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SECOND IN SERIES ON THE EXTRATERRITORIAL INCOME REGIME

HEARING

BEFORE THE

SUBCOMMITTEE ON SELECT REVENUE MEASURES

OF THE

COMMITTEE ON WAYS AND MEANS
HOUSE OF REPRESENTATIVES

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SECOND IN SERIES ON THE EXTRATERRITORIAL INCOME REGIME

THURSDAY, MAY 9, 2002

HOUSE OF REPRESENTATIVES,
COMMITTEE ON WAYS AND MEANS,
SUBCOMMITTEE ON SELECT REVENUE MEASURES,
Washington, DC.

The Subcommittee met, pursuant to notice, at 2:05 p.m., in room 1100 Longworth House Office Building, Hon. Jim McCrery, (Chairman of the Subcommittee) presiding.

[The advisory announcing the hearing follows:]

ADVISORY

FROM THE COMMITTEE ON WAYS AND MEANS

SUBCOMMITTEE ON SELECT REVENUE MEASURES

FOR IMMEDIATE RELEASE
May 2, 2002
No. SRM–6

Contact: (202) 226–5911

McCrery Announces Second in a Series of Hearings on the Extraterritorial Income Regime

Congressman Jim McCrery (R–LA), Chairman, Subcommittee on Select Revenue Measures of the Committee on Ways and Means, today announced that the Subcommittee will hold its second hearing on the extraterritorial income (ETI) regime. **The hearing will take place on Thursday, May 9, 2002, in the main Committee hearing room, 1100 Longworth House Office building, beginning at 2:00 p.m.**

In view of the limited time available to hear witnesses, oral testimony at this hearing will be from invited witnesses only. However, any individual or organization not scheduled for an oral appearance may submit a written statement for consideration by the Committee and for inclusion in the printed record of the hearing.

BACKGROUND:

On January 14, 2002, the World Trade Organization (WTO) Appellate Panel issued its report finding the United States' ETI rules to be a prohibited export subsidy. This marks the fourth time in the past two and one-half years that the United States has lost this issue, twice in the Foreign Sales Corporation case and now twice in the ETI case. There is no opportunity for the United States to appeal this latest determination.

On January 29, 2002, a WTO Arbitration Panel began proceedings to determine the amount of retaliatory trade sanctions that the European Union (EU) can impose against U.S. exports to the EU. The EU has requested $4.043 billion in sanctions. The United States has asserted that the proper measure of sanctions is no more than $1.1 billion. Originally expected on April 29, 2002, a decision by the panel is now expected by June 17, 2002.

The Subcommittee held its first hearing on the issue on April 10, 2002. The Full Committee held a hearing on February 27, 2002.

In announcing the hearing, Chairman McCrery stated: "Witnesses at our last hearing unanimously agreed that the United States cannot tinker with the ETI regime in a way which preserves its current structure and beneficiaries in a WTO-compliant manner. It is clear a broader approach is necessary. One approach which merits careful consideration is fundamental reform of our tax code. This hearing will give the Subcommittee an opportunity to learn more about proposals such as flat taxes, sales taxes, and value added taxes and whether they can help promote American exports."

FOCUS OF THE HEARING:

The focus of the hearing will be to examine whether fundamental reform of the current corporate tax system is a viable alternative to promote the competitiveness of U.S. businesses in the global marketplace.

DETAILS FOR SUBMISSION OF WRITTEN COMMENTS:

Please Note: Due to the change in House mail policy, any person or organization wishing to submit a written statement for the printed record of the hearing should send it electronically to *hearingclerks.waysandmeans@mail.house.gov*, along with a fax copy to (202) 225–2610, by the close of business, Thursday, May 23, 2002. Those filing written statements who wish to have their statements distributed to the press and interested public at the hearing should deliver their 200 copies to the Sub-

committee on Select Revenue Measures in room 1135 Longworth House Office Building, in an open and searchable package 48 hours before the hearing. The U.S. Capitol Police will refuse sealed-packaged deliveries to all House Office Buildings.

FORMATTING REQUIREMENTS:

Each statement presented for printing to the Committee by a witness, any written statement or exhibit submitted for the printed record or any written comments in response to a request for written comments must conform to the guidelines listed below. Any statement or exhibit not in compliance with these guidelines will not be printed, but will be maintained in the Committee files for review and use by the Committee.

1. Due to the change in House mail policy, all statements and any accompanying exhibits for printing must be submitted electronically to *hearingclerks.waysandmeans@mail.house.gov*, along with a fax copy to (202) 225–2610, in Word Perfect or MS Word format and MUST NOT exceed a total of 10 pages including attachments. Witnesses are advised that the Committee will rely on electronic submissions for printing the official hearing record.

2. Copies of whole documents submitted as exhibit material will not be accepted for printing. Instead, exhibit material should be referenced and quoted or paraphrased. All exhibit material not meeting these specifications will be maintained in the Committee files for review and use by the Committee.

3. Any statements must include a list of all clients, persons, or organizations on whose behalf the witness appears. A supplemental sheet must accompany each statement listing the name, company, address, telephone and fax numbers of each witness.

Note: All Committee advisories and news releases are available on the World Wide Web at *http://waysandmeans.house.gov/*.

The Committee seeks to make its facilities accessible to persons with disabilities. If you are in need of special accommodations, please call 202–225–1721 or 202–226–3411 TTD/TTY in advance of the event (four business days notice is requested). Questions with regard to special accommodation needs in general (including availability of Committee materials in alternative formats) may be directed to the Committee as noted above.

Chairman McCRERY. Good afternoon, everyone. If our guests will take their seats, we will begin the hearing.

Welcome, everyone. This afternoon, the Subcommittee on Select Revenue Measures continues its examination of the issues surrounding World Trade Organization's (WTO's) determination that the Extraterritorial Income (ETI) Exclusion Act regime is an export subsidy inconsistent with our international trade obligations. As Members of this Committee know, we are fast approaching the June 17 date on which the WTO arbitration panel will determine the level of authorized sanctions which the European Union may impose to offset the impact of the subsidy provided by the ETI regime. The looming deadline makes it particularly important that we handle this task with both speed and precision.

I was heartened by recent news reports that the European Union understands the difficult challenges we face in untangling the ETI rules and is inclined to withhold imposing sanctions as long as we continue to make meaningful progress toward a legislative solution to this issue. Despite that positive development, though, it would be unwise for their Committee or the Congress to pause in our efforts to bring the Tax Code into compliance with our obligations under the WTO.

One month ago the Subcommittee held its first hearing on Foreign Sales Corporation (FSC) ETI. The consensus of all the witnesses, including former Members of this Committee who helped draft those laws, was that the benefits of FSC could not be replicated in a WTO-compliant manner. Simply put, if we are to avoid retaliation from Europe while continuing to help our exporters com-

pete in the global marketplace, we must explore more far-reaching changes to the Tax Code.

Today's hearing continues to search for answers by considering fundamental tax reform proposals or, as Secretary O'Neill was quoted as saying today in the Wall Street Journal, "an overhaul of the tax system."

Fundamental tax reform proposals are generally variations of a consumption tax, such as a retail sales tax, a value-added tax (VAT) or a flat tax. On one point, supporters of each of those are correct—any would be, at least in my opinion, a vast improvement over the current system.

In addition to hearing from advocates of various reform proposals, I am hopeful this session will allow for a give-and-take between the witnesses which we have assembled before us. As one of our Subcommittee Members said to me upon entering the room and surveying the panel, wow, we have got some smart guys here to testify today.

So, as long as we have you here, I hope there is some give-and-take among the witnesses so that will help this Subcommittee better understand the extent of the differences that you have, differences of opinion that you have, and also the areas of common ground which you might share.

In particular, I will be interested to learn more about the contention made by some of the witnesses that the differences between a consumption tax and the current corporate income tax are more a matter of form than substance, and that only a few changes to the current Tax Code would be necessary to make the corporate tax border-adjustable.

As my colleagues know, in prior years, this Committee has held several hearings to better understand this and other issues related to fundamental tax reform. It is my hope that this session will build upon those inquiries. In particular, we will be interested in learning what effect these proposals will have on efforts to promote U.S. exports within the bounds of our international trade obligations.

Before introducing the panel of excellent witnesses today, I will yield to my friend from New York for any comments he may wish to make.

[The opening statement of Chairman McCrery follows:]

Opening Statement of the Hon. Jim McCrery, a Representative in Congress from the State of Louisiana, and Chairman, Subcommittee on Select Revenue Measures

Good afternoon and welcome.

Today, the Subcommittee on Select Revenue Measures continues its examination of the issues surrounding the World Trade Organization's determination that the Extra-Territorial Income regime is an export subsidy inconsistent with our international trade obligations.

As members of this Committee know, we are fast approaching the June 17 date on which the WTO arbitration panel will determine the level of authorized sanctions which the European Union may impose to offset the impact of the subsidy provided by the ETI regime. The looming deadline makes it particularly important we handle the task before us with both speed and precision.

I was heartened by recent news reports that the European Union understands the difficult challenges we face in untangling the ETI rules and is inclined to withhold imposing sanctions as long as we continue to make meaningful progress toward a legislative solution to this issue.

Despite that positive development, it would be unwise for this Committee or the Congress to pause in our efforts to bring the tax code into compliance with our obligations under the WTO.

One month ago, the Subcommittee held its first hearing on FSC/ETI. The consensus of all of the witnesses, including former Members of this Committee who helped draft those laws, was that the benefits of FSC cannot be replicated in a WTO-compliant manner. Simply put, if we are to avoid retaliation from Europe while continuing to help our exporters compete in the global marketplace, we must explore more far-reaching changes to the tax code.

Today's hearing continues the search for answers by considering fundamental tax reform proposals.

Fundamental tax reform proposals are generally variations of a consumption tax, such as a retail sales tax, a value added tax, or a flat tax. On one point, supporters of each are correct—any would be a vast improvement over the current system.

In addition to hearing from advocates of various reform proposals, I am hopeful this session will allow for a give-and-take between the witnesses which will help better define the extent of their disagreements and the areas of common ground.

In particular, I will be interested to learn more about the contention made by some of the witnesses that the differences between a consumption tax and the current corporate income tax are more a matter of form than substance and that only a few changes to the current code would be necessary to make the corporate tax border adjustable.

As my colleagues know, in prior years, this Committee has held several hearings to better understand this and other issues related to fundamental tax reform. It is my hope this session will build upon those inquiries. In particular, we will be interested in learning what effect these proposals will have on our efforts to promote U.S. exports within the bounds of our international trade obligations.

Mr. MCNULTY. I thank the Chairman for calling this very important hearing. I thank him for his understanding that I may have to leave to go to the Floor once or twice, because I am involved in one of the issues in the Defense Authorization bill which is currently on the Floor; and in the interest of time, I will just make a very brief opening statement and ask unanimous consent that my entire statement appear in the record.

Chairman MCCRERY. Without objection.

Mr. MCNULTY. Our hearing today will focus on whether fundamental corporate tax reform provides a viable option for replacing the ETI. I look forward to receiving the testimony of experts on proposals for a flat tax, a national retail sales tax, and various European-style value-added taxes.

I am deeply grateful to each and every one of the panel Members for coming here today and sharing their very valuable time and expertise with the Members of the Committee.

With that, I would like to get right to the panel, Mr. Chairman.

[The opening statement of Mr. McNulty follows:]

Opening Statement of the Hon. Michael McNulty, a Representative in Congress from the State of New York

The Select Revenue Measures Subcommittee is holding its second in a series of hearings on replacement of the "Extraterritorial Income" (ETI) regime which the World Trade Organization (WTO) ruled to be a prohibited export subsidy.

Our hearing focus today will be on whether "fundamental corporate tax reform" provides a viable option for replacing the ETI. I look forward to receiving the testimony of experts on proposals for a flat tax, a national retail sales tax, and various European-style value-added taxes.

For most of us the debate over fundamental corporate tax reform is a very familiar one. This Committee spent many hearing sessions exploring the issue as part of former Chairman Archer's unsuccessful search for a viable legislative reform proposal to bring to the Congress. Many others have introduced reform plans over the past decade, each proposal differing in form and advantages and disadvantages.

Today, we are reviewing tax reform in the context of promoting U.S. exports. There is no question that the Administration must respond to the WTO ruling in a way that does not harm the overall competitiveness of American businesses in the global marketplace. However, it is unlikely that our future response can be found in a massive overhaul of our current corporate tax system. Fundamental tax reform is not something that can be done quickly. Also, the idea of fundamental reform often sounds very simple. It can be, in theory. Further insight will show that most proposal reforms are regressive, very complex to administer, and often create new openings for tax sheltering activities and tax evasion.

I know that all the Subcommittee Members will want to join me looking beyond theoretical approaches and discuss realistic alternatives. I want to thank Committee Chairman McCrery for scheduling this important hearing.

Chairman MCCRERY. Thank you, Mr. McNulty. With that, we will certainly turn right to the panel. Our first witness today is Mr. Eric Engen, who is a Resident Scholar with the American Enterprise Institute.

Mr. Engen, your written testimony will be included in its entirety in the record, but we would like for you to orally summarize your testimony in about 5 minutes. Thank you for coming, and you may begin.

STATEMENT OF ERIC M. ENGEN, RESIDENT SCHOLAR, AMERICAN ENTERPRISE INSTITUTE

Mr. ENGEN. Thank you, Mr. Chairman and Members of the Subcommittee. It is a great privilege to have the opportunity to appear before you today. My testimony today provides some broad perspectives on reforms of the corporate tax system and international competitiveness.

The ETI regime exists to help offset some of the efficiency-distorting and anti-competitiveness features of the U.S. corporate income tax. The WTO's decision on the ETI provides an opportunity to rethink the current U.S. corporate income tax structure and consider whether more fundamental tax reform would have an even greater positive effect than the ETI regime on the competitiveness of U.S. businesses.

Economic growth and a higher standard of living in the United States are ultimately achieved by increasing the productivity of U.S. workers. Increased productivity requires savings and investment. It is greater savings and investment and productivity that give businesses improved capabilities to produce goods and services at the relatively lower costs that are demanded in foreign markets.

Businesses must contend not only with making fundamental economic decisions, but also with how to deal with taxes. When compared to our primary economic competitors, such as countries in the Organization of Economic Cooperation and Development (OECD), the United States has a relatively high corporate income tax rate, and unlike most of these competitors, does not provide relief for the double taxation of corporate income.

The U.S. corporate income tax rate is 35 percent, while the average corporate rate for OECD countries is about 30 percent. Moreover, the United States is one of only three of OECD countries that does not have provisions in the Tax Code for some relief from the double taxation of corporate dividends. Coupled with individual income tax rates, the overall marginal tax rate on distributed corporate income in the United States can easily be over 60 percent.

High marginal rates discourage savings and investment in corporate capital and inhibit the competitiveness of U.S. companies in foreign markets.

Some options for corporate income tax reforms are as follows:

First, if the ETI is repealed, then the revenue gain from repeal of the ETI could be used to cut other components of the corporate income tax, such as reducing the corporate alternative minimum tax (AMT). While eliminating or reducing the AMT would be a laudable achievement, it still is only a step in addressing the problem of hefty corporate burdens for U.S. firms relative to their competitors, which initially led to the creation of the ETI.

Second, more fundamental changes that would maintain the basic structure of the corporate income tax system would be to reduce the U.S. corporate tax rate commensurate with the tax rates of competitors and provide relief from the double taxation of dividends.

Both of these changes would increase corporate investment and productivity in the United States and put the taxation of U.S. corporations more on a par with its primary economic competitors, thus increasing the competitiveness of U.S.-based firms and reducing the pressures for an ETI regime. Reducing the U.S. corporate income tax rate from 35 percent to 30 percent, for example, would remove the difference in corporate tax rates between the United States and other OECD countries. Corporate tax rates in OECD countries have decreased, on average, about 11 percentage points over the past 15 years from about 41 percent to almost 30 percent.

In a 1992 report, the U.S. Department of the Treasury recommended that dividend tax relief could best be implemented if a shareholder was allowed to exclude from growth income the dividends received from a corporation, which could be implemented with little structural change to the Tax Code.

Both of these tax changes would likely reduce revenue collected by the Federal Government even if dynamic macro effects were accounted for.

Some additional revenues should be raised, or spending reduced, in order to be budget-neutral. A good general principle for revenue-neutral tax reform is often to broaden the base and lower the rate. This principle suggests that some broadening of the corporate tax base should be considered; on the spending side, government subsidies to corporations could be analyzed.

Third, a much more substantial tax reform would be to completely replace the corporate income tax with a national sales tax, or a VAT.

Replacing the corporate income tax with a consumption tax would remove a large portion of the tax distortion on capital formation in the United States. Moreover, the sales tax or the VAT could be set to be revenue-neutral. However, the incidence of this tax reform would almost certainly be argued by opponents along the lines of it is a tax cut for rich corporations financed by tax hikes on poor consumers, and that argument may very well win the debate.

An alternative that may be more viable would be to fundamentally change the entire tax system. Both the corporate income tax and the personal income tax could be replaced with a flat tax or with a variant of the flat tax, the X tax, that has been proposed

by tax economist, David Bradford, of Princeton University. The X tax is a two-component system comprised of a business tax that would replace the corporate income tax and a compensation tax that would replace the individual tax. Businesses would pay tax on—a flat rate on a base consisting of the receipts from sales less outlays from purchases from other businesses. This part is similar to a VAT and essentially allows complete expensing of all investment.

In addition, business deduct all payments to workers. Workers pay tax on the amount received from businesses, and then total compensation could be taxed with progressive rates, if desired, including allowing an earned income tax credit (EITC) for low-compensation taxpayers. No other income, such as the interest, dividends, rent, or capital gains is included in the compensation tax base; thus, normal returns to capital are not taxed at either the business or individual level.

Although this approach goes well beyond what to do in the near term regarding the ETI regime, this type of fundamental tax reform, in my opinion, holds the most promise for ultimately making U.S. businesses more competitive by putting them in a tax environment that promotes savings and investment and that ultimately leads to higher productivity.

However, one of the potentially toughest issues in fundamental tax reform is the transition from the old tax system to the new system. In particular, there is sort of a "free rider" problem that would tend to rise. Whereas, a majority may agree that the new tax system would be a better overall system, many groups would want to keep their favorite tax preference from the old tax system. However, if most, or all, of these tax preferences in the old income tax system are incorporated into the new consumption-based tax system, then many of the advantages of tax reform become diluted.

Thank you.

[The prepared statement of Mr. Engen follows:]

Statement of Eric M. Engen, Resident Scholar, American Enterprise Institute

Introduction

Mr. Chairman and members of the subcommittee, it is a great privilege to have the opportunity to appear before you today. My name is Eric Engen. I am a resident scholar at the American Enterprise Institute in Washington, D.C. where my research focuses on the effects of tax and budget policy on the economy. My testimony provides some perspectives on reforms of the current corporate tax system and international competitiveness.[1]

My principal conclusions are as follows:

- The competitiveness of U.S. firms in a global economy is influenced most significantly by the level of taxation on capital, especially relative to the tax burden imposed on firms in other countries. In particular, higher marginal corporate tax rates in the United States and the double taxation of dividends puts U.S. firms at a tax disadvantage. The ETI regime exists to try to offset some of this disadvantage.
- Simply repealing the ETI regime does not do anything to address the reasons for implementing the ETI in the first place.
- Reducing corporate income tax rates and integrating the corporate income tax with the personal income tax so that dividends are not taxed twice would significantly improve the economic incentives for investment and make U.S.

[1] I am testifying on my own behalf and not as a representative of AEI.

firms more competitive. However, the corporate tax base should be broadened, or other revenues raise, and/or spending should be reduced so that these tax changes do not have negative consequences for the federal budget.

- An alternative that would go even further to reduce the tax distortions on capital formation, increase investment, and boost U.S. competitiveness would be to fundamentally reform the income tax system by replacing the corporate income tax, and possibly the personal income tax also, with a consumption tax. While this type of fundamental tax reform would likely have the largest payoff, it would, however, be more difficult to implement.

Background

The extraterritorial income (ETI) regime exists to help offset some of the efficiency-distorting and anti-competitiveness features of the tax system for corporate income in the United States. The WTO's decision to rule that the ETI is a prohibited export subsidy, along with earlier adverse decisions regarding the foreign sales corporations (FSC) regime and domestic international sales corporations (DISCs), has led most international tax law experts to conclude that it does not appear possible to comply with WTO and replicate the tax benefits of the ETI statute. This situation provides an opportunity to rethink the current U.S. corporate income tax structure and consider whether more fundamental tax reform would have even greater positive effects than a FSC–ETI-like regime on the competitiveness of U.S. businesses in the global economy.

The Competitiveness of U.S. companies in a Global Economy

The global economy is expanding rapidly. It is vital to the growth of the U.S. economy for U.S. businesses to be internationally competitive. Economic growth and a higher standard of living in the United States are ultimately achieved by increasing the productivity of U.S. workers. Increased productivity requires investment, which is funded by saving. Investment is comprised of both physical investment—such as purchases of plant, machinery, and equipment—and investment in human capital—such as education and research. It is greater savings and investment and productivity that gives businesses improved capabilities to produce goods and services, at relatively lower costs, that are demanded in foreign markets.

Businesses must not only contend with making fundamental economic decisions concerning what investments to make, how to finance those investments, what workers to hire, what products and services to produce, where to locate production and distribution, and what markets to enter, but also how to deal with taxes imposed on their activities. Tax revenue must be raised somehow by the government, but the goal should be to raise revenue in a manner that imposes the fewest and smallest distortions on fundamental economic behavior. Taxes that discourage saving and investment, distort the types of investments that are made, and that cause resources to be wasted on tax administration, compliance, and avoidance activities, reduce the rate of growth of the economy and living standards and hinder the international competitiveness of businesses if these tax burdens are greater than in other countries.

When compared to our primary economic competitors, such as countries in the OECD, the United States has a relatively high corporate income tax rate and, unlike most of these competitors, does not provide relief for the double taxation of corporate income.[2] The U.S. corporate income tax rate is 35 percent while the average corporate income tax rate for OECD member countries is about 30 percent.[3] Moreover, the United States is one of only three OECD member countries that does not have provisions in its tax code for some relief from the double layer of taxation of corporate dividends.[4] Coupled with individual income tax rates (which, after last

[2] Dividend payments are not deductible in the corporate income tax and thus are included in the taxable incomes of corporations. The second layer of taxation arises because dividends are also included in the taxable income of shareholders facing the personal income tax. (This second layer of taxes on dividends can be avoided only if the shareholder is tax-exempt, such as a nonprofit organization, although personal tax payments are delayed until withdrawal if the dividends go to shares held in a tax-preferred retirement or insurance arrangement, such as a 401(k) or other pension plan, an IRA, or variable annuity.)

[3] For example, the corporate income tax rate is 25 percent in Germany, 27 percent in Canada, 28 percent in Sweden, and 30 percent in the U.K. and Japan. These figures are for 2001 and are from the American Council for Capital Formation, "The Role of Federal Tax Policy and Regulatory Reform in Promoting Economic Recovery and Long-Term Growth" (November 2001).

[4] The Netherlands and Switzerland are the other two OECD countries that do not have some method for reducing the double taxation of corporate dividends. Most OECD countries relieve

Continued

year's tax cut, currently range from 27 to 38.6 percent for most shareholders), the overall marginal tax rate on distributed corporate income can easily be over 60 percent. Even if corporate earnings are retained but ultimately dispersed to shareholders through the redemption of stocks that give rise to capital gains, which are typically taxed at a 20 percent rate in the personal income tax, the tax bite on the return from investment in corporate capital is still quite sizable.

These features of the U.S. corporate income tax come at an economic cost. Most importantly, high marginal tax rates discourage saving and investing in corporate capital. Moreover, because dividends are not tax deductible while interest on debt is deductible, corporations are encouraged to finance their activities through debt or retained earnings and discouraged from distributing dividends.[5] These distortions of corporate investment and financial policy reduce productivity and economic growth in the United States. Moreover, higher taxes in the United States on the returns to corporate capital also inhibit the competitiveness of U.S.-based companies in foreign markets. As financial markets become more global, U.S. investors may tend to be more willing to invest in foreign-based rather than U.S.-based companies. Mergers may be more likely to be set up as a foreign acquisition of a U.S. corporation. Transactions where a foreign subsidiary acquires a U.S.-based parent company may become more frequent. The high rates of taxation on the return from corporate investment can tend to make the United States a relatively unbecoming location for the headquarters of a multinational corporation, which can, in turn, cause U.S. multinationals share in the global market to shrink and the promotion of U.S. exports to decline.

Some Options for Corporate Income Tax Reform

Repeal the ETI and the AMT

Following the WTO's adverse ruling, some people have suggested that the Congress should simply repeal the ETI regime and be done with the matter. It has been argued that the revenue gain from repeal of the ETI would help improve the federal deficit, and that repeal of the ETI regime would help show that the United States supports free trade principles. Others have proposed that the revenue gained from repeal of the ETI structure could be used to cut other components of the corporate income tax, such as reducing or phasing-out the corporate alternative minimum tax (AMT). While eliminating or reducing the AMT—especially as many businesses are currently still trying to recover from the recent economic slowdown—would be a laudable achievement within the current framework of the corporate income tax system, it still is only a step in addressing the problem of hefty corporate tax burdens for U.S. firms relative to their competitors, and does not fully address the competitiveness issues for U.S. companies that initially led to the creation of the EGI and similar regimes.

Reduce Corporate Tax Rates and Remove the Double Taxation of Dividends

A much more fundamental change that would address the U.S. corporate tax burden and competitiveness directly while still maintaining the basic structure of the current corporate tax system would involve: 1) reducing the U.S. corporate tax rate commensurate with the corporate tax rate(s) of U.S. competitors, and 2) provide relief from the double taxation of dividends. Both of these changes would increase corporate investment and productivity in the United States, and put the taxation of U.S. corporations more on par with its primary economic competitors, thus increasing the competitiveness of U.S.-based firms and reducing the pressures for an ETI-like regime that is viewed by the WTO and other countries as a corporate subsidy and a hindrance to free trade.

Reducing the U.S. corporate income tax rate from 35 percent to 30 percent, for example, would remove all or much of the difference in corporate rates between the United States and other OECD countries and increase U.S. investment and productivity. A decrease of this magnitude is not unprecedented. The Tax Reform Act of 1986 reduced the U.S. corporate income tax rate from 46 to 34 percent. Moreover, corporate tax rates in OECD countries have decreased, on average, about 11 per-

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some of the double taxation of corporate dividends through a credit, exemption, or lower tax rate for dividend income in the personal income tax on shareholders.

[5] In the wake of the Enron debacle, renowned financial economist Jeremy Siegel, a professor in the Wharton Business School at the University of Pennsylvania, noted that it is the corporate tax codes discouragement of dividend payments that helped allow the misinformation about the financial position of Enron to be accepted by its shareholders. If shareholders expected companies to pay dividends then companies that were in financial trouble would be more easily identifiable because it is would be difficult for them to pay dividends. ("Dividends, Not Growth, Is Wave of Future," The Wall Street Journal, 08/21/2001.)

centage points over the past 15 years—from about 41 percent to almost 30 percent.[6] These reductions in corporate tax rates in other countries have increasingly tested the competitiveness of U.S. companies and will likely provide ongoing temptation for companies to headquarter outside of the United States.

There are several different methods in which relief could be provided for the double taxation of corporate dividends in the United States. One would provide a shareholder credit for corporate taxes paid. When a corporate shareholder receives a taxable dividend, the shareholder would be entitled to a credit against their taxes for the corporate taxes effectively paid on the dividend income. Most countries that have tax relief for double taxation of dividends use a form of the shareholder credit. However, the Treasury Department advised against this approach in a 1992 report because of the complexity of actually implementing the shareholder credit.[7] In its report, Treasury recommended instead that dividend tax relief could be better implemented if a shareholder was allowed to exclude from gross income the dividends received from a corporation. I concur with Treasury's assessment that this dividend exclusion framework is simpler than a shareholder credit, and could be implemented with little structural change to the tax code.[8]

Both of these tax changes would reduce revenue collected by the Federal Government. Because both lowering the corporate income tax rate and removing the double taxation of dividends would reduce the cost of capital to corporations and spur investment, which in turn would tend to increase GDP, the official score of the lost revenues from these changes would likely be greater than the actual revenue reduction. Nevertheless, some additional revenues would have to be raised, or spending reduced, in order for these corporate tax changes to be budget neutral. A good general principle for revenue-neutral tax reform is often "broaden the base and lower the rate." Since a corporate tax rate reduction is what is being proposed here, then this principle would suggest that some broadening of the corporate tax base should be considered. On the spending side, government subsidies to corporations should probably be considered first but other spending should also be put up to scrutiny. Indeed, the degree to which the corporate tax rate can be reduced and the degree to which dividends can be excluded would seem to almost certainly depend on the willingness of the Congress to undertake some of these more unpopular measures.

Replace the Corporate Income Tax with a Consumption-Based Tax

A much more substantial tax reform would be to completely replace the corporation income tax with a consumption tax such as a national sales tax or a value-added tax (VAT). A sales tax would be imposed and collected on sales to final, or end-use, consumers, and would likely be similar to the broad-based sales tax levied many state governments. The more likely method that would be used to implement a VAT would be a credit-invoice VAT. In a credit-invoice VAT, the tax is applied to gross sales by firms and credits for previously paid taxes on gross purchases are allowed. While probably more difficult to implement than the changes to the corporate income tax suggested above, replacing the corporate income tax with a consumption tax would remove a large portion of the distortionary tax burden on capital formation in the United States.[9] The lower cost of capital would increase investment, improve productivity, and enhance the competitiveness of U.S. firms in foreign markets. Moreover, the sales tax rate or VAT rate could be set such that the revenue expected to be lost from the corporate income tax was made up by the revenue expected to be generated by the consumption tax.[10]

Some have argued that the distributional impacts of this type of tax change would be a shift in the tax burden from corporations to consumers. However, this argument typically only reflects the statutory, or legal, incidence of the corporate tax and a consumption tax. From an economic perspective, an important principle is that

[6] These figures are from the American Council for Capital Formation, "The Role of Federal Tax Policy and Regulatory Reform in Promoting Economic Recovery and Long-Term Growth" (November 2001).

