. However, the tax base should only be broadened to the extent that can be accomplished without imposing multiple levels of taxation on savings and investment. High marginal tax rates discourage work, savings and investment. Conversely, reducing marginal tax rates encourages work, savings and investment. Reducing marginal tax rates also increases entrepreneurial risk-taking because less of the potential reward from the risk-taking will be taken by government. Furthermore, lower marginal tax rates reduce the cost of capital and increase productivity increasing investment.

The economic loss associated with the tax system increases with the square of the tax rate increase.<sup>7</sup> Thus, doubling the tax rate will result in a four-fold increase in the adverse economic

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<sup>5</sup> A consumed income tax is sometimes called an expenditure tax (Kaldor), cash flow tax (Aaron-Galper) or inflow-outflow tax (Ture) depending on the author or analyst. The only significant difference among the various proposals is the inclusion (or not) of the proceeds from debt in the tax base and the deduction from the tax base of principal payments.

<sup>6</sup> There is an argument sometimes made that exchange rates will adjust to compensate for this effect. It is beyond the scope of this short statement to address that subject. Suffice it to say that the tax system alters costs, relative prices and rates of return and therefore alters behavior, in this case, just like other better understood cases.

<sup>7</sup> Alan Auerbach, "The Theory of Excess Burden and Optimal Taxation," in the Handbook of Public Economics, Alan Auerbach and Martin Feldstein, Editors, 1985; Harry Watson, "Excess Burden," Encyclopedia of Taxation and Tax Policy, Joseph J. Cordes, Robert D. Ebel, and Jane G. Gravelle, Editors, 2005; John Creedy, "The Excess Burden of Taxation and Why It (Approximately) Quadruples When the Tax Rate Doubles," New Zealand Treasury Working Paper 3/29, December 2003.

effect of the tax system. This effect is equally true in reverse. Lowering marginal tax rates has a disproportionately positive impact on the economy.

The U.S. currently has one of the highest statutory corporate tax rates in the developed world. This is mitigated to some degree by U.S. capital cost recovery allowances that are somewhat more rapid than in many countries.

Small businesses are, however, overwhelmingly pass-through entities and pay at the individual tax rates which are also higher than business tax rates in most countries. Small businesses also create most of the new jobs created in the U.S. economy. Raising the top tax rates on small businesses by increasing individual tax rates will have an adverse impact on small businesses, job creation and the economy.

### **Provide for a Neutral Tax Treatment of Savings and Investment**

The current tax system is quite biased against savings and investment. Corporate income and corporate capital gains are taxed. Dividends paid from after-tax income are taxed again.<sup>8</sup> Individual capital gains are taxed but capital gains are simply increases in the present value of future income stream that will be taxed. What is left over and not spent is also taxed by the unified estate and gift tax. Moreover, there are numerous places in the code that force businesses to delay deducting costs incurred now. This raises their costs and reduces their cash flow. Examples include the amortization of start-up expenses and the inventory capitalization requirements of section 263A. But the most important example is the requirement that purchases of equipment and structures be deducted over a period of many years rather than be expensed.

Adequate capital cost recovery allowances, preferably expensing, are critical to maintaining a reasonable cost of capital and to firms of all sizes being able to afford the capital investment necessary to compete in the international marketplace.<sup>9</sup> It is hard to overstate this point. Capital formation is critical to maintaining long-term competitiveness and preserving relatively high U.S. wage rates. Unless U.S. firms invest in productivity-enhancing or innovative cutting-edge equipment that provides new capabilities, U.S. firms will only be able to compete by accepting lower returns and by paying workers less. If, of course, they fall far enough behind, the firms will simply fail.

Section 179 expensing is of vital importance for smaller firms, particularly those in more capital intensive industries. It should be retained or expanded. For now, section 179 eliminates the tax bias against savings and investment for firms that can take advantage of it. It reduces the user cost of capital considerably for small firms. For 2011, up to \$500,000 of investment

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<sup>8</sup> Even Henry Simons, one of the fathers of the modern income tax thought double taxing corporations was wrong. In his 1938 book *Personal Income Taxation: the Definition of Income as a Problem of Fiscal Policy* he proposed integrating the personal and corporate income tax to prevent double taxation.

<sup>9</sup> Expensing is always the correct answer in a consumption tax where either (i) interest is neither taxable nor deductible or (ii) debt proceeds are includible in the taxable base and principle and interest are deductible. In a hybrid system, such as the current U.S. system, some limits on debt financed investment in expensed property may be appropriate. As a practical matter, this will only be important in the case of large enterprises with large borrowing capacity.

purchases may be deducted. In 2012, the figure falls to \$125,000. Thereafter, unless Congress acts, the amount deductible will fall to \$25,000. This latter limitation dramatically limits the number of firms that can appreciably benefit and dramatically reduces the economic effect of the provision. Retaining the current \$500,000 threshold should be high on the Congressional agenda.

## **Eliminate Provisions in the Tax Law that Provide Artificial Incentives to Undertake Particular Kinds of Economic Activity**

The economy will grow most rapidly and society's scarce resources be used most effectively if the tax code's many provision rewarding or punishing particular types of investment or other economic behavior are eliminated. Business decisions should be made for business reasons not because of the tax treatment or tax subsidy accorded certain activities.

The FairTax and other consumption taxes eliminate the large differential returns caused by the income tax and would channel business investment to the most economically efficient investments. This, along with the reduce user costs of capital and lower marginal tax rates, will have a pronounced positive impact on the economy.

## **Remove Tax Impediments to the Free Flow of Capital and to Repatriating Profits Earned Abroad to the U.S.**

Having adequate capital in the U.S. is important to U.S. businesses. Small businesses, in particular, have difficulty obtaining adequate capital for their businesses. Eliminating barriers to the repatriation of capital to the U.S. will help small businesses in two ways. First, by increasing the amount of capital on deposit with U.S. financial institutions, it will improve the likelihood of U.S. small businesses obtaining capital and reduce the cost of obtaining capital.<sup>10</sup> Second, money invested in the U.S. instead of abroad will have positive effects because employment and investment are occurring here. That, in turn, will increase small businesses opportunities.

There is reportedly at least \$1.5 trillion "trapped" or "locked-in" off shore because repatriating those funds will trigger a large tax whereas keeping those funds invested abroad will not. It is time to bring these funds home.

There are three ways to eliminate this "lock-in" effect while retaining the income tax. One approach is to move to a territorial system where foreign source income is not subject to U.S. tax. There would presumably, therefore, be a zero percent tax on repatriated income. This approach has received a great deal of attention lately and is discussed below. A second approach, tried in 2004, is to apply a substantially lower tax rate on repatriations made during a specified window of time. A significant disadvantage of this approach is that it is a temporary solution.<sup>11</sup> A third approach is to eliminate the deferral allowed by the law relating to Controlled Foreign Corporations (CFCs) and in general tax income earned by U.S. businesses currently.<sup>12</sup> Any of these approaches would eliminate the lock-in effect and increase repatriations. It is possible that the latter approach may harm U.S. businesses in other ways. For example, it is thought that U.S. owned subsidiaries are disproportionately likely to buy from the U.S. By

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<sup>10</sup> Financial intermediation will direct this capital far beyond just banks.

<sup>11</sup> A permanently reduced rate on repatriations would reduce the lock-in effect to the extent the rate was reduced but would not accelerate the tax revenue gain as much as a short-term reduction to the extent firms believed the change was permanent.

<sup>12</sup> Subchapter N, Part III, Subpart F of the Internal Revenue Code. In principle, the Passive Foreign Investment Company rules would need amended as well. These are much less important than the CFC rules.

making U.S. owned foreign manufacturing subsidiaries less attractive, it may be that U.S. exports are harmed. This third approach would also (at least in the short run) raise taxes on multinational business.

An entirely different means of solving the problem is to move to a destination principle consumption tax such as the FairTax. Under the FairTax, repatriation of foreign source income would not be a taxable event. Neither foreign source nor U.S. source income would be taxed. Instead, domestic consumption would be taxed.

### **Proposals to Move to a Territorial Tax System**

A number of advocates have advocated that the U.S. move from its current world-wide taxing system to a territorial system income tax system. The Joint Committee on Taxation has estimated that with the appropriate rules regarding intangibles, such a move could actually increase tax revenues. It is remarkable that imposing a zero tax on foreign source income could raise tax revenue. It is also a reminder of how broken the current system is.

A territorial **income tax** system will put tremendous, probably fatal, pressure on the section 482 inter-company pricing rules. Pushing those rules hard is one of the central reasons that the current tax system raises so little revenue from taxing the overseas operations of U.S. multinationals. There is a small industry of lawyers, accountants and economists devoted to helping large corporations defend aggressive intercompany pricing. Those rules will only be pushed that much harder if the U.S. adopts a territorial income tax system. Since there is no single “correct” transfer price, there will be a huge incentive to manipulate intercompany prices to transfer income outside of the U.S. if the tax rate on U.S. source income is 35 percent and the tax rate on foreign source income is zero.

U.S. parents will tend to sell domestic goods cheaply to their foreign subsidiaries so their foreign subsidiaries will show the profits.<sup>13</sup> U.S. corporations will tend to transfer ownership of their intellectual property<sup>14</sup> (a form of intangible property) to their foreign subsidiaries so the income from licensing that IP will be “foreign source.” Of course, if the Treasury gets too aggressive in policing such transfers, the multinationals will simply start conducting the research overseas or purchasing it from trusted foreign strategic partners subject to appropriate licensing and disclosure agreements. This would be economically counterproductive. Thus, a lot of U.S. source income will end up be scored as foreign source income not subject to tax.

As supporters of the FairTax, the NSBA has no problem with eliminating the corporate income tax. We do not believe, however, that the right way to go about that is to make the corporate income tax largely optional for multinationals while corporations operating solely in the U.S. must pay significant corporate income taxes.

It is true that the current U.S. tax system makes headquartering a company in the U.S. unattractive compared to most developed countries. Most developed countries have some form

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<sup>13</sup> Since, contrary to popular belief, profits are a small percentage of gross revenues, it does not take much of a change in the price to shift all or most of the profits.

<sup>14</sup> Including patents, trademarks, copyrights and, to a lesser extent, unpatented trade secrets.

of territorial tax system. Thus, a company headquartered there can take advantage of tax rates lower than those in the home country. A U.S. company cannot since the U.S. world-wide system taxes companies on their income throughout the world, allowing a foreign tax credit for foreign taxes paid.<sup>15</sup> For example, taxes are the primary reason that when Mercedes merged with Chrysler, the parent was in Germany not in the U.S. It is in the interest of small businesses and workers to have large corporations headquartered in the U.S. due to business and employment they generate.

There is among many analysts a concern, not entirely unfounded, that a territorial income tax system will provide an incentive for U.S. firms to locate their manufacturing operations in low tax foreign jurisdictions rather than the U.S. The counter argument is that if U.S. owned firms do not do so, then European and Asian firms will and, once again, U.S. firms are rendered less competitive by the current tax system.

There is a solution to these problems. Do not move to a territorial **income tax** system. Instead, move to a territorial **consumption tax** system. In a consumption tax, like the FairTax, intercompany pricing is irrelevant to the tax result and there is no tax incentive to place manufacturing operations abroad. This is because such a tax does not tax production anywhere. Both U.S. and foreign operations of U.S. firms would be free of tax. Headquartering a company in the U.S. would make perfect tax sense. Goods consumed in the U.S. would be taxed, whether they were made here or abroad and goods shipped abroad would not be subject to any tax. Therefore, the tax bias against U.S. producers would be eliminated.

### **Consumption Taxes**

Most real world consumption taxes in the world today are sales taxes or credit invoice method value added taxes (aka goods and services taxes). They are border adjusted either because exports are excluded from the tax base and imports are subject to tax upon entry (a VAT) or because of their nature (a retail sales tax). They are territorial. No tax is imposed on foreign operations, income or consumption. They are neutral toward savings (all savings is effectively accord Roth IRA tax treatment due to the nature of the tax) and investment (all investment is either expensed (VAT) or not subject to tax (national sales tax)).<sup>16</sup>

### **The FairTax**

Obviously there are a lot of ways to improve the tax system. To be better than the current system doesn't take a lot. But NSBA regards the FairTax as the best fundamental tax reform proposal. In an international context, it would have a dramatic positive impact on the competitiveness of U.S. businesses. A summary of why:

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<sup>15</sup> Subject, in general, to a limit equal the U.S. tax rate times foreign source income. In reality, the foreign tax credit system is much more complex because of the separate baskets that income is separated into.

<sup>16</sup> The FairTax and the Schaefer-Tauzin national retail sales tax excluded all business to business transactions from to prevent cascading. Unfortunately, U.S. state sales taxes collect a substantial portion of their revenue from taxing business inputs.



1. It would be simple and dramatically reduce compliance costs that place U.S. firms at a substantial disadvantage.
2. For the first time, the tax system would impose the same tax burden on foreign produced goods and U.S. produced goods and eliminate the current origin principle system that places U.S. based firms at such a large disadvantage. This is because the FairTax is a destination principle tax (i.e. it is, in effect, border adjusted).
3. It would be neutral toward savings and investment and reduce the user cost of capital substantially. The capital stock would therefore grow. Productivity and innovation would increase.
4. Entrepreneurial risk-taking and innovation would increase because more investment capital would be available and the tax on capital gains would be zero.
5. The U.S. would attract capital from throughout the planet. Investment in the U.S. whether by Americans or foreigners would not be taxed. The U.S. would, in effect, become the largest tax haven in the world. The “giant sucking sound” you would hear, to paraphrase Ross Perot’s memorable metaphor, would be the U.S. attracting capital from throughout the world. Having adequate capital is important for all businesses but particularly important for small and start-up businesses.
6. The FairTax has much lower marginal tax rates than the current tax system and has virtually the lowest possible marginal tax rate consistent with a neutral tax treatment of savings and investment.<sup>17</sup>

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<sup>17</sup> The only reason it does not have the lowest possible rate theoretically possible is the rebate that prevents the poor from paying any federal income or payroll tax and reduces middle class effective tax rates substantially.

Appendix  
The Equivalence of Consumption Tax Bases (Domestic Analysis)

C = Consumption  
O = Output  
I = Investment  
W = Wages  
Y = Income  
S = Savings

Retail Sales Tax

Sales Tax Base = C (goods & services)

Business Transfer Tax (Subtraction Method Valued Added Tax)

BTT Tax Base = Output less Investment =  $O - I = C$

Flat Tax (bifurcated Subtraction Method Valued Added Tax)  
[Hall-Rabushka-Armev-Forbes type flat tax]

Business Tax Base

Business Flat Tax Base = Output less Investment less wages =  $O - I - W = C - W$

Individual Tax Base

Individual Flat Tax Base = wages = W

Overall Tax Base

Flat Tax Base = Output less Investment less wages plus wages  
 $O - I - W + W = O - I = C$

Expenditure Tax or Consumed Income Tax or Inflow-outflow Tax or Cash Flow Tax

Expenditure Tax Base = Income less savings =  $Y - S = C$

Note: For an expenditure tax to properly measure consumption debt incurred must be included in the taxable base and debt principal payments must be deductible.

All of the above assumes away international transactions. Or, stated differently they fail to distinguish between consumption ( $C_\alpha$ ) of U.S. produced goods **consumed** anywhere in the world and consumption ( $C_\beta$ ) in the U.S. of goods **produced** anywhere in the world. The category into which each proposed system falls is shown below.

Taxation of consumption ( $C_\alpha$ ) of U.S. produced goods **consumed** anywhere in the world<sup>18</sup>

1. Flat Tax<sup>19</sup>
2. X Tax<sup>20</sup>
3. Consumed Income, Expenditure, Cash Flow or Inflow-Outflow Tax<sup>21</sup>

Taxation of consumption ( $C_\beta$ ) in the U.S. of goods **produced** anywhere in the world<sup>22</sup>

1. Retail Sales Tax
2. Value Added Tax or Goods and Services Tax (Credit-Invoice Method)
3. Business Transfer Tax (Subtraction Method VAT)

It is the contention of NSBA that the difference between destination and origin principle tax systems matters a great deal and that the taxation of U.S. consumed goods produced anywhere in the world is much better for American businesses and the American people than the taxation of U.S. produced goods consumed anywhere in the world. Border adjusted tax systems that treat U.S. produced goods and foreign produced goods alike are superior.

Given the large merchandise trade deficit that the U.S. is running and has run for many years, the tax base  $C_\beta$  (the taxation of consumption in the U.S. of goods produced anywhere in the world) will be substantially larger than the tax base  $C_\alpha$  (the taxation of consumption of U.S. produced goods anywhere in the world). Thus, the  $C_\beta$  systems (border adjusted systems) will be able to have a lower marginal tax rate while raising the same revenue.

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<sup>18</sup> These are origin principle consumption taxes.

<sup>19</sup> It is unclear whether it is WTO legal, but the President's Advisory Panel on Federal Tax Reform (report issued November 2005) proposed a flat tax that was border adjusted. In principle, such a proposal should be WTO legal since a flat tax is a VAT. But it looks a great deal like an income tax and most of its supporters do not understand that it is a special type of VAT rather than an income tax. So it is not clear whether the WTO would regard it as a direct or indirect tax.

<sup>20</sup> The X Tax is a proposal by David Bradford that would apply graduated tax rates to the Hall-Rabushka flat tax base. In other words, it is a graduated rate bifurcated subtraction method value added tax.

<sup>21</sup> It is virtually impossible to make these tax systems destination principle taxes.

<sup>22</sup> These are destination principle consumption taxes.