

Viewpoints



U.S. International Tax Reform? Define ‘Reform’ for Me

by Dan R. Mastromarco

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On June 22, 2006, as congressional taxwriters shuffled in and out of the hearing room, the second panel of witnesses before the House Ways and Means Subcommittee on Select Revenue Measures lectured the assembled group on Advanced International Tax Solutions 401. What the taxwriters could have used instead was a primer on International Tax Policy and Economics 101 — a course designed to untangle the underbrush of competing proposals to provide a foundation on what competitiveness really means and how to achieve it.

For those who couldn't attend the recent lecture, permit me to share my viewpoint.¹ Witnesses on the first panel discussed the orthodoxy of the normative benchmarks for measuring international tax efficiency: capital export neutrality (CEN), capital import neutrality (CIN), and national neutrality (NN).

¹See <http://waysandmeans.house.gov/hearings.asp?formmode=detail&hearing=470>.

Professor James R. Hines Jr. of the University of Michigan explained how the relevance of those concepts has changed over time,² and he introduced his models of capital ownership neutrality (CON) and national ownership neutrality (NON), useful academic tools if one wants to theorize about how tax regimes might maximize global economic output (or to advocate a territorial system).

The “solution guys” sat on the next panel like contestants in an academic game show. They agreed that U.S. corporate marginal tax rates should come down from their dubious pedestal as the highest in the developed world through some form of “base broadening” (construed loosely to mean taxing the same income in its many forms many times). But they offered diametrically opposed reform solutions, more or less untethered to and untested against different goals. The basic lesson to the policymakers: “Just adopt the reform I concocted. The other guy’s doesn’t cut it.”³

²Most of these goals are now largely vestiges of the past.

³The staff of the Joint Committee on Taxation prepared a background report for the hearing. See “The Impact of International Tax Reform: Background and Selected Issues Relating to U.S. International Tax Rules and the Competitiveness of U.S. Businesses,” scheduled for a public hearing before the Subcommittee on Select Revenue Measures of the House Committee on Ways and Means (June 22, 2006). Prepared by the staff of the Joint Committee on Taxation June 21, 2006 (JCX-22-06) (2006 WTD 120-8 or Doc 2006-12053). See also, “U.S. International Tax Rules: Background and Selected (Footnote continued on next page.)”

Contestant Number 1, Professor Michael J. Graetz of Yale Law School, offered, well, the “Graetz solution.” His plan, although never advanced beyond concept, in effect advocates that the United States adopt a version of the Sixth Directive of the European Union.⁴ Although this is somewhat of an oversimplified description, the Graetz solution would in fact retain much of the complexity and dead-weight loss inefficiencies of current law by layering a European style credit-invoice VAT on top of corporate and personal income taxes, payroll taxes, capital gains and death taxes.⁵

Based on some of the panegyrics heard from tax lawyers about the Graetz solution, there is much to recommend it. I can understand the excitement. The Graetz concept enables policymakers to treat reform as a conceptual framework without having to tackle the difficult questions that would subject the concept to greater scrutiny. If the plan ever got to the point of copious legislative language, those same policymakers would warm the collective aortas of the tax

bar by further complicating the Internal Revenue Code.⁶ That, of course, is good news for the National Treasury Employees Union too. The Graetz proposal would temporarily provide a \$50,000 exemption from application of the income tax (similar to what was proven successful in 1913),⁷ remove a substantial number of citizens and resident aliens from feeling vested in our tax system, and hide the taxes the exempted citizens do pay in withheld payroll taxes or in the prices of goods and services.⁸ It would also depress the economy and real wages relative to comprehensive consumption plans, but this dynamic tax gap in lost productivity would be hidden as well provided we can keep policymakers in the dark by demanding static scoring. At the same time, the proposal would offer the masses false protection against future tax increases by requiring a two-thirds supermajority of Congress to vote for increases, even though that requirement could be overridden by a simple majority (if the base doesn’t decrease faster than after the 1986 Tax Reform Act).⁹

Issues Relating to the Competitiveness of U.S. Businesses Abroad,” scheduled for a July 15, 2003, public hearing before the Senate Finance Committee, prepared by the staff of the Joint Committee on Taxation July 14, 2003 (JCX-68-03) (2003 WTD 135-12 or Doc 2003-16584).

⁴The EU VAT system is imposed by a series of European Union directives, the most important of which is the Sixth VAT Directive (Directive 77/388/EC). Michael J. Graetz, *The U.S. Income Tax: What It Is, How It Got That Way, and Where We Go From Here* (New York: Norton, 1999); Michael J. Graetz, “100 Million Unnecessary Returns: A Fresh Start for the U.S. Tax System,” 112 *Yale Law Journal*, pp. 261-310. For a discussion of some problems with the Graetz concept from the liberal perspective, see Center on Budget and Policy Priorities, “The Graetz Tax Reform Plan and the Treatment of Low-Income Households,” by Robert Greenstein and Iris Lav, June 27, 2005. I find fault with the Graetz concept on several levels; most notably, (1) it retains the complexity of the code, (2) is not transparent, and (3) it is not wholly neutral on savings and investment and will stifle growth.

⁵Graetz’s proposal would actually create two categories of income — exempt income and income currently taxable subject to foreign tax credits — and he would advocate reduction of the current-law separate baskets to a single basket. The four pieces of Graetz’s proposal are: (1) repeal of the regular individual income tax; (2) indexation of the alternative minimum tax (with an increase in the AMT exemption for married couples to \$100,000 — the exemption would be set at \$50,000 for single filers — and a lowering of the AMT rate to 25 percent); (3) reduction of the corporate income tax rate to 25 percent; (4) imposition of a value added tax at a 10 percent to 14 percent rate to replace revenue that would be lost; and (5) replacement of the earned income tax credit with a refundable payroll tax offset. Graetz’s plan would keep deductions for charitable contributions, home mortgage interest, and large medical expenses. Congress could also allow a deduction for state and local taxes and could tax capital gains at the standard 25 percent rate or lower.

The Graetz proposal would depress the economy and real wages relative to comprehensive consumption plans.

So as not to award Graetz a monopoly on those selling points, Contestant Number 2, Stephen E. Shay of Ropes & Gray in Boston, would retain the crediting mechanism and partially or fully eliminate

⁶For example, it would greatly increase the importance of the intercompany transfer rules, while retaining the complexity of the income tax for high earners. Graetz himself notes questions that will also arise about the proper scope of subpart F, particularly for base company income and other types of active business income, such as the income of financial services businesses.

⁷The first Form 1040 levied a 1 percent tax on net personal incomes above \$3,000, with a 6 percent surtax on incomes of more than \$500,000.

⁸This includes payroll taxes, the cost of complexity, and the economic loss that distortions would create. For example, it is estimated that our current income tax system ensures our economy is about 20 percent smaller than it would be in a decade after enacting a true consumption tax, such as the FairTax. Recent simulations under the current system show capital per unit of human capital declining by 5 percent over the century for an 18 percent decline over the long run in after-tax take-home pay. However, because this “economic gap” is not visible, nobody complains.

⁹Graetz has already ceded two deductions for the National Association of Realtors (the home mortgage deduction) and for the Independent Sector (charitable contributions). The lesser-known lobbyists are right behind them.

deferral, while temporarily broadening the base so future tax hikes can be greater.¹⁰ Contestant Number 3, Paul W. Oosterhuis of Skadden, Arps, Slate, Meagher & Flom, would eliminate parts of subpart F that lead to the current taxation of active foreign business income or, alternatively, move to a territorial system. In a nutshell, one and one-half of the solutions would adopt a territorial tax system on active trade or business income (exempting that income from tax) while the others would either tax that income currently as if subpart F were expanded or restrict subpart F to allow for more deferral.

Can the taxwriters really say after these hearings on international tax reform that they have any greater grasp of the effects of the tax laws over which they preside than they did before, that is, why the system needs reforming? Are taxwriters any closer to settling on the criteria by which international reform should really be evaluated, that is, what is competitiveness and how do we achieve it? Despite the effervescent pedagogical repartee among the witnesses, the answer to both those questions is no.

The true test of international competitiveness should be whether the tax regime achieves the quaint goal of raising the standard of living of the American people who sit as Congress's board of directors.

Permit me to make a suggestion: Before taxwriters vote any individual plan off the tax policy island, they might want to start at the beginning. That means that before rushing to adopt a proposal that seeks to address a problem on which there is no genuine consensus, Congress should better define

¹⁰Shay's practical proposal to the subcommittee would be to currently tax some U.S. shareholders under an expansion of subpart F (a conduit approach that would eliminate deferral) for those who own more than 50 percent of the controlled foreign corporation. He would propose that less-than-10-percent U.S. shareholders and 10 percent U.S. shareholders in foreign corporations that did not have a controlling U.S. shareholder group be taxed under current-law rules on distributions when received. But his optimal approach would be for broad repeal of deferral. That proposal would apply mandatory passthrough treatment to 10 percent or greater shareholders in foreign corporations. Robert J. Peroni, J. Clifton Fleming Jr., and Stephen E. Shay, "Getting Serious About Curtailing Deferral of U.S. Tax on Foreign Source Income," 52 *SMU L. Rev.* 455 (1999); J. Clifton Fleming Jr., Robert J. Peroni, and Stephen E. Shay, "An Alternative View of Deferral: Considering a Proposal to Curtail, Not Expand, Deferral," *Tax Notes Int'l*, Jan. 31, 2000, p. 547.

the contours of the fuzzword "international competitiveness" by (1) deciding on the proper objectives of reform and then (2) grading plans against objectives.

The true test of international competitiveness cannot be whether a tax system benefits multinationals, which by definition know neither national boundaries nor allegiances.¹¹ Rather, the true test of international competitiveness should be whether the tax regime achieves the quaint goal of raising the standard of living of the American people who sit as Congress's board of directors.

Perhaps Congress might want to subject the proposals to a grading template that disaggregates that central goal in a much more practical way. Instead of theorizing about how competing and increasingly irrelevant principles of capital neutrality are met,¹² Congress might want to ask if a particular solution:

- creates a better tax environment for domestic companies to produce in the United States (and hire American workers) rather than produce abroad (and hire foreign workers);
- creates a better tax environment for foreign direct investment in plants and operations in the United States than that provided by competing venues;
- encourages tax competition (that is, encourages global rates on savings and investment to fall) or encourages a race to the top;
- reduces the costs of compliance associated with the international tax system for companies that produce here relative to abroad;
- increases the income of U.S. residents;
- increases the purchasing power of U.S. residents' income;
- affords an easy transition from the current system to the proposed approach;
- allows businesses to make decisions based entirely on economic, rather than tax planning, grounds;
- offers a sustainable or merely temporary fix; and
- favorably interacts with foreign tax systems.

As it revisits International Tax Policy and Economics 101, Congress might also want to explore what effect our failure to adopt a border-adjusted,

¹¹Some of the members appeared to assume that what is good for the multinational must be good for America. As a tax lawyer, Shay deserves credit for seeking to correct that notion.

¹²Many of which are wholly irrelevant under a consumption tax.

destination-based consumption tax has on U.S. competitiveness by adding two more queries. Does a particular solution:

- make the U.S. a better tax environment from which to export than a foreign country?
- tax foreign-produced goods and U.S.-produced goods alike in the U.S. market or advantage Americans' consumption of foreign goods over domestically produced goods?

Although these are probably most of the criteria against which international tax reform should be measured, none of the witnesses compared their plans against them, and for good reason. When their plans are graded against this criterion for international reform (whether it will benefit the American people), the witnesses receive a lower than passing grade. Only one plan, the FairTax national sales tax plan (a single-stage consumption tax),¹³ addresses many of the issues raised, both theoretical and practical. It is the only destination-based consumption tax that is fully border-adjusted, for instance. The FairTax happens to be the most popular tax reform plan among the American people and is endorsed by small firms, farm groups, and more than 56 congressional cosponsors (at the time of this writing). But the FairTax suffers for all of these reasons. On account of the fact it is simple, transparent, and popular, it is the one plan most tax glitterati pooh-poo. As a result, its attributes were not fully aired during the subcommittee's hearing.

Consider how easily the second panel's witnesses leapt over the issue of border adjustability (the first panel ignored it entirely). Border-adjusted taxes are consumption taxes that are removed — or not imposed in the first place — on exports by producing nations and are assessed on imports as ad valorem taxes. Twenty-nine of 30 OECD countries have border-adjusted tax regimes. Only one — the United States — refuses to adopt a border-adjusted tax system and continues to rely on an origin principle, direct, worldwide income tax system.

Despite the cavalier demurrer with which some economists reject the notion of adopting a border-adjusted regime, our unique failure to adopt a destination-based consumption tax combined with our uniquely high marginal corporate rates sends curious messages to multinationals: "Move your plants and facilities overseas, hire foreign workers, and then market your products to the American consumers whose tax system favors consumption over investment and savings." To retailers: "Stock foreign inventory." To consumers: "Buy foreign products." The burgeoning trade deficit, the loss of

American jobs, and stagnating blue-collar wages are consequences of capital owners hearing that message and taking Congress's advice. The FairTax is the only fully border-adjustable plan.

As our nation's producers and workers struggle to compete in a global market where capital, technology, and — increasingly — labor (and eventually management) can be sourced in any venue offering the best opportunities for profit, any discussion on competitiveness should be welcome. However, American producers and the workers whose jobs depend on them have needs beyond rhetoric. Auto workers whose jobs are replaced by foreign workers do not see the phenomenon as a healthy correction in the economy, a normal casualty of destructive capitalism, or a statistical abstraction relevant only to those nostalgic about America's industrial past. Rather, they see destruction of America's manufacturing base as a harbinger of hardship for future generations of Americans. Our merchandise trade deficit is not caused by welfare-enhancing market forces but by a series of bad policies, tax policy being the most important.

Members of this Congress have a duty to take the time to understand how the tax laws they have constructed injure our national welfare and to understand how to fix them.

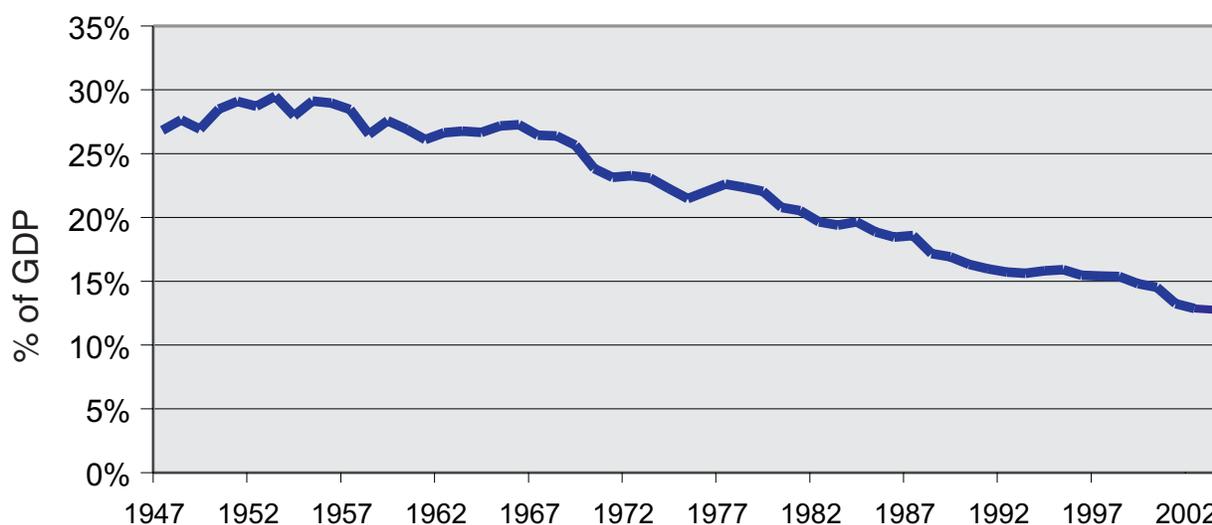
Beyond the rhetoric or the attempt to build a record to support a reform some members find convenient, this Congress has a duty to take the time to understand how the tax laws it has constructed injure our national welfare and to understand how to fix them. This article begins with a reminder of why we need international tax reform, explores the relevant criteria for reform for the welfare maximization of the American people, and discusses how the various plans, including the FairTax, meet or fail to meet those criteria.

Why We Need Int'l Tax Reform

For decades, American manufacturing has been the nutrient of national prosperity and security — raising the standard of living for working Americans, fulfilling dreams of immigrants, enabling sustainable national security, building communities, and placing America on the global stage as a world leader. American industry has long been distinguished for its productivity and sustained innovation. The health of the United States, the well-being of its citizenry, and its very survival are undeniably and inextricably bound to the health, well-being,

¹³H.R. 25, The Fair Tax Act of 2005, and its Senate companion bill, S. 25.

Figure 1. Manufacturing as a Percentage of U.S. GDP, 1947-2002.



and survival of the American manufacturer. Without strong manufacturing, America's strength cannot endure.

But U.S. manufacturing is rapidly eroding in the face of foreign competition. That erosion is visible in the dwindling contribution of manufacturing as a share of the U.S. economy.¹⁴ (See Figure 1.)

With each year, manufacturing has become a decreasing part of the overall economy. Consider that the value of all goods manufactured in the U.S. was roughly 30 percent of the value of all goods and services in the economy in 1953, 25 percent in 1970, 20 percent in 1982, and less than 15 percent in 2001. The share of the U.S. labor force working in the manufacturing sector fell over the same period from over 26 percent to about 10 percent. Today manufacturing represents half of what its share of gross domestic product was in the 1950s.

When manufacturing moves overseas to China, India, East Asia, or Europe, it takes engineering know-how with it because engineers will ply their trade where the action is — outside the United States. While venerable U.S. engineering institutions still maintain their foothold, more than half of

their doctoral degrees are awarded to foreign students.¹⁵ At some universities, it is much more. At six large engineering schools, more than four-fifths of the doctoral degrees are awarded to foreigners.¹⁶ Manufacturing has declined so severely in many communities that basic industrial skills and the small-business suppliers and support industries necessary to sustain manufacturing are disappearing. Even the industrial base necessary to maintain a technological edge in military hardware and the ability to ramp up for war are starting to vanish. The National Association of Manufacturers has warned that the country “may be dropping below critical mass in manufacturing.”¹⁷

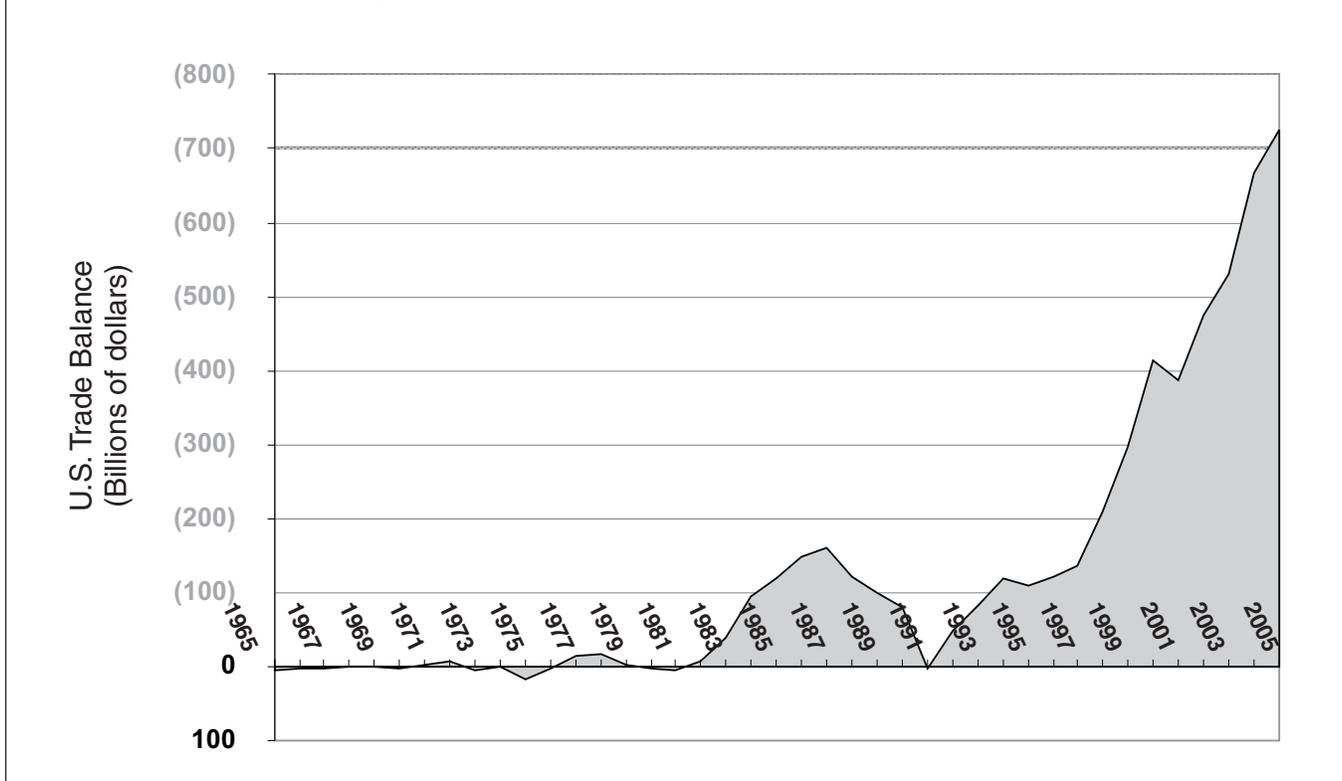
The bad news doesn't stop there. The U.S. runs a sizable negative merchandise trade imbalance with every principal nation and region in almost every category of goods — so large an imbalance that the U.S. trade deficit exceeded \$700 billion in 2005,

¹⁵A more detailed view of 333 U.S. and 8 Canadian engineering colleges can be found at www.asee.org/colleges.

¹⁶New Jersey Inst. of Technology, 91.4 percent; SUNY, Buffalo, 88.2 percent; Illinois Institute of Technology, 82.1 percent; Clemson University, 81.8 percent; SUNY, Stony Brook, 81.4 percent; and Texas A&M, 80.9 percent.

¹⁷Joel Popkin, “Securing America's Future: The Case for a Strong Manufacturing Base,” June 2003 (Prepared for the NAM Council of Manufacturing Associations). “Group Warns Factory Weakness Could Hurt U.S.,” *The Wall Street Journal*, June 11, 2003, pp. 2-4.

¹⁴Table 2, Bureau of Economic Analysis, “Gross Domestic Product by Industry, New Estimates Based on the North American Industry Classification System,” Robert E. Yuskavage and Mahnaz Fahim-Nader (December 2005). See http://www.bea.gov/bea/ARTICLES/2005/12December/1205_GDP-NAICS.pdf

Figure 2. U.S. Trade Deficit, 1965-2002.

around 6 percent of GDP.¹⁸ (See Figure 2.) Even the agricultural trade surplus has unceremoniously disappeared. In what is an unsustainable pattern, we produce only two-thirds of the goods we consume.¹⁹ And the relentless growth of the trade deficit has converted the United States, once the world's largest creditor, into the world's largest debtor, enabling foreigners to own an estimated \$3.7 trillion in U.S. assets (an amount on scale with the total privately owned portion of the U.S. federal debt).²⁰

The effect of this decline is not a numerical abstraction. It can be felt in the shrinking share of

U.S. income earned by blue-collar workers. The decimation of our domestic producer base has resulted in job losses for America's middle class, lost opportunities for the young, suffering for the poor, and a widening wealth gap. This decline corresponds with the outsourcing of jobs and production overseas and an increase in the number of manufacturing start-ups basing their operations on foreign soil.

Meeting the Goals of Reform

There is little question that taxwriters must ensure that the product for which they are responsible — our nation's tax laws — is state of the art. The way to ensure that the best reform product is chosen is to compare the problems with the solutions.

The Benchmarks for Neutrality

Academics believe that neutrality is the Holy Grail of international tax policy efficiency, and the value of the international system can be measured by how well it achieves neutrality. There is sound economic reasoning behind this. Neutrality promotes efficiency in a tax system by minimizing the impact of taxes on economic decisions. However, with Professor Hines's two new formulations of

¹⁸U.S. Census Bureau, Foreign Trade Division. U.S. Trade in Goods and Services — Balance of Payments Basis Value in millions of dollars (1960 through 2005). See <http://www.census.gov/foreign-trade/statistics/historical/gands.txt>

¹⁹This, of course, means the U.S. is running a large capital surplus, but the inflow of capital is not being used to fund new investment. Business fixed investment is stable at roughly 15 percent of GDP. Instead the U.S. is selling its assets to fund current consumption.

²⁰This alone should call into question the continued relevance of CEN as a goal.

neutrality benchmarks, there are now a total of five competing theories of neutrality: CEN, CIN, NN, NON, and CON.

And if the existence of so many competing theories proves one thing, it is this: International tax economists have yet to develop an acceptable yardstick for measuring neutrality. The tax community is still split on whether taxation of investment should be neutral relative to the residence of the taxpayer (capital export neutrality) or relative to where the investment is located (capital import neutrality). Capital export and capital import neutrality each may be satisfied only if there is uniformity of taxation by all residence and source countries, which of course is never the case absent tax hegemony. Further, all such theoretical benchmarks are not only inconsistent, they are also increasingly irrelevant especially under a pro-growth consumption tax.

Let us analyze them one at a time. Consider CEN first, the most popular theoretical benchmark for “outbound” transactions. CEN can be fully achieved only if a U.S. taxpayer’s choice to invest domestically or abroad is unaffected by taxation — that is, if the return on capital is taxed at the same level to the resident regardless of its source.

We fail to effectuate CEN today through the foreign tax credit mechanism. True enough, the crediting mechanism permits a dollar-for-dollar credit for foreign income taxes paid up to the tentative U.S. tax on that net foreign-source income and thereby seeks to tax foreign-source earnings the same as U.S.-source earnings. However, we would truly tax foreign earnings the same only if we were willing to immediately tax foreign earnings with no allowance of deferral and no foreign tax credit limitation. Only by eliminating the advantage of deferral together with the limitation would a U.S. taxpayer’s decision to invest here or abroad be unaffected by the foreign tax imposed.

Be that as it may, adopting all these changes — as Shay would almost have us do²¹ — would not serve the greater efficiency objective CEN boasts. As witnesses at the hearing pointed out, CEN is increasingly irrelevant because the United States is no longer a net exporter of capital. But the problems go well beyond that. Indeed, by allowing a credit up to the highest tax rate in the world, CEN introduces the collateral problem of effectively subsidizing high foreign marginal tax rates that reduce global welfare in a race to the top marginal rates. CEN therefore introduces an incentive for global tax reform. And our reliance on CEN is based on the faulty premise that

a U.S.-based company has but two choices — invest here or abroad — when today’s choice may be over which jurisdiction offers the better tax regime. The obvious failure of the theoretical benefits from CEN is that the concept fails to fully appreciate investors and companies are not held captive to the U.S. tax system. Headquarters of the companies themselves can be relocated to enjoy lower rates (markets can be lost to lower taxed foreign competitors). In the context of reform toward a consumption tax, CEN has no continued relevance. The only way to ensure that companies want to continue to produce in the United States is to create a better tax environment here for them to do so and to seek neutrality with respect to both the situs of investors and investment.

Capital import neutrality is achieved when all firms doing business in a market are taxed at the same rate, regardless of where the owners are resident.

Capital import neutrality is achieved when all firms doing business in a market are taxed at the same rate, regardless of where the owners are resident. To fully implement capital import neutrality worldwide, all residence countries would exempt foreign income and tax would be levied only by the country where income is earned (the source country). Some aspects of our current system, such as the taxation of inbound transactions, seek to achieve that objective to the degree foreign direct investment is taxed the same as the domestic investment of a U.S. resident.

Like CEN, CIN is a goal that is not only dubious but unachieved today. For instance, on the inbound side the U.S. withholding tax on dividends and interest (to the degree treaties don’t reduce it to zero) disadvantages foreign capital owners and places foreign direct investment at a disadvantage to domestic direct investment. CIN is violated in the outbound context for several reasons. Our crediting mechanism ensures that U.S. foreign investment is taxed at the U.S. rate, not at the rate of the host country. Moreover, most nations impose an ad valorem tax on goods imported into their markets, while the U.S. income tax often imposes a double layer of tax.²²

Graetz’s plan would theoretically be the best of the three witnesses’ proposals at achieving CIN by exempting foreign-source income. The exemption would ensure that the U.S. firm doing business in a

²¹Although Shay would not allow an unlimited credit, it doesn’t matter too much when we have the highest rates in the world.

²²Discussed below.

foreign market is taxed at the same rate as a domestic firm in that market, or as a firm domiciled in a country that also has a similar territorial system.²³ However, Graetz's concept fails to achieve CIN also because (1) not all competitors will be from territorial jurisdictions, (2) tax sparing may be used to attract some firms and not others, (3) U.S. inbound transactions may be taxed at a higher rate because of withholding, and (4) the incidence of some U.S. taxes may effectively impose a higher tax burden on the earnings no matter where located. The FairTax accomplishes CIN by not taxing earnings until final retail consumption. As a result, U.S. companies enjoy a zero rate of tax on income whether that income is located here or abroad.²⁴

The policy of allowing deductions only for foreign taxes is sometimes known as "national neutrality." The national neutrality doctrine implies that, to maximize the national gain from the worldwide investment of U.S. capital, the tax system taxes U.S. residents on foreign and domestic income after foreign taxes by treating foreign tax payments as a (deductible) expense associated with doing business abroad.²⁵ By not allowing a foreign tax credit or exempting foreign income, a capital-exporting nation does not cede full taxing jurisdiction to foreign nations regardless of the source, penalizes outbound investment, and generally seeks to ensure that the governments' share of the earnings is the same wherever the investment takes place. National neutrality maximizes the revenue of the nation at the expense of efficiency. This neutrality principle is not worth examining because the objective it seeks to achieve — government benefit at the expense of prosperity — is not a proper role for the government.

Hines argues that normative benchmarks of CEN, CIN, and NN carry very different implications by failing to account for the productivity effects of tax-induced changes in capital ownership. He assumes output can be maximized by encouraging the most productive ownership of assets within the set of feasible investors. The benchmarks of CON and

NON measure desirability of international tax reforms from these perspectives.²⁶

- CON is satisfied if taxes do not distort the ownership of capital assets. An example is a regime that exempts foreign income from taxation.
- NON is satisfied if a tax system promotes the profitability of domestic firms, and therefore home country welfare.

The argument for NON and CON as a global objective is also suspect, most notably because only half of the OECD countries have a territorial tax system (either by statute or treaty) by which a parent company is not subject to tax on the active income earned by a foreign subsidiary. Moreover, the benchmarks appear to leave out that the full taxation of the capital owners by the resident country would argue against the neutrality of capital ownership.²⁷

Although it is beyond the scope of this article to fully explore the neutrality principles or to discuss how various reforms fail to satisfy them, it is important to point out that the FairTax is the one plan that best meets the theoretical benchmarks of neutrality outlined above. Because the FairTax does not tax production at all, whether conducted domestically or overseas, it achieves all the traditional measurements of neutrality. To the degree foreign countries reduce their taxation on returns to capital (and they may have to), the FairTax also accomplishes CEN. And while we are again on the subject of neutrality, why not propose a couple more measurements? The FairTax is the only plan that is consumption neutral, because it favors consumption of neither domestically nor foreign-produced goods.

Presumed Objectives of Territoriality

Taxwriters heard from most of the witnesses at the hearing that international competitiveness can be advanced by three silver bullets: territoriality, rate reductions, and simplicity. But does a territorial income tax regime truly fulfill the economic promises of territorial advocates?²⁸

²³Shay's proposal would not be capital import neutral for outbound transactions because it would tax foreign-source earnings at U.S. levels.

²⁴The dubious objective of CEN is best achieved by Shay's plan because he would eliminate deferral and allow crediting. The FairTax does not make U.S. residents indifferent to foreign tax levels and therefore does not achieve CEN unless those jurisdictions reduce their tax rates to zero. However, the goal should be to pressure jurisdictions to reduce their rates rather than encourage them to maintain high rates through what is an effective subsidy for doing so.

²⁵For further discussion, see Jane G. Gravelle, *National Tax Journal*, Vol. LVII, No. 3 (September 2004).

²⁶The following paper formed a foundation for their testimony: Mihir A. Desai and James R. Hines Jr., "Evaluating International Tax Reform," 56 *National Tax Journal* 487-502 (September 2003).

²⁷A better measurement might be production neutrality (PN), which might analyze if the tax systems improve the chances that goods and services will be produced in the home country. Another measurement might be consumption neutrality (CN), under which consumption of either domestically or foreign-produced goods is favored. This is discussed in the border adjustability section.

²⁸Although today the United States taxes its citizens and residents on income no matter where it is earned, under a
(Footnote continued on next page.)

The first argument made by proponents of territoriality is that if a U.S. company can enjoy low taxes and still be headquartered here, the management functions will remain in the United States and the company will be less likely to be acquired by a foreign corporation. Ironically, that argument is partly based on a premise that the tax environment elsewhere is implicitly more conducive to production.²⁹ Economists have argued that as American production chases better tax rates, the foreign direct investment that results will complement, and not substitute for, domestic investment. In other words, it will not reduce U.S. exports or displace U.S. jobs.³⁰ Hines notes that national welfare could be maximized by exempting foreign income from taxation in cases in which additional foreign investment does not reduce domestic tax revenue raised from domestic economic activity.³¹ Some have even sought to quantify how much overseas production generates exports.³² Other territoriality proponents argue that international tax laws are complex, gamed, and poorly enforced, so companies must spend billions complying with rules that have been recognized by the Joint Committee on Taxation staff to yield little or no revenue.³³ A minority argues that allowing U.S. production to move where the taxes are lowest will compel the United States to lower its corporate tax rates.³⁴

territorial system the United States would exercise taxing jurisdiction only when income is earned in the United States. That regime, for example, would allow a U.S. multinational to escape U.S. corporate taxes on its foreign earnings.

²⁹While this is an admitted oversimplification, there is merit to the irony.

³⁰Council of Economic Advisers, *Economic Report of the President* (Washington: U.S. Government Printing Office), February 1991, p. 259.

³¹This condition is satisfied if, to the extent that marginal foreign investment reduces domestic investment by domestic firms, it triggers an equally productive amount of new inbound investment from foreign firms. The problem is that foreign capital imports are being used to further consumption of foreign goods and not to invest in plants and equipment, as shown by the current account deficit data.

³²Robert E. Lipsey, "Outward Direct Investment and the U.S. Economy," in Martin Feldstein, James R. Hines Jr., and R. Glenn Hubbard (eds.), *The Effects of Taxation on Multinational Corporations*, (Chicago: University of Chicago Press, 1995). In a more recent survey, Lipsey reaches similar conclusions. Robert E. Lipsey, "Home and Host Country Effects of FDI," National Bureau of Economic Research Working Paper No. 9293, October 2002.

³³"Options to Improve Tax Compliance and Reform Tax Expenditures," Joint Committee on Taxation, Jan. 27, 2005 (JCS-02-05, pp. 186-197) (2005 WTD 21-22 or Doc 2005-1714).

³⁴Cato Policy Analysis, "International Tax Competition: A 21st-Century Restraint on Government." Chris Edwards and Veronique de Rugy. No. 431, Apr. 12, 2002.

These points are at first convincing — particularly the argument that territoriality will put needed pressure on politicians to reduce marginal rates. But while economists insist there may be "little reason to believe that increased investment abroad necessarily implies less economic activity at home,"³⁵ that expert guess may not be a comforting thought to the U.S. production worker. Although members of Congress who promote a territorial plan will probably not be called stupid by academicians at Yale, Michigan, and Columbia, Congress should consider how that yet-uncertain conclusion bears on the political practicability of a territorial approach.

Over four decades ago, during President John F. Kennedy's administration, the same question arose in an almost identical context: Should the United States tax the foreign earned profits of U.S. multinationals (should U.S. companies doing business overseas escape U.S. taxes)? Predictably, the debate pitted management (who wanted white-collar jobs to remain in the United States) against unions (who argued that it would also be a good idea to keep U.S. blue-collar jobs in the United States). It pitted Democrat against Republican, economist against economist. And the unions argued, understandably, that if American companies are able to take advantage of tax sparing, they will establish themselves overseas to the detriment of the U.S. workforce. The debate had one good consequence — it propelled a reduction of rates. However, it did so in exchange for subpart F.

And Congress should consider also that it is not at all certain that the unions could be wrong. As noted, a strict territorial income tax system or the elimination of subpart F for active trade or business income might help temporarily to make the United States a more desirable place to invest if that is accompanied by lower marginal rates, but it is questionable that the benefit would redound to the workforce. Territoriality has the potential to drive job-generating plants and facilities overseas in search of tax sparing, so that only the shell corporation remains headquartered here. At the same time, a broad income tax base coupled with a crediting mechanism may make it disadvantageous for companies to base operations here.

³⁵Statement of R. Glenn Hubbard, Dean and Russell L. Carson Professor of Finance and Economics, Columbia University Business School, before the Subcommittee on Select Revenue Measures of the House Committee on Ways and Means (June 22, 2006). See also, Report of the President's Advisory Panel on Federal Tax Reform suggesting that there was no definite evidence that location incentives would be significantly changed and that, in any case, companies can effectively exploit the current deferral rules to achieve virtual exemption (IMF Working Paper Fiscal Affairs Department, "Moving to Territoriality? Implications for the United States and the Rest of the World," Peter Mullins (June 2006)).

Forty-five years later, what lesson does that tax debate hold for policymakers?

It means the debate over territoriality is potentially more politically contentious than economically constructive and is not merely an extension of the temporary repatriation rules.³⁶ It means that taxwriters who choose to stroll unwittingly into that political minefield should be prepared for an intractable and uninformed engagement. Unless unions internationalize, American blue-collar workers will probably not stand idly by while Congress does what is perceived to be as legitimizing corporate inversions de jure, whereby companies can remain in the United States by address only while the jobs flock to nations that dole out the tax holidays. George Santayana wrote that “those who cannot remember the past are condemned to repeat it.”³⁷ Past tax policy debate echoes valuable prologue on the possible effects of this choice.

Territoriality has the potential to drive job-generating plants and facilities overseas in search of tax sparing, so that only the shell corporation remains headquartered here.

And apart from complicating politics, simply adopting a territorial system does not simplify compliance either. A territorial system may allow for some simplification by repealing section 956 and section 367(b), and it would presumably eliminate dividends as a category of subpart F income. Overall, however, territoriality may do little to reduce the hundreds of pages of complexity that constitute our international tax system, from the income sourcing and expense allocation rules (yes, those will be

important unless Congress wants to delegate that to section 482), to the foreign tax credit limitations on portfolio income, to subpart F's new definitions, to personal holding company rules, to determining the difference between passive and active income,³⁸ to the various baskets of income that have made tax lawyers basket cases.³⁹ Determining whether activity takes place inside or outside the United States, applying income sourcing and expense allocation rules, and figuring out how to treat older earnings that will be repatriated will equal or exceed the complexity posed by the arcane rules of current law because the stakes will not be merely tax deferral, but exclusion from tax. Those who advocate territoriality underestimate the complexity of ongoing rules, the necessary transition rules, and the sustainability of the proposals. Those are significant factors because territorial proposals retain almost all the cost drivers of current law.

Finally, it is questionable whether or not territoriality will serve the purpose of pressuring lawmakers to reduce rates. Nobody is seriously advocating that territoriality be permitted for passive, movable portfolio investment, if only for the enforcement problems that presents. Consider the preservation of the crediting mechanism for portfolio investors and the payment of royalties or dividends. Since a crediting mechanism with high marginal rates makes taxpayers relatively indifferent about which jurisdiction they invest in, the U.S. tax system's high marginal rates provide an incentive for other taxing jurisdictions to increase their rates. This does not benefit the United States at all, since absorption of the tax credits against the high rate also prevents the United States from preserving its base.

³⁶This is an allusion to section 271 of the House bill and section 231 of the Senate amendment to the American Jobs Creation Act of 2004, 108th Congress 2nd Session. See Conf. Rep. 108-755 to accompany H.R. 4520. The act provided a temporary incentive to bring foreign earnings back to the United States by reducing the effective tax rate on dividends from foreign subsidiaries from 35 percent to 5.25 percent. The ability to use the reduced rate, however, is subject to several limitations: The dividends (1) must be paid in cash; (2) must exceed the taxpayer's average repatriations for a five-year base period (average of five last years, excluding the high and low years); (3) must be invested in the United States under a domestic reinvestment plan; (4) are limited to the greater of \$500 million or some foreign investments shown on the financial statements; and (5) must be paid to the parent of a controlled foreign corporation.

³⁷Santayana, *The Life of Reason*, Vol. I, “Reason in Common Sense.”

³⁸To ensure that the reform would not discriminate against any sector of the economy, exemption of foreign earnings from taxation may not focus on the form (that is, dividend, royalty, interest, and so forth) in which the earnings are received by the U.S. taxpayer; rather, the focus should be on whether the earnings are active or passive. It has been argued that “active” foreign dividends, royalties, interest, and other forms of income should be exempt from U.S. taxation and that passive income from those categories of income should be subject to tax. By way of example, exempting only dividends would discriminate against the software industry because a significant portion of its revenue is in the form of royalties.

³⁹Some argue that under a territorial regime, there should be only one basket, but that raises additional issues of neutrality for Hines. For instance, why should U.S. investment be directed toward high-tax jurisdictions that can offset their higher taxes against low-tax jurisdictions? The current international tax system is designed to protect the U.S. tax base by preventing taxpayers from reducing their U.S. tax liabilities on domestic income with credits for taxes paid to foreign governments.

Here again, the FairTax has all the economic advantages without the political drawbacks. The FairTax eliminates the complexity of the foreign tax credit scheme, the personal foreign holding company rules, intercompany transfer pricing rules, subpart F, income sourcing and expense allocation rules, and many other complex international tax rules that create high compliance costs today. It does so by eliminating any business-to-business taxation and by taxing only consumption in the United States. And it accomplishes the underlying objectives of territoriality without driving plants and jobs offshore.

Improving the Welfare of the American People

1. Key Questions Asked and Answered

Craig R. Barrett, chairman of the board of Intel Corp., framed what was perhaps the most useful question policymakers should ask — whether the plans create a better tax environment for domestic rather than foreign production. In the final analysis, that question hinges on which jurisdiction offers the lowest and most sustainable tax rates.

The FairTax stands alone among all reform plans in ensuring domestic corporations enjoy a zero rate of tax for producing in the United States.

Most of the plans suggested by the hearing's witnesses are intended to reduce taxes on domestic production. However, while Graetz and Shay want to lower rates by "broadening" the income tax base (at least until it disintegrates), they err by defining a broad base as a system that taxes the same income multiple times. The Graetz plan, for example, would impose several layers of tax on the same dollar of earnings before it can be consumed. At its source, the income would be taxed at reduced corporate income tax rates (25 percent), while the earnings or salaries would presumably be taxed by the new AMT and by FICA taxes (three-quarters of Americans pay more in FICA taxes than income taxes today), the gains on stock sold would be taxed as capital gains, and the stock in one's estate could be subject to transfer taxes. Meanwhile the proposed VAT would likely be passed forward in the form of higher-priced goods and services — the VAT would largely be the same as a retail sales tax without a rebate. Shay would simply keep the multiple layers of tax of the current system, which is justifiably criticized as taxing a dollar of income three or four times today. When the same income is taxed several times, the base of taxation is not broadened; the taxes are simply reimposed time and time again as the income shifts pockets. To determine the true calculation of

the burden of marginal rates, we would have to add up the taxing events on the same dollar of income until consumed.

The FairTax stands alone among all reform plans in ensuring (1) domestic corporations enjoy a zero rate of tax for producing in the United States and (2) a dollar of income is taxed only once. Because the FairTax would impose a zero rate of tax on productive activity within the United States, it would create the *ne plus ultra* environment for foreign direct investment in American plants, equipment, and labor. The FairTax by definition has the lowest rate of any tax reform plan that does not lower the amount of revenue the government receives in real dollars, reduce government spending in real dollars, tax the poor, tax exports, tax savings, or tax the same income more than once. Its base is in fact twice that of taxable income today.

The second practical question posed is whether the plans create a better tax environment for foreign direct investment in plants and operations in the U.S. than in competing venues. Few witnesses discussed what is known as "inbound" transactions, presumably because those transactions would maintain the complex and nonneutral rules that exist today when we tax income effectively connected with a U.S. trade or business, including the branch profits. The current law retains not only anomalous rates for foreign direct investment because of the separate taxation of fixed, determinable, and periodic income, but also retains the problems under the intercompany transfer pricing rules. The FairTax would not discriminate against foreign returns on capital or U.S. returns on capital, but as a destination-based consumption tax, it would ensure that the product of either foreign or domestic production is taxed at exactly the same level by imposing a single retail sales tax on both.

Asking whether the plans encourage tax competition (that is, whether they encourage rather than discourage a reduction in global rates) again favors the FairTax. Today, our crediting mechanism serves as a disincentive for nations that import U.S. capital to lower their tax rates below the unnecessarily high marginal rates of U.S. corporate tax. Although soak-up taxes are not technically not creditable,⁴⁰ the practical effect of allowing credits up to the U.S. tax liability on foreign-source income is that countries can tax up to that limit without further disadvantaging American capital investment anymore than we already do. Shay's proposal would retain and perhaps worsen that disincentive. Graetz's proposal would have the beneficial effect of putting

⁴⁰A soak-up tax means the U.S. taxpayer is liable for the tax only to the extent that the tax is creditable.

some downward pressure on U.S. rates as the U.S. competes for its own multinationals' investment. But as noted earlier, the effectiveness would be diminished by the ability of corporations to simply relocate their activity. The zero rate of tax the FairTax provides would give foreign jurisdictions two choices: reduce their tax rate on savings and investment (which will stimulate global economic reform and growth) or lose investment to America. This would have a pronounced positive effect not only on corporate decisionmakers but also on politicians worldwide.

If the taxwriters were to examine if plans afford an easy transition from the current system to the alternative, they would discover that moving to a territorial income tax would raise many transition issues, including how to treat preenactment dividends and how to treat excess foreign tax credits.

The FairTax increases the income of U.S. residents and the purchasing power of U.S. residents' income.

Here again, only the FairTax would completely remove taxes from decisionmaking by being vertically and horizontally equitable. And only the FairTax would provide a sustainable solution. The FairTax is the only plan that ensures our tax system will not disintegrate into the current mess by eliminating the income tax and by promoting repeal of the 16th Amendment to forbid an income tax. As noted, the supermajority requirement for increasing taxes as contained in the Graetz proposal and in many flat tax proposals offers false hope for the sustainability of such plans. And only the FairTax eliminates fully the need to coordinate jurisdictional taxation, because source income is not taxed.

Perhaps more important than any of those advantages, the FairTax increases the income of U.S. residents and the purchasing power of U.S. residents' income. Recent studies show that under the FairTax, a decade from now the economy would be about 20 percent larger, and real wages would increase far more than under current law. In fact, recent simulations under the current system show capital per unit of human capital declining 5 percent over the course of the century for an 18 percent decline over the long run in after-tax take-home pay. A switch to the FairTax would cause real wages to rise by 13 percent for an 18 percent difference in remuneration; by 2030 real wages under the FairTax would be 9.3 percent higher than they otherwise would be. The shift to the FairTax would raise marginal labor productivity and real wages over the course of the century by 18.9 percent and long-run output by 10.6 percent. In the long run, low-income

households would experience a 26.7 percent welfare gain, middle-income households a 10.9 percent welfare gain, and high-income households a 4.7 percent welfare gain. The other plans fail to fully integrate what ought to be one of the driving influences of domestic reform: economic growth. In fact, to support Shay's or Graetz's proposals is to support less prosperity, greater poverty, and harder times for Americans.

2. American Disadvantage in the Global Marketplace

That the issue of border tax adjustment was discussed to such a limited degree in the hearings may have something to do with the fact that, for various reasons, none of the plans the witnesses championed could be made fully border adjusted.⁴¹

a. Why Is Border Adjustability Important?

The United States should not target a particular trade deficit level, subsidize its exporters, or impose tariffs on imports. By doing so, we would interfere with mutually beneficial transnational economic exchanges to the disadvantage of both countries' economies. That is the premise behind striving for neutrality in its various forms (CEN, CIN, NN, CON, and NON), which are mutually unobtainable goals. By the same token, however, the U.S. government should not grant an advantage to foreign companies competing in the U.S. market or impose a disadvantage on American producers and workers selling their goods and services in the United States and foreign markets, as it now does as a matter of policy. Our failure to conform our tax system to a border-adjusted regime is a potent weapon against U.S. producers and workers — a weapon we use to shoot ourselves in the foot both in the sense that we redistribute existing production and introduce huge distortions that misallocate resources to the detriment of global growth. We would greatly benefit from replacing the income tax (which places our people at a disadvantage) with a border-adjusted destination principle system (which is neutral between foreign and U.S. goods).

How does our failure to enact a border-adjusted tax system affect us? Recall that U.S. corporate taxes are the highest in the industrialized world, with a top corporate rate about 9 percentage points higher than the OECD average.⁴² To the extent these corporate taxes and payroll taxes imposed on

⁴¹Even though Graetz admitted the importance of border adjustability, his proposal can be made only partially border adjusted because the payroll taxes and income tax component of his base cannot be border adjusted.

⁴²Martin A. Sullivan, "Economic Analysis: On Corporate Tax Reform, Europe Surpasses the U.S.," *Tax Notes Int'l*, June 5, 2006, p. 855. If you compute the EU average marginal rates (Footnote continued on next page.)

Table 1. Advantage for Foreign Producers.

Origin	Sold in U.S. Market	Sold in Foreign Markets
U.S. production	Pays U.S. income and payroll taxes.	Pays U.S. income and payroll taxes and foreign VAT.
Foreign production	Pays no U.S. income or payroll tax and no foreign VAT.	Pays foreign VAT.

producers and workers have forward incidence and remain embedded in the producer prices, relative prices of goods (and services) in the global marketplace are altered. To the extent that the incidence is on the factors of production, it makes the returns to investment in the United States lower and reduces U.S. capital stock and U.S. productivity. Well-established price theory would lead an analyst to conclude that in almost all cases, the incidence is shared between consumers and producers, but the economic effect is largely the same.

When two nations with border-adjusted tax regimes trade together, embedded taxes can negate themselves. Taxes one nation rebates on domestically produced exports are reimposed by the importing jurisdiction in what is effectively an economic wash. But the interaction of indirect border-adjustable systems with the U.S.'s tax system has no reciprocal effect. Foreign VATs, which are a major component of the total revenue raised elsewhere, are rebated when foreign goods are exported to the U.S. market. Conversely, the U.S. tax system imposes no corresponding tax burden on foreign goods sold in the U.S. market. The United States' failure to answer with an ad valorem tax or to remove the tax on exports creates a large and artificial relative price advantage for foreign goods in both the U.S. market and abroad. Table 1 illustrates the penalty U.S. producers pay in taxes.

Indeed, it has been estimated that border-adjusted regimes effectively grant foreign producers an approximately 18 percent price advantage over U.S.-produced goods, whether they are sold within or without the United States.⁴³ Since all our trading partners have border-adjusted regimes, our failure

for each year, you will find that they have declined from 35 percent in 1996 to 26 percent in 2005.

⁴³David A. Hartman, "The Case for Border-Adjusted Taxation in the United States," *Tax Notes Int'l*, Sept. 27, 2004, p. 1183. Conversely, in U.S. markets, foreign goods bear no U.S. tax and the foreign VAT is forgiven. Thus, among the most manifest violations of neutrality in the U.S. tax system is that it places U.S. producers — including businesses and workers in manufacturing, agriculture, mining, and forestry — at a

(Footnote continued in next column.)

to follow suit results in the equivalent of a self-imposed handicap, stimulating outsourcing, encouraging plant relocations, and lowering the wages of the American workers. A recent report by Jim Hausman, professor of economics at the Massachusetts Institute of Technology, states that the U.S. failure to recognize and confront this problem costs it more than \$100 billion in exports annually.⁴⁴ In my judgment, Hausman's is a conservative estimate.

Our failure to replace our origin principle tax with a border-adjusted tax explicitly encourages consumption of foreign, rather than American, goods. And it converts many of our nation's retailers into what are effectively tax-free trade zones for foreign-produced goods.

The self-flagellating tax policy is an anachronism for the most part. Our laudable commitment to free enterprise and rejection of mercantilism and colonialism has existed since World War II, because American business and political leaders have viewed free trade as the basis for international peace and prosperity. As the dominant economic and military power, the U.S. led the movement to dismantle trade barriers and supported international trade liberalization (GATT and WTO), economic cooperation (OECD), and customs unions (such as the European Union and NAFTA).

We have been successful, sort of. The OECD says its members have reduced their average tariff rates from 40 percent at the end of World War II to 4 percent today. But today the European Union has an average standard VAT of 19 percent, while the

large competitive disadvantage relative to their foreign competitors both in U.S. markets and in foreign markets. If Hines were to add one more neutrality dynamic to the CEN, CIN, NN, CON, and NON, he might add the notion of export-import neutrality, which would integrate not only marginal rates of production but also consider whether a consumption tax system treats foreign and domestic goods alike in the marketplace. Only a destination-based system can achieve that neutrality.

⁴⁴Hausman Study Shows Distortions in International Trading System Hurting U.S. Manufacturers: An Economic Analysis of WTO Rules on Border Adjustability of Taxes," May 2006 (<http://www.standupforsteel.org/hausman.html>).

average OECD standard VAT is 17.7 percent.⁴⁵ During the 1990s, Mexico and Canada increased composite rates to 15 percent from 10 percent and 7 percent, respectively. China adopted a 17 percent VAT in 1994. As foreign governments increased the VAT, they also reduced effective corporate income taxes. Meanwhile, high U.S. corporate tax rates today, coupled with U.S. taxation of the foreign income of corporations based in the United States, caused corporations to relocate their headquarters to countries that exempt taxation of overseas income. In effect, the U.S. tax system is distorting the international marketplace and driving plants and good jobs out of the country at a devastating and unsustainable pace. There are only so many assets we can sell to foreigners before the entire financial system experiences a crisis.

If America wants to rebuild its manufacturing base and remain competitive, it must adopt a border-adjusted tax system.

At a time when U.S. companies are losing ground against foreign manufacturers, at a time of record trade deficits and manufacturing job losses, at a time when the taxwriting committees should finally realize that they cannot legally offer domestic producers direct export incentives like the foreign sales corporation and extraterritorial income exclusion⁴⁶ without violating WTO rules, Congress must address this problem. If America wants to rebuild its manufacturing base and remain competitive, it must adopt a border-adjusted tax system.

b. Counterarguments Are Usually Self-Serving

Some economists mistakenly argue that all of this is a load of poppycock. If America adopted a border-adjusted tax system, any relative price change would be eliminated by an offsetting appreciation in the dollar.

But consider the source. That argument is normally advanced by supporters of tax plans (most of whom are paid by groups that support non-border-adjustable plans) that aren't or can't be made border adjustable. And the argument is normally advanced by the new breed of econo-lobbyists who have given the matter little genuine thought. They hypothesize, for example, that if the FairTax were implemented,

⁴⁵See http://taxpolicycenter.org/TaxFacts/TFDB/Content/Excel/vat_current_rtr.xls/.

⁴⁶Or any of its predecessor gimmicks, such as the domestic international sales corporation and the interest charge DISC, which were struck down by GATT.

the price changes would be offset by a 23 percent immediate appreciation in the dollar. They contend that the appreciation would be caused by a reduction in U.S. demand for foreign currency to acquire (the now more expensive) foreign goods and by an increase in foreign demand for U.S. currency to acquire (the now less expensive) U.S. goods.

Those arguments are as specious as they are ill-considered. The fallacy is that the demand for U.S. dollars is not limited to the traded-goods market. Nearly \$90 trillion in U.S. assets owned by households and nonfinancial businesses is denominated in dollars. Financial institutions trade trillions of dollars in securities and currency each day based on expectations and guesses. And the nontraded-goods and services sector is much larger than the traded-goods sector and is also denominated in dollars.⁴⁷

Prominent commentators have recently begun to publicly disagree with their colleagues on the mitigating effects of exchange rates. Michael Graetz at the subcommittee's hearing for example stated that border adjustability affects competitiveness, disagreeing with President Bush's former economic advisor Glenn Hubbard, Ph.D., who also testified before the Ways and Means Committee earlier on the topic. This topic has also been debated in the pages of *Tax Notes* by ArgusGroup partner David R. Burton.^{48,49} A recent study by Hausman found that:

- Existing disparities in treatment of corporate income taxes and VAT for purposes of border adjustment lead to large economic distortions.
- U.S. exporters bear both domestic income taxes and foreign VAT when selling abroad.
- Foreign exporters in countries relying largely on VAT typically receive a full rebate of those taxes on export to the United States and are not subject to U.S. corporate taxes.

⁴⁷If these economists are right and there is no increase in the competitiveness of U.S. goods because of a 23 percent increase in the price of the dollar relative to foreign currency, that means the FairTax will have succeeded in increasing the wealth of the American people by something on the order of \$20 trillion (23 percent of \$90 trillion) relative to the rest of the world — an instantaneous increase nearly equal to the value of all the goods and services produced in the U.S. over two years. Although that would be reason enough to enact the FairTax, it is impossible for the traded-goods sector to dominate the currency movements, since the dollar-asset markets are perhaps 100 times as large as the annual traded-goods market (net basis). See B. 100 and B. 102, Flow of Funds Accounts, United States of America, Fourth Quarter 2004, Federal Reserve System, for statistical information on asset markets.

⁴⁸See *Tax Notes*, Oct. 25, 2004, p. 611. For the hearing where this was discussed, see Committee on Ways and Means, Hearing on Tax Reform, Wednesday, June 8, 2005.

- This situation creates a significant tax and cost disadvantage for U.S. producers in international trade that affects investment decisions — leading to the location of major manufacturing and other production facilities in countries that benefit from current rules on the border adjustment of taxes.
- The economic implications for the United States are large.
- Elimination of the current disparity in WTO rules (by eliminating border adjustment for either direct or indirect taxes) would increase U.S. exports by 14 percent to 15 percent, or approximately \$100 billion based on 2004 import levels.
- Eliminating economic distortions should be a high priority.

In sum, Hausman agrees that exchange rates are not likely to counteract the relative price advantage of foreign-produced goods.

c. Confronting Border-Adjustable Tax Regimes
i. Changing the GATT/WTO Rules

Assuming taxwriters actually want to stop punishing domestic production, there are two ways they could do so: (1) encourage our trade representatives and trading partners to allow income taxes to be border adjusted, or (2) adopt a destination principle consumption tax. For our trading partners to allow border-adjusted income taxes (direct taxes), they would have to eliminate the admittedly artificial distinction between direct taxes (income taxes) and indirect taxes (consumption taxes) alluded to earlier. Because GATT/WTO rules treat border tax adjustment of “direct taxes” as a prohibited export subsidy, border-adjusted taxes are permissible only in the case of indirect taxing regimes and then only insofar as the amount remitted doesn’t exceed the amount of indirect tax “levied in respect of the production.” That rule was written so the U.S. income tax would not pass muster as a border-adjustable tax, and as a direct tax it does not. Hall and Rabushka’s flat tax proposal would also probably fail to satisfy that rule. So also likely would the proposals of the President’s Advisory Panel on Federal Tax Reform, although that panel recognized the importance of border-adjustability as well.

Were it politically expedient to eliminate the indirect/direct distinction in the Doha Round of WTO negotiations, the Washington lobby could immediately return to work resuscitating FSCs, ETIs, DISCs, interest-charge DISCs, and other export subsidy vehicles that from time to time have been lobbied for, enacted, and then quickly run afoul of the WTO (and before that, GATT). But negotiating away the indirect/direct distinction is not a sensible long-term policy response, because convincing the WTO’s 139 member countries to abandon the

indirect/direct distinction — no matter how baseless that distinction — would take phenomenal diplomatic acumen. If we can’t transform our own system into one that stimulates economic growth for our own benefit (if a subcommittee holding hearings on “international competitiveness” cannot itself appreciate the importance of granting foreign producers unchallenged advantages when competing against domestic producers), and if the Europeans were willing to sue for a relatively minor export incentive worth about \$4 billion annually (FSC/ETI), is it naive to assume our negotiators would prevail in convincing the Chinese, Japanese, Canadians, Mexicans, Koreans, Indians, and Europeans that they should abandon their unique bargaining leverage attributable to their border adjusted taxes? After all, those nations adopted border-adjusted tax systems with the sole purpose of granting themselves a unilateral trade advantage against the U.S.

Assuming arguendo that this diplomacy was miraculously successful, eliminating the indirect/direct distinction would solve only a fraction of the economic problem, and then only for exporters. If the indirect/direct distinction were fully eliminated, an export subsidy would allow exporters to defer or exempt a portion of their income tax only, even though payroll taxes constitute about 36 percent of the gross collections by type of tax. And lest we forget about our record trade deficits, this does nothing to level the playing field on imports, which continue to compete against domestic producers unfairly on our own soil. To correct that imbalance under the income tax, we would have to impose a tax on imports equal to the income tax rate, something that is unenforceable and illegal under our international agreements.

Even if the negotiators were successful, that would be but one step in a process. The Ways and Means Committee is unlikely to have the will to pay for another major FSC provision given the current level of deficit spending.

Finally, eliminating the indirect/direct distinction would merely encourage countermeasures by our trading partners.

ii. Enacting a Destination-Principle System

U.S. manufacturers can compete effectively as the most productive and innovative workers in the world, but the United States must first remove this large and unjustified inequity against U.S. domestic producers. The removal of this tax disadvantage is nothing more than the advancement of another dimension of neutrality, not the enactment of a special advantage. Replacing current U.S. income taxation with comparable border-adjusted taxation would tax all goods consumed in the United States, whether they are produced in the United States or abroad. We need to eliminate those aspects of the

U.S. tax system that artificially place U.S. production at a competitive disadvantage compared to foreign production.

The November 2005 report of the President's Advisory Panel on Federal Tax Reform recommends a border-adjusted tax system,⁴⁹ but fails to conclude that none of its proposals would pass muster under the WTO/GATT rules. In fact, of the five candidates for true tax reform, only three are or could be made border adjusted. They are the FairTax (the most comprehensive, single-stage consumption tax), a business transfer tax (BTT), or a credit-invoice method value added tax (which is called a goods and services tax in Canada and Australia). Each is a destination-principle consumption tax.

Of those plans, only the FairTax is hard-wired to make the entire system border adjusted. The FairTax would transform the entire U.S. tax system by:

- repealing all upstream federal taxes now embedded in the product price of U.S. goods and eliminating any business-to-business taxes, including payroll taxes;
- completely exempting exports from taxation; and
- imposing the FairTax on foreign goods entering the country for final consumption.

When we look at the plans suggested by the witnesses to the House Ways and Means subcommittee, none are fully border adjustable and only one can be made partially border adjustable. Shay's plan could do nothing to stop the imposition of ad valorem taxes by the world's VAT regimes. Nor would Shay's plan remove the "Buy American" penalty on domestically produced goods, because it would do nothing to counteract the VAT rebate on foreign-produced goods. Graetz, while testifying that the border-adjustable issue has merit, failed to admit that his plan could be made border adjustable only for the revenue to be derived from the VAT, and only if the VAT is made explicitly border adjustable.

Only under the FairTax would foreign-manufactured goods and U.S.-manufactured goods bear the same tax burden when the goods are sold at retail in the United States. Only under the FairTax would U.S. businesses selling goods or services in

foreign markets be fully relieved of federal tax (including payroll taxes).⁵⁰

Conclusion

The hearings Congress has held are inauspicious. Congress is missing the opportunity to clarify what it means by competitiveness. And it appears to be blind to border adjustability as a factor that affects U.S. producers' and workers' ability to compete in the world. As negotiators work to level the playing field in the Doha round of trade talks in the coming months, the subcommittee should hold a second competitiveness hearing to focus solely on border-tax adjustments. And it might wish to first establish the criteria on which reform should be based.

The FairTax will probably win few converts among the tax glitterati because it strives for simplicity as a goal and offers dramatic reform. It solves a problem that many ignore by converting the entire U.S. tax base into a border-adjusted destination-base consumption tax system that rejects the argument that the only way to achieve distributional equity is to tax the same income many times, and to punish savings and investment. Through WTO legal means, the FairTax exempts exports from taxation, while taxing imports the same as U.S.-produced goods for the first time. The FairTax even accomplishes the neutrality principles laid out by Hines. Its fault is that it is the simplest plan that could be devised, without the intercompany (and intracompany) transfer pricing problems of an origin-principle income or consumption tax and without divesting 100 million taxpayers from their civic responsibility of paying tax. It reduces U.S. corporate rates to zero, ensuring the United States is the most competitive environment in which to produce and from which to export, while being a competitive irritant for other nations. It would stimulate economic growth by broadening the tax base and reducing marginal rates well beyond any other proposal, and it would do so in a way that does not tax the poor, punish savings and investment, or tax income more than once.

None of that would please the Capitol Hill lobbyists or those whose personal capital stock is dependent on continuation of the status quo. But that isn't really the proper criterion for reform, is it? ♦

⁴⁹See "Simple, Fair, and Pro-Growth: Proposals to Fix America's Tax System," report of the President's Advisory Panel on Federal Tax Reform, November 2005, pp. 171-172 and 283.

⁵⁰The problem with other consumption tax plans — apart from the fact that they can quickly develop into income taxes — is that they make only nonpayroll taxes border adjustable. For example, the BTT, which allows for complete expensing of business inputs, could be made border adjustable by not allowing a deduction for foreign business inputs and exempting export sales. The FlatTax is not border adjusted.