[7] Department of the Treasury, "Integration of the Individual and Corporate Tax Systems: Taxing Business Income Once" (January 1992).

[8] Indeed, for about a decade prior to its repeal in the Tax Reform Act of 1986, taxpayers were permitted a limited exclusion of dividends from gross income in the personal income tax.

[9] I am assuming in this scenario that the individual income tax is unchanged and capital income is still taxed at the personal level.

[10] An official "static" score of this tax change would not account for the increase in GDP resulting from the higher investment and productivity that would stem from the lower tax burden on capital. If a static tax score was used then the consumption tax rate might be set higher than what actually ends up being necessary to generate the same revenue. If that ends up being the case, then consumption tax rate could be adjusted down after an increase in revenue becomes evident.

only individuals ultimately bear the incidence of taxes. Moreover, all individuals are consumers, while at the same time, most individuals also are workers and/or capital owners. Furthermore, the economic incidence of the corporate income tax is still a contested issue in the economics profession. Although the corporate income tax has traditionally been thought to ultimately be born by capital owners, more recent analysis has suggested that labor may bear some of the corporate income tax burden or even more of the tax burden than capital owners. Thus, the actual distributional effects of switching from the corporate tax to a consumption tax would be much more complicated than this simple argument suggests and would depend importantly on the initial assumptions about the incidence of the corporate income tax. That said, the "political incidence" of this type of tax reform would almost certainly be argued by opponents of this type of reform along the lines of "it is a tax cut for rich corporations financed by tax hikes on poor consumers," and that argument may very well win the political debate.

An alternative to replacing just the corporate income tax with sales tax or VAT—that may be more politically viable—would be to fundamentally change the entire income tax system. Both the corporate income tax and the personal income tax could be replaced with a flat tax or with a variant of the flat tax, which I support, that has been proposed by well-known tax economist David Bradford of Princeton University.[11] Bradford's proposal, which he calls the X tax, is a two-component system comprised of a business tax that would replace the corporate income tax and a compensation tax that would replace the individual income tax. All businesses pay tax at a flat rate on a base consisting of the receipt from all sales, including sales from inventories and sales of existing assets, less the outlays for purchases from other businesses. This part is similar to a VAT and essentially allows complete expensing for all investment. In addition, businesses deduct all payments to workers. Workers pay tax on the amount received from businesses. Total compensation can be taxed progressively, if desired, with an earned income credit for low-compensation taxpayers, and successively higher rates starting at zero on higher levels of compensation. To avoid income shifting, the top rate of the compensation tax should be the same as the business tax rate. No other income, such as interest, dividends, rent, and capital gains, is include in the compensation tax base. Thus, normal returns to capital are not taxed at either the business or individual level. With regard to distributional concerns, the tax burden on workers is adjusted according to their earnings.[12] Within the context of the international economy, it would still have to be determined whether the X tax would be a destination-based system or an origin-based system in its treatment of cross-border transactions—there are pluses and minuses associated with either treatment.

Although this approach goes well beyond what to do in the near term regarding the ETI regime, this type of fundamental tax reform, in my opinion, holds the most promise for ultimately making U.S. businesses more competitive by putting them in a tax environment that promotes saving and investment and that ultimately leads to higher productivity. However, a tax reform of this magnitude would not be easy to enact, even if it is worthwhile. One of the potentially toughest issues in fundamental tax reform is the transition from the old tax system to the new tax system. In particular, there is a sort of free-rider problem that would tend to arise. Whereas a majority may agree that the new tax system would be a better overall system, many groups would want to keep their favorite tax preference from the old tax system. However, if most or all of those tax preferences in the old income tax system are then incorporated into the new consumption-based tax system then many of the advantages of the tax reform become diluted.

Chairman MCCRERY. Thank you, Mr. Engen.

Our next witness is Mr. Herman Cain, who has vast experience in the private sector as a chief executive officer and President of corporations; started a consulting business, among other things, in the private sector; and is here today as the spokesman for Americans for Fair Taxation, based in Atlanta, Georgia—or at least Mr. Cain is based in Atlanta, Georgia.

Mr. CAIN. That is correct, Mr. Chairman.

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[11] David Bradford, "Untangling the Income Tax" (1986) and "Blueprints for International Tax Reform" (2001).

[12] This very brief thumbnail sketch of the X tax does not elaborate on many of the other problems in the existing tax system that this type of tax reform would address.

Chairman McCRERY. Thank you for coming today, Mr. Cain. Likewise, your full testimony will be entered in the record, and we would ask you to summarize it in about 5 minutes. You may proceed.

STATEMENT OF HERMAN CAIN, CHAIRMAN, GODFATHER'S PIZZA, INC., OMAHA, NEBRASKA; CHIEF EXECUTIVE OFFICE, T.H.E., INC., OMAHA, NEBRASKA; AND MEMBER, AMERICANS FOR FAIR TAXATION, HOUSTON, TEXAS

Mr. CAIN. Thank you, sir. Thank you very much, Mr. Chairman and Members of the Committee.

Nothing would promote the competitiveness of U.S. businesses more than a growing national economy, and since my full testimony has been submitted and already incorporated into the record, there are three key compelling points that I would like to try to make with the Committee.

First, our current Tax Code, which you have heard before, is an 8-million-word mess. It is beyond fundamental or any other kind of reform. The message that I would like to leave on behalf of not only Americans for Fair Taxation, but the many Americans that I talk with throughout my travels is that we should replace the current Tax Code, not try and reform it. That is point number one, to replace it.

I won't belabor all of the things that are wrong with the current Income Tax Code, but simply leave you with a message, which I hope will resonate, and that is, we need to be talking about replacement, because that would resolve all of the border adjustability issues, as well as being able to unleash the full potential of the economic platform in this country.

The second key point I would like to impress upon you, there is analogous to an old southern saying, "Don't shoot the dog before the hunt is over." The hunt is for a replacement system.

It is real easy for people to find every reason why we should do something. It is real easy for people to identify all of the reasons why a bold move, such as replacing the current system, is too big of a task to take on; and my point, that I want to impress upon you, is, let's not shoot the dog.

If we were able to put a man on the moon, we can find transition rules to move us from an archaic system to a system that would unleash the maximum potential of this economy, and also release the potential for every American to pursue their definition of the American dream.

When President John F. Kennedy said, We will walk on the moon by the end of the decade of the sixties, he didn't say "maybe." He didn't say, It's a good idea. He said, "We will," and that determination and leadership is what caused the entire country to figure out the steps and the solutions that would get us there.

We need that same type of resolve in order to be able to replace the current income tax structure with the fair tax, which is a national sales consumption tax.

The third point that I would like to leave with you is something that is very disturbing to me personally as a citizen of this country. Many Americans simply do not believe that we will replace the system. They do not believe we can fix this mess. They have simply

given up on Congress' ability—not all, but some Members' ability—to address the real solution, which is to install a brand-new system.

This is about reinvigorating the belief that our Founding Fathers had. When I tell people that I believe that the fair tax, which is a national sales consumption tax, is the best way to go at this point in terms of eliminating all of the problems that you are dealing with, even with respect to the Subcommittee, they say they don't believe it can be done. I simply remind them, where would we be today if George Washington and our Founding Fathers didn't believe that we could defeat the British? We simply wouldn't be here.

So, in summary, we must replace the current structure with the fair tax; number two, let us not shoot the dog before the hunt is over, we can work out all of the issues relative to how we get there; and number three, let us restore believability on the part of the American people.

Thank you very much.

[The prepared statement of Mr. Cain follows:]

Statement of Herman Cain, Chairman, Godfather's Pizza, Inc., Omaha, Nebraska; Chief Executive Officer, T.H.E., Inc., Omaha, Nebraska; and Member, Americans for Fair Taxation, Houston, Texas

Thank you Mr. Chairman and members of the committee. I am Herman Cain, Chairman of Godfather's Pizza, Inc., a chain of 600 small businesses, Chief Executive Officer of T.H.E., Inc., a leadership consulting company, and, I am a member of and speaking on behalf of Americans For Fair Taxation. I appreciate the opportunity to testify before your committee on "promoting the global competitiveness of U.S. businesses in the global market place."

There are two basic issues for multinational corporations in the global market place. First, they are at a competitive disadvantage due to the imbedded costs of taxes on corporate profits, and taxes on payroll for domestically produced products. Secondly, the variations in tax law from country to country create many complex and costly inconsistencies. In fact, the extremely high cost of compliance may actually exceed the amount of taxes paid. The net result is that billions of dollars of foreign profits by U.S. businesses are stranded overseas, which cannot be economically repatriated to benefit our domestic economy. The solution is not more laws, more regulations, or even more tax treaties with more countries. The solution is a new tax system, which would eliminate these issues.

The current income tax system cannot be reformed. It creates disadvantages for multinational businesses, domestic businesses, individuals, and our government. No amount of tinkering with a portion of the tax code is going to fix it. It is too complicated. It inflates the costs of U.S. goods and services to other nations. It is too unfair and inefficient. It discourages people from working harder to achieve upward economic mobility, which destroys hope and opportunity. **The current tax system needs to be replaced**. It can be replaced with The FairTax (H.R. 2525), which was reintroduced in the House in 2001 by Congressmen John Linder of Georgia, and Colin Peterson of Minnesota.

Several commissions over the last 20 years, including the one I served on in 1995 (The National Commission on Economic Growth and Tax Reform), have all concluded that a replacement tax system should satisfy six principles. First, it should **promote economic growth** by reducing marginal tax rates and eliminating the tax bias against savings and investments. Second, it should **promote fairness** by having one tax rate and eliminating all loopholes, preferences and special deductions, credits and exclusions. Third, it should **be simple and understandable.** Simplicity would dramatically reduce compliance costs and allow people to truly comprehend their actual tax burden. Fourth, it should **be neutral** rather than allowing misguided officials to manipulate and micromanage our economy by favoring some at the expense of others. Fifth, it should **be visible** so it clearly conveys the true cost of government and so people would not be subjected to hidden changes in the tax law. Sixth, it should **be stable** rather than changing every year or two so people can better plan their businesses and their lives. Before expanding on each

principle, consider the compelling advantages of **replacing** the current income tax code with The FairTax.

- Gross Domestic Product (GDP) would increase 10.5% in the first year and level off in succeeding years at approximately 5% annually. (Dr. Dale Jorgensen of Harvard University)
- Consumer prices would decrease 20 to 30 percent by eliminating the nearly 250 billion dollars in annual compliance costs, and eliminating the taxes on corporate profits and labor (payroll taxes), which are imbedded in what we pay for goods and services. (Dr. Dale Jorgensen and other economists)
- A single national sales tax rate on all new goods and services of approximately 24% (to be revenue-neutral) would replace the 1.7 trillion dollars of taxes on income.
- Annual uncollected taxes of 210 billion dollars (IRS estimates) would not escape The FairTax. This amount grows by 12 billion dollars each year.
- Taxes of 35 billion dollars on expenditures by non-residents would be collected.
- Taxes from the "underground" economy would be a bonus to the federal treasury.
- Imported goods would be treated the same as domestically produced goods. This means U.S. businesses would be much less likely to locate their plants overseas.
- All taxpayers would have an equal voice, not just people who can afford tax lobbyists and skilled tax accountants.
- No taxes on the "poor" because basic necessities, as defined by the Department of Health and Human Services, would not be taxed by utilizing a rebate.
- No taxes on earnings from a second job for someone who is trying to "get ahead."
- No taxes on education.
- More time for Government to focus on national and international issues.

These advantages of a national sales tax on consumption have been well researched, analyzed and documented by some of the most respected business people, economists, and academicians in the country. Hundreds of thousands of citizens are now actively supporting a change from an income tax to a national sales tax on consumption. We are now seeking the political leadership and courage to make the greatest country in the world even greater.

The FairTax (NST) would encourage Economic Growth

The FairTax would significantly enhance economic performance by improving the incentives for work and entrepreneurial activity and by raising the marginal return on savings and investments. Entrepreneurs and small business owners would be given greater access to capital, the life-blood of a free economy. Investments would rise, the capital stock would grow, productivity would increase and the output of goods and services would expand. The economy would create more and better paying jobs for American workers and take-home pay would increase considerably.

Although the magnitude of the economic growth generated by a single rate, neutral tax system causes lively debate among economists, virtually all agree that the large marginal tax rate reductions with a national sales tax combined with neutral taxation of savings and investments, would have a powerful positive effect on the economy.

For example, Dr. Dale Jorgensen of Harvard University conducted a research analysis (1997), which showed that a national sales tax would produce a 10.5% increase in Gross Domestic Product, a 76% increase in real investments, and a 26% increase in exports in the first year of a national sales tax enactment. Those increases would level off at 5%, 15%, and 13% respectively over the succeeding twenty-five years. Nothing promotes the competitiveness of U.S. businesses more than growth in our national economy, more dollars to grow our businesses, and a level playing field for selling our products and services to other nations.

The FairTax would be Fair, untax the "Poor," and untax Education

The FairTax would provide every household in America with a rebate of sales tax paid on necessities. Thus, The FairTax is progressive and every family is protected from tax on essential goods and services. Because of the planned rebate, those below the poverty line would have a negative effective tax rate and lower middle-income families would enjoy low effective tax rates.

The responsibility of paying taxes to fund our way of life would be fairly distributed. It would, in fact, be much more fairly distributed than the income tax. Wealthy people spend more money than other individuals. The FairTax will tax

them on their purchases and as a result, the wealthy pay more in taxes. If, however, they use their money to invest in job creating businesses, or to finance research and development to create new products, (all of which help improve the standard of living of others), those activities would not be taxed. The FairTax is premised on the notion that it is fairer to tax individuals when they consume for themselves above the essentials of life, rather than when they invest in others or contribute to society.

The FairTax would in effect give a supercharged charitable contribution deduction because people would be able to give to their favorite charity free of any income tax, payroll tax or sales tax. The charitable deduction today allows people to make their contributions with pre income tax dollars, but after payroll tax dollars. For the three-quarters of Americans who do not itemize, most must today earn $155 to give $100 to their favorite charity or to their place of worship.[1] Under The FairTax, they must earn only $100 to give $100, since under The FairTax what you earn is what you keep and charitable contributions are not taxed.

Education is one of the keys (along with savings and hard work) to an improved standard of living. That certainly was true in my case. I was the first person in my family to attend and graduate from college. It took a lot of hard work, and a lot of sacrifice by my parents. The FairTax is education friendly and is dramatically more supportive of education than current law. The FairTax embodies the principle that investments in people (human capital) and investments in things (physical capital) should be treated comparably. The current tax system, in stark contrast, treats educational expenditures very unfavorably.

Education is the best means for the vast majority of people to improve their economic position. It is the most reliable means people have to invest in themselves and improve their earning potential. Yet the tax system today punishes people who invest in education, virtually doubling its cost. Only a national sales tax on consumption would remove this impediment to upward mobility. No other tax plan would do so.[2]

Today, to pay $10,000 in college or private school tuition, a typical middle-class American must earn $15,540 based only on federal income taxes and the employee payroll tax.[3] The amount one must earn to pay the $10,000 is really more like $20,120 once employer and state income taxes are taken into account.[4]

The FairTax would not tax education expenditures. Education would be paid for with pre-tax dollars. This is the equivalent of making educational expenses deductible against both the income tax and payroll taxes today. Thus, a family would need to earn $10,000 to pay $10,000 in tuition, making education much more affordable (not considering state income taxes on education). The FairTax would make education about half as expensive to American families compared to today.

The FairTax would improve upward mobility but no longer punish work, savings, investments or education. It would better enable people to improve their lives. It would no longer hold people back.

The FairTax would be Simple

The FairTax is a simple tax. Individuals who are not in business would have absolutely no compliance burden, nor would they be subject to the discretionary interpretation of the current convoluted tax code. As for businesses, it puts many fewer administrative burdens on businesses. In fact, filling out The FairTax tax return is comparable to filling out line one (gross revenue) of an income tax return. There would be no more alternative minimum tax, no more depreciation schedules, no more complex employee benefit rules, no more complex qualified account and pension rules, no more complex income sourcing and expense allocation rules, no more foreign tax credit, no more complex rules governing corporate acquisitions, divisions and other reorganizations, no more uniform capitalization requirements, no more complex tax inventory accounting rules, no more income and payroll tax withholding and the list goes on. Businesses would simply need to keep track of how much they sold to consumers.

Compliance costs would, therefore, fall under The FairTax. Today, according to the Tax Foundation, we spend about $250 billion each year filling out forms, hiring

[1] $155.40 less 7.65 percent in employee Social Security ($11.89) and Medicare payroll taxes less 28 percent in federal income taxes ($43.51) leaves $10,000.

[2] Neither the flat tax nor the USA Tax would remedy the current bias against education.

[3] $15,540 less 7.65 percent in employee Social Security ($1,189) and Medicare payroll taxes less 28 percent in federal income taxes ($4,351) leaves $10,000.

[4] Economists generally agree that the employer share of payroll taxes is borne by the employee in the form of lower wages. This figure assumes that employees bear the burden of the employer payroll tax and that they are in a seven percent state and local income tax bracket. $20,120 less $5,634 in income tax (28 percent), $3,079 in payroll taxes (15.3 percent) and $1,408 in state and local income taxes (7 percent leaves $10,000.

tax lawyers, accountants, benefits consultants, collecting information needed only for tax purposes and the like. These unnecessary costs amount to about $850 for every man, woman and child in America. To the extent these costs are incurred by businesses, they must be recovered and consequently are embedded in the cost of everything we buy. The money we spend on unnecessary compliance costs is money we might as well burn for all of the good it does us. The Tax Foundation has estimated that compliance costs would drop by about 90 percent under a national sales tax.

The FairTax would be Neutral

Under The FairTax, all consumption would be treated equally. The tax code punishes those who save and rewards consumption. Under The FairTax, no longer would the tax system be in the business of picking winners and losers. The tax code would be neutral in the choice between savings and consumption, neutral between types of savings and investments and neutral between types of consumption.

The FairTax would be Visible

The FairTax is highly visible, because there would be only one tax rate Congress could modify on all taxpayers at the same time. Moreover, all citizens would be subject to any tax increases, not just a targeted few. It would be much harder for Congress to adopt the typical divide-and-conquer, hide-and-disguise tax increase strategy it uses today. The FairTax would explicitly state the contribution to the Federal Government each and every time a good or service is purchased.

The FairTax would be Stable

The FairTax would be more stable than the present system for two reasons. First, because it is so simple and transparent, it would not invite tinkering in the way that the current system with its thousands of pages of code and regulations does. People would resist attempts to make it more complex and attempts to favor special interests because they would understand what is going on. Second, taxing consumption is a more stable source of revenue than taxing income. There are fewer fluctuations in the consumption base than in the income base.

A recent study showed that for the years 1959 to 1995, a national sales tax base was less variable than the income tax base. Why? When times are unusually good, people will usually save a little more. People tend to smooth out their consumption over their lifetime. They borrow when young, save in middle age and spend more than their income in retirement.

Impact on Businesses

Businesses would utilize a zero corporate tax rate to create new jobs, grow their businesses, and be more competitive in the global market place. Their shareholders would not be taxed on dividends received from the corporation, or taxed on capital gains made on their investment in the business. This would stimulate business investments, creating more opportunities for working Americans. Compliance costs would be lower. Moreover, over time, most states would make their sales taxes conform to the federal sales tax, reducing the costs of complying with multiple rules in each state and political subdivisions.

If people were willing and able to purchase more goods and services in a healthy economy, they would spend more money at retailers. Spending and shopping is no longer a luxury activity, it is a part of our way of life. There is nothing that hurts businesses more than a slow economy and nothing that helps them more than a good economy. In this sense, The FairTax would help all businesses.

Currently, consumption purchases must be made with after-income-tax and after-payroll-tax dollars. The primary difference between a sales tax and an income tax is that the income tax doubles, triples or sometimes quadruples taxes on savings. Consumers would see their paychecks increase by nearly two trillion dollars. Since The FairTax is not a tax increase but is revenue neutral, the repeal of the income and payroll taxes, plus the decrease in consumer prices would provide consumers with the money necessary to pay for The FairTax.

Instead of having to comply with the complexities of the income tax, payroll tax, and various excise taxes, there would be one sales tax on all goods and services. Period. Retail businesses would simply need to calculate on a monthly basis its total retail sales. Retailers would receive an administrative fee (¼ of one percent) for collecting the sales tax.

In summary, The FairTax would be a "win, win, win" for businesses, citizens, and government. Just consider the compelling nature of the advantages discussed earlier.

I realize that there are political and public hurdles to making such a change to how we fund our government. In fact, many people simply don't believe that it can happen. They have given up on our government's ability to do what is in the best interest of its people and our Nation. To those people I ask, where would we be today if George Washington and the founding fathers had given up the fight to become an independent nation? We owe it to them, to ourselves, and most importantly to our children to correct a system that has gotten out of control.

Conclusion

People want to be able to dream and to pursue their dreams. People want the liberties for which our founding fathers fought and DIED. People want to pay their fair share to keep this Country safe and great. As Dr. Benjamin E. Mays, late President Emeritus of Morehouse College said, "It isn't a calamity to die with dreams unfulfilled, but it is a calamity to have no dreams." The current tax system not only destroys the ability of people to dream and make their dreams real, it causes too many people to just give up.

We need The FairTax—a tax system more appropriate for a free society. The current tax code CANNOT BE REFORMED to achieve the stated objectives. **It** MUST BE REPLACED. Please use the power of the Congress to replace our current income tax code.

Chairman MCCRERY. Thank you, Mr. Cain.

Our next witness is an old friend who has been kind enough to show me through a few tax problems, tax issues, over the past dozen years or so, 20 years maybe. He has been around a while, and I have a lot of respect for his knowledge of the Tax Code. I don't blame him for all of it, but some of it.

Mr. Christian, you probably should share the blame for it. So I will be interested to hear your comments about how we fix it.

Mr. Christian is the Chief Counsel for the Center for Strategic Tax Reform. Ernie, it is nice to have you with us, and you may proceed.

STATEMENT OF ERNEST S. CHRISTIAN, CHIEF COUNSEL, CENTER FOR STRATEGIC TAX REFORM

Mr. CHRISTIAN. Thank you, Mr. Chairman. I assure you, I have repented, and I am now on the side of good.

Chairman MCCRERY. Thank you.

Mr. CHRISTIAN. There is another old southern expression that I would submit to my friend, Herman Cain, and that is, "Let's not get the cart before the horse."

Everyone wants an internationally competitive tax system for the United States of America. We need it.

That laudable goal is readily attainable without adopting some radical or experimental new tax system, I respectfully submit. With only two simple amendments, we can convert our existing corporate income tax into what, under WTO, is called an "indirect tax." Devices such as FSC and ETI would then be unnecessary. In a WTO-legal way, we could then fully exclude U.S. export income from U.S. tax, as we ought to do as a matter of policy. That would provide U.S. manufacturers with the option of staying home while exporting American-made products to markets all around the world.

Having done that, we could then take the next important step. We could adopt a territorial tax system that would allow American companies a fair opportunity to directly compete in those foreign markets that cannot be fully served by exports from America alone.

Under WTO, a tax with a tax base equal to value added is an indirect tax, but value added, Mr. Chairman and Members of the

Committee, is an accounting concept similar to net income which is the base of our current corporate income tax. Value added as a measurement device has nothing whatsoever to do with taxing consumers or a sales tax or any of the other kinds of things often associated with a VAT.

To convert our corporate net income tax base into a corporate value-added tax base, we need to make the interest that corporations pay to their debt holders nondeductible, the same way that dividends paid to equity shareholders are under the current Tax Code already nondeductible. Not deducting interest is not the big deal it might appear. The corporate tax rate would be only 8 to 10 percent after the base is broadened to include full value added, which is an extension of net income.

A Treasury Department study in 1992 by Glenn Hubbard, who is presently the Chairman of the President's Council of Economic Advisers, and my good friend and former Treasury Department colleague, Michael Graetz, sitting to my left, who is a distinguished professor at Yale, pointed out the negative impact on economic growth that results under present law from treating debt capital more favorably than equity capital.

They recommended a comprehensive business income tax in 1992, CBIT as it was called. It allowed no deduction for interest. It equalized the treatment of debt and equity. It is, in fact, the baseline from which we will proceed.

The second amendment is to make wages nondeductible against the 8- to 10-percent corporate tax rate. Before you recoil in horror, remember that employers already pay a 7.65-percent employer payroll tax on wages up to $84,900 per year per employee, the familiar employer FICA tax, Federal Insurance Contributions Act. Thus, wages are already nondeductible under present law against a rate which is almost as high as the 8- to 10-percent corporate rate that we are projecting in this proposal.

In order to avoid double taxation in the wage area, employers would be allowed a credit against the corporate tax for the payroll tax they pay on the same wages. No messing with Social Security whatsoever. Thus, in reality, there would be no major change in the deductibility versus nondeductibility of wages except in the case of the highest paid employees, and even in their case, not very much.

I am not suggesting, Mr. Chairman, that our friends in Brussels will automatically roll over and immediately accept without argument that America's revised corporate tax is an indirect tax under WTO. They won't. They will wiggle and they will squirm. They may even litigate, but I respectfully submit, Mr. Chairman, that they will have a devil of a time saying with any credibility that our tax, which has the same base as their tax, does not qualify simply because we do not engage in the rhetorical charade about VATs.

The Congress, in my opinion, has a golden opportunity before it to act on a bipartisan basis to provide the solution to some longstanding problems. I hope that you and the other Members of Congress will take advantage of that opportunity.

Thank you very much.

[The prepared statement of Mr. Christian follows:]

Statement of Ernest S. Christian, Chief Counsel, Center for Strategic Tax Reform

Mr. Chairman and Members of the Committee. I am honored to appear before you today to talk about WTO-legal ways of making American companies and their employees more competitive in world trade.

Some people think that the answer may be provided by the so-called subtraction-method value added tax. In reality, however, the subtraction method VAT is largely a mirage that exists primarily in the imaginations of some academics. The tax they so describe is, in substance, identical to a slightly amended version of our present corporate income tax that takes into account the existence of the employer payroll tax (the FICA tax as it is often called).

Therefore, let us set aside the VAT syndrome and the political baggage that goes with it. We can then concentrate on the few changes in the current corporate income tax that are necessary for it to qualify as an "indirect tax" under WTO rules.

Once we have qualified our corporate tax as an "indirect tax", we can then exclude export income from U.S. tax. Once we have excluded export income from tax, we can then adopt a truly territorial tax system that will allow U.S. companies to invest and compete directly in foreign markets. Devices such as FSC and ETI are unnecessary.

There is no need to resort to some new and radical tax system. Indirect tax status is imminently obtainable within the framework of current law and within the framework of American tax traditions.

An "indirect tax" under WTO rules has a base equal to value added. To most people, the most familiar form is the European-style VAT structured to resemble a sales tax, but there are other forms of taxes on value added that bear no resemblance whatsoever to a sales tax and have nothing whatsoever to do with taxing consumers.

Value added is a concept similar to net income—as explained in the Appendix to my testimony.

Only two amendments are necessary to convert our existing corporate tax on net income into a tax on value added. Each such amendment is meritorious on its own and neither is shocking.

The first amendment is to make the interest that a corporation pays to its debtholders nondeductible in the same way that the dividends it pays to its equity shareholders are presently nondeductible. As a result, all the income from both debt and equity capital would be included in the corporation's tax base.

After having included in the tax base the income from capital, the other step necessary to complete the value added base would be to include the income from labor. The measure of this income is the amount of wages paid to the corporation's employees—just as the amount of income from capital is the amount of interest and dividends paid by the corporation.

Under the present corporate income tax, wages are, *in form,* deductible and, therefore, *in form,* are not included in the corporation's tax base, but, in reality, under current law, the corporation must pay a 7.65 percent FICA payroll tax on the first $84,900 of each employee's wages. Thus, under current law, wages up to $84,900 are already included in the corporate tax base—except at a 7.65 percent tax rate instead of the 35 percent tax rate that applies to the rest of the corporate tax base.

The obvious solution is to broaden the corporate income tax base by allowing no deductions for interest, dividends or wages—and, with that broad tax base, lower the corporate tax rate to the range of 8 to 12 percent on a revenue-neutral basis. In order not to double tax the wage component of the new tax base, corporations would be allowed a credit for the employer payroll tax or corporations would be allowed to deduct wages up to $84,900 per employee with only the excess for highly paid employees being nondeductible.

There are various ways of "integrating" the existing corporate income and payroll taxes in order to have a base equal to value added and, therefore, to have the same base as an indirect tax under WTO rules. None of these increases the tax burden on the labor component of GDP except in the case of the highest paid employees and, even in their case, not by very much.

This is not pie-in-the-sky stuff. Its pedigree is impeccable. The starting point is the Comprehensive Business Income Tax (CBIT) proposal made in 1992 by the Treasury Department after years of study.[1] The study was primarily authored by

[1] Department of the Treasury, *Integratin of the Individual and Corporate Tax Systems—Tax Business Income Once* (Washington, DC: GPO, 1992). Because the CBIT proposal would have maintained a higher rate of tax—about 31 percent on corporations—it recommended that the

the Honorable R. Glenn Hubbard, presently Chairman of the President's Council of Economic Advisors, and Professor Michael J. Graetz of Yale University, both of whom were Deputy Assistant Secretaries of the Treasury at the time. The 1992 Treasury study suggested that (1) interest be made nondeductible like dividends and (2) that all businesses, whether or not incorporated, be subject to a uniform business tax which involved a half dozen or so amendments to the then current corporate income tax. The Treasury made this recommendation after concluding that allowing a deduction for interest, but not dividends, and taxing incorporated businesses differently from unincorporated businesses, had a significant negative effect on GDP growth.

Other amendments that would normally be included in converting the corporate income tax into a more comprehensive tax with a base equal to value added are (1) cash accounting for inventory and (2) full first-year expensing of capital equipment, but neither of these are necessary.[2]

Only the two simple amendments already described are necessary to achieve "indirect tax" status and the ability to solve the FSC/ETI problems and much more.

This Committee and this Congress have before them a huge bipartisan opportunity to serve the national interest. You can enact a few simple amendments that will then open the door to all kinds of opportunities for enhanced world trade, more and better paying manufacturing jobs in America, and overall higher standards of living for Americans.

Instead of penalizing exports and, therefore, driving offshore American companies that would rather stay home, we can exclude exports from tax and make the United States of America a prime location for manufacturing and selling to markets around the world. The U.S. would be an especially desirable location if we also amended the code to allow full first-year expensing such as proposed by Congressman Philip English and Congressman Richard Neal in their recent High Productivity Investment Act (H.R. 2485).

Instead of making it hard for American companies to directly compete in foreign markets that cannot be fully served by exports at the outset, we could adopt a territorial system that would give them an even chance. Moreover, when U.S. companies do succeed in a foreign market, we could stop penalizing them if they bring their money home for reinvestment in the American economy. (Present law gives them a tax break if they keep the money abroad invested in someone else's economy.) We could also stop favoring large companies (who can afford to keep the money abroad) over small companies who need to bring the cash home and, who, therefore, must pay the tax penalty imposed by current law.

The need to cure these and many other fundamental defects in America's international tax rules is a long-standing bipartisan point of view. Moreover, it is in the joint and mutual interest of all *companies* and all *employees* for America to be the location of choice for companies—foreign and domestic—engaged in world trade.

In the past, the barrier to action was the mistaken belief that in order to do so, America would have to take some drastic step such as repealing the income tax and replacing it with some kind of sales tax.

Today, we know better. Only a few straightforward amendments to the income tax are necessary.

The time for bipartisan action is now. The need is great. The opportunity is here.

Appendix to Testimony

A Step-By-Step Guide: How To Convert The Corporate Income Tax Into An Indirect Tax under WTO and Thereby Solve the FSC/ETI Dilemma and Much More

Preamble: Why Do It

FSC/ETI and/or an outright exclusion of export income would be legal under WTO rules if the existing corporate income tax (or an amended version thereof) were classified as an "indirect" tax. So-called "inversions" and other devices by which U.S. companies flee to foreign locations would also be eliminated. Indeed, the United States of America would become the location of choice for both U.S.-owned and foreign-owned companies engaged in world trade.

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nondeductibility of interest be phase in over a period of time. DBIT would also have excluded interest and dividends at the personal level.

[2] Some kind of border tax adjustment for imports could also be added—such as if a company sought to move a plant abroad and sell back into the United States—but that is not a necessary component and is outside the scope of the present inquiry.

What Is An Indirect Tax

A tax with a base equal to value added is classified as an indirect tax. The most familiar form is the European-style VAT which is structured to resemble a sales tax, but there are other forms of taxes on value added that bear no resemblance whatsoever to a sales tax. Indeed, as will be seen later, when the existing corporate income tax and the existing employer payroll tax are considered together, their consolidated tax base is almost exactly equal to value added.

Thus, it is not only the VAT-type sales tax that can have a value added base and, thereby, can gain the advantages that accrue under the WTO to taxes classified as "indirect".

A modified version of the existing corporate income tax can also gain those advantages for the United States.

The Concepts of Value Added and Income Are Similar

Like the corporate income tax, a tax on value added is imposed on businesses, not on individuals. Compared to the corporate income tax, the essential difference is in the tax base. In its most simple form (before adjustment for exports and imports), a business's value added tax base is equal to its gross income.

Example: During the year, Black Corps. has gross income of $100X from the production and sale of widgets. Its value added tax base is $100X.

This simple form of gross receipts tax would work just fine if all goods and services were produced and sold by one gigantic company, but, in reality, the total *value* of goods and services in the economy is *added* in bits and pieces by a large number of companies.

Note: The fundamental flaw with any gross receipts tax is the obvious pyramiding of tax that occurs when more than one company is involved in producing a particular product or service. For example, if, in order to produce and sell $100X of widgets, Black Corps. had bought widget parts and components from White Corps. for $30X, the combined tax base of the two companies would be $130X even though only $100X of final product had been produced and sold.

Therefore, in order to void pyramiding, taxes on value added as well as taxes on net income typically allow a business to deduct from its tax base the cost of the inputs (such as parts and components) that it purchases from some other business.

Example: Black Corps. paid (1) $30X for widget components, (2) $10X for a widget assembly machine, (3) $1X for interest on debt to finance that machine and (4) $50X for employees to produce and sell the $100X of widgets it sold during the taxable year. Black Corps. also paid a $9X dividend to its shareholders.

(1) Value Added Calculation: Black Corps.'s value added tax base for the year is $60X, computed as follows:

Gross Income	$100X
Less: Deductible Costs Paid to Another Business for Components and Included in Payee's Tax Base under Value Added System	$(30X)
Deductible Costs Paid to Another Business for a Machine and Included in Payee's Tax Base under Value Added System	$(10X)
Value Added	$60X

Nondeductible Costs Not Included in Payee's Tax Base under a Value Added System:

$1X of Interest

$9X of Dividends

$50X Salaries to Employees

Note: In value-added parlance, Black Corps. has been allowed to deduct the amounts paid to other businesses because those amounts are included in the other business's value added tax base. Salaries paid to employees are not deducted because the employee's wages are not taxable under the value-added tax. Only businesses are subject to the tax on value added. In income tax parlance, it would be said that Black Corps. has been able to deduct inventory costs in the year paid (instead of using inventory accounting which over time tends to defer deductions beyond the year of payment). In income tax parlance, it would also be said that Black Corps. has been able to expense capital equipment (instead of depreciating its cost over a period of years), but has not been able to deduct wages paid to employees or interest paid to debtholders or dividends paid to shareholders.

(2) Net Income Calculation: Black Corps.'s net income tax base for the year is approximately $24X, computed as follows:

Gross Income	$100X

Less: Approximate Amount of Deductions Allowed under Inventory Accounting Rules for the $30X Paid for Components that was included in the Payee's Tax Base [a]	$(20X)
First-Year Depreciation Deduction Allowed for the $10X Paid for the Machine that was included in the Payee's Gross Income [b]	($4.4X)
Cost of Salaries Paid to Employees	($50X)
Interest Cost	($1X)
Net Income	$24.6X

[a] Although in our overly simplified example where all purchases and sales are made in the same year, the full $30X would be deductible, in the typical real-life case, the business would have some costs that would be perpetually deferred under inventory accounting rules.

[b] The depreciation calculation assumes 30% bonus depreciation and MACRS depreciation on 5-year property.

Comparison of Value Added and Net Income Calculations

The differences between the two systems are easily discernible (and, as shown later, easily reconcilable).

a. Cash vs. Inventory Accounting. In the example, the value added system uses cash accounting whereas the net income calculation uses inventory accounting, but this is not an inherent difference: an amended corporate income tax whose base was equal to value added could continue to use inventory accounting. A cash system is simpler and generally better, but that reform is not necessary in order to convert the corporate income tax into an "indirect tax".

b. Expensing vs. Depreciation. In the example, the value added system expenses capital equipment purchases, whereas the net income calculation uses depreciation, but, again, this difference is not immutable. Expensing is a superior rule, but the corporate income tax can be converted into an "indirect tax" without making that change. The corporate tax could qualify even though it continued to use the depreciation rules of current law.

The two remaining differences relate to the deductions allowed under the current corporate income tax for interest paid to debtholders and compensation paid to employees. Because a value added base (the key to "indirect tax" status) includes the output of *all* capital (as well as the output of labor), no deductions for interest or compensation are allowed. Therefore, in this case, the familiar income tax deductions must give way to the value added rule but, as shown below, the deduction for interest is not an inherent characteristic of a corporate income tax and, insofar as concerns wages, the absence of any income tax deduction for compensation paid employees is not the radical change that might be thought. In fact, when the existing payroll tax is taken into account, a large portion of wages paid are, in effect, already nondeductible under present law.

c. No Deduction for Interest Paid. A deduction for interest paid is not an inherent or necessary characteristic of a corporate income tax. Indeed, allowing a deduction for interest (the cost of debt capital) but not for dividends (the cost of equity capital) is a major distortion under present law that impedes GDP growth according to a Treasury study a few years ago.[3] That study recommended replacing the current corporate income tax with a Comprehensive Business Income Tax (CBIT) that allowed no deduction for interest. (Dividends are not deductible under present law.) (As will be seen later, had the CBIT proposal raised its horizons only slightly higher and taken into account the payroll tax that existed then (and now) in another portion of the Internal Revenue Code, the Comprehensive Business Income Tax would have had a base equal to value added.

d. No Deduction for Wages. The idea that wages paid *are* fully deductible under present law is largely a mirage arising from the fact that the corporate income tax (where wages are deductible and are not part of the tax base) is in one part of the tax code and the employer payroll tax (where wages are not deductible and are in the tax base) is in another part of the tax code. When, however, these two taxes are viewed together, it is easily seen that *in substance* most wages are already nondeductible. In form, under present law when a business pays wages it is entitled to deduct them from its corporate base, but when the business turns to another page of its tax return,

[3] *Supra* at n. 1.

> it must add back those wages to the base of its employer payroll tax and pay tax on them. The difference is, of course, that the corporate rate is presently 35 percent whereas the payroll tax rate is presently 7.65 percent, but under the reformed corporate tax, the tax rate would be much lower—about the same as the 7.65 percent employer payroll. In that case, the amended "indirect" corporate income tax could continue to allow a deduction for wages up the $84,900 cutoff point of the payroll tax or could disallow a deduction for all wages, but allow a credit for the payroll tax. In either case, the total tax attributable to wages—whether called a corporate tax or payroll tax would not be greatly different from present law.

Thus, like so much else about the comparison between a value added base and a net income tax, the differences are much less than thought.

Obvious Conclusion: The Existing Corporate Income Tax Can Readily Be Converted into an Indirect Tax

The bottom line point is glaringly simple: Forget about VATs (subtraction-method or otherwise) and all other exotic tax reforms. Instead, convert the existing corporate income tax into an indirect tax by the simple expedient of disallowing the deduction for interest (treat same as dividends) and integrating the corporate income tax with the existing payroll tax by various cross credits or offset formulas that results in a combined labor and capital base equal to value added.

Once indirect status is achieved, export income can be excluded from tax. Once export income is excluded, a correct and fair territorial system could be adopted. With indirect status, imports could also be brought into the U.S. tax base. That is, however, an option, not a requirement.

Chairman McCRERY. Thank you, Mr. Christian.

Our next witness is also one who is not unfamiliar with the way tax laws are made, and we welcome him to our panel this afternoon. He is Michael Graetz, who is a Professor of Law, as mentioned by Mr. Christian, at a small school in the Northeast, Yale Law School.

Mr. Graetz, we look forward to your testimony, and as with all the other witnesses, your testimony will be included in its entirety. Please summarize in about 5 minutes.

STATEMENT OF MICHAEL J. GRAETZ, PROFESSOR OF LAW, YALE LAW SCHOOL, NEW HAVEN, CONNECTICUT

Mr. GRAETZ. Thank you, Mr. Chairman.

To promote economic growth and enhance Americans' standard of living, the Nation's tax system should be transparent and simple, should minimize economic distortions and taxpayers' compliance costs, and should impose the lowest rates feasible to fund the government's expenditures. The tax system should enhance productivity and should not inhibit savings. The Nation's tax system should also distribute its burdens equitably, and both the tax law and its administration should be regarded by the American people as fair.

By these measures, the American tax system is badly out of whack. We rely too heavily on income taxes and insufficiently on consumption taxes. We could improve our tax system along all of these dimensions by replacing a substantial part of both individual and corporate income taxes with a consumption tax, and by doing so, we could have a tax system the Internal Revenue Service (IRS) could administer.

To get there from here, ideologues on both sides of the political spectrum must compromise. Consumption tax proponents must abandon the fantasy that by enacting a consumption tax, we can completely eliminate the income tax; and income tax adherents

must retreat from their stance that any consumption tax necessarily represents an attack on poor and middle-income taxpayers. Retaining and tinkering with the current system offers a poor prescription for either economic progress or tax justice.

Today, Presidents and Congress use the income tax the way my mother used chicken soup, as a magic solution to solve all of the Nation's economic problems. If we have a problem in access to education, child care affordability, health insurance coverage, or financing of long-term care, to name just a few, the answer is a tax credit or deduction. Tax legislation during the nineties completed the unraveling of the 1986 Tax Reform Act, which had promised, but failed to deliver, a broad-based, low-rate, fair and simple tax.

In 1940, Mr. Chairman, the instructions for the Form 1040 were four pages long. Last year, the booklet was 117 pages long. The Form 1040 for last year had 11 schedules and 20 additional work sheets. As the Congress has introduced new problems into the tax system, old problems have multiplied, and as these hearings suggest, probably the most important relate to the internationalization of the world economy.

Clearly, we need a fundamental reexamination of U.S. income tax policies regarding international income, but more fundamental change is needed. I am a great fan of the current IRS Commissioner Charles Rossotti, but I remain wary when people talk about a customer-friendly IRS. I have often said, I will become a werewolf before I would be a customer of the IRS.

To think that the IRS can become a modern financial services institution without an overhaul of the tax law it administers is to believe that you can turn a Winnebago around without taking it out of the garage. The fundamental problem is that the IRS is being asked to do too much. It cannot do all of the things that Congress is now asking it to do.

The sales tax proponents are right. The majority of American families should not have to file tax returns or deal with the IRS at all. Everyone else proposing tax reform, the flat taxers, the income tax reformers, those who favor progressive consumption taxes, would fail to remove the IRS from the lives of average Americans.

Flat tax advocates trumpet their claim that they would shorten the individual tax return to fit on a postcard, but, given Congress' propensity for enacting tax breaks for this or that, it is foolish to believe that a flat tax would stay flat or simple for very long. The political allure of giving Americans tax breaks for specific expenditures is catnip to both the Congress and the White House. The flat tax's treatment of exports and imports is properly anathema to American businesses.

In contrast, since the reporting of sales taxes would be done by retail businesses and no individual returns would be required, a sales tax would offer genuine and lasting simplification for the American people. The rub, however, is that complete replacement of the income tax with a sales tax would provide a large tax reduction for the country's wealthiest people.

Both the flat tax and the sales tax would shift the Nation's tax burden from high-income people to those with lower income. As the New York Times columnist, William Safire, has said, "Most of us

accept as fair this principle: The poor should pay nothing, the middle something, and the rich the highest percentage."

The current income tax is a horrible mess, and in thinking about how we should move forward to a new tax regime, I believe we can profitably learn from the tax policies of our past. We can achieve low rates and a reasonably simple tax system by replacing most of the income tax with a tax on consumption. In the process, we should return the income tax to its pre-World War II status, a low-rate tax on a relatively thin slice of higher-income Americans.

The value-added tax is a revenue-producing mainstay in over 120 countries on 5 continents. Sales taxes are far more susceptible to tax evasion than a value added tax. A VAT imposed at about a 12-percent rate could finance an exemption from income tax of families with up to $100,000 of income, and enacting a VAT would allow a vastly simpler income tax at about a 25-percent rate or less to be applied to income over $100,000. This shift in the composition of the Nation's taxes would eliminate more than 85 percent of the American people from the income tax rolls.

This is a practical and workable plan. Low- and middle-income families could be protected from any tax increase through payroll tax offsets. The corporate income tax could also be reduced to 25 percent or less, the same rate that would apply to the income of high-income individuals. This plan is designed to be both revenue-neutral to the Federal Government and distributionally neutral for the American people. It is a practical plan and I urge the Committee to consider it.

Thank you.

[The prepared statement of Mr. Graetz follows:]

Statement of the Michael J. Graetz, Professor of Law, Yale Law School, New Haven, Connecticut

Mr. Chairman and Members of the Committee:

Thank you for inviting me to testify here today on the issue of fundamental reform of the U.S. tax system and how it might improve the economic well-being of Americans.

To promote economic growth and enhance Americans standard of living, the Nation's tax system should be as transparent and simple as practicable, should minimize economic distortions and taxpayers' compliance costs and should impose the lowest rates feasible to fund the government's expenditures. The tax system should, to the extent possible, enhance productivity and not inhibit national savings. The Nation's tax system must also distribute its burdens equitably, and both the tax law and its administration should be regarded by the American people as fair.

By these measures, our tax system is badly out of whack. We rely too heavily on income taxes and insufficiently on consumption taxes. We could improve our tax system along all dimensions by replacing a *substantial part* of both individual and corporate income taxes with a consumption tax. And, by doing so, we could have a tax system that the IRS can readily administer.

But to get there from here, ideologues on both sides of the political spectrum must compromise. Consumption tax proponents must abandon the fantasy that by enacting a consumption tax, we can completely eliminate the income tax. And income tax adherents must retreat from their stance that any consumption tax necessarily represents an attack on poor and middle-income families. Retaining—and tinkering with—the current income tax offers a poor prescription for either economic progress or tax justice.

During the past twenty-five years the income tax has fallen into disrepute and disfavor, properly so. A substantial part of my book on the income tax endeavors to explain why this has happened, a story I will not repeat here, but the key facts are these: From the period immediately after the Second World War until 1972, the

American people viewed the income tax as the most fair tax in the Nation.[1] Since 1980, they have consistently viewed it as the least fair. Today about half of the American people favor changing to a "completely different" tax system. No matter what the data show about the amount of income taxes being paid by high income taxpayers or about the relationship of corporate taxes to corporate profits, Joe Sixpack no longer believes he is getting a fair shake. Joe believes that wealthy people and large corporations have tax advisers—lawyers, accountants, investment bankers, magicians and alchemists—to help them arrange their affairs to duck the taxes they should be paying, to avoid their fair share of the tax burden.

And the American people are right; substantively, the income tax is a mess. Taxpayers at every income level must confront extraordinary complexity. In 1940, the instructions to the Form 1040 were about four pages long. By 1976, they had expanded to 48 pages. For the tax year 2001, the instruction booklet was 117 pages long. The Form 1040 for 2001 had eleven schedules and twenty additional worksheets.

Presidents and Congress now use the income tax the way my mother employed chicken soup: as a magic elixir to solve all the Nation's economic and social difficulties. If the Nation has a problem in access to education, child care affordability, health insurance coverage, or financing of long-term care, to name just a few, an income tax deduction or credit is the answer. Tax legislation during the 1990s completed the unraveling of the 1986 Tax Reform Act, which had promised, but failed to deliver, a broad-based, low-rate, fairer and simpler income tax.

Given recent changes in the economy and technology and in how business is now conducted, the income tax would have become more complex even without its increased use as the favorite mechanism to address social and economic problems. While old income tax problems have worsened, new problems have emerged. As these hearings suggest, probably the most important are due to the internationalization of the world economy. Flows of both direct and portfolio investments into and out of the United States have increased dramatically in recent years. Foreign trade is increasingly important, as are international business and investment activities. Tax-favorable foreign financial centers and global trading have become commonplace. Individuals have also increased their foreign business activities. These developments, along with new ways of doing business, especially innovative financial instruments, pose striking challenges for taxation, especially income taxation. Elsewhere I have urged a fundamental reexamination of U.S. international income tax policies.[2] No one can doubt the necessity of this task. Without it, the taxation of international income may completely unravel.

Americans regard the income tax both as too complicated and unfair. Not only has this phenomenon diminished popular support for the income tax, it also threatens income tax compliance. Lou Harris, among others, has reported a growing sentiment—especially among the young—that there is nothing wrong with tax cheating. The January 2002 Report of the IRS Board of Oversight reported a similar disturbing trend.

While I am a great fan of the current IRS commissioner Charles Rossotti and his efforts to reorganize the IRS, I remain wary when people talk about a customer-friendly IRS. I will become a werewolf before I change from a taxpayer into a "customer" of the IRS. To think that the IRS can become a modern financial services institution without a major overhaul of the tax law it administers, is to believe that you can turn a Winnebago around without taking it out of its garage.

The fundamental problem is that the IRS is being asked to do too much. Having to administer the EITC, the Nation's wage subsidy for low-income workers, has diverted IRS audit resources away from business and high income individual returns, leading to headlines that the Service is targeting the poor for audits. The IRS also administers the programs providing employees their health insurance and pensions, the Nation's largest subsidy for childcare and the many income tax provisions to help families finance the costs of financing higher education. The IRS routinely processes over 200 million individual and corporate tax returns and nearly 1.5 billion information documents each year. We also expect the IRS promptly to issue regulations implementing frequent and massive legislative changes, to ferret out and deter corporate tax shelters, to halt tax evasion and to bring the underground economy to the surface. The Internal Revenue Service cannot do all of these things well. Many it cannot do at all. We should not expect it to. A major simplification of the

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[1] Michael J. Graetz, The U.S. Income Tax: What It Is, How It Got That Way, and Where We Go From Here, New York: W.W. Norton & Co. (1999).

[2] Michael J. Graetz, *The David R. Tillinghast Lecture Taxing International Income: Inadequate Principles, Outdated Concepts, and Unsatisfactory Policies*, 54 Tax L. Rev. 261 (2001), reprinted at 26 Brooklyn J. of Int. law 1357 (2001).

Nation's tax law is necessary. We need a fundamental overhaul of our Nation's tax system.

The vast majority of American families should not have to file tax returns or deal with the IRS at all. In the current tax reform debate, only the proponents of a national sales tax seem committed to this result. Everyone else proposing tax reform—the flat-taxers, the income tax reformers, those who favor progressive consumption taxes—would fail to remove the IRS from the lives of average Americans.

Flat-tax advocates trumpet their claim that they would shrink the individual tax return to fit on a postcard. But given Congress's propensity for enacting tax breaks to encourage this or that expenditure or activity, it is foolish to believe that a flat tax—which would require all wage earners to file tax returns—would stay flat or simple for very long. The political allure of giving Americans tax breaks for specific expenditures or investments is catnip to both Congress and the White House. And the flat tax would tax the entire value of goods manufactured in the U.S. whether sold here or abroad, but would tax only the U.S. mark-up of imported goods manufactured abroad. The flat tax's treatment of exports and imports is anathema to American businesses.

In contrast, since all reporting of sales taxes would be done by retail businesses and no individual returns would be required, a sales tax would offer a genuine and lasting simplification for American families. The rub, however, is that complete replacement of the income tax with a national sales tax would provide a large tax reduction for the country's wealthiest people. Neither the flat tax nor a national sales tax would be fair as a full replacement for the income tax. Both would shift the Nation's tax burden from high-income families to those with less income. The tax system can, and should, be fixed without such a shift in the Nation's tax burdens. As the New York Times columnist William Safire, who called the flat-tax "Draconian," has said: "Most of us accept as 'fair' this principle: The poor should pay nothing, the middlers something, the rich the highest percentage."

The current income tax is a horrible mess. But in the course of radically restructuring our tax system we should not enact a massive tax reduction for the country's most wealthy people, those who least need such relief.

In discovering how we should move forward to a new tax regime, we can profitably learn from the tax policies of our past. We can achieve low-tax rates and a reasonably simple tax system by replacing most of the income tax with a tax on consumption. In the process we should return the income tax to its pre-World War II status—a low-rate tax on a relatively thin slice of higher income Americans. Whittling down the income tax would be financed by enacting a value-added tax (VAT), a consumption tax commonly used throughout the world. The VAT is a revenue-producing mainstay in over 120 countries on five continents. A VAT operates much like a national sales tax, but is collected at all stages of production rather than just from retailers. Sales taxes are far more susceptible to tax evasion than a value added tax.

A VAT imposed at about a 12 percent rate could finance an exemption from income tax for families with up to $100,000 of income. And enacting a VAT would allow a vastly simpler income tax at a rate of 25 percent or less to be applied to income over $100,000. This shift in taxes would eliminate more than 85 percent of American families from the income tax rolls. Only about 15 million of the 125 million individual income tax returns would still be filed; 110 million returns would be eliminated. If small businesses were exempt from filing VAT tax returns, as they should be, only about 12–13 million VAT returns would be required to be filed.

This is a practical and workable plan, which distinguishes it from the ideas for restructuring of the Nation's tax system which have so far received the most attention in the Congress. People freed from income taxation would pay their federal taxes when they purchase goods and services, as they now do with state sales taxes. They would not be required to file any tax returns. They would have no dealings at all with the Internal Revenue Service. The income tax that would remain for high-income taxpayers would be shrunken and simplified substantially. A low, flat rate of tax would be imposed on the taxable income of high-income individuals and corporations. The marriage penalties of the existing income tax would be eliminated. The alternative minimum tax would be repealed. Most of the special income tax credits and allowances that now crowd the tax code and complicate tax forms would be repealed.

Low and middle income families would be protected from any tax increase and receive amounts roughly equivalent to their current EITC through payroll tax offsets. Providing low-income workers tax offsets through the payroll tax withholding system would allow elimination of the tax return filing requirement for these workers without increasing their taxes or eliminating their wage subsidy. Moreover, payroll tax offsets would put money in low-income workers' pockets when their pay-

checks are earned, rather than through a lump-sum tax refund after year end, as the EITC now does.

The corporate income tax rate would also be reduced to 25 percent or less, the same rate that would apply to the income of high-income individuals. The corporate income tax would be simplified substantially and the corporate alternative minimum tax would be repealed. By adopting identical tax rates (and depreciation allowances) under the individual and corporate income taxes, the income of small corporations could be taxed on a flow-through basis, thereby eliminating the separate corporate tax for many small businesses and taxing their income directly to their owners. This would also allow small business income to qualify for the $100,000 income tax family allowance. The corporate income tax would generally apply only to large publicly-held companies.

With a low corporate income tax rate, international business income taxation might be substantially simplified by moving to a "territorial" system of taxation. Under this kind of tax system, which is used in about half the OECD countries, the United States would collect tax on all business income earned in the United States, regardless of who owns the business, but the U.S. would not tax active business income earned abroad by corporations owned by Americans. In addition, to the extent that corporate income taxes are passed on to consumers in higher prices, substituting value added taxes on a destination basis would directly benefit American exports.

This plan is designed to be revenue-neutral to the Federal Government. Nor would it result in a substantial shift in the distribution of the current burdens of the tax system. Thus, unlike proposals to replace completely the income tax with either a "flat tax" or a national sales tax, this plan does not entail a substantial tax cut for high income individuals or a tax increase for those below the top tier. And this new tax system would be considerably more favorable to savings than the current tax law. Most families would be able to save free of tax, and the tax burden on savings would be reduced for everyone.

Currently the U.S. taxes consumption considerably less than our trading partners. (See Figures 1 and 2.) Reducing income taxes will make the U.S. tax system more favorable to investments by both U.S. residents and foreigners. Our income tax would be lower than that most of other nations and our taxes on consumption would be comparable to those imposed elsewhere. If the U.S. were to add a federal VAT of this rate to existing state sales taxes, the total U.S. tax rate on consumption would approximately equal the average VAT rates in Europe. (See Figure 3.) This is a realistic and feasible plan for restructuring the tax system of the United States.

There are a variety of methods for imposing and collecting such a consumption tax. In my view, the best alternative is a so-called credit (or invoice) method value-added tax of the sort used predominantly throughout OECD nations. Experience demonstrates that such a tax works well. Sellers of goods and services collect taxes and receive credits for VAT paid on their purchases. This allows tax revenues to be collected regularly throughout the year from companies at all levels of production, rather than just from retailers, thereby easing enforcement of the tax. A credit-method value-added tax also permits exemptions for small businesses (and for specified goods or services if such exemptions become politically necessary). A credit-method VAT can be applied on a destination basis—taxing imports and exempting exports—in full compliance with the GATT rules, a quality that only the sales tax can also claim with certainty.

While I favor the credit method of collecting consumption tax, principally for its compliance advantages and its ability to be imposed on a destination basis under GATT, the particular form of consumption tax is not critical to the proposal I am offering here. (For example, a subtraction-method VAT might be used instead, but since it is imposed on entities rather than on transactions, it might be regarded as a "direct" rather than "indirect" tax under the archaic GATT classifications, and, if so, exempting exports might be vulnerable to a challenge in the WTO.)

The key points are these: The consumption tax should be collected only from businesses. It should exempt exports and tax imports. And the tax base and rate of the VAT should be structured to free the vast majority of Americans from any income tax liability and from any requirement to file tax returns. This can be done without reducing overall federal revenues.

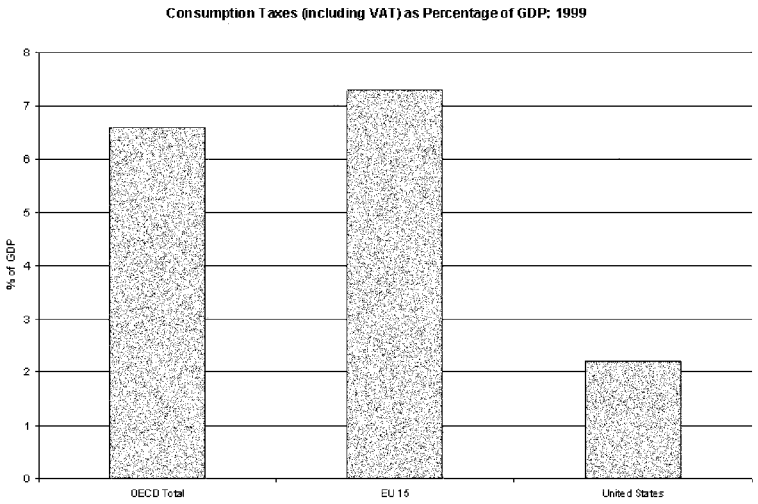
Consider what this plan would mean for the tax lives of the American people. This plan would eliminate about 85 percent of the income tax returns that currently are filed each year and would allow substantial simplification of the sliver of an income tax that would remain. The IRS should then be fully capable of administering the Nation's tax system, a task which it is unable to fulfill under the current tax law. As sales tax proponents are fond of saying, for the more than 150 million people

from whom no income tax would be required, April 15 would be just another spring day.

Revamping the Nation's tax system in this manner would also produce positive economic benefits. The new tax system would be friendlier to savings and investment than the existing tax law. Both the individual and corporate income taxes would be reduced to a rate of 25 percent or less. This would make U.S. companies more competitive and the United States an extremely attractive Nation for corporate investments for both U.S. citizens and foreigners. Restructuring the U.S. tax system this way should stimulate economic growth and additional jobs for American workers. It should produce substantial long-term benefits for the American economy.

This plan merits this Committee's careful consideration.

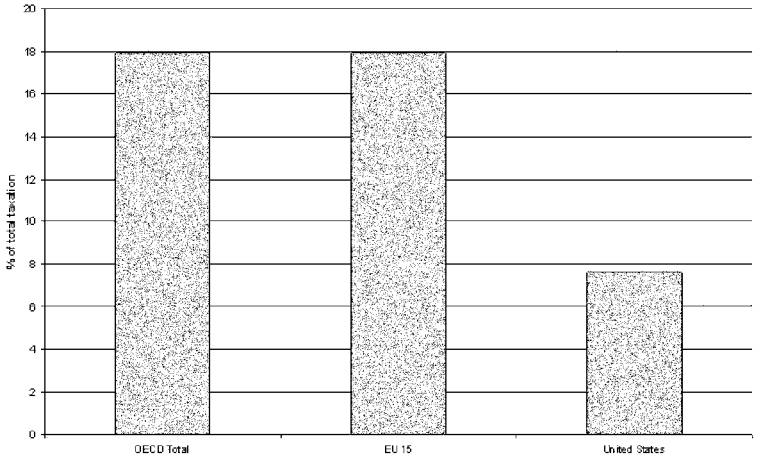
Figure 1



Source: Consumption Tax Trends 2001 (OECD) Table 3.1

Figure 2

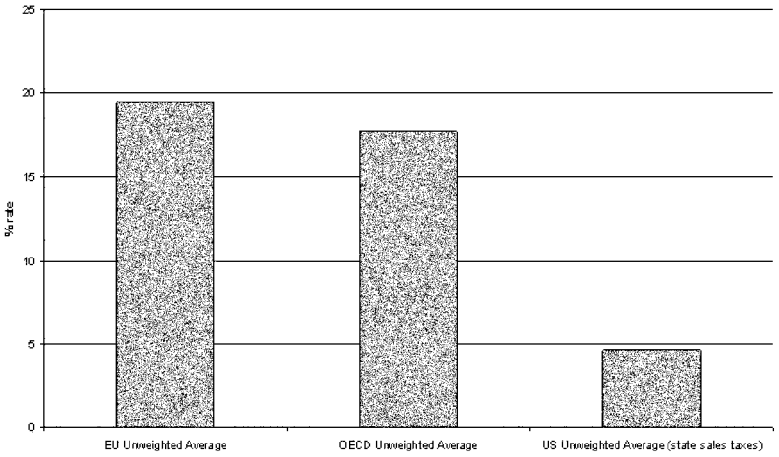
Consumption Taxes (including VAT) as Percentage of Total Taxation: 1999



Source: Consumption Tax Trends 2001 (OECD) Table 3.2

Figure 3

Consumption (VAT) Tax Rates in the EU, OECD members, and US: 2000 (unweighted rate averages)



Source: Consumption Tax Trends 2001 (OECD) Table 3.5; U.S. computations based on data from http://salestaxinstitute.com (visited 1/10/2002)

Chairman McCRERY. Thank you, Mr. Graetz.

Our next witness is Mr. Stephen J. Entin, who is President and Executive Director for the Institute for Research on the Economics of Taxation. Mr. Entin, you may proceed.

STATEMENT OF STEPHEN J. ENTIN, PRESIDENT, INSTITUTE FOR RESEARCH ON THE ECONOMICS OF TAXATION

Mr. ENTIN. Thank you, Mr. Chairman and Members of the Subcommittee. I am grateful to the Subcommittee for bring renewed attention to the issues of international taxation and competitiveness and for asking me to testify.

The Subcommittee has asked if fundamental tax reform can act as a substitute for ETI in increasing U.S. exports. Such reforms could include a national retail sales tax, a credit invoice VAT, a subtraction method VAT, a business activities tax, a flat tax or a simple cash flow tax on individuals, which I hope you will add to your list.

The simple answer to the Subcommittee's question is that any of the major tax reform proposals would dramatically increase the size of the U.S. capital stock and boost national income by about $4,000 to $6,000 per family. Production for domestic sale would certainly increase. Over time, exports would very probably rise and imports would very probably rise as well.

Manufacturers, whether import competitors or exporters, would certainly benefit. The increased domestic income would be reflected primarily in increased wages and salaries with some lesser gains in domestic capital income as well.

The precise effect on the difference between exports and imports over time is harder to predict. It would depend on whether national saving had risen by more or less than domestic investment in a given year.

All of the major tax reform proposals are territorial in nature. Some of these territorial tax reform proposals are border-adjusted tax (BAT) and some are not. All of the major tax reform proposals eliminate the major biases in the income tax system against savings and investment and produce a tax system that is neutral between income used for consumption and income used for saving and investment. It is this last criterion, neutrality, that would lower the excess tax burden on U.S.-sited capital and would have the biggest impact on business investment, production and employment in the United States and on the resulting trade flows.

The United States is no longer a low-tax country for business. The current tax regime's foreign tax credit is so limited by various divisions, by country and type of income, that it places U.S. businesses at a serious disadvantage to foreign businesses competing in foreign markets. That problem would be solved by a territorial tax system.

Territorial taxation would benefit all U.S. multinational industries and would eliminate the U.S. tax penalties that pressure global countries to incorporate abroad rather than in the United States. It would not, however, specifically benefit the export operations of domestic producers and those who currently benefit from the ETI.

Border adjustability is a different issue. A territorial tax can be border adjusted or not depending where in the production process it is levied. Economists generally believe that after an initial tran-

sition, it matters very little whether the tax system is of the border adjusted or nonborder adjusted type. What really matters is whether it treats capital formation and consumption neutrally and taxes them at a low rate.

The income tax treats income used for savings and investment more harshly than income used for consumption, and that is the root of the problem. Income is taxed when earned. If used for consumption, there is generally no further Federal tax, except a few excises. However, income that is saved is subject to several additional taxes on the earnings, including income tax on the interest, dividends and capital gains, to the corporate income tax and to the estate tax.

To correct the bias against saving, either income used for saving must be tax deferred and the earnings and principal taxed when withdrawn for consumption, or the earnings used for saving must be taxed up front and the earnings be left tax exempt.

Fixing the added tax biases against corporate income would require that it not be taxed at both the individual and shareholder level, and there should be no estate and gift tax. If saving is invested directly in physical assets, the correct treatment is immediate expensing of the investment rather than depreciation. The table in my paper shows you the damage that depreciation is doing. Many of the industries hit by the shortfall of depreciation are in import competing and exporting sectors. Most would benefit greatly if we moved toward expensing; they would become more competitive.

Recapping the rules for neutrality: If a tax is imposed at the individual level, saving must be tax deferred. Alternatively, if the saving is taxed, the returns must be left exempt. If the tax is imposed at the business level, investment must be expensed, not depreciated. All the major tax reform plans follow those rules.

A retail sales tax is collected by retailers based on the consumption spending of individuals, which means the tax base is their earnings less their saving.

Value-added taxes and the BAT are collected by businesses in increments through the production process, and are based on a business's sales less its investment expenses. This involves expensing, and the tax base equals national income less saving.

An individual cash flow tax is collected from individuals based on their earnings less their saving. A non-corporate business's investment is expensed.

In the flat tax, income from capital would be taxed at the business level before being distributed to the owners or reinvested and, as in a VAT, firms would expense their investment.

Except for a few quirks, all the major reform approaches have the same fundamental tax base, revenues less saving, or revenues less investment. This is the proper definition of net income. These reforms should not be thought of as consumption taxes. They are properly defined income taxes. They all reduce the excess tax burden on investment.

If I had to choose among them, it would be on the basis of transparency, which tax most clearly reveals to taxpayer voters the extent of the government's tax take. That would be the individual cash flow tax.

Thank you.

[The prepared statement of Mr. Entin follows:]

Statement of the Stephen J. Entin, President, Institute for Research on the Economics of Taxation

Mr. Chairman and members of the subcommittee,

My name is Stephen J. Entin, President of the Institute for Research on the Economics of Taxation. I am an economist with a background in tax analysis and international economics. I served as Deputy Assistant Secretary of the Treasury for Economic Policy from 1981 to 1988, a period when significant tax changes were enacted, and significant shifts occurred in exchange rates, international capital flows, and trade balances. I am grateful to the Subcommittee for bringing renewed attention to these issues with these hearings, and for asking me to testify.

Congress enacted the extraterritorial income exclusion (ETI) in response to World Trade Organization objections to the Foreign Sales Corporation (FSC) provision of the tax code. The WTO has since ruled that the ETI is also in violation of WTO rules against explicit export subsidies. They state that a nation may have a border-adjusted "indirect" tax, such as a VAT or sales tax, or a non-border-adjusted "direct" tax, such as an individual or corporate income tax, but not a border-adjusted "direct" tax. With particular regard to the ETI, declaring the export income to be "foreign source" (when it actually represents domestic value added) and declaring the corporate tax system to be "territorial" (but only for the selected exports, and not for income actually generated abroad) will not follow the usual meanings of the terms and will not satisfy WTO conventions. In fact, the distinction between a "direct" and an "indirect" tax is purely semantic and is economically meaningless. The difference in how the two types of tax treat international transactions has more to do with administrative convenience, bureaucratic custom and legal precedence, and less with real economic consequences.

Alternatives to the FSC–ETI regimes.

Given the WTO's insistence that the ETI be abandoned, the subcommittee has asked if fundamental tax reform can act as a substitute for ETI in increasing U.S. exports. Such reforms could include a national retail sales tax, a credit-invoice VAT, a subtraction method VAT, a business activities tax, a "flat tax", or a simple cash flow tax. I have been asked to focus particularly on how the flat tax and a simple cash flow tax would affect the issue.

Effect of tax reform on exports.

The simple answer to the subcommittee's question is that any of the major tax reform proposals would dramatically increase the size of the U.S. capital stock, wages, employment, and national income. (Replacing the corporate and personal income taxes and transfer taxes with these reformed systems could raise incomes by perhaps ten percent across the board in real terms, or about $4,000 to $6,000 per family, equivalent to giving each about $150,000 in current income-generating assets.) In the process, production for domestic sale would certainly increase. Over time, exports would very probably rise, and imports would very probably rise as well. Ending the tax bias against capital would be of particular benefit to the capital intensive industrial sectors of the economy and to commercial and residential rental real estate. Manufacturers, whether import competitors or exporters, would certainly benefit.

The precise effect on the difference between exports and imports over time is harder to predict. The effect on the trade balance in any given year would depend on whether national saving had risen by more or less than domestic investment by that point. During the initial spurt of domestic investment and growth that would follow the elimination of the excess tax burden on capital, the United States would probably save more, and also send less of its saving abroad and attract more saving from foreigners. The rise in the net capital inflow (capital account surplus) would be accompanied by an increase in the current account deficit; that is, imports would rise by more than exports. Later, as domestic productive capacity expanded, there would be a rise in exports; the current account (including trade in goods and services) would move back toward balance or surplus. At the same time, domestic saving would tend to catch up with the increase in investment, and the capital account surplus would be further reduced by the additional interest and dividend payments being made to the foreign investors. (The balances on capital and current account are of necessity equal in value and opposite in sign. They always sum to zero and move by equal amounts in opposite directions. The net international capital flow is

the chief determinate of the balances, not the specific tax treatment accorded exports and imports.)

The ultimate increases in domestic product and income would dwarf the changes in the foreign accounts. The increased domestic income would be reflected primarily in increased wages and salaries, with some lesser gains in domestic capital income as well.

Incidence of the tax changes.

The FSC and the ETI have allowed exporting businesses to save about $5 billion in taxes. The bulk of the total goes to a few dozen large companies with high export earnings. It should be noted up front that no general tax reduction on saving, investment, or labor, spread evenly across the production process, will target these exporters in precisely this manner. Reforming the tax treatment of foreign source income, which is a worthy goal, would greatly improve the competitive position of U.S. firms operating abroad, but these are not necessarily the same export-oriented businesses benefiting from the current ETI regime. Nor will the small sums involved in the ETI provision cover much static revenue reduction to aid in adopting a fundamental reform of the whole tax system. Therefore, eliminating excess layers of tax on capital formation would require spending restraint or offsetting tax increases to produce a static "revenue neutral" result. (Tax reform would be made much easier if the government would take account of the benefits to the federal budget of the additional capital formation, employment, and national income that the reform would induce.)

Territorial, border adjustable, and neutral: three different tax attributes.

All of the major tax reform proposals are territorial in nature, subjecting domestic income to tax, and excluding foreign source income from tax. Some of these territorial tax reform proposals are border-adjusted (imposed on imports but not on exports) and some are not. All of the major tax reform proposals eliminate the major biases in the income tax system against saving and investment, and produce a tax system that is neutral between income used for consumption and income used for saving and investment. It is this last criterion, neutrality, that would have the biggest impact on business investment, production, and employment in the United States, and the resulting trade and capital flows.

Territoriality. Territoriality and border adjustability are two separate concepts that are often confused. It is sometimes asserted that territorial taxation helps a country's trade balance. Most people who say that are thinking of tax systems that are border-adjusted, and are assuming that border-adjusted tax systems boost exports. Many territorial tax systems are also border-adjusted, but some territorial systems are not border-adjusted. When the Congress adopted the ETI, it was the border-adjusted element, not the territorial element, that was assumed to promote exports. The border adjustment aspect of the ETI only affects the exports eligible for the tax relief, and while it may encourage certain exports, it probably does not alter the total balance between exports and imports.

A shift to a territorial tax would be very beneficial for simplicity of tax compliance and tax enforcement. It would prevent double taxation of foreign source income more cleanly than the current approach, which imposes global taxation with a credit for foreign taxes paid, even assuming that the current credit mechanism were applied uniformly. It would certainly be an improvement over the current form of the foreign tax credit, which is so limited by various divisions by country and type of income that it places U.S. multi-national businesses at a serious tax disadvantage to foreign businesses competing in foreign markets. This distorting effect of the current code is a serious problem that would be solved by adoption of a truly territorial tax system. Territorial taxation would benefit all U.S. multi-national industries, including financial services companies, natural resources companies, software and entertainment companies, and manufacturers with facilities abroad.

A territorial tax would not, however, specifically benefit the export operations of domestic producers. It would not generally or broadly lower the costs of producing goods and services in the United States relative to costs of producing abroad. It could benefit U.S. exports by making U.S. firms better able to service foreign customers from foreign production and sales offices, and if the increased activity at such sites then increased orders for U.S. components and licensed technology. It would eliminate the U.S. tax penalties that pressure global companies to incorporate abroad rather than in the United States.

Border-adjustability. Border-adjustability is a different issue. A territorial tax (or non-territorial tax for that matter) can be border-adjusted or not, depending on where in the production process it is levied. Some territorial taxes are explicitly border-adjusted, imposed on income spent on goods and services in the United States,

including imports, while either being rebated on, or otherwise not imposed on, exports. Other territorial taxes are not border-adjusted.

A territorial VAT, business activities tax, or retail sales tax would normally be border-adjusted (although they could be designed without this feature). It would be explicitly imposed on purchases by residents of goods and services in the United States, whether domestic products or imports; the portion otherwise due on exports would be refunded.

An individual cash flow or "consumed income" tax would be territorial but not border-adjusted. The income subject to the tax would be income earned in the United States, so the tax would be territorial. It would be collected from individuals on their U.S. source income less net saving, in effect taxing income that was going to be used for consumption before the taxpayers spent it. It would naturally fall on income spent on domestic and imported goods and services, and would naturally not fall on the income that foreigners spend on U.S. products, with no explicit border adjustment required.

Economists generally believe that, after initial transition effects have dissipated, and all prices, wages, and exchange rates have adjusted to whichever tax regime is chosen, it matters very little whether the tax system is of the border-adjusted or non-border-adjusted type. Output and income will be roughly the same either way. What matters, rather, is whether domestically sited capital formation is taxed on a par with consumption, or more heavily than consumption, and at what rates capital and labor services are taxed.

Neutrality issues: the bias against saving and investment in the current tax system, and steps to fix it. The income tax treats income used for saving and investment more harshly than income used for consumption. Income is taxed when earned. If it is used for consumption, there is generally no further federal tax (except for selected excise taxes on a few products). One can buy a loaf of bread with after-tax dollars and not be taxed again while eating it, or buy a television with after-tax dollars and not be taxed when watching the stream of programming. But buy a bond or stock with after-tax dollars and one faces a second layer of federal income tax on the stream of interest, dividends, or, if retained earnings boost the share price, on capital gains. This is the basic income tax bias against saving, and it stems from taxing both the income that is saved and the returns on the saving.[1] If the saving is in the form of a purchase of corporate stock, there is also the corporate tax to be paid on the corporate income even before the dividend is distributed or the retained earnings can be reinvested, constituting a third layer of income tax on income saved in this form. Another layer of bias is imposed if the already-taxed saving is large enough to trigger estate and gift taxes.

To put the tax treatment of income used for saving and investment on a neutral basis with income used for consumption would require several changes to the tax system. To correct the basic bias, either income used for saving must be tax-deferred, and the earnings and principal taxed only when withdrawn for consumption, or the income used for saving must be taxed up front, with no further tax on the earnings of the saving.[2] Corporate income would not be taxed at both the corporate and shareholder levels; one or the layer of tax would go. There would be no estate and gift tax.

Fixing the basic income tax bias against saving and investment. A saving-deferred tax would treat all saving in the same manner as current law treats retirement accounts such as deductible IRAs and pensions. Income is a net concept, revenue less the cost of earning the revenue. Buying a bond or stock or adding to a bank balance is a cost of earning future income, and should be deductible (deferred) until it is recovered. Therefore, earnings less saving is the correct measure of income. It is also the amount of earnings one spends on consumption.

The other approach to neutrality, a returns exempt tax, is similar to the tax treatment given to Roth IRAs and tax exempt state and local bonds. The two methods

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[1] Consider a hypothetical 20% income tax on income used for either saving and consumption, and assume a 4% interest rate. Without the tax, one could earn $100 and consume $100 or buy a $100 bond and earn interest of $4 a year. With the tax, one must earn $125 to have $100 left after tax for consumption, a jump of 25% in the cost of consumption. To earn the same $4 in interest, however, one must earn $156.25, pay $31.25 in tax, buy a $125 bond, earn $5 in interest, pay $1 in tax on the interest, and have $4 left after all taxes. The cost of the saving has gone up 56.25% because of the taxation of the saving and the return.

[2] Either allowing deferral of income saved or exempting the return from tax would restore the no-tax relationship between saving and consuming. Continuing the previous example, under deferral, one could earn $125, buy a $125 bond, earn $5 in interest, pay $1 in tax, and have $4 to consume. Under exempt returns, one could earn $125, pay $25 in tax, buy a $100 bond, and earn $4 tax free. In either case, the cost of obtaining the $4 in after-tax interest has risen 25%, the same as for the consumption.

are equivalent for savers in the same tax bracket over the life of the saving.[3] All major tax reform plans use one or the other method to produce a neutral outcome.

If the saving is invested directly in physical assets (plant, equipment, buildings, etc.) the correct treatment is immediate expensing of the investment (first year write-off), rather than depreciation. Depreciation, which stretches out the deduction over many years, results in a write-off of less than the full present value cost of the asset, overstating income and raising the effective tax rate.

Present Value of Current Law Capital Consumption Allowances per Dollar of Investment Compared to Expensing (First-year Write-off)

Asset lives:		3yrs	5yrs	7yrs	10yrs	15yrs	20yrs	39yrs
Present value of first-year write-off of $1 of investment:	.....	$1.00	$1.00	$1.00	$1.00	$1.00	$1.00	$1.00
Present value of current law write-off of $1 if inflation rate is:	0%	$0.96	$0.94	$0.91	$0.88	$0.80	$0.74	$0.55
	3%	$0.94	$0.89	$0.85	$0.79	$0.67	$0.59	$0.37
	5%	$0.92	$0.86	$0.81	$0.74	$0.60	$0.52	$0.30

Assumes a 3.5 percent real discount rate, 3–20 year assets placed in service in first quarter of the year, 39 year assets placed in service in January.

A dollar spent on a seven year asset gets a write-off that is only worth $0.91 cents in present value if inflation is zero. A dollar spent on a building (written-off over 39 years) gets a deduction worth just $0.55 cents in present value. The cost of the delay rises with inflation. At 5% inflation, the 7-year asset's write-off is worth only $0.81, and the building's write-off drops in value to $0.30. At modest rates of inflation, the overstatement of business income by depreciation can cut the rate of return on business investment in half. The shortfall in depreciation hits manufacturing and real estate particularly hard, and hits the industries with the longest lived assets the hardest. Many of these are import-competing or exporting sectors. Moving toward expensing would make these industries more competitive.

Ending the corporate tax bias. Full neutrality would require ending the additional tax on corporate income, either by taxing capital income at the corporate level but not at the shareholder level, or vice versa. The combined federal individual and corporate tax rates on reinvested earnings and dividends can range as high as 48% to 60% (higher, if a company gets dividends from another before passing them on to the shareholders). The United States is no longer a low corporate tax country. The combined U.S. federal and state corporate tax rate averages 40%. This is the fourth highest combined national and local level corporate tax rate among the nations of the thirty member Organization for Economic Cooperation and Development (OECD). It is exceeded only in Belgium, Italy, and Japan, and is nearly 9 percentage points above the OECD average. Three members have corporate tax rates between 16 and 18 percent, seven between 24 and 29.7 percent, and fifteen between

[3] Using another example, suppose that interest rates are 7.2 percent. At that rate of interest, $1 saved would grow, with interest, to $2 in ten years. (Alternatively, suppose that reinvested earnings caused the price of a share of stock to double in ten years, and that the stock is sold and the capital gain is realized at that time.) Suppose also that the income tax rate is 20%. Under the saving-deductible method, an individual could earn $100, save it without paying tax up front on the deposit or on the annual interest build-up (or on the stock purchase and accruing gain), and withdraw $200 ten years later. After paying a 20% tax on the withdrawal (or the proceeds of the stock sale), the saver would have $160 to spend. Under the returns-exempt method, an individual could earn $100, pay a 20% tax, and save the remaining $80. Without owing any further tax on the returns, he could withdraw $160 ten years later, and, here too, would have $160 to spend.

Either neutral method is better than current law. Under the current tax system, an individual earning $100 would have to pay a 20% tax, save $80, and owe tax annually on the interest, reducing the 7.2% percent interest rate to an after-tax rate of 5.76%. With less interest left to build up after taxes, the saver would have only $140 to withdraw and spend after ten years. The $20 difference ($160–$140) between current law and the neutral systems (about a third of the interest over 10 years) is a measure of the double taxation imposed by current law on income that is saved. Alternatively, note that the same $140 balance would have been achieved by putting a neutral tax of 30% on the original saving (instead of the assumed 20%), leaving $70 to double to $140 over ten years. Clearly, ordinary income taxation imposes a substantially higher tax penalty on income saved than on income used for consumption.

24 and 29.7 percent.[4] In addition, many nations have greater offsets to the extra layer of taxation of corporate income than does the United States. Some have lower tax rates on capital gains, lower tax rates or partial exemption for dividends, partial expensing of share purchases, shareholder credits for corporate taxes paid or partial corporate deductions for dividends or other forms of partial integration of corporate and individual income taxes.

Ending the estate tax bias. The transfer tax (estate and gift tax) must be eliminated to have a neutral tax system. Every cent saved to create an estate has either been taxed already when the decedent (and the companies she or he may have owned shares in) paid income taxes, or, if the saving is in a tax-deferred retirement plan, it will be subject to the heir's income tax. The estate tax is always an extra layer of tax on saving.

Systems that tax in a neutral manner.

Recapping the rules for neutrality: If a tax is imposed at the individual level, saving must be tax deferred and the returns must be taxed. (Alternatively, if the saving is taxed, the returns must be left tax exempt). If the tax is imposed at the business level, investment must be expensed, not depreciated.

Several specific examples of saving-consumption neutral tax systems have been developed, such as the cash flow tax, the Flat Tax, the USA tax, the VAT, the Business Activities Tax, and the national retail sales tax, all of which use either a saving-deferred or returns-exempt approach to tax neutrality. All would lead to higher levels of investment, productivity, and income. Whatever direction fundamental tax restructuring may take, it is important to remember that all these neutral approaches have in common this great advantage over current law.

A retail sales tax is collected by retailers based on the consumption spending of individuals (earnings not devoted to saving). Value added taxes are collected by businesses in increments throughout the production process based on sales less investment expenses (equals national income less saving which again equals the amount spent on consumption goods and services). An individual cash-flow tax is collected from individuals based on their earnings less their saving (equals spending on consumption goods and services).

Except for a few idiosyncrasies, all the major consumption-saving neutral tax reform approaches are unbiased taxes on labor and capital income, properly measured, either when earned or when spent. In other words, they have the same fundamental tax base: revenues less saving (or revenues less investment). This is the proper definition of net income. It also equals the amount spent on consumption. Consequently, saving-consumption neutral taxes are sometimes referred to as consumption taxes (if they are of the sales tax or VAT variety) or consumed-income taxes (if they are of the cash flow type). However, the point of collection of the taxes does not change their nature; they are all saving-consumption neutral taxes on people's income (properly defined), and should not viewed as taxes on consumption goods and services.[5]

The national retail sales tax. The national retail sales tax can be looked at as a saving-deferred tax. It is imposed on income used to purchase consumption goods and services and is collected from consumers by businesses at the point of final sale. It falls on earnings that are not saved, the part of people's earnings that is spent on consumption. It can also be regarded as falling on national output/income less investment (investment, including spending on education, not being part of retail

[4] See CATO Institute Tax & Budget Bulletin No. 3, April, 2002, citing figures from KPMG, "Corporate Tax Rate Survey," January 2002, www.us.kpmg.copm/microsite/Global—Tax/Tax-Facts.

[5] The nature of the neutral taxes must be clearly understood. Various types of sales taxes and excise taxes are often referred to as "consumption taxes", rather than income taxes, because they are collected when products are produced or sold. A broadly-imposed national retail sales tax would fall on an amount of GNP that equals total consumption. Nonetheless, these are not taxes on the act of consumption or on the goods and services consumed. Goods and services do not pay taxes. Only people pay taxes. All taxes, in fact, are taxes on income. Sales and excise taxes and VATs either depress sales of the taxed products, reducing the incomes of the people who provide the labor and capital used to make them, or they reduce the purchasing power of that income when the workers and savers attempt to spend it. The two neutral consumed-income style taxes are imposed on income as it is earned, but properly measured, with either the amount saved and invested deferred or the earnings of saving excluded. Excluding from total income the amount that is saved and used to finance investment leaves an amount equal in a given time period to total consumption. This does not convert the tax into a "tax on consumption", however; it is merely a means of avoiding multiple taxation of income used for saving, and the returns on the saving will be taxed when earned, unless reinvested in turn. It bears repeating that all taxes are paid out of income by people, not by businesses, and not by goods and services.

consumption), which also equals consumption spending. It falls on imports but not exports, since imports are part of the consumption spending of U.S. residents. There would be the usual problem of imposing tax on imports acquired thorough hard-to-monitor channels, such as items or services bought over the Internet.

The VAT and the business activities tax. The VAT and the business activities tax are imposed in stages throughout the production process from raw materials up through processing, fabrication, distribution and final sales. Businesses are taxed on revenues less purchases from other domestic businesses, including the immediate subtraction of investment (expensing, not depreciation). Their tax base is national output/income less investment, equal to net income, which also equals earnings used for consumption. They fall on net income spent on imports but not exports.

The cash flow tax. The cash flow tax on individuals (such as the "inflow-outflow" tax designed by Dr. Norman Ture or the individual side of the original USA Tax introduced by former Senator Sam Nunn (D–GA) and Pete Domenici (R–NM)) is a universal saving-deferred tax. It is imposed on individuals' earnings and transfers received, less net saving (including investment in non-corporate businesses and spending on education) and less transfers to others (including gifts and state and local taxes paid). There is no additional tax at the corporate level; earnings of capital are taxed at the individual level if not reinvested. The tax is collected at the household level before the taxpayers go shopping, and therefore is not explicitly border adjustable, even though it has virtually the same tax base as the retail sales tax. Unlike the sales tax, it would not require a "use tax" on goods or services purchased abroad over the internet. It is territorial, not including foreign source income in the tax base.[6]

The "Flat Tax". The "Flat Tax", as designed by Professors Hall and Rabushka and introduced by Representative Dick Armey (R–TX) and Senator Richard Shelby (R–AL) can be described as a split VAT. Unlike a regular VAT, wage and salary payments would be deductible by businesses, and the labor income would be passed on to be taxed on the workers' personal tax returns. As with a VAT, income from capital would be taxed at the business level before being distributed to the owners or reinvested. After subtracting labor compensation, the capital income would be calculated as remaining revenue less the cost of goods bought from other businesses, including the immediate expensing of investment. Thus, viewed form the business side, it is a saving-deferred tax. Viewed at the individual level, it allows individuals no deduction for saving in financial instruments but does not tax the returns at the individual level.[7] The authors of the "Flat Tax" made it territorial but not border-adjusted. The tax on capital income is not rebated on exports. Most income, that of labor, is taxed on individual tax forms, where the tax is collected before the taxpayers spend the income. It therefore falls on income used to purchase domestic and imported goods and services without being border adjustable.

Conclusion.

With only minor differences, all these taxes fall on revenue less saving/investment, which is the correct measure of income for tax purposes. All will have roughly the same beneficial impact on income and economic activity, including exports, imports, saving, and investment. If I had to choose among them, it would be on the basis of transparency: which tax most clearly reveals to taxpayer-voters the extent of the government's tax take. That would be the individual cash flow tax, which hides none of the tax collections at the business level. Hiding taxes from the taxpayers disguises the cost of government, and encourages voters to approve more government spending than they would favor if they were fully aware of the tax cost.

Chairman MCCRERY. Thank you, Mr. Entin.

Our next witness is a gentleman who has been very generous with his time of late with some of us on the Committee on Ways

[6] For simplicity, the cash flow tax would not allow a deduction for saving in foreign assets and would not tax foreign source interest, dividends, or other foreign investment income. That is, it would be a returns exempt tax on foreign saving by U.S. residents. This would eliminate the tricky enforcement problem of collecting income data from foreign payers and the complexity of filing for a foreign tax credit.

[7] The Flat Tax makes no allowance for investment in education, but does tax the higher incomes that result from education, and so it is slightly "non-neutral" in that regard. Also, unlike the other taxes, it includes income given to others in the donors' incomes instead of the recipients', including charitable contributions and transfer payments and education outlays made through state and local taxes. It therefore has a slightly different distribution of the tax base across individuals from the cash flow, VAT, BAT, and national retail sales tax.

and Means, and we look forward once again to hearing his testimony today. He is William G. Gale who is a Senior Fellow at the Brookings Institution.

Welcome back, Mr. Gale, and please proceed with your oral testimony.

STATEMENT OF WILLIAM G. GALE, SENIOR FELLOW, BROOKINGS INSTITUTION

Mr. GALE. Thank you very much. It's a privilege to be here this afternoon.

So far we have reinvented the Federal tax system about five times in the last 20 minutes. My head is spinning, and I study this stuff all day long. So I'm going to depart from what I planned to say a little bit and try to take a step back and focus on two issues.

One is the specific international tax issues that I think motivated this hearing; and second is, what is the role of fundamental tax reform in addressing those issues? Now, that doesn't help us stop our heads from spinning too much because international taxation is notoriously complicated even for experts, but what I would like to do is focus on the forest rather than the trees here.

There is a single kind of bright line on the international tax issues that has to be focused on amid all the detail and legal and economic discussion, and that is the principle that features of the Tax Code that affect the taxation of offshore income should not be allowed to erode the taxation of domestic income. If you cross that line, then you have created the biggest tax shelter in history. Just as when you put a hole in a dam, you don't just lose the water right in front of the hole, you lose all the water that is near it, the same thing would happen to tax revenues.

So forget about all the gobbledegook and focus on this one issue that whatever happens on the international side should not be allowed to let firms reduce their domestic taxes. I think that's the fundamental issue on the international side.

Having said that, let me turn to export subsidies. The United States subsidizes exports in a couple of ways. I think that the WTO rulings were and are the right ones, that is, our export subsidies violate the WTO regulations, but even ignoring the legal issues, export subsidies are not effective. They are not effective in improving the trade balance. They are not effective in that they pass on some of the subsidies to foreigners, who benefit from lower-priced U.S. exports. They are not effective in that they encourage U.S. firms to choose projects that have low total returns over different projects that have high total returns because of the differential tax treatment.

Most importantly, some of our current export subsidies cross the bright line I mentioned, and they let U.S. firms reduce taxes on their domestic income on the basis of features of their foreign source income. That's a mistake.

So, regardless of what the WTO said, I think it is right that the export incentives should be repealed. Both national welfare and the public fiasco would be improved. I say, may it rest in peace, may ETI rest in peace.

The second international issue that has come to attention recently is corporate inversions. Corporate inversions occur when

firms move their legal headquarters out of the United States solely for tax purposes. Although inversions are perfectly legal and they make perfect since sense from firms' perspective, they are extraordinarily bad public policy. The reason is that inversions allow firms not only to reduce or eliminate the taxes on their foreign source income, they allow them to reduce or eliminate taxes on their domestic income.

So, once again, inversions cross that bright line, and that is a line where you sort of have to make your last stand. I don't know enough about the legal details to suggest exactly what type of laws should be written to restrict those, but I would argue that is a high priority for tax policy.

My testimony goes through two reasons why moving to a territorial tax system is not an effective response to the repeal of ETI or an effective response to the increase in inversions. Let me just mention that moving to a territorial system which only taxes U.S. income in response to inversions is basically like saying we are going to reduce the crime rate by making various crimes legal; so you could reduce the crime rate if you make murder legal. That wouldn't reduce murder, but it would reduce the crime rate.

That is the equivalent of going to a territorial system in order to stop inversions. It would no longer be considered an inversion because it would be a perfectly natural part of the Tax Code.

Let me turn to fundamental tax reform. I think the issue here is replacing the corporate income tax with a value-added tax, not replacing the whole system with a value-added tax because it would not tax exports if we could get WTO to agree on that.

The VAT obviates any potential need for export subsidies. It is my conjecture, though, that the political demand for export subsidies would not disappear. Also, it is important to know that moving to a VAT would not stop the inversion problem, and the reason is, under the value-added tax, some firms would see their tax payments skyrocket and the reason is because the VAT tax base is different from the corporate income tax base.

The VAT does not tax profits, and so a company like General Motors, if we move to the flat tax, their tax liabilities would have gone from $110 million in the early nineties to $2.7 billion; and that is an estimate from Hall and Rabushka, the creators of the flat tax. If you go to a VAT, their tax liability would go up even more because they couldn't deduct wages. So we are talking about some firms having massive increases in tax liabilities, some having massive reductions in tax liabilities. That is the way the VAT is supposed to work relative to the existing system, but firms that have massive increases would still want to invert for the same reason their firms want to invert now.

I would be happy to talk more about the VAT, but my basic point is that neither moving to a territorial system nor fundamental tax reform represents an effective response to the ETI problem or the inversion problem. More direct measures would solve those problems without creating all the side issues that fundamental tax reform raises.

Thank you very much.

[The prepared statement of Mr. Gale follows:]

Statement of William G. Gale, Senior Fellow, Brookings Institutions

Mr. Chairman and Members of the Committee:

Thank you for giving me the opportunity to testify at this hearing. The tax treatment of foreign income has become increasingly important in light of the WTO's decisions regarding U.S. export subsidies, and growing controversies regarding corporate sheltering and corporate inversions. These concerns have also increased interest in long-standing debates about whether the U.S. should switch to a territorial tax system, and whether and how the international competitiveness of U.S. firms can be enhanced.

My testimony contains two parts: a summary of principal conclusions, and supporting analysis.

Principal Conclusions

- The bright line: The concepts of international taxation are sometimes murky and the practice of international taxation can be complex and situation-specific. Despite, or because, of these factors, Congress should keep one overarching principle in mind in redesigning the taxation of international income. That principle is that features of the tax code that affect the taxation of offshore income should not be allowed to erode the taxation of domestically generated income. If this "bright line" is crossed on an enduring basis, the consequences could be very serious.
- Export subsidies: I agree with the EU that U.S. tax incentives for exports should be considered prohibited subsidies. Even ignoring their legality, the export incentives are ineffective in improving the trade balance, and inefficient in that they pass subsidies on to foreigners and cause firms to choose projects with lower total returns over projects with higher total returns. In addition, some current export subsidies cross over the "bright line" noted above and let firms reduce taxes on their domestically generated income. Both national welfare and the public fiasco would be improved if the subsidies were abolished. If Congress would like to recycle the revenue savings into the corporate tax system, the best use would be a reduction in the corporate tax rate or the AMT.
- Corporate inversions: Inversions occur when firms move their legal headquarters out of the U.S. solely for tax purposes. Although they are not illegal and do make perfect sense from the firm's perspective, inversions are particularly troubling from a policy viewpoint. Specifically, inversions allow firms not only to reduce or eliminate taxes on their foreign source income, but also to reduce or eliminate taxes on their domestic income. And they create these incentives without requiring any sort of change in "real" economic activity. Thus, they cross the "bright line" noted above. New laws should strive to eliminate the tax savings from inversions.
- Territorial tax system: Although the best solutions would be to repeal export subsidies and outlaw inversions, it is also natural to consider more broad-based reforms to the tax system. Moving to a territorial tax system is not a useful substitute for export subsidies, for two reasons. First, a territorial tax system reduces the taxation of foreign investment by U.S. firms, which is quite different from reducing the cost of exporting goods. Second, the export subsidies are counterproductive in the first place and should not be replaced. Nor is moving to a territorial system a helpful way to deal with corporate inversions. Territorial systems generally make it more difficult to defend the domestic tax base from attack, since moving offshore results in a bigger tax savings under a territorial system than a world-wide system. That is, territorial systems enhance and legitimize methods of tax avoidance and evasion that should be curtailed under any sensible policy rule. Going to a territorial system as a response to corporate inversions is like choosing to reduce the crime rate by legalizing certain crimes. Thus, although there are reasons to consider territorial tax systems, substituting for export subsidies and stopping inversions are not among them.
- Fundamental tax reform: Replacing the corporate income tax with a value-added tax raises many important issues, including the impact on economic growth, the distribution of tax burdens, tax complexity and so on. Fundamental tax reform obviates the need for export subsidies, but that does not mean the subsidies will disappear. Replacing the corporate tax with a VAT would likely worsen the trade balance, since it will increase investment more than saving. Likewise, a VAT would not relieve the demand for corporate in-

versions. Some businesses would see their tax liabilities skyrocket under a VAT and thus would have incentives to shift profits out of the U.S.

Analysis [1]

Recent events have drawn increasing attention to international aspects of the United States tax system. First, the World Trade Organization (WTO) has now ruled several times that traditional and current U.S. tax incentives for exports represent prohibited subsidies under WTO regulations. The implication of these rulings—that the United States must significantly alter the tax treatment of exports—seems (finally) to have taken hold in the public debate. Second, aggressive corporate sheltering techniques in general, and so-called corporate inversions in particular, have shown that current tax rules allow firms not only to reduce or eliminate taxes on foreign source income, but also to reduce or eliminate taxes on domestic income as well. In addition, these techniques often are based on practices that make no sense except as tax avoidance devices. As a result, many observers believe these practices have gone too far and need to be reined in. These events have also renewed interest in long-standing discussions about whether the United States should switch from a world-wide to a territorial system and how to raise the competitiveness of American firms. Policy makers are now considering a wide range of options to address all of these issues.

The remainder of this testimony is divided into five sections. Sections I and II provide background information. Section I summarizes current U.S. tax rules for international income. Section II examines two conceptual issues: the relationships between several different tax rates affecting international investment, and the determinants of the trade balance. Section III describes export subsidies and corporate inversions and discusses direct policy responses. Sections IV and V discuss potential indirect and broader responses to these problems, including switching to a territorial system and enacting fundamental tax reform.

I. International features of the U.S. tax system

The United States taxes the world-wide income of its individual and corporate residents. Although this may sound simple in theory, in practice it raises a number of difficult issues.

To avoid having the foreign source income of its residents taxed twice, the U.S. provides a foreign tax credit for income taxes paid to foreign governments. To ensure that the credit does not reduce tax on domestic income, the credit cannot exceed the tax liability that would have been due had the income been generated domestically. Firms with credits above that amount in a given year have "excess" foreign tax credits, which can be applied against their foreign source income for the previous two years or the subsequent five years. To limit the ability of firms to use foreign tax credits for one type of foreign source income to reduce taxes on a different type of foreign income, the foreign tax credit limitation is calculated separately for nine different "baskets" of income.

Foreign branches of U.S. corporations are considered U.S. residents and therefore are subject to immediate taxation on foreign source income and eligible for the foreign tax credit. In contrast, controlled foreign corporations (CFCs, which are American-owned, separately incorporated foreign subsidiaries of U.S. corporations) are not considered U.S. residents. Their profits, therefore, are not taxable as long as the earnings are retained and reinvested locally in active lines of business. That is, U.S. income tax (and foreign tax credits) on such income is deferred until the income is repatriated to the U.S. parent.

Deferral of taxes and credits on retained earnings is intended to allow foreign subsidiaries to compete on a more even basis with local firms. To ensure that the benefits of deferral are used only to achieve that goal, the law provides complex and extensive limits on the ability to defer income. These rules (subpart F) make deferral available only on active business income that is reinvested locally. Certain forms of income are "deemed distributed" and thus denied deferral. These include passive income broadly defined, and including portfolio interest and dividends.

Because the tax treatment of domestic and foreign income differ under the U.S. system, firms have incentives to shift income to low-tax jurisdictions and deductions to high-tax jurisdictions. Income can be shifted via the transfer prices at which internal firm transactions are recorded. As a result, the U.S. imposes an extensive set of rules, that essentially require that transfer prices correspond to the prices that

[1] Due to time constraints in the development of this testimony, I do not provide references to particular publications used throughout the text. Rather, the sources listed at the end of the text include the publications that I referenced in developing these comments.

would have occurred in an arms-length transaction. These rules, however, are notoriously difficult to enforce and, in some cases, to interpret.

The U.S. also imposes rules regarding the allocation of deductible expenses—such as research and development costs and interest payments—across jurisdictions. U.S. corporations may allocate only a portion of their expenses to domestic operations, with the rest being allocated against foreign income. The U.S. generally treats exports as taxable income and imports as deductible expenses. But, relative to the rules above, the U.S. subsidizes exports in two ways. First, the sales source rule allows taxpayers that manufacture in the U.S. and sell outside the U.S. to report 50 percent of the income from the sale as foreign income. For firms with sufficient excess foreign tax credits, this provision eliminates U.S. income tax on half of export sales. The U.S. also provides a subsidy for extra-territorial income. Taxpayers are allowed to exclude a portion of their income that is attributable to "foreign trading gross receipts" (FTGR) or net income from FTGR.

A firm cannot generally benefit from both the ETI regime and the sales sourcing rules. Firms with excess foreign tax credits will generally save more through the sales sourcing rules. The ETI rules thus mainly benefit taxpayers that do not have excess foreign tax credits—that is, those who either operate in low-tax foreign countries or do not have foreign operations.The U.S. taxes foreigners on income from their active business operations in the U.S. The U.S. imposes 30 percent withholding taxes on interest (but not portfolio interest, which is untaxed), royalties, and dividends that flow to foreigners, but frequently reduces or eliminates the withholding tax rate through bilateral tax treaties.

II. Two conceptual issues

A. Alternative tax rates

The basic issues in international taxation are sometimes difficult to understand in part because the tax rules are so complex. There are at least four effective tax rates that are of interest. Consider the following definitions of tax rates for the U.S. and a foreign country (FC):

Tax	Country of residence	Location of Production/ Operations	Location of Sales
T1	US	US	US
T2	US	US	FC
T3	US	FC	FC
T4	FC	VC	FC

In words, T1 is the U.S. tax rate faced by U.S. firms on domestic operations that result in domestic sales; T2 is the U.S. tax rate faced by U.S. firms on domestic operations that result in exports; T3 is the total (U.S. and foreign country) tax rate paid by U.S. firms on operations and sales in foreign country FC; and T4 = the FC tax rate paid by a FC firm on operations and sales in FC. It bears emphasis that all of the rates refer to effective tax rates, taking into account the whole tax system (in terms of base, rates, exemptions, deductions, credits, integration of corporate and personal taxes, etc.), not just the statutory corporate rate. Also, I assume the taxes are all enforced.

T1 and T4 are typically not equal. This occurs, for example, when the U.S. taxes its own domestic firms differently than other countries tax their own domestic firms. This is a perfectly natural and normal result of a system in which countries tailor their own fiscal policies. Relative to our industrial trading partners, U.S. domestic taxation of domestic firms is the same or lower than the other countries taxation of their own firms (Table 1 and Figure 1 offer suggestive but not conclusive evidence of this.) Relative to many other countries, and to tax havens in particular, U.S. taxation of domestic firms is higher than those countries' taxation of their domestic firms. In particular, in countries in which T4 < T1, U.S. businesses often complain that the U.S. tax system makes it difficult for them to compete with local firms in the foreign countries.

Under this circumstance, the key issue is how should the U.S. set T2 and T3? If the U.S. were to tax all income at the same rate, then T1 = T2 = T3 > T4. This would be "fair" from a domestic perspective—as the tax on U.S. firms would depend only on the income they earned—but it would put U.S. firms at a disadvantage relative to foreign firms in country x. If the U.S. were to allow all foreign income to

be taxed at the foreign country's rate, then T1 > T2 = T3 = T4. This would ensure that U.S. firms could compete on an equal tax footing abroad, but would then bias U.S. firms away from producing for the domestic market and would allow foreign countries to set U.S. tax policy. If T2 does not equal T3, U.S. firms have incentives to move export production either on-shore or off-shore depending on the direction of the inequality.

The issues addressed below can also be seen in light of these tax rates. Export subsidies set T2 < T1. A pure world-wide tax system sets T1 = T2 = T3. A pure territorial system sets T3 = T4. Inversions are problematic because they reduce not only T3 but also T1 and T2, and the reduction is not naturally bounded by T4, where T4 applies to the country in which the firm has real foreign operations (as opposed to nominal headquarters).

B. Taxes, competitiveness and the trade balance

National income accounting provides a potent way of understanding the dynamics of tax policy and the trade balance. The budget constraint of the private sector implies that

(1) $$Y = C + S + T,$$

where Y is national income, C is private consumption, S is private saving, and T is tax payments. Likewise, national output, which equals national income, can be expressed as the sum of different types of spending:

(2) $$Y = C + I + G + X - M,$$

where I is investment, G is government purchases, X is exports and M is imports. Combining these equations yields

(3) $$X - M = (S - I) + (T - G).$$

Equation (3) has says that the trade surplus (X − M, deficit if negative) is the sum of the excess of private saving over private investment and of government revenues less purchases of goods and services. Thus, if the U.S. has a trade deficit (X < M), it must be the case that private saving falls below private investment and/or government revenues are less than government purchases

The simple nature of equation (3) belies its importance in understanding the impact of tax policy on "competitiveness" as expressed by the trade balance. In particular, policies affect the trade balance only through their effects on private saving, private investment, tax revenues and government purchases. This means that tax adjustments at the border should have no long-term impact on the trade balance. Likewise, export subsidies have no effect on the trade balance unless they alter the right hand side variables. Fundamental tax reform may well alter the trade balance, but not through its effects on border tax adjustments. Rather, its impact on capital accumulation and labor supply may alter the balance between domestic saving and investment.

III. Current Issues

A. Export subsidies

Background. The U.S. has long subsidized exports. In 1971, Congress allowed U.S. companies to form tax-favored export-intensive corporations known as domestic international sales corporations (DISCs). DISCs were exempt from corporate income tax and had other benefits. In 1976, DISCs were found to violate GATT rules prohibiting export subsidies. In 1984, after protracted discussions and without admitting guilt, the U.S. repealed the DISC rules and created foreign sales corporations (FSCs). With a FSC, firms who had a foreign presence and performed export-related activities outside the U.S. could exempt 15–30 percent of export income from taxes. In 2000, the WTO found the FSC to be a prohibited subsidy. The U.S. repealed FSC and established the extraterritorial income (ETI) regime. ETI provides the same magnitude of tax benefits for exports as FSC did. The ETI provisions, however, also provide between a 15 percent and 30 percent tax exemption for a limited amount of income from foreign operations. This extension to foreign source income was apparently designed to incorporate elements of territorial taxation. However, WTO ruled that ETI was also a prohibited subsidy.

The sales sourcing rule has not been challenged by the WTO. The reason why is not entirely clear. It may be because the sales sourcing rule is used by firms with excess foreign tax credits, so it is seen as reducing double taxation.

In 2002, the ETI regime and the sales sourcing rules will each save U.S. firms about $4.8 billion. Most of these benefits go to large firms. In 1996, 709 firms with more than $1 billion in assets filed 26 percent of FSC returns and received 77 per-

cent of the benefits. These firms also make major campaign contributions and lobbying efforts. Thus, the activities that benefit from FSC and ETI regimes are a small portion of overall U.S. cross-border economic activity.

Economic Effects. Although export subsidies have a long history in the United States, they have little economic rationale. First, although the subsidies may increase exports, they do not improve the trade balance. As noted above, the trade balance depends on the relationship between how much a country produces and how much it consumes. If it consumes more than it produces, it must be running a trade deficit. If export subsidies do not alter total production or consumption of U.S. citizens, they cannot alter the trade balance. Another way to see this is to note that in order to purchase more exports of American goods, other countries need more dollars. This drives up the demand for dollars and hence causes the exchange rate to appreciate. This makes exports from the U.S. more expensive, and imports to the U.S. less expensive. This rise in imports hurts U.S. industries that compete with imports.

Second, tax subsidies for exports spread some of the benefits of the tax cut to foreigners. It is not clear why subsidizing foreign consumption of American goods is preferred to domestic consumption of American goods. Third, export subsidies will encourage firms to make inefficient choices—that is, to favor export projects with lower total return, but higher after-tax return, over domestic projects with higher total return but lower after-tax return.

Finally, and most importantly, note that the sales sourcing rule violates of the "bright line" principle. The sales sourcing rule uses tax rules for foreign source income (in particular the foreign tax credit) to reduce by half taxes on exports, which are the product of domestic operations. In contrast, the foreign tax credit is designed explicitly to stop firms from cutting taxes on their domestic operations.

Policy response. Given the ineffectiveness of export subsidies, their minor role in international economic transactions of the United States, their violation of the "bright line" principle, and the valid objections of the WTO, the most sensible policy would be to abolish the export incentives. The revenue saved could be used to reduce corporate tax rates, reduce the AMT, or pay down public debt.

B. Inversions

Background. "Inversions" refer to a complicated set of procedures that allow firms not only to reduce their taxes on foreign source income, but to reduce taxes on domestic income as well. Here is how a typical inversion works. First, a domestic corporation creates a foreign parent in a country like Bermuda—which has no income tax and no tax treaty with the United States. This allows it to eliminate U.S. taxes on foreign source income. Second, the domestic corporation sets up a foreign subsidiary of the foreign parent in a third country—often Barbados or Luxembourg—that has a treaty with the United States and has lax residency requirements. To qualify as a resident of Barbados, for example, the company just has to meet there once a year. The reason the third country and its U.S. tax treaty are important for this scheme is that the tax treaty eliminates withholding taxes on flows of royalties or interest payments from the U.S. to the third country. Thus, once the funds are transferred to Bermuda, which does not have a treaty, there is no access to the funds by U.S. Government.

With the new foreign parent in place and the existing foreign subsidiaries turned over to the foreign parent, the inversion works in two steps. First, the American company "sends profits" to the foreign subsidiary in the third country. Sending profits means the American company makes payments to the subsidiary that are deductible under U.S. tax law. Note that this reduces the American company's American taxes on domestic operations. These payments could include interest payments, royalties for use of the company logo, and so on. No taxes are withheld on these transactions because of tax treaties with the U.S. and the third country. Second, the foreign subsidiary then sends the funds to the foreign parent in Bermuda, which has no income tax. As a result, taxable American profits have been shifted to Bermuda and escape U.S. taxation.

Economic analysis. Inversions have nothing to do with a lack of competitiveness of our tax system. Competitiveness, if it means anything, should refer to the effective rate of taxation on businesses. The effective rate of taxation depends on the statutory tax rate, depreciation rules, whether the corporate and personal taxes are integrated. The ETR does not affect the incentive for inversions. Rather, inversions depend only on the statutory tax rate. That is, U.S. firms have incentives to shift profits out of the U.S. because of the 35 percent statutory corporate tax rate. *This would be true even if investments were expensed, which would reduce the effective tax rate on capital income to below zero, since some investment is debt-financed.*

Policy Response. Inversions violate the "bright line" principle noted above. Indeed, their whole reason for existence is to violate that principle. That is, they exist in order to reduce U.S. taxes in what are in most case clearly U.S. operations. This is a dangerous precedent for Congress to allow and it should be eliminated as swiftly and completely as possible. (Note also that many of the same issues apply to other corporate sheltering techniques.)

IV. Territorial versus world-wide taxation

Background. I believe the most natural and direct responses to export subsidies and inversions would be to repeal the first and outlaw the second. But it is also natural and appropriate to examine the extent to which broader changes in the underlying nature of the tax system could resolve these problems.

As noted above, the U.S. operates its tax system on what is essentially a world-wide basis. No country, though, operates a pure territorial or world wide system. About half of OECD countries operate systems that are essentially territorial, while the other half operate systems that are basically world-wide in nature.

In theory, the differences between a pure world-wide system and a pure territorial system are large. A world-wide system taxes all income of residents regardless of where it is earned, gives credits for foreign income taxes paid, and defers taxation of foreign subsidiaries until the funds are repatriated. As noted above, these rules lead to complex provisions regarding foreign tax credit limitations, anti-deferral rules, and income and expense allocation. In contrast, a territorial system only taxes income earned within the country's borders and only allows deductions for expenses incurred within the borders.

While a territorial system sounds simpler in theory, in practice it often turns out not to be. First, territorial systems have to define the income that is exempt. In practice, territorial systems tend to apply only to active business income. Even within that category, the territorial system may only exempt active business income (a) if it faces taxes above a certain threshold level in the host country, (b) from a certain type of business (e.g., e-commerce), and/or (c) from certain countries. Second, the treatment of non-exempt income must be specified. Third, the allocation of income and expenses across jurisdictions takes on heightened importance in a territorial system. For all of these reasons, territorial systems end up with complex rules regarding foreign tax credits, anti-deferral mechanisms, and allocation of income and expenses.

Economic issues. Although the two systems are not as different in practice as in theory, they do have different tendencies that are worth noting.

First, in a world of sophisticated and mobile transactions and firms, neither system is easy to operate. A territorial system is based on being able to define the geographic area where income is earned and expenses are incurred. A world-wide system is based on being able to define the geographic area where a corporation is resident. Both concepts are becoming increasingly difficult to assign and monitor and increasingly easy for firms to manipulate.

Second, changing to a territorial system is not a natural or appropriate response to the removal of export subsidies. Export subsidies promote U.S. exports. Territorial systems would promote U.S. investment in low-tax foreign countries. These are related but quite different issues.

Third, changing to a territorial system would be a curious and flawed response to corporate inversions (and corporate shelters more generally). Territorial systems make it *harder* to protect the domestic tax base. In a world-wide system, if firms go abroad, their income is still taxable. In a territorial system, it is not. Thus, going to a territorial system as a response to inversions would not make the underlying problem go away, it would simply ignore it by legitimizing and enhancing opportunities for behavior that should instead be prohibited or curtailed. It would be like legalizing a criminal activity as a way of reducing the reported crime rate.

Finally, it should also be noted that territorial systems are not generally much simpler than world-wide systems, for reasons noted above. In addition, moving to a territorial system may generate difficult transition issues with respect to deferred income, deferred losses and accumulated tax credits in the old system. It may also require the renegotiation of numerous tax treaties. For all of these reasons, although there may be many reasons to consider a territorial tax system, switching to one does not seem to be a useful way to address the problems raised by export subsidies or inversions.

V. Fundamental tax reform

A. Background

In recent years, increased attention has been given to fundamental tax reform. Usually, this refers to the idea of eliminating the individual income tax, corporate income tax, and estate tax (and sometimes payroll and excise taxes, too) and replacing them with broad-based, low-rate taxes on consumption.

Four main alternatives have emerged in recent years. A national retail sales tax (NRST) would tax all sales between businesses and households. A value added tax (VAT) would tax each firm on the difference between the sales of goods and its purchases of goods from other businesses. (Alternatively, firms pay VAT on their sales of goods and receive tax credits for the VAT that they paid on their input purchases.)

The NRST and VAT are similar in economic substance. First, the retail price of a good represents the entire value added of that good. Thus, the NRST collects all tax on the value added at the final sale to the consumer. The VAT, in contrast, collects the same amount of tax (if VAT and NRST rates are the same), but collects it at each stage of production. Second, both are consumption taxes.The similarity in structure between the VAT and the NRST indicate why it is appropriate for European countries to rebate VAT on exports. No one would expect a country to charge a retail sales tax on its exports. Thus, by rebating the VAT payments made up to the point of exports, European countries are giving firms the same treatment under a VAT as they would get under a retail sales tax.

A third approach to fundamental tax reform—the flat tax—is probably the most well known and the best conceived. Essentially, the flat tax is a VAT that is divided into two parts. The flat tax would tax non-wage valued added at the firm level and wages at the household level. There are some other differences (the VAT taxes pension contributions when made, the flat tax taxes pension contributions when they are consumed; the VAT is destination-based whereas the flat tax is origin-based), but essentially the flat tax is a two-part VAT. This means that the flat tax is also a consumption tax, though it may not appear that way to consumers or businesses.

A fourth approach is the so-called USA (unlimited saving allowance) tax, which combines a personal consumption tax and a VAT on businesses. Since both of these taxes are consumption taxes, the overall system would be a consumption.

In considering replacements for the corporate income tax, however, there are only two fundamental reform options: the NRST and the VAT. The flat tax and USA tax would not be implemented without repeal of the individual income tax, too. For purposes of this testimony, therefore, I focus on the NRST and VAT. Moreover, since all European countries that experimented with national retail sales taxes eventually switched to a VAT, I focus exclusively on switching the corporate tax to a VAT in this testimony.

B. Analysis: Domestic issues

Replacing the corporate tax with a VAT raises numerous issues. The main result, however, should be clear. The VAT would not be a panacea and although it offers the potential for improvement, it provides no guarantees of that, and indeed it creates several other identifiable problems.

Although VATs can be described simply (see above), in practice VATs are extremely complex. Thus, one should compare existing corporate taxes to VATs as they would likely be created, not as they exist on paper.

Basically, the broader the tax base (i.e., the fewer the number of zero-rated or exempt goods), the lower the tax rate can be and (with a few exceptions) the simpler the tax system can be. But if the VAT is the only tax affecting corporations, one can expect to see pressure to allow corporations to deduct health insurance payments, payroll taxes and state and local taxes as they currently do. If these deductions were allowed, the required rate would jump significantly. This in turn would create pressure to exempt certain goods—e.g., food, health insurance, housing—which would raise rates further. In addition, items like energy subsidies and other forms of "corporate welfare" could be implemented through the VAT. Unless some mechanism were developed to keep such subsidies out, the VAT base would be eroded like the corporate base currently is and rates would be quite high.

Even if the VAT base is kept broad (and it is not in most European countries), there would be a fundamental conflict in the U.S. system with having an individual income tax but a VAT at the corporate level. Essentially, income could be sheltered indefinitely via retained earnings in corporations. This problem does not arise in Europe because European countries have a corporate income tax as well as a VAT.

Also, under a VAT, firms have incentives to report any cash inflow as an interest receipt and any cash outflow as a deductible expense. This would give firms incen-

tives, in their transactions with government, non-profits, and foreigners, to relabel cash flows. Zodrow and McLure in a 1996 paper declared that this feature of the flat tax (it is also a feature of the VAT) offered unacceptable opportunities for abuse. Again, these issues do not arise with VATs in Europe because those countries have corporate income taxes (that tax interest income).

Switching from the corporate income tax to a VAT would likely be regressive. The ultimate incidence of the corporate income tax is unclear, but most estimates suggest it is borne by capital owners. The VAT, in turn, would be borne by consumers. In addition, the appearance of changes in distributional effects might prove very important: it would be hard to make the political case, for example, for a tax that raised the cost of food and health care for low-income families in order to reduce the costs for a multinational corporation to invest in a foreign country.

The impact on growth of a switch would likely be positive, if the VAT were implemented in a simple broad-based way. But if a U.S. VAT ends up looking like a European VAT, the net effects on growth may be substantially smaller. Many papers suggest that replacing the *entire* U.S. tax system with a *clean, broad-based, low-rate* consumption tax would raise the size of the economy by about 1–2 percent over the next 10–15 years. Certainly, replacing only one small portion of that system—the corporate tax—with a complex VAT would have significantly smaller effects.

Unlike the current corporate or individual business taxes, the VAT does not attempt to tax profits as commonly understood. Changing the entire logic and structure of business taxation will create several situations that will be perceived as problems by taxpayers and firms, even if they make perfect sense within the overall logic of the VAT. First, some businesses will see massive changes in their tax liabilities. For example, the developers of the flat tax, Hall and Rabushka, note that General Motors' tax liability would have risen from $110 million in 1993 under the current system to $2.7 billion under a 19 percent flat tax—and the flat tax offers deductions for wages, which a VAT would not.

Some businesses with large profits will pay no taxes. This will occur because calculations of profit (before federal taxes) include revenue from all sources and subtract expenses for a variety of items, including fringe benefits, interest payments, payroll taxes, and state and local income and property taxes. In the VAT, only revenues from sales of goods and services is included (financial income is omitted) and expenses on fringe benefits, interest payments and other taxes are not deductible. Thus, firms may be in the enviable position of reporting huge profits to shareholders, while paying no federal tax. This sort of situation makes perfect sense within the context of the VAT. However, in the past, precisely this situation led to the strengthening of the corporate and individual alternative minimum taxes, which are universally regarded as one of the most complex areas of the tax code. It is hard to see why those same pressures would not arise in the VAT.

Conversely, some firms with low or negative profits may be forced to make very large tax payments. Again, this makes sense within the context of the VAT, but will not be viewed as fair by firm owners who wonder why they have to pay taxes in years when they lose money and who will push for reforms.

Finally, converting the corporate income tax to a VAT would raise difficult transition with respect to unused depreciation allowances, interest payments on previously incurred debt, net operating loss carryovers, excess foreign tax credits and so on.

C. Analysis: International issues

The VAT would be border adjustable, but this in and of itself, would have no effect on the trade balance. To the extent that replacing the corporate income tax with a VAT raised investment more than saving, it would make the trade balance *worse.*

Because it would not exports, the VAT obviates any potential need for export subsidies. It is my conjecture, however, that the political demand for export subsidies would not disappear. Interestingly, by taxing imports and giving a deduction for exports, the VAT provides cash flow tax treatment for net foreign investment. Given that the U.S. is a debtor nation, its net foreign asset holdings are negative, and the present value of associated cash flows is therefore also negative. Thus, including those cash flows in the base—as the VAT does—will lead to a narrower tax base.

Finally, the generally lower tax rate on a VAT would cause firms to set transfer prices to shift income into the U.S. But even with a lower-rate VAT, there would be big incentives for corporate inversions, especially for firms whose tax burdens rise under a VAT relative to the current system.

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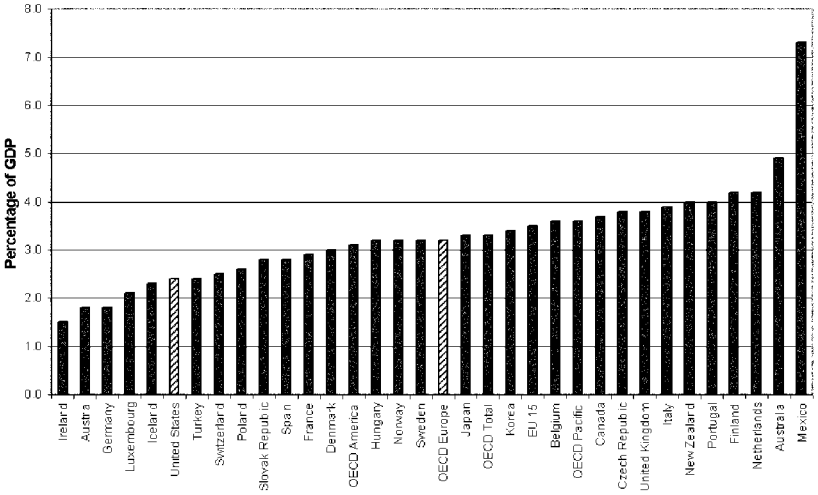
Table 1

Corporate Taxes in OECD Countries

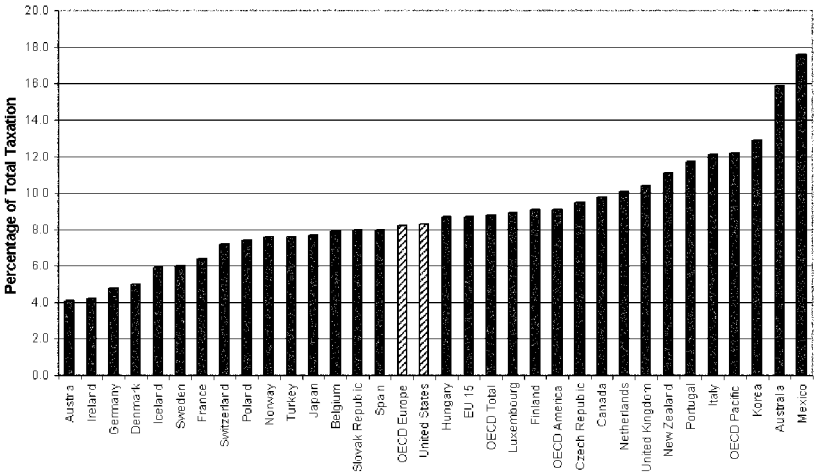
Country	Corporate Income Tax/ GDP, 1999	Corporate Income Tax/Total Tax, 1999	Top Marginal Federal Corporate Income Tax Rate, 1998	Top Marginal Total Corporate Income Tax Rate, 1998
United States	2.4	8.3	35.0	39.5
Australia	4.9	15.9	36.0	36.0
Austria	1.8	4.1	34.0	34.0
Belgium	3.6	7.9	40.2	40.2
Canada	3.7	9.8	29.1	46.1
Czech Republic	3.8	9.5	35.0	35.0
Denmark	3.0	5.0	34.0	34.0
Finland	4.2	9.1	28.0	28.0
France	2.9	6.4	41.6	41.7
Germany	1.8	4.8	47.5	58.2
Hungary	3.2	8.7	18.0	19.1
Iceland	2.3	5.9	30.0	30.0
Ireland	1.5	4.2	32.0	32.0
Italy	3.9	12.1	37.0	37.0
Japan	3.3	7.7	33.5	50.0
Korea	3.4	12.9	28.0	31.2
Luxembourg	2.1	8.9	31.2	39.6
Mexico	7.3	17.6	34.0	34.0
Netherlands	4.2	10.1	35.0	35.0
New Zealand	4.0	11.1	33.0	33.0
Norway	3.2	7.6	28.0	28.0
Poland	2.6	7.4	36.0	36.0
Portugal	4.0	11.7	34.0	37.4
Slovak Republic	2.8	8.0		
Spain	2.8	8.0	35.8	35.8
Sweden	3.2	6.0	28.0	28.0
Switzerland	2.5	7.2	7.8	33.2
Turkey	2.4	7.6	44.0	44.0
United Kingdom	3.8	10.4	31.0	31.0
EU 15	3.5	8.7		
OECD America	3.1	9.1		
OECD Europe	3.2	8.2		
OECD Pacific	3.6	12.2		
OECD Total	3.3	8.8		

Sources: Organization for Economic Co-operation and Development. *Revenue Statistics 1965–2000*. OECD, 2001., and Slemrod, Joel and Jon Bakija. *Taxing Ourselves: A Citizen's Guide to the Great Debate Over Tax Reform*. 2nd edition. Cambridge, MA: The MIT Press, 2000. Table A.2.

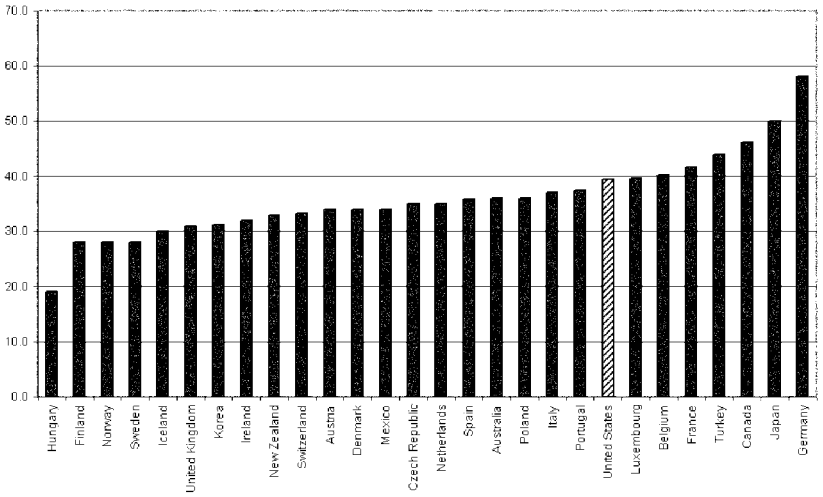
Taxes on Corporate Income as Percentage of GDP in OECD Countries, 1999



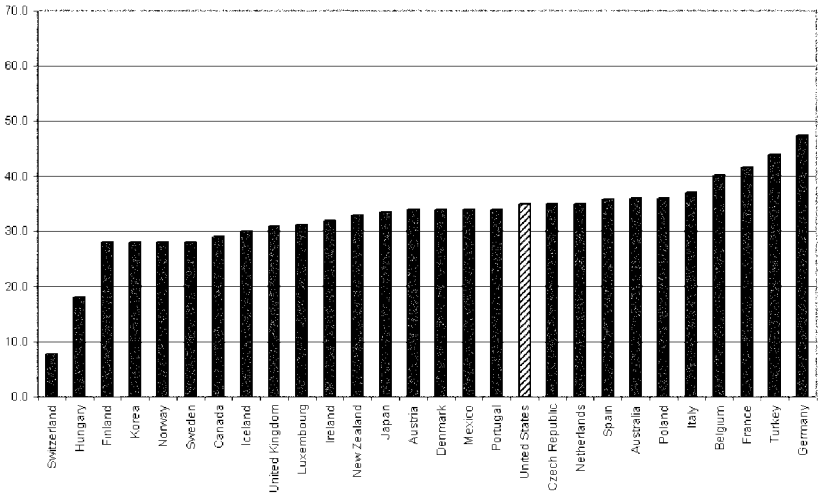
Taxes on Corporate Income as Percentage of Total Taxation in OECD Countries, 1999



Top Marginal Total Corporate Income Tax Rates in OECD Countries, 1998



Top Marginal Federal Corporate Income Tax Rates in OECD Countries, 1999



Chairman MCCRERY. Thank you, Mr. Gale.

Our final witness on the panel today is a respected Professor of Economics at another small school in the Northeast, Harvard.

Mr. Jorgensen, welcome today. We appreciate your taking time out to join us, and we look forward to hearing your oral testimony. You may proceed, sir. Thank you.

STATEMENT OF DALE W. JORGENSEN, FREDERIC EATON ABBE PROFESSOR OF ECONOMICS, HARVARD UNIVERSITY, CAMBRIDGE, MASSACHUSETTS

Mr. JORGENSEN. Thank you, Mr. Chairman, distinguished Members of the Committee. It is a very great privilege to participate in these hearings.

I think that you have heard from the other witnesses about the serious deficiencies in our existing tax system. What I would argue is that this is the time for reform, and the argument is going to be based on the fact that the U.S. economy is emerging from a recession at the moment. Maybe we have already emerged.

Investment is still seriously depressed, especially in the corporate sector. Therefore, it is very appropriate for these hearings to focus on the corporations' income tax, as you did in the call for the hearings that are taking place now. Therefore, I am going to propose to focus on tax reform that would have the effect of stimulating investment and thereby accelerating the rate of economic growth to the higher potential that is now evident from our productivity statistics issued only last Monday.

I want to make three points. I want to talk in a little bit more detail about the potential economic impact of tax reform. I think it is very important to try to quantify that, to appreciate the scope of what is under discussion here.

Second, I would like to outline a tax reform proposal that focuses on investment and making investment more effective, as well as providing more for more investment.

Then, finally, I would like to refer to the issue of transition rules and simplification, which is also very much on everybody's mind.

What I would like to propose is, in fact, that every dollar of investment should be earning precisely the same rate return before any taxes are levied. That ought to be the fundamental principle, because that is the only way that it is going to be possible to generate the kind of economic growth of which our economy is capable.

The second step in fundamental tax reform is to reduce marginal rates, the rates on the last dollar of income earned, in order to provide the maximum incentives for American workers. My written statement outlines an approach to tax reform that would achieve these two objectives, and it would consist of two parts: a capital income tax rate that equalized before-tax rates of return, and a proportional earnings tax that minimizes the marginal tax rate on earned income.

What kind of effect would this have on our economic growth? Well, for that purpose, I would like to propose a very simple yardstick, and that is the impact on consumer welfare measured in dollars. The reforms I have suggested would have a massive welfare impact amounting to $4.9 trillion. By comparison, U.S. national wealth in the year of the comparison was only $25.4 trillion. So the welfare impact amounts to 19 cents on our National wealth, or 19 cents for every dollar of assets that we hold as a Nation.

How much would the impact be for the kind of value-added tax that has been described by other witnesses? The answer is about 40 percent as much. I estimate that would be $2.06 trillion, about 40 percent of the $4.9 trillion that is potential.

In short, the opportunity we face for stimulating investment and bringing our economic growth up to full potential is staggering, and to take advantage of this historic opportunity, I think what we have to do is to reform our taxation of property-type income so as to equalize the burdens. We have to reform our taxation of earned income in order to minimize the marginal rates.

The kind of reform that I have discussed in my written statement, which I hope you have before you, would produce a rate on earned income of only 10.9 percent. For property-type income, the rate would turn out to be something like 30.8 percent, far below the combination of individual and corporate taxation which are now faced by corporate investors. So, the system that I am proposing is one that introduces differential taxation of property-type income and earned income.

This is something that has a great history in U.S. tax law, and precisely this kind of differential taxation existed between 1962 and 1983, for two decades. So, there is a long tradition here to draw on. The definitions of income in the Tax Code would remain unchanged, and the rate structure on property-type income would remain unchanged.

So, this method is based on the idea of reintroducing investment tax credits that would be specific to specific forms of legal organizations. In particular, corporations would receive tax credits of 3.9 cents on the dollar for new investments in equipment and 18.9 cents on the dollar for new investments in structures. Noncorporate businesses would be given a tax credit of 0.5 cent on equipment and 8 cents per dollar on structures. The effect of that is essentially to eliminate, that is to say, abolish the distinction between corporate and noncorporate income so far as the tax structure is concerned.

This would be financed by means of a system of taxation on new investments by the household sector in housing and in equipment, and the rates would be set in such a way as to achieve a revenue-neutral system altogether.

So far as transition rules are concerned, there aren't any. This doesn't require any transition rules. It is a very straightforward system, and there is nothing inconsistent between what I have proposed and any program of tax simplification like the three volume proposal which has been made by the Joint Committee on Taxation.

So, to sum up, the system that I propose is a fundamental reform that deals with the issue that you identified in calling for these hearings, namely, the deficiencies of our current corporate tax system. It is a system that would promote investment, especially in the corporate sector, and it would enhance the competitiveness of American businesses in the global marketplace. This would be a forceful and effective response to the World Trade Organization and will meet the needs of American businesses and consumers in our 21st-century economy.

Thank you.

[The prepared statement of Mr. Jorgensen follows:]

Statement of Dale W. Jorgensen, Frederic Eaton Abbe Professor of Economics, Harvard University, Cambridge, Massachusetts

EFFICIENT TAXATION OF INCOME
A NEW APPROACH TO FUNDAMENTAL TAX REFORM

Summary

1. Fundamental tax reform through the EFFICIENT TAXATION OF INCOME consists of two parts, an Efficient Capital Income Tax and a Proportional Labor Income Tax. Adjusted Gross Income for individuals and Corporate Income would be defined as in the existing tax code. The Proportional Labor Tax would tax labor income at a flat rate of 10.9%. The Efficient Capital Tax would tax capital income at an effective rate of 30.8%.

2. Since the definition of income would be unchanged and the rate structure for capital income would be preserved, the Efficient Capital Tax would introduce a system of Investment Tax Credits to equalize before-tax rates of return on all business assets. The average tax credits for the business sector would be:

Corporate business: 3.9% on equipment, 18.9% on structures.
Non-corporate business: 0.5% on equipment, 8.1% on structures.

To equalize before-tax rates of return on assets in the business and household sectors, new taxes on investments by households would be collected by car dealers, real estate developers, and other providers of investment goods to households at the rates:

7.2% on equipment, 32.5% on structures.

Tax credits for businesses and taxes on household investments would apply only to new assets and would not apply to existing assets.

3. The welfare gains from this tax reform would be $4.90 trillion; by comparison GDP was $8.11 trillion and National Wealth was $25.38 trillion in 1997, the base year for our welfare comparison. The welfare gains would amount to 19.3% of our national wealth or 19.3 cents for every dollar of wealth.

Source: Dale W. Jorgensen and Kun-Young Yun, LIFTING THE BURDEN: Tax Reform, the Cost of Capital and U.S. Economic Growth, Cambridge, MA: The MIT Press, 2001.

EFFICIENT TAXATION OF INCOME

Frequently Asked Questions

Question 1: Is this a good time to introduce EFFICIENT TAXATION OF INCOME?

Answer: The U.S. economy is just emerging from recession and investment is depressed, relative to the boom period in the 1990's. Instituting investment tax credits, like those under EFFICIENT TAXATION OF INCOME, would stimulate investment, especially in the corporate sector.

Question 2: What about the long-run effects?

Answer: These are measured by the welfare gains. The welfare impact of $4.90 trillion is the answer to the question: How much additional wealth would be required to purchase the added consumption of goods and leisure made possible by tax reform? The welfare gains reflect more investment and faster economic growth.

Question 3. Is EFFICIENT TAXATION OF INCOME a tax on income or a tax on consumption?

Answer: As the name suggests, EFFICIENT TAXATION OF INCOME is a tax on income rather than consumption. Income would be defined in exactly the same way as in the existing tax code.

Question 4: What about transition rules?

Answer: Since the definition of income would be unchanged, no transition rules would be required. EFFICIENT TAXATION OF INCOME could be enacted today and implemented tomorrow. All existing tax exemptions and deductions on capital income would be unaffected. This would include depreciation and interest deductions by businesses as well as mortgage interest and property tax deductions by existing homeowners.

Question 5: What about tax simplification?

Answer: The system of tax credits for businesses and taxes on household investments could be adjusted to preserve equality of before-tax rates of return on all as-

sets whenever the tax code is altered. In short, there is no conflict between EFFICIENT TAXATION OF INCOME and simplification of the tax code.

Question 6. How would the tax rates under EFFICIENT TAXATION OF INCOME compare with rates under consumption taxes? The tax rates under EFFICIENT TAXATION OF INCOME would be

labor income tax	10.9%
effective capital income tax rate	30.8%

Key tax rates for some of the popular consumption tax proposals are:

Hall-Rabushka Flat Tax	
flat tax rate	27.6%
average labor tax rate	15.3%

Progressive National Retail Sales Tax (No Deductions; Exemptions like the Flat Tax)

marginal sales tax rate	40.1%
average sales tax rate	29.6%

Proportional National Retail Sales Tax (No Deductions, No Exemptions).

sales tax rate	28.5%

Question 7. How do the welfare gains from EFFICIENT TAXATION OF INCOME compare with gains from consumption taxes?

Answer: EFFICIENT TAXATION OF INCOME would have a larger impact than a Proportional National Retail Sales Tax and twice the impact of the popular Flat Tax proposal. Here are the numbers:

EFFICIENT TAXATION OF INCOME	$4.90 trillion
Hall-Rabushka Flat Tax	$2.06 trillion
Progressive National Retail Sales Tax	$3.32 trillion
Proportional National Retail Sales Tax	$4.69 trillion

Question 8: Does EFFICIENT TAXATION OF INCOME sacrifice progressivity?

Answer: Progressivity would result from differences between taxation of capital income and taxation of labor income, not from exemptions like those in the Flat Tax or a progressive rate structure like the current income tax.

Question 9: Why not introduce exemptions and/or a progressive rate structure?

Answer: The welfare gains would depend critically on lowering the marginal rates on both capital and labor income; these are the rates on the "last dollar" of income. Exemptions and progressive tax rates would increase the marginal rates and reduce the welfare gains.

Question 10: How would EFFICIENT TAXATION OF INCOME be affected by introducing exemptions like those in the Flat Tax?

Answer: The capital income tax rate would be unaffected, but the marginal labor income tax rate, the rate on the last dollar of income, would rise from 10.8% to 26.0%. As a consequence, the welfare gains would be sharply reduced to $2.02 trillion.

Question 11: What would happen to Social Security and Medicare contributions under EFFICIENT TAXATION OF INCOME?

Answer: These would be unchanged.

Question 12: What about contributions to private pension funds through 401(k)'s and similar provisions of the existing tax code?

Answer: These would also be unchanged.

Question 13: What would happen to property values for home owners?

Answer: Existing home owners would be deemed to have paid taxes on their property at the time they originally purchased it. They would be exempt from all future taxes on this property, including capital gains taxes when they eventually sell it. Property values would be protected by the reduction in future capital gains taxes and the taxes on new housing, so that home owners would share in the welfare gains from EFFICIENT TAXATION OF INCOME.

Question 14: How does this affect people thinking of becoming home owners?

Answer: By definition, these people are renters, not home owners, and they would be made better off. They would find home ownership slightly more expensive and rental housing somewhat less expensive. In short, they would also share in the welfare gains from EFFICIENT TAXATION OF INCOME.

Question 15: What would happen to stock market values for corporate shareholders?

Answer: Since the new investment tax credits would reduce the cost of acquiring new assets after taxes, the value of existing assets would fall. However, this would be offset by an increase in the rate of return on these assets, so that stock market values would be largely unaffected.

Question 16: How would EFFICIENT TAXATION OF INCOME impact states and localities?

Answer: Most states use the same tax bases as federal corporate and individual income taxes. Since the tax bases would not change, state and local income taxes could be left unchanged. More likely, states and localities would follow the Federal Government in adopting EFFICIENT TAXATION OF INCOME. The tax rates given above assume that they would, so that these rates include federal, state, and local taxes.

Question 17: What about state sales and property taxes?

Answer: These would not be affected. Also, deductions of these taxes at the federal level would be preserved.

Question 18: What would happen to tax revenues?

Answer: EFFICIENT TAXATION OF INCOME is revenue-neutral, so that tax revenues at federal, state, and local levels would be unchanged.

Source: Dale W. Jorgensen and Kun-Young Yun, LIFTING THE BURDEN: Tax Reform, the Cost of Capital and U.S. Economic Growth, Cambridge, MA: The MIT Press, 2001

Chairman McCRERY. Thank you. Mr. Jorgensen.

We thank all of you on the panel for providing us with some excellent testimony and some excellent ideas for us to think about.

Now we have the privilege of asking you a few questions regarding your testimony and anything else that the panel of Members wishes to inquire about. I would tell the Members of the Subcommittee that if the panel is amenable to staying around, I will allow a second round of questions if anybody wants to stick around for a second round, because this subject matter, as anybody who might be watching on TV has figured out by now, is fairly complex; and if they weren't convinced before Mr. Jorgensen's testimony, they certainly are now. Mr. Jorgensen, if you could hang around for about another 6 months, we could get some excellent feedback from your testimony.

Mr. Gale, I can't help but go back to your analogy about crimes and reducing the crime rate. Some might retort that if the crime were reading any writings of Thomas Paine or reading any writings of Ivy League professors, it might be a good thing to abolish that crime and reduce the crime rate. So keep that in mind.

We are going to have a hearing in June that will specifically include the subject of corporate inversions, so we hope to further explore that issue at that hearing. It is a very important issue for us to learn more about and to explore, and we intend to do that in the June hearing, but I appreciate your remarks today about that.

Mr. Entin, let me start with you, but I want others to comment on this. I have heard in other for a—some of you comment on this. Generally, the economists and the tax experts that have spoken to Members of the Committee on Ways and Means and in other settings have agreed that border adjustability is not necessarily an advantage, it is not an advantage or a disadvantage in terms of the competitiveness of our domestic corporations.

Do you agree with that, Mr. Entin?

Mr. ENTIN. I do agree with that. Sometimes people do a partial analysis; they take the first step and then they don't allow other things to adjust.

When adjustments are made, border adjustment washes out. The neutral taxes that you see in fundamental tax reform proposals are collected at various points in the production process. Labor and capital come together and produce a product, and the business sells it. The proceeds are paid out to the labor and the capital, and the labor and the capital go off and buy the goods.

A sales tax is imposed at the point of sale, at retail. Products that are sold to exporters don't go through the retail. Thus, they are not taxed. Sold to the domestic person, they are. Imports are taxed when the family takes its income and goes to the retailer and spends it.

In the cash flow tax that I described, individuals take their income, subtract their saving and pay tax on what is left; then they go to the store. Whether they buy an import or an export, there is no tax there. It was collected before they left the house.

If you tax the same tax base before they leave the house or after they get to the store, it is the same tax base. One appears to be border adjustable. One is sort of implicitly border adjustable. There is no difference.

That would be true also for the VAT, which is collected within the firms as their products go up through the production process, or in the sort of Roth-style flat tax approach. All these things wash out.

What the tax reforms do for exporters, I think, is twofold. They take away the extra layer of tax on corporations, many of whom are large exporters and many of whom are import competitors. For corporations and for the small businessman, they also move from depreciation to expensing. These steps lower the cost of capital.

In the United States, we hit manufacturers harder than the service sectors because manufacturers use more capital. The manufacturers with the longest-lived capital get hit the hardest because depreciation shortchanges longer lived assets the most; and if there is inflation, it is even worse. So by fixing that element of it, you happen to benefit many of the sectors that have suffered over the years, sectors that have experienced a shift of our resources into other sectors. You are undoing this effect of the bad tax system on manufacturers, and they will grow. There will be some more exports, perhaps, but there will also perhaps be some more imports.

The difference between exports and imports may not be affected very much, but the sectors that you worry about the most and which are complaining the most about import competition are really complaining about the fact that our tax system is hitting them over the head with a two-by-four. Fix that and they won't worry so much about whether their competitors are down the street or over the ocean.

Chairman McCRERY. Does anyone on the panel think that border adjustability is important for competitiveness?

Mr. GRAETZ. Mr. Chairman——

Chairman McCRERY. Go ahead, Mr. Graetz, and then I will call on Ernie.

Mr. GRAETZ. I think that it is important. The economic analysis suggests that it doesn't matter whether you apply a consumption-type tax on an origin basis or whether you apply it on a destination basis with border adjustments. The argument is that foreign currency relationships will change to equalize things over time.

The first point I would make is, this is an "over time" story, and the question of how much time is required is not clear.

The second point I would make is, if you take an origin-based tax like the flat tax, it taxes imports only on their U.S. markup, whereas a domestic business is taxed on its full value added, if you will. American business properly is going to say that system is creating an unfair advantage for imports.

We went through this many times with energy-type taxes. You may remember proposals for energy taxes that were not border adjustable, and the American manufacturers insisted that this put them at a tremendous competitive disadvantage.

I think it is extremely important that you have a tax that does have border adjustments in order to achieve a level playing field quality, and in order not to a rely on the currency adjustments that the economists assure us will take place to protect American businesses. So, it is fundamental issue, and it is not a subsidy.

Border adjustments are not a subsidy for U.S. exports. They just put imports and exports in the same place in terms of what the American consumer pays for them, but I think, in terms of practicality, there is all the difference in the world.

Chairman MCCRERY. Mr. Christian.

Mr. CHRISTIAN. Well, what Mike says is by and large correct. I would further point out that this "over time" theoretical adjustment of exchange rates that he has referred to might be an extremely long period of time. Given that transactions in goods are only a very small portion of the transactions in the current account, they are almost too small to have the effect that economists predict in theory.

The point really is that what we should stop, as a practical real-life matter, penalizing manufacturing in the United States and exporting it to a foreign market. Companies should have the option of staying at home and selling into a foreign market. At the present time we provide an incentive to manufacture abroad and sell abroad. At the present time—if you do succeed in a foreign market, we penalize you if you bring the money home for reinvestment in the United States of America, whereas, if you can keep it abroad, if you are a large enough company to do so, and reinvest it in someone else's economy, you can defer U.S. tax indefinitely.

Applying little theoretical catechisms to little pieces of the puzzle is wrong. We have to look at the practical picture of what is occurring with respect to U.S. exports. Manufacturing in the United States is in a decline and has been in a decline for a very long period of time.

Mr. CHRISTIAN. It is almost not an issue worth debating. It is like arguing about the last war and the tactics that were employed by generals in the last war. We are in a different situation now.

Chairman MCCRERY. Mr. Cain.

Mr. CAIN. I would just like to add that if we were able to develop the perfect border adjustability formula under the current

system, the revenue impact that we are talking about would be minuscule compared to the upside if we put an economic boon in the U.S. economy by changing the entire system. That is one of the points that I wanted to make, because if we go to a national consumption tax, imports and exports get treated the same. The U.S. businesses would applaud that. They know how to compete if there is a level playing field. This is why we are proposing to look at replacing the system such that the temptation to build plants overseas would be gone. There would be an even greater temptation to build plants at home by eliminating that.

Chairman MCCRERY. Before I go to Mr. Neal, Mr. Engen, on a variation of this question, and if you want to comment on that question you may, but is it your opinion that U.S. companies and taxpayers are paying a portion of other country's social welfare costs when value-added taxes are imposed on U.S. exports at the border of those other countries?

Mr. ENGEN. I think it depends on what transactions you are looking at specifically. I mean, I think there is a possibility with the way some of the border adjustments work that with some of the payments, those are going into the tax revenues of other countries, and thus of funding whatever they choose to spend on it. I don't necessarily believe that is an obvious conclusion.

The one thing to comment on from before is, I think I would agree with Mr. Cain to my left, that one of the most important things here is not necessarily the border adjustment, that in the end, that is a relatively small issue, although there are some practical issues in this. In that sense, Mr. Graetz's points that, you know, in the near term and for practical purposes, there are some various issues with the X tax that I was talking about, which is a variant of the flat tax. It can matter in some small ways whether you choose an origin base or a destination base how you do the border adjustments.

I think the main issue is the point brought up is that if we reduce the tax distortion on capital, it is going to make the U.S. economy a much more friendly place for businesses to invest, and it takes away a lot of these other pressures, a lot of the concerns about border adjustment and import—export subsidies.

Chairman MCCRERY. Thank you. Mr. Neal.

Mr. NEAL. Thank you, Mr. Chairman. Thank you for holding this hearing, and I think these get-togethers are most helpful. Indeed, Chairman Thomas' decision to hold the sessions with the Congressional Research Service also I think have been very, very helpful.

I want to also publicly thank you for agreeing to hold a hearing in early June on the whole issue of corporate inversions.

Stanley Works voted this morning to leave the United States and to reincorporate in Bermuda. That is going to set off a fire storm on both sides of the aisle. A very prominent Republican said to me before the last vote, "You are absolutely right; if this gets to the Floor, I am with you."

I would like to ask first of all, Mr. Gale, and then come back to Mr. Graetz for a second, sometimes it is very hard for all of us to understand what is meant by international competitiveness. Does

it mean that tax reductions that are good for some multinational corporations are good for America as a whole?

Mr. GALE. Economists usually like to squirm at the popular definition of competitiveness, which is often defined in terms of the trade balance. Then we get into these arguments about whether border adjusting improves the trade balance, and economists generally think in the long term the answer is no, on the short term generally, I think the answer is no too, but there is room for discussion there, I guess.

Different people define competitiveness in different ways. There is an issue, if it is defined in terms of the trade balance, then border adjustability is just not a big issue. If it is defined in terms of the underlying productivity of American firms, then you have something you can sort of grab on to and talk about how different policies affect productivity. That is a little less of a swishy concept than competitiveness as it usually is applied in the public sector.

Mr. NEAL. Okay. Mr. Graetz, regarding companies that are avoiding U.S. tax by reincorporating with a Bermuda mailbox, would rules to stop this hurt U.S. international competitiveness or speed harmful foreign takeovers of U.S. businesses?

Mr. GRAETZ. Mr. Neal, I don't believe so. I believe the corporate inversion problem does need to be stopped because I think that—actually, this is one of the places I can actually agree with Bill Gale, which I like to do if I can—one of the things that is going on in these inversions is an effort to eliminate U.S. tax on U.S. source income. This is not a story that is limited to competitiveness in foreign markets. When some corporations can find it possible and easy to avoid U.S. tax, and others do not, I see no reason to think that this is good for America. Nor do I think it is good for America to have our tax base depend on a mailbox in Bermuda and a meeting in Barbados. I think now you need both. That is Stanley Works' plan, as I understand it; you have to have a mailbox in Bermuda and you have to meet once a year in Barbados, not that is such a hardship for the companies. I think it is an important problem, and I think it needs prompt attention by the Congress.

Mr. NEAL. Thank you. I want to ask another question if I could, then feel free to expound upon it. Mr. Cain, do you think that we are going to change the Tax Code? You said the American people don't believe we are going to change the Tax Code. Do you think we are going to?

Mr. CAIN. Do I think?

Mr. NEAL. That Congress is going to change substantially the Tax Code? Do you think we are going to a consumption tax or flat tax?

Mr. CAIN. I believe so, because even if we were to pass regulations, or if Congress were to pass regulations to address the issue that you are talking about, it would simply create more complexity, more costs. So we really aren't solving the problem. I firmly believe that the American people have a desire to see some bold action on this thing. So I think that there are a lot of people who believe that it can be done, but doing it to stop that type of thing would just make it more complex.

If I may add one other thing, let me give you the definition of competitiveness that I know most businessmen share, whether it is

in the domestic or international. It is a level playing field with the absence of disadvantages and disincentives to do business. That is all American businesses want, whether that is domestic or in the international arena.

Mr. NEAL. I would just close if I could. Back in 1995, the Majority Leader here talked extensively and expansively about changes in the Tax Code. He said, in this Committee, we were going to, I think, pull the Tax Code up by its roots. He said, we were going to drive a stake into its heart. We were moving in the direction of a consumption tax 1 day and a flat tax the next day. One thing I am curious about, Mr. Cain, is whether you think it is going to happen, because I haven't seen a lot of evidence around here that it is going to happen.

Mr. CAIN. Mr. Neal, I believe it can happen, but more importantly, I believe it must happen. I am familiar with those hearings and those statements because you may recall, I was on the Tax Commission in 1994–1995, but that is part of the problem. We have debated this for a long time, but due to lack of follow-through and leadership, nothing has been done yet.

Mr. NEAL. Thank you very much, Mr. Cain.

Chairman MCCRERY. Thank you, Mr. Neal. Mr. Weller?

Mr. WELLER. Thank you, Mr. Chairman. I commend you for this series of hearings which are very informative as we look at ways of creating economic growth and making or giving the opportunity for American companies to be competitive on the global stage. I recognize we are limited on time, we have a vote here to go to, so I am going to cut to the point here. Over the last several years, it has become very clear that our Tax Code hampers economic growth in the way we depreciate assets or how we recover the cost of assets in our economy. The office computer we carry on the books for 5 years, it has depreciated over 5 years, but on average, business replaces it every 14 months. It just doesn't make sense under our current Tax Code.

My colleague, Mr. English, and I know, Mr. Neal and others, we have all been advocating ideas out of the expense and Technology Reform Act, which will allow you to fully expense computers and telecommunications equipment, wireless, medical technology, security equipment, surveillance equipment, and biometrics and other equipment, that has a very short real life.

Mr. Christian, you in particular have been one who has been very involved and engaged on this issue in cost recovery and depreciation reform. With the Chairman's leadership, we were successful in beginning that process in the economic stimulus plan that the President signed with a 30-percent expensing, or some call bonus depreciation or accelerated depreciation component That is temporary, and we have introduced legislation to make it permanent as the bottom line as we look at depreciation reform. Mr. Christian, I would like to hear from you and others on the panel just what your thoughts are about how expensing in particular how you feel that would impact capital formation, how it would impact economic growth, and also our international competitiveness.

Mr. CHRISTIAN. Mr. Weller, thank you. You and Mr. Neal and Mr. English and others you have taken the leadership role, which has already benefited America. The 30-percent expensing was done

in a bipartisan way. I have come here today to propose a bipartisan solution to an international problem involving exports. If you adopted the solution we are talking about and in the same bill went to 100-percent expensing, you would essentially have a neutral tax system for exports from the United States, you would have credited a neutral tax system for capital recovery.

Moving quickly then to the issue of inversions and the international situation which is becoming intense. People are fleeing. Foreign companies are not coming here to make this their headquarters. If we did in one bill what you and Mr. Neal and others under the Chairman's leadership have been trying to do for several years by enacting 100-percent expensing, and if we made the changes to exclude export income from U.S. income tax.

The United States would be the most desirable place in the world for all business, whether American-owned business or foreign-owned business, to conduct world trade throughout the world. Companies that have fled America would want to come home. Those who are thinking about fleeing it would not do so.

There are various kinds of inversions and there are various things about inversions such as earning stripping, that are not good. Mr. Graetz has pointed that out. Those are not small issues, but they are, in a way, tangential issues to what is the larger problem of the cost of capital in the United States and how we treat our exports relative to how other countries treat theirs.

I commend you, Mr. Neal, and others for the progress you have already made on expensing.

Mr. WELLER. Thank you, Mr. Christian. I realize I have run out of time here. I would comment that one thing I would hope that our Subcommittee would look at is how our competitors overseas treat assets when it comes to cost recovery. I have seen information which would suggest that particularly our competition in Asia and Korea and some other countries overseas, that their tax treatment of assets is much more favorable than ours giving their companies a greater advantage when it comes to economic growth.

Thank you, Mr. Chairman.

Chairman MCCRERY. Thank you Mr. Weller. Gentlemen, we have a vote on the House Floor. I am going to recess the Subcommittee for just a few minutes just long enough for us to run over vote and come right back. So the Committee will stand in recess.

[Recess.]

Chairman MCCRERY. The Committee will come to order. I appreciate our panel of witnesses being patient with our duty to vote, and we don't expect another vote for a while. So, we should have sufficient time to finish the questioning. Now I would like to turn to another distinguished Member of the Subcommittee, Mr. Ryan from Wisconsin.

Mr. RYAN. Thank you, Mr. Chairman. Before I ask a couple quick questions, I thought that just for the record there might be some clarifications. It's been said a couple of times that the flat tax is not a consumption tax. That is just not the case. The flat tax is a consumption tax. I just want to make that clear for the record. Also it is a progressive tax. It is a tax because of generous exemp-

tions means that it is effectively a progressive tax. So I just wanted to kind of clear that.

I wanted to nail down this issue of those of you who are for destination principle taxation versus origin principle taxation, different from an economic standpoint, from a competitiveness standpoint on having a territorial origin tax system versus the destination principle system. I would like to continue that road. I saw a couple heads shaking when Mr. Graetz, and I think Mr. Christian, were talking about it.

Steve, let me go to you. I think your head was shaking the most. When we talked about that, and it is the idea that over time, the differences made up and that exchange rates play into it, I would like to see if we can just focus on that discussion right now.

Mr. ENTIN. This is so much easier with a blackboard and maybe about 16 weeks. About the timeframe; orders for goods and services change over time, and there is usually a prolonged period waiting for payment. Back in the old days we used to think that exchange rate changes took a long time to work.

The bond market, the stock market, and particularly the foreign exchange market which have gotten so much bigger since the thirties and forties. All of these adjust instantly, unless it is a weekend, and even then there is after-hours trading.

If I were to go from a system where we have no border adjustability and then simply impose one, initially I would be saying, "Look, there is a 10-percent drop in the price of exports, a 10-percent tax on imports." But within a matter of a blink of an eye, the exchange rate could go bang, and jump up 10 percent, and the drop in the price of the exports would be undone and the cost of the imports would be driven right back down to where they were a nanosecond ago. That is what we are taught in school.

More to the point, assume that we are at full employment and the Europeans are at full employment (or what passes for it given their huge tax load—it looks like their unemployment rate is very high, but nobody can afford to hire them so they are stuck). We have low unemployment, or did until a few weeks ago. If we are at full employment and someone comes along and says, "I am going to do something that boosts your exports," that is fine, but what happens next? Instead of selling my product down the street, I am selling it to the guy in Canada. I am still getting paid so I am still going shopping. The guy down the street is still getting paid, and he is still going shopping. If the product I was putting into the domestic market has gone overseas and we all are still going shopping, and we still want to buy just as much stuff, then we are going to have to buy something to fill in the hole left by the exports, and it is going to be an import.

Exports and imports go up at the same time. So, you are going to get the same trade balance, which is governed by whether capital is flowing in or not, but, in fact, the exchange rates adjust and you generally don't get such a big swing in either exports or imports. That is why economists say the adjustment happens quickly and there is not much effect on the pattern of production.

If you want to fix the sectors that are hurting from imports, look and see if our tax system is doing anything particularly brutal to those sectors.

Mr. RYAN. That is the discussion on manufacturing we have been having.

Mr. ENTIN. That is the sector you can help less with depreciation reform, moving to expensing, and perhaps by eliminating or reducing the added layer of corporate taxes, at which point the rest of the concerns about competitiveness pretty much fall into line. I am not saying you shouldn't have a border adjustable tax. It you are going to do a VAT, it's naturally border adjustable. Any retail sales tax is naturally border adjustable, although it is sort of implicit in the way you collect it. If you do a cash flow tax where you collect it before people leave the house, as in the personal side of the old Nunn-Domenici bill, it is not explicitly border adjustable, but people pay the tax and then when they go shopping, it falls equally on what they buy, whether it is domestic or imported. It is implicit. All of these things are. Don't fuss over it so much. Just get rid of the excess tax layers on capital, and make to border adjusted or not, whichever way it naturally turns out to be in the reform you choose, and it is going to take care of it itself.

Mr. RYAN. Mr. Graetz, you are going to answer that, I know, but let me ask you a quick question on top of that because I see the time going. Your proposal, which I just sketched out, you said a 12-percent VAT plus a 25-percent income tax rate on individuals over $100,000 and a corporate rate. I guess it depends on the rate, or if you folded into the tax rate, isn't that effectively a higher tax burden on Subchapter S corporations or the corporate structure? You went through the plan so fast I didn't—you said it was also not only revenue-neutral, but distribution-neutral? I have never seen anybody accomplish that before when they are proposing tax reform, but could you enlighten me on that as well?

Mr. GRAETZ. I can. I am happy to supplement it for the record, or in other conversations with you, but, yes, the basic plan is to substitute a 12-percent VAT, I think, 12 percent is about right, it may be 13 percent. I may be off a little bit on the number. I am not sure that the 25-percent income tax rate doesn't come down. Those numbers can be adjusted. But the basic point is that for people with under $100,000 of income, you are collecting only a consumption tax and no income tax. That plan can be made distributionally neutral as long as you take care of the low income and moderate income people. The plan is also revenue-neutral because what you are doing is you are using the VAT to fund the exemption of $100,000. That benefits Subchapter S corporations, because they will have a $100,000 exemption on their first $100,000 of income and pay only a 25- or 20-percent rate on their income over that.

The value-added tax is like a retail sales tax. I do think people have gotten confused in thinking about the value-added tax, even when Bill Gale was talking about the burden on American companies. The difference between a value-added tax and retail sales tax is only in the way it is collected. The VAT is collected at all stages of consumption. So, if you want to think about it as a sales tax instead of value-added tax, that is fine with me. The only advantage of a value added tax, as far as I am concerned, is that you are collecting it at different stages of production. So, if somebody gets

cash at the retail level they don't rip off the whole tax base, they just rip off a little share of the tax base.

So, the VAT is more protected against evasion, but if you want to think about it as a sales tax, I have a 12-percent sales tax, and I have an exemption of $100,000 for Subchapter S businesses. They are much better off than they are under the current system. It is a much lower tax on capital and small businesses than the current system would be.

Mr. RYAN. Origin versus destination.

Mr. GRAETZ. Destination. What I can't imagine, what I cannot imagine in the political context is how you are going to be able to say to General Motors that your tax base is everything you do in the United States, your manufacturing and the markup, but for imported automobiles, it is just the dealer markup.

That is the way the flat tax works, and can you tell them—which, you know, all the economists agree, and I don't disagree with the economists—tell them "Well, exchange rates are going to adjust instantaneously and take care of you." Is that going to be your solution? I just don't think it is politically feasible —it is a political point as much as anything.

I believe that it comes back to what Mr. Cain said about a level playing field. The American businesses that now talk about competitiveness are going to talk about competitiveness in much higher octaves if you tax only dealer markup on imported goods and tax the full value added of products produced in the United States, whether they are consumed here or whether they are consumed abroad.

Mr. RYAN. I see my time is well over. So, I would love to talk to you about that more. Maybe another time.

Chairman MCCRERY. Mr. English.

Mr. ENGLISH. Thank you, Mr. Chairman, and thank you for the opportunity to sit today as part of the Subcommittee. To my untrained mind much of the debate over whether border adjustability makes a difference, particularly the argument that border adjustability does not have a substantial impact on imports and exports, has a little bit of the flavor of Xeno's Paradox. The motion because you are going in a straight line you are always in motion, that Achilles will never catch the tortoise.

I have to believe that there is some distortion involved in imports and exports by having a tax burden placed on exports, that is a result of the cost of doing business in this country and no comparable tax burden placed on imports. I have to believe that has—that makes a difference somewhere. I am struck by something Mr. Entin said that maybe we should be looking at specifically, certain sectors or certain kinds of product lines that might—where it might be having some kind of an impact.

Mr. Christian, if I could pick you out, since do you believe that border adjustability matters at some level, could you give your view on whether there are certain sections of the economy, manufacturing to be specific, where with a mature industry, a capital intensive industry, relatively low profit margins, that border adjustability could have a significant impact on decisions?

Mr. CHRISTIAN. I don't think there is any question about it, Mr. English. On the outbound side, on the export side, we are mak-

ing it extraordinarily difficult for manufacturing to exist in the United States. There is this constant pressure to move. I am talking about eliminating that pressure to move. Let people remain in the United States and let companies that have fled come back, let foreigners who wish to come here, trade around the world without paying U.S. income tax on their foreign source income. That is an enormous boon to employment, to business growth, and to economic growth in the United States.

The attenuated counter argument that some people make about exchange rates is 10 or 15 years old as I said earlier, like generals fighting the last war. It is not really the issue today. It is not really the issue, I believe, before the Congress of the United States. It is not really a practical debate. The practical debate is what we can do to eliminate the impediments, the hobbles, if you will, that we have placed on American companies and their ability and their employees' ability to participate in this global economy.

On the in-bound side, the import side, if you will permit me, the Chairman, Mr. McCrery, earlier asked a question about the Europeans who impose an import tax when we sell into their country. Mr. McCrery asked whether by doing so, they were, in effect, forcing us to pay their social welfare costs. My answer to that is yes, there is no question about that.

The so-called origin and destination principle that the VAT advocates like to talk about is actually operating in reverse. The origin of an automobile exported from the United States is the United States. Its destination is Europe. Europe imposes a tax relative to that automobile. The burden of that tax falls back on its origin in the United States. It falls back on the labor and capital in the United States that produced it.

We, in turn, could make a kind of a border adjustment for imports into the United States. There are various ways of doing this. One is to simply redefine what the cost of goods sold is under section 61 definition of gross income as Professor Graetz was referring to in another context earlier. If we had a border adjustment, we would bring foreign labor and capital into the tax base of the United States, not just the distribution markup that Professor Graetz was referring to, but the entire output of labor and capital that is reflected in that commodity, product, or other transaction.

That would be a neutral kind of system that would work greatly to the advantage of the U.S. economy. On the in-bound side, we would want to have some kind of exception for goods on a "short supply" list that are not subject to a competitive international market. As long as there is a competitive market on goods, the burden of the import adjustment would fall on foreign labor and companies.

I don't want to get into it in great detail today because I don't have time, I suppose, but the implicit in this idea of being able to bring foreign labor and capital into the U.S. tax base, much more than we did under section 482 today, is the potential for an enormous shift in the tax burden.

There is the potential for a shift of about $100 billion off of U.S. labor and capital and on to foreign labor and capital. That might be the subject of another hearing. I assure you that is not some pie-in-the-sky idea that I just scribbled down on the back of a yellow

pad on the way up here in the car. It is a very important thought that has been given a great deal of analysis and effort over a number of years.

Mr. ENGLISH. I thank you. My time has expired. I want to thank you, Mr. Entin and the entire panel for providing some intellectual heft to this discussion. Thank you, Mr. Chairman for allowing me to inquire.

Chairman MCCRERY. Thank you, Mr. English. Mr. Foley.

Mr. FOLEY. Thank you, Mr. Chairman. Just very quickly, Mr. Christian, you mentioned about the taxation issue relative to corporations, and there have been a flight of companies leaving to go to Bermuda for instance. Could you elaborate again on your response to that?

Mr. CHRISTIAN. Yes, sir, Mr. Foley. There are two or three kinds of situations, and I am not an expert on all the details. Some of them are what are called earnings stripping transactions where you are using devices, shall we say, to strip out of your U.S. company its U.S. income from activities in the United States. You need to do something about that.

I would hate to see you create another destructive Rube Goldberg kind of thing like subpart F. You need to be very careful in addressing the flight of American companies abroad. We are forcing them to do it, really. We ought to deal with the fundamentals here at home and eliminate some needless tax aberrations, if you will, which cause people to want to go abroad. I think we can do that by the kind of proposals that I have sketched out today.

Mr. FOLEY. I missed some of your testimony. That is why I was asking specifically. You are talking about not taxing income that is derived from overseas or——

Mr. CHRISTIAN. Yes, sir. I am talking about not taxing income which is derived from trading with foreigners. Today we have a strange sort of definition in the Tax Code. We define as foreign source income, income that is derived from selling something to a foreigner only when the activity that produces that income has occurred abroad. When the activity that produces income occurs in the United States, we define the income as U.S. source income even though the sale is to a foreigner. I am simply saying if we are talking about foreign trade income, income derived from selling to a foreign purchaser, whether by export or by going there directly, all of that income ought to be foreign source income and exempt from U.S. tax. It is a very fundamental and long-talked about proposition. There is nothing new or shocking about it.

Mr. FOLEY. I know Florida in the eighties had a rather memorable experience with trying to tax—it was called at that time a unitary tax that was brought forward by first Senator Bob Graham and then actually applied by Governor Bob Martinez, one Democrat and one Republican. Ultimately we lost a lot of corporations because they said if you were in Florida doing business abroad, you would pay worldwide taxes to Florida for that income. It chased out some giants. We lost IBM. They were ultimately downsizing, but they ultimately left completely virtually the State of Florida and a lot of other corporations. Do you see that as an impediment to corporate strength of America the continuation of those taxes?

Mr. CHRISTIAN. Yes sir. I remember the unitary problem quite well. I spent many years working on it. We used to think in this country that we had a closed economy. Yes, various States had to worry about companies fleeing if they had such a bad tax system that companies wanted to get out, but we always thought that America had a closed economy here. Well, we don't anymore.

Professor Harberger and others have concluded that we really don't and that capital is highly mobile. Capital is the engine that makes it work, that makes the jobs, provides the tools for American workers. It is highly mobile today, and it can flee.

So, why should we create in the United States a hostile tax environment for our own companies and a hostile tax environment for companies who are foreign? I don't think it has escaped the attention of this Committee that before inversion was the problem of the day there was the earlier problem when foreign companies were acquiring U.S. companies wholesale and sort of moving their headquarters abroad. People often wondered why the foreign companies that acquired U.S. companies didn't move their own headquarters here when they were virtually equal in size. Well, I can tell you the reason they don't do that. It is because of the U.S. tax system.

Mr. FOLEY. Probably. DaimlerChrysler is an example. Deutsch Bank buying certain corporations. There are a lot of examples that should be quite frightening, and should be to American enterprise, because it is virtually suggesting they are not welcome here, and you might as well assemble your corporate entities overseas. Bermuda is, right now, an attractive target, and I think that Chairman Johnson is very mindful of that from Connecticut.

We have some exposure and experience in Florida. Tyco bought a company that was headquartered there and but now has moved a lot of their operations, which was ADT and now Tyco what have you. It is troubling because you lose jobs, you lose prestige of having the corporate presence. You lose real estate sales for communities that are dependent, on those large corporate transfers that are, at least when they leave, they flee and take a lot of good business with them. Does anybody else, quickly, I know the Chairman has been very kind.

Mr. CAIN. If I may add, you are absolutely right because there have been a large number of American companies that have been bought by foreign companies because they have certain advantages which basically addresses your point relative to some of the things that we have seen happen. So, I would underscore that just by looking at the companies that have been bought out here now, they are foreign-controlled rather than U.S.-controlled. I would like to point out that if some rules were passed, just to try and discourage companies being able to locate in other countries, we would simply be making the problem worse. We really wouldn't be fixing the problem, because then in the long run, we would have to come back and try to put in another stop gap.

Mr. ENTIN. Mr. Foley, 10 to 30 years ago when our tax rates were relatively low compared to Europe, it was American firms buying European firms. Now their tax rates are lower than ours, and it is their firms buying ours. We need to fix our tax rate.

Mr. FOLEY. Just the other day, Miller Beer announced they may be selling to a foreign source. There are a lot of companies that

have long been the flagships of American industries, and all of a sudden, you keep reading in the trade papers the acquisition of another American brand by—and maybe that is global competitiveness. It seems there is an impediment to them remaining even aggressively buying on the other side of the waters. I would rather our companies be buying them.

Mr. CAIN. It is the tax on the income and the labor that is causing that. You would see a flip-flop if American companies didn't have that penalty on their corporate profits and that penalty on labor. More U.S. companies could buy more foreign companies.

Mr. FOLEY. I wish Mr. Crane was here. He would applaud this, because he has long advocated the abolition of corporate income taxes since it is double taxation. Thank you, Mr. Chairman for your indulgence.

Chairman MCCRERY. Thank you, Mr. Foley. All good questions. I saw Mr. Entin nodding as Mr. Cain was making his point that if we went to a consumption tax, and I assume you would say do away with the corporate income tax all together, that would solve the problem of American companies being bought by foreign companies. Did you mean to nod?

Mr. ENTIN. Yes.

Chairman MCCRERY. Why is that? Why would—also I think in your testimony, Mr. Entin, you said that if we were to go to a consumption tax, that the U.S. national income would rise as a result of that. Would you get into both of those questions a little bit?

Mr. ENTIN. I am tempted next time to write shorter testimony. The current broad based income tax raises its revenue with heavier taxes on income that is saved and invested than on income used for consumption, because capital is very sensitive to taxation, and because capital has to shrink a great deal to drive its returns up by enough to pay the higher tax, the current tax system shrinks the capital stock a great deal. That reduces productivity, which reduces wages and employment. If we had a tax that was less punitive on capital and brought the tax on income that is saved down to match the tax on income that is used for consumption, we would have a much larger capital stock, higher productivity and much higher wages. That is the connection, because capital so sensitive to tax and because it is being mistreated under current law.

The major tax reform plans are often called consumption taxes. Mr. Christian makes a point a lot, and it is a very good one: we really shouldn't think of the consumed income tax or the VAT or the national retail sales tax as consumption taxes. Goods and services don't pay taxes. People pay taxes. If you remember that income is a net concept, revenue minus the cost of earning the revenue, then you can start thinking of saving as a cost of earning interest. You have to buy the bond to earn the interest. You have to buy the stock to earn the dividend. You have to buy the machine to earn the return.

The correct tax treatment, then, is to look at net income, which is revenue minus the saving, or revenue minus is the expense investment. We should be giving all saving the treatment we give the regular deductible IRA, individual retirement account, or a Roth-style treatment, which is the same thing in present value. We should be expensing plant equipment, not depreciating it. Income

is really that net concept. Then we see that the things we are calling consumed income taxes are really income taxes where income is correctly viewed as net income, and saving is recognized as a cost of earning income. Don't think of them as goods and services taxes. These are income taxes where income is properly defined, and if you went to a properly defined income tax, you would have a much higher capital stock and a much higher level of output and income.

Chairman MCCRERY. I believe in your testimony you also concluded that going to a consumption tax would make U.S. businesses more competitive; is that right?

Mr. ENTIN. It would make all businesses more productive. Of course, if we were more productive and sold more goods abroad, we would earn more foreign exchange and buy more imports, too, but we would certainly be a more productive economy. So, the competition is not really between the U.S. firm and the foreign firm, or the United States and a foreign government, it is between from the bad current tax system that is shooting us in the foot and a good alternative tax system that wouldn't shoot us in the foot.

Chairman MCCRERY. Is our goal to raise our National income? Does that trump everything else, or are there considerations of job creation and the type of jobs that we have?

Mr. ENTIN. In shooting ourselves in the foot, we are shooting ourselves in the manufacturing foot twice and the other foot once. We would have higher income and a bigger manufacturing sector. So if you fix this, you happen to be also helping the manufacturing sector which is suffering from under depreciation.

Chairman MCCRERY. So, if we go to a consumption tax, we not only raise our national income, but we increase the number of manufacturing jobs in this country?

Mr. ENTIN. Probably.

Mr. CAIN. Yes, sir. If I could comment on it, it starts with supercharging the economy at a growth rate much higher than we anticipate at the present time with the current tax system. So, if the gross domestic product (GDP) is growing at 5 percent instead of a paltry 1 percent or 1½ percent—and Mr. Jorgensen has actually done some research on that—consumer prices go down to help offset the fact that you have a national consumption tax.

One other point I wanted to make very quickly is that in the United States—if we change to a consumption tax, they would be forced to reexamine their tax structures, which would create a ripple effect around the world because of all the new companies that are going to want to come here. This is because of the—increased competitiveness of businesses operating here. So, fixing the real problem has far-reaching impacts not only relevant to the issues of border adjustability and relative to some of the other issues you are dealing with, but also in terms of keeping this country as the leader economically with respect to building on its economic platform.

Mr. GALE. Could I add a comment there? You asked about the effects of consumption taxes on national income or on economic growth. There is a range of estimates. The most well-known academically refereed estimates are by Alan, Averbach, and a team of coauthors in an article that came out in the American Economic Review a couple of years ago. That paper suggests that, using a

very sophisticated model, that after 15 years if you introduced a realistic flat tax—that is, one that had transition relief—the economy would be about 1.5 percent larger than it otherwise would be. That is after 15 years. That is for a well-designed flat tax that did not have, for example, deductions for health insurance, deductions for State and local taxes, firm deductions for payroll taxes. It had no EITC, no child credit, no education credit, and so forth. If you think that for political reasons those things would creep back into a flat tax, the growth effect would go to zero really fast.

So, the results that everyone is talking about, about how going to a consumption tax would raise national income, that is true if we go to a pure or very broad-based consumption tax. If we go to a consumption tax that looks like European consumption taxes, for example—and there is no reason to think that we are going to be purer about this than the Europeans will be—if we go to a consumption tax like theirs, there is no reason to think that there is going to be very big growth effects at all.

The one thing we do know is that we will redistribute tax burdens, and normally we think of some—at least along some dimensions of tradeoffs between equity and efficiency. So, you should not think that moving to a consumption tax basically solves the growth equation or is an unambiguously positive growth effect. It is quite possible, and I would venture it is probable, that if we designed the consumption tax, it would be pockmarked, so full of holes that the rate would have to be so high that the growth effect would be zero or negative.

Chairman MCCRERY. Mr. Jorgensen, did you have a comment on that?

Mr. JORGENSEN. Yes. I wanted to make a point again that I suggested in my earlier testimony. I think that if you think in terms of the potential impact of tax reform, the consumption tax achieves about 40 percent of that potential, and that is essentially with the most optimistic assumptions. I am overlooking all of the issues that Bill Gale just raised.

Another issue is why don't we have a consumption tax? As you remember, Chairman Archer held hearings for many years which many of us participated in. There is lots and lots of testimony about all the plans that have been discussed here about a consumption tax. The reason is because the tax rates are staggering.

For example, if you have a progressive national retail sales tax—this is what Archer originally was interested in—the marginal tax rate, the tax that you would have to collect on every dollar at the retail level—just imagine this—is 40 cents. That is what we are talking about. So, it is not a very practical idea. I think that is what led to the neglect of consumption tax reform when this issue was very thoroughly discussed by the Committee on Ways and Means in the middle nineties.

I think you have really put your finger on the issue here. The issue here is not how to benefit the corporations which have been up to this point benefiting from the export subsidies that have now been struck down by the World Trade Organization, the issue here is how to enhance the productivity of the U.S. economy. We have an extremely productive economy. Since 1995 our economy has been growing at more than 4 percent a year. If you look at the way

that productivity is behaving in the current recession, it is running at about 1.1 percent above what it has in previous recessions throughout the whole postwar period. We are in a new economy. What do we need to do to deal with the issues of a new economy? We need to focus on investment and how to stimulate investment, and that, it seems to me, is where the attention should be directed rather than toward a consumption tax.

Chairman McCRERY. Yes, Mr. Entin.

Mr. ENTIN. The Joint Committee on Taxation had a panel about 4 years ago, and they are going to revive this for some future work, which looked an a number of models and how they would model going to fundamental tax reform. The models showed great differences in the amount of growth that you would get out of tax reform, according to whether the models assumed that there was a free flow of capital and goods, including manufactured goods and investment goods, across borders, or whether the economy was closed to such flows. In the closed economy models, which relied entirely on increasing U.S. saving to fund the additional capital and assumed very low rates of elasticity of domestic saving, it took forever to get to the higher growth levels, and those models showed very small growth numbers. The open economies showed growth in the 6- to 15-percent range, and I took a 10-percent estimate in my paper.

Since the opening of the capital markets in the last two decades, we really cannot look at closed models as being realistic. I once debated someone from a major econometric modeling company who was worried about the effect that the flat tax would have on mortgage interest and have values. I said, "We are going to get a lot of growth." He said, "You will never get enough saving to fund it." He said that foreigners are already lending us $100 billion a year—this was way back in the eighties—and we cannot expect them to go to $200 billion a year. I said, "You know those capital flow figures that you just quoted? Those are net figures." At the time, there were about $300 billion of investment going out and about $400 billion coming in to the United States each year. It was $700 billion to play with, not $100 billion, and all we had to do was stop lending abroad. He turned beet red. He remembered after I said it that the net capital inflow number was, in fact, a net figure.

When we lowered the inflation rate in the early eighties and prospectively enacted some accelerated depreciation which was later repealed, businesses started thinking that it was a good idea to invest in the United States instead of in Brazil and Argentina and all around the world. Between 1982 and 1984, the United States lending abroad from the banking system fell by over 85 percent, from about $120 billion annually to less than $20 billion. There was very little increase in the inflow from Europe. Essentially it was our own savings staying home. As for physical capital investment, if you run into problems in the machine tool industry and they can only ramp up output 25 percent, you can buy more machine tools from Europe, and you can add very quickly to the domestic capital stock. You can get the growth quickly, and it can be a big change. Always use an open model, because the world is open.

Mr. GALE. Can I respond to that, just one more comment? If you have an open economy model, as Steve mentioned, you will defi-

nitely get more GDP growth; that is, gross domestic product. You will get more capital coming in if you move to a reform like that. What you won't necessarily get more of is more national income, more gross national product (GNP), and if you want to look at the future welfare of Americans, you need to look at the national income numbers. Money that comes in has to be paid back. So it increases our GDP, but it is essentially a mortgage against the GDP. So once we pay that back, we are not anywhere near as better off as the GDP figures themselves would suggest, and when you want to look at the future welfare of American citizens, you want to focus mainly on GNP or national income rather than on national product.

Mr. ENTIN. If I borrow $100 to put a machine in my shop, and I have had to borrow it from a foreigner, then the interest is going to go to the foreigner. If I borrow it from my brother-in-law, the interest is going to my brother-in-law. Either way, I get to work with that machine and my employees get to work with that machine and 75 percent of the economy is wages. So our workers get to benefit from the machine, regardless of who paid for it and who gets the interest or the dividend.

Mr. CAIN. Mr. Chairman, if I can just add one comment.

Chairman MCCRERY. I think I agree with Mr. Entin. It is not that I disagree with Mr. Gale. It just seems to me—and I am not an economist, thank goodness, but it just seems to me that, Mr. Gale, your argument is up here floating around in the ether, when Mr. Entin's is right on the ground in terms of jobs and job creation.

Mr. GALE. Oh, I agree that his is on the ground. The issue is that if you—in Steve's example, when you pay your brother-in-law back, that dollar is still in the economy. Okay. When you pay the foreigner, it is out. It is gone. So there is a distinction between how much we produce—how much is produced in the United States. That is GDP, and that would go up substantially, as Steve mentioned. How much of that is ours.

Chairman MCCRERY. But isn't that——

Mr. GALE. That is national income.

Chairman MCCRERY. If GDP goes up, isn't that good?

Mr. GALE. Of course. Other things equal, yes. My point is that GNP, national income, is the measure of economic welfare. The wealth of Americans depends on the national income, not on national product. This is Econ 1 stuff, but there is a difference between producing in the United States and having the proceeds of that output go to Americans, and that is the fundamental issue here.

Chairman MCCRERY. I appreciate your treating us like we are in Econ 101, because we are not economists, and we need to learn. So, I do appreciate your taking the time to try to explain, but surely you are not saying that there is no relationship between GDP growth and GNP growth or national income?

Mr. GALE. No, I don't think I said that. I said that GDP growth that is financed by capital inflows has to be paid back via capital outflows in the future, and sort of the question is are you—if you——

Chairman MCCRERY. Let me just interject, but if that capital inflow continues and so we continue to create jobs and increase

productivity, what difference does it make if for a temporary period of time it goes back overseas? If it is——

Mr. GALE. If we can create a system where we have continual capital inflows, then you have solved all of our problems. Normally people have to pay back their capital inflows, and that is the nature of borrowing is you have to pay it back, but I agree, if we——

Chairman MCCRERY. You are paying back the capital and the interest. I mean, as long as they are willing to continue to finance growth here in the United States, that is a good thing, I think.

Mr. GALE. That is a good thing, except that then we also have to pay it back. I am just saying we don't get the entire proceeds of capital borrowed from abroad.

Chairman MCCRERY. I agree, we don't get the entire proceeds, but in a global economy, it just seems to me that we can no longer think or expect to be self-contained and to have just a circular flow of capital here in the United States.

Mr. GALE. No one is suggesting that. All I am suggesting is that when we talk about big output effects or potentially big output effects of tax reform, that does not necessarily translate into big national income effects. That is the only point I was trying to make.

Mr. CAIN. Mr. Chairman, I am not an economist either. Let me give an example that I can relate to as a businessman. The advantage of having a very vibrant gross domestic product, as you have pointed out, is that it would create more jobs. Unemployment would go down. We would be able to employ those people that want to be employed, and so forth, but one of the things that it would allow people to do by taking the tax off of income and putting it on consumption is that it would not penalize people's sweat equity. I am looking at it more from a standpoint that if someone chooses to work a little harder or extra, they won't be penalized when they are trying to increase their individual income. So from that perspective, that is the importance of having a very vibrant GDP. Quite frankly, I don't worry as much about national income as the ability of individuals to increase their own income with their own sweat equity.

Chairman MCCRERY. Mr. Engen.

Mr. ENGEN. If I could just wade in carefully. As an economist on a couple of things here, one, I was on the Joint Committee on Taxation modeling group that was brought up here, and one of the things that I want to point out was in that looking at the number of different models that—looking at the effects of flat taxes, all of them were positive in terms of their growth effects. There was a range, but they were all positive. Some were at a lower end, and some were unbelievably high.

That said, the point that Bill brought up in that, well, if you do enough in terms of adding in other components, you can erode the growth effects back to zero or close to zero is true, and that was the final point I made in my testimony. Essentially what you are doing is you are then—you are saying we are going to switch to, say, a flat tax or another type of consumption tax, but then you are building in all of the features of the income tax that we are having problems now. So that is a key feature.

I mean, Bill's point is one that should be definitely heeded, that an important part of getting the positive growth effects from a flat

tax, just for example, is that you cannot let all of these other exceptions come in as people want to keep their favorite tax preference from the old system and put it in the new system.

The second thing is that just it is the case that if we have the increased capital financed by domestic saving, then yes, all of the proceeds from that output, both that go to labor and that go to capital, stay in the United States. If that capital does come from outside of the United States, yeah, you do have to make payments back on that, but in all likelihood, the labor that foreign investment in the United States is hiring is U.S. labor, and that is still kept in the States.

So there is—there can be a discrepancy on that, and, yes, it is more beneficial if U.S. capital formation is financed by U.S. saving—or it can be, but there is still a return to labor.

Chairman MCCRERY. One more comment, and then I would like to——

Mr. JORGENSEN. I just want to make a comment about transition rules. I think that Bill has made a very important point that Eric is agreeing with. Let us think of what these transition rules amount to. Are you saying that after you change to a consumption tax, you are going to take away all of the depreciation allowances you promised all of those investors who have in good faith bought equipment and built factories and commercial buildings and so on, with the expectation they are going to be able to make deductions? I don't think so. Are you going to say that every corporation that has issued a bond is not going to be able to deduct the interest payments that it was contemplating when it issued that security? I don't think so, and if you simply go down the list—I have just mentioned the two most prominent examples. These are not airy-fairy examples. This is something that is the heart and soul of tax policy. You are going to end up, as Bill said, undermining most of the benefits that are associated with the switchover.

So you might say, should we give up, do we have to abandon the effort? Should we just say, well, we have had these hearings; can't do it. I mean, it is just impossible.

Chairman MCCRERY. That is what we have done so far.

Mr. JORGENSEN. The answer is that we start from the income tax. That is the key idea. Forget about the idea of a consumption tax. It just isn't going to happen. An income tax that focuses on investment is feasible. It is something that doesn't require any transition rules. Why? Because it leaves all of the provisions of the income tax in place, and I am referring to the depreciation provisions, the tax deductibility of interest and all of the things that fill 110 volumes of the Internal Revenue Code.

Now, how do we fix this? What we do is simply take a step that will make sure that every asset in the economy earns the same rate of return before taxes. In order to do that, all we need to do is to change the method by which we carry out our capital cost recovery. In the system that prevailed before January 1, 1987, when the investment tax credit was abolished, we had a two-pronged approach to that. We had capital consumption allowances and we had the investment tax credit. My proposal is to simply reinstitute the investment tax credit, but in a way that would achieve the goal.

What is the goal again? The goal is trying to equalize the rate of return before taxes on all assets, and that doesn't require any transition rules. It starts with new assets. It doesn't affect any existing assets. All existing assets would be treated in exactly the same way, and existing liabilities. If you take a bond, for example, tax deductibility of bond interest would continue. Capital consumption on allowances on all of the existing assets would continue, but this would superimpose on it a system of tax credits that would eliminate the corporate tax. If you don't call that a tax reform, I don't know what it is.

Mr. GRAETZ. Mr. Chairman, can I make one point?

Chairman MCCRERY. Sure.

Mr. GRAETZ. This transition problem, I think, is a very important problem——

Chairman MCCRERY. Yeah, and I was going to get into that.

Mr. GRAETZ. When people are talking about an entire replacement of the system we now have with some form of consumption tax, among the reasons to try and do the kind of hybrid approach that I have been pushing here, is that you get the advantage of low rates. You shift the burden to consumption substantially, but you are retaining a corporate tax at a 20- or 25-percent rate, which makes the United States very attractive, both as a headquarters and as a source of investment. You have taken away some of the advantage of those depreciation and interest deductions, they were going to get against the 35-percent rate. Now they are only going to get those deductions against a 20-percent rate, but nobody can complain about that, because you have kept the tax in place, and you have lowered the rate. This is not the kind of transition relief Congress has ever felt necessary to give, in effect to say, you have really got to get the benefit of your depreciation against a higher rate when we are lowering corporate rates. We don't do that.

So, my plan gets some of the advantages of Dale's ideas, but it is not the kind of radical change that either the proponents of going fully to a consumption tax are arguing for or the proponents of going to a full investment relief for new capital are arguing for. My plan really is a compromise. I just want to emphasize that fact. It avoids many of the problems, including the transition problems of the total restructuring of the system of the sort this Committee has been talking about so far. I really urge you to start thinking about this in a broader way, and not to think that you are going to replace the entire income tax with a sales tax. If you replace it for 85 percent of Americans and they don't have to file tax returns, that would be a major improvement in the lives of the American people. And it would whittle the IRS down to a size that would enable it to do what it might be able to do. So, this plan is a major step in the direction that people have been advocating, but it doesn't cause the kind of problems that have been discussed so far here today.

Chairman MCCRERY. Well, let me try to pose some problems with your approach. Your approach—I think you have just stated clearly the advantage to your approach, which is that you avoid a lot of the transition problems associated with a complete overhaul to a sales tax or VAT or anything else, and those problems are substantial, in my view. There are a number of conservatives who

would say to you, my goodness, you are going to create another tax—you are not going to do away with any tax. You are going to keep an income tax. You are going to keep all of the State sales taxes and everything, and then you are going to add a new tax, a VAT or, you know, some kind of consumption tax on top of that. My goodness, the Congress would have all kinds of opportunities to increase taxes on the American people. They could do a little bit here, a little bit there, and tweak it here and there, and you just really increase the opportunity for more of our National income to go to the Federal Government in the form of revenues. Isn't that a legitimate concern?

Mr. GRAETZ. Well, I think it is always appropriate to be concerned about Congress increasing taxes and how they might do that.

Chairman MCCRERY. But haven't you increased their opportunity——

Mr. GRAETZ. I don't think this proposal increases the opportunities in the following sense, Mr. Chairman. I cannot imagine a Congressman standing up on the Floor of either the House or the Senate and suggesting that you lower the $100,000 exemption from the income tax. It took the Second World War for the income tax that we had from the beginning of the century until the Second World War to become a tax on the masses, and it would take that kind of catastrophe to bring that 85 percent of Americans back in. So that is the first point. The second——

Chairman MCCRERY. That underscoring the flip side danger, which is that you have such a small amount of the American public paying income taxes, that it is much easier for a politician to say, why do I care about that 15 percent? It is the other 85 percent that is going to elect me. I can increase the taxes, which is my only pool of income tax revenues. I can just easily—politically easily increase their taxes.

Mr. GRAETZ. Let me make two comments about that. One is, it is easy under the current system.

Chairman MCCRERY. It is getting easier, I know.

Mr. GRAETZ. It is easy under the current system. That is exactly what Bill Clinton did in 1993. He said, let's take the top rate, which was 31 percent, and let's move it up to 40 percent and not bother with anybody below that level. If you have a majority in the Congress, that can be done.

The answer to that, I think is—and this is a reform that the House voted, and appropriately so in my view, is to put in a super majority rule that says that you cannot raise rates, you cannot raise tax rates as part of this plan without having a 60 percent vote in both the House and the Senate. That would——

Chairman MCCRERY. That would overcome a lot of objections, but I am not sure we can——

Mr. GRAETZ. I think that the problem is, Mr. Chairman, that when you think, well, we are going to raise those rates—remember the goal here. The rate we are talking about is a much lower tax rate than we now face. That is, we would have lowered the rate on marginal investments, on marginal income, on all of these people by dividing the tax base up so that we are not relying entirely on

an income tax to finance our government. No other country does that.

If you look at the chart at the end of my testimony and you look at how the U.S. taxes consumption compared to how everybody else in the industrial world does, we have given up an important tool. We have given up the consumption tax tool. The advantage to us is that we have lower taxes compared to GDP than our trading partners. We have said we are not going to have lower tax rates. We can let other countries have lower tax rates, because we have given up the tool of a tax on consumption which could ease the burden on capital and production in the United States. I think that in terms of long-run health of the economy and long-run marginal tax rates, this program would be lower. I am just as conservative as you are on the thought that—let's not make this an occasion for bringing more money into Washington. I understand that objection and I sympathize with it entirely, but I don't think that is a good reason, frankly, to give up the tool of taxing consumption in a greater way and easing the burden of taxes on production and investment.

Chairman McCRERY. Mr. Engen, do you agree with that? Would you like to see us create a consumption tax and keep the income tax?

Mr. ENGEN. I have sort of struggled over this particular issue, and indeed it was one of the things I mulled over quite a bit as I was writing my testimony for this. On the one hand—I guess I am going to be an economist here; do the one-hand, two-hand thing. I do have sympathy with I think the point of view that you are bringing up. When I look at countries that do have this extra tax lever to the greater degree, they are ones in Europe, and they have an overall tax burden on the economy as a whole that is higher.

On the other hand, I think that the type of proposal that Mr. Graetz is putting forth is a nice medium ground, in between some of the various proposals that are out there, and as long as you could implement these restrictions on raising taxes in the future, then it would be okay. I guess I am not quite as convinced that you could implement those, but of course, I am an economist and not a politician, so I have less of a view on that. I think it is a reasonable concern.

Chairman McCRERY. Thanks for clearing that up. I don't mean to belittle what you just said. You are right. Mr. Graetz certainly, I think, has a proposal that is worth looking at, and it may be the only—well, not the only, but it may be one of a very few realistic proposals that we could possibly enact. It does scare me and a lot of others, I think, as well as you, that we are creating another opportunity for tax increases.

Mr. Gale.

Mr. GALE. Thanks. Just real quickly, I have read literally every word of Mike's book and wrote a 35-page review of it for a legal journal, which was a huge mistake. I want to say two things. One is, it is one of the few serious large-scale proposals out there. The flat tax X tax is another, and something like broad-based income tax reform is the third. So, I think it is a very serious proposal. I don't want to sound like a broken record here, but the thing to re-

member is that the rates that were quoted depend on having a very broad base. Mike is right that, pre-World War II, we had an income tax that was only on high-income people. On the other hand, we have had a mortgage interest deduction since 1913. We have had a State and local tax deduction since sometime in the teens, I think in 1913. We have had a charitable deduction since the teens. We have had a health insurance adjustment since way back before 1920. So when you start adding those in, they take out big chunks of the income of people that have income above $75,000 or $100,000, and the rates have to go up.

Similarly with the VAT. If you exempt things the way the European countries have exempted in a VAT, the rates go way up. So, I congratulate Mike on putting forward a doable, cohesive, coherent proposal, but I just want to caution that all of these rate estimates depend on how broad the base is. As soon as we start introducing these subsidies, the rates go through the ceiling.

Chairman MCCRERY. You have made that point several times, and it has sunk in, even into this country lawyer.

Mr. GRAETZ. One point with which I certainly agree. The VAT base needs to be very broad in order to get the kind of rate I am talking about, but I think it is realistically broad. I have looked at this deal pretty carefully. The income tax on people above the $100,000 floor does not eliminate the deduction for charitable contributions or home mortgage interest, as one might believe. You can still, based on information I have, get to the right rates, but this is an important question as to whether the rates are realistic or not. I would only hope that we would be sitting in this room.

Chairman MCCRERY. Trying to set the rate.

Mr. GRAETZ. Trying to set the rate and making sure the rates are low enough.

Chairman MCCRERY. Right. Mr. Entin, do you want to jump in on this?

Mr. ENTIN. I think I am of the view—my boss who was a tax expert in town for many years, Norman Ture, kept drumming into my head that taxes needed to be transparent and visible to the electorate, otherwise people would think someone else was paying them. They would vote for people who were promising more government than they would vote for if they knew that they were paying it. So, I favor broadly based taxes without a lot of people dropped off the rolls, and I don't particularly care for taxes hidden at the business level, when in fact it is the workers and the consumers and the shareholders who are paying the taxes. I do worry that we would get a runaway tax situation if we left too many people off the income tax.

The other thing I worry about are those distribution tables which will guide you in picking one plan over another simply because the initial incidence at the time is imposed will look better or worse. Not one of your burden tables is correct. Not one of them is close to being correct. When you put taxes, for example, on upper-income doctors or impose huge malpractice premiums on them, what do you think happens to the quantity of those doctors? People retire early. They don't enter the profession. The number of doctors shrinks. They don't employ as many nurses or other workers in the offices. They don't produce as much health care for the people, and

the providers who remain can charge a higher price so that they can pay their malpractice insurance and their higher income taxes. It is the consumers who end up paying the higher premiums and taxes through their insurance company.

The same thing is true for income taxes. A lot of people who have been pushed into the upper brackets go to their corporations and say, "If you want my skills, you are going to have to pay my tax bill." Then it shows up in the price of the product.

Taxes never stay where you think you are putting them. The payroll tax partly falls on capital, because it shrinks the labor supply. Capital taxes partially fall on the work force because it shrinks the capital stock. Upper income taxes fall on lower income people. Lower income taxes to some extent fall on the upper-income people. Please don't let those silly burden tables take you away from a good tax plan and push you toward a bad one.

Chairman MCCRERY. Easier said than done.

Let me try to conclude, getting not back to, because all of this has a relation to the subject of the hearing—or the series of hearings, which is the ETI, and what do we do about losing the ETI, which I think everyone that has talked to the Committee has said you are going to lose the ETI eventually. You are going to have to do something with it, or the Europeans will retaliate. They have shown some forbearance. They think that we are, in good faith, searching for a solution to the problem, and so they are not retaliating now, and no indication that they will in the next couple of months or so. Eventually we are going to have to find a replacement or a substitute, something, or we are going to have to decide—and this is the question I want to put to you—we are going to have to decide that the economic value to the country is not sufficient to justify risking a trade relationship, and instead of trying to replicate or trying to take care of those specific companies, that group of companies that were benefited by the ETI, we take that income, and we spread it throughout corporate America, or whatever, in the form of lower rates or more expensing.

So I suppose—I would want to ask you to give me your thoughts on that generally and mix into that more on the subject of today's hearing. Even though we all agree our current tax system is convoluted and complex and burdensome in terms of the compliance costs, all those bad things, still in all, don't we have as a Nation generally have a tax burden that is competitive, so to speak, if not advantageous in terms of our trading partners around the world? I mean, if you look at the total tax burden in any European country, it is probably going to be higher than the total tax burden here in the United States.

So what should this Committee do in terms of trying to fix ETI in the context of our entire tax burden here? Ernie?

Mr. CHRISTIAN. Mr. Chairman, I think that the ETI is gone, it is lost. I think we should move on beyond that. I think that I would, of course, stick with the suggestion I made about the easy way to fix it; and that is, adjust our base a little bit in the corporate tax and exclude exports.

We need to be practical about what can happen and what can't happen. I have concentrated here today on something I think is a very practical, doable solution to the problem that you identify. I

have probably worked for 20 years on various different fundamental tax reform proposals. I suspect I have perhaps spent as many hours on that as anybody at this table. I have concluded that fundamental tax reform, as such, is simply too big, is too hard. It is a symphony with too many notes to be played in this body.

We need to concentrate on the things that are good components of fundamental tax reform, that we can do and that solve real problems. One of the impediments to that is trying to do too much, and another one is simply terminology. We here today use the word "consumption tax" to refer to two different things and in two different ways. Realistically, the only consumption tax being talked about is Mr. Cain's retail sales tax and Mike Graetz's particular version of the European credit invoice VAT, which is a sales tax. That is a tax on consumers.

Economists, including many here today, have on the other hand been referring to—as a "consumption tax"—an income tax amended in only one respect. That is, it expenses capital equipment. So, I would hope that rather than becoming embroiled in this morass of calling an income tax with expensing a consumption tax, and confusing ourselves and everybody else, we would talk about our income tax with all its warts and about how we can fix it on the international side, on the investment side, and in other ways that represent longstanding, familiar amendments that can be enacted into law. We cannot tear the whole thing out by its roots, as the former Chairman used to say, and start over and rebuild it on some other grounds, like a sales tax or something like that. It is basically in my opinion contrary to the American tradition and ethic of taxation at the Federal level.

So, we need to operate in that tradition, that ethic, and I think by deftly doing it, we can find our way through this process and end up with the components, the economic components, that are actually the substance of all of the tax reform proposals that everybody has been talking about for years: not double-taxing investment, not double-taxing personal saving, a genuinely workable, competitive, international tax system with an expert exclusion, and, if we wish, bringing foreigners into the U.S. tax base by means of an import adjustment or a cost-of-goods-sold adjustment.

When stated in those ways, those are imminently doable things for the most part. It doesn't scare anybody. It is not too hard, and we can do it. When we got to the last page and turned it over, we would have accomplished the economic substance involved in all of the tax reform proposals, including the four or five I have drafted over the years, and Professor Graetz's and others, is my answer.

Mr. GRAETZ. Mr. Chairman, I do want to point out that—and I am a person who was involved in the creation, along with Glen Hubbard and others, of the Comprehensive Business Income Tax (CBIT) bit proposal that is the basis for Ernie Christian's testimony—I believe that the CBIT tax, which is a single business tax without a deduction for interest or dividends, and no taxation of interest or dividends at the individual level, is a better tax system than the one we now have and would be a great improvement.

On the other hand, I also want to say, having managed to get that proposal out the door of the Treasury Department after a lot of conversations with a lot of people, that denying the corporate in-

terest deduction is not a small step as it has just been painted. It is really quite a large step.

So, I think the question of what is realistic and what is not realistic in this environment is one that the Congress is going to have to come to grips with. Ultimately I believe, with the help of the President of the United States—I think that the one lesson of the 1986 act that was well learned is that when a President of the United States makes a tax change of some major sort a key issue—fundamental reform can happen. And in the absence of that kind of Presidential leadership, it is not likely to happen. The 1986 act, whatever you think about it, would never have been passed if Ronald Reagan hadn't come to the Congress the way he did in 1995 and 1986 and made it a key issue.

I have been around tax legislation with Ernie for 30 years, and we have been around different tables doing this sort of thing for a long time. I remain much more optimistic than he does about what Congress can do. I am actually with Herman Cain in his optimism. I think that the tax system that we have and that we are relying on, that this income tax and tinkering with depreciation and tinkering with investment tax credits in order to try and make us more competitive, is a road to disaster. I think it has proved to be a dead end. We can go on for another 5 or 10 years continuing to prove it to be a dead end.

It wouldn't shock me if this kind of change doesn't happen overnight, but I think that the optimism that Mr. Cain has suggested is the right way to think about this. I do think we have to be realistic about what we can do. I don't believe we can take a system that we have relied for the 20th century as heavily—not entirely until the Second World War, because we had tariffs as our consumption tax—but as heavily as we have relied on the income tax, and say we are going to throw that tax away and that we are now going to go to a consumption tax system all in one step. I just don't see it happening, and I don't see it happening largely because of the distributional question. I think I have been in print more critical of distribution tables than anyone at this table. I have called them paint-by-numbers tax law making and all sorts of other ugly names. The truth of the matter is that there are serious questions about what happens to the distribution of the tax burden and who we shift it to by moving completely from an income tax to a consumption tax. We would shift the tax burden down the income scale in ways that I think are going to be ultimately unacceptable if we replace the income tax in full, and that is why I think looking for some middle ground is important.

I do not think it is worth this Committee's time and effort to jeopardize our trade relationships by looking for some new export subsidy. I was at the Treasury Department, I guess Ernie was, too, when we did the DISC, Domestic International Sales Corp. Then we did the FSC, and then we did the ETI, and each time the WTO has said no-go. I believe that if you think seriously about consumption taxes, it is very important to think about ones that will get through the WTO, because we have committed ourselves to this international trade relationship, and I think properly so. I think it is not clear that a subtraction method value-added tax will get through WTO if challenged. Japan currently has such a tax. It has

not been challenged. Their economy has been in very bad shape and nobody wants to challenge them. If the United States went to such a tax, I am not at all sure it wouldn't be challenged. Whether it would succeed or not, I don't know. It should succeed.

The indirect/direct distinction—the distinction between taxing transactions as Mr. Cain's tax and mine do, or taxing entities as Mr. Christian's and Mr. Entin's and others do—is not a substantive distinction. The WTO has an indirect/direct distinction that it may well stick to, no matter how archaic, particularly if it gives it a lever vis-á-vis the United States on trade issues, which is what has happened in the recent round here.

I would give up on the ETI. I think the question is where can the revenue best be spent, and that is the question that this Committee ought to turn to and address. There are lots of possibilities, but I would hope that we would move in directions that keep this fundamental tax reform issue on the agenda as you have tried to do in these hearings.

Chairman McCRERY. We will go to Bill and then Mr. Jorgensen.

Mr. JORGENSEN. All right. Thanks. This has been a very fun and illuminating hearing. I just want to say a couple of things. One is, as I mentioned earlier, I think we should let ETI die a peaceful death. I would consider the revenues gained sort of money that could be used anywhere you want to. Cut the corporate tax rate. You know, pay down the public debt. Whatever. I don't see any obligation to put it back into an export subsidy, and I want to emphasize from a macro economics viewpoint, they don't do any good, although they may benefit the bottom lines of several major corporations.

On the broader picture, there are a number of well-conceived tax reforms that would be unambiguous improvements over our existing system. I mentioned the—Mike's proposal, a flat tax, slash, X tax proposal or broad-based income reform. The problem with all of those and the things that I worry about is they only exist on paper, and in order to get them to exist in the real world, they have to go through the political process. They have to be inured against attack by aggressive tax attorneys and accountants and tax planners, and they have to transition from the existing system.

So, there are basically two problems. One is, how do you get to any of these systems? That is the transition problem. Second is, how do you stay there? I think basically you have to repeal politics, repeal the politics of tax policy in order to stay there. I don't know how you do that, because the complications that exist in our income tax, you know, weren't there at the beginning, but they grew in; not because anyone wanted to make it more complicated, but because it was a natural response of the political system.

So, I am not at all opposed at the principle level to broad-based tax reform, but I don't know how we get there, and I am worried that if we do that and then the political process takes over, we end up with a situation where we have done a huge amount of work to change the entire tax system. The one thing we know, we would do is redistribute tax burdens away from the wealthiest households, and we would probably end up with a system that probably isn't a whole lot better than what we have. I don't think it is worth

taking the leap in order to do that unless we have some assurances.

I hear this man on the Moon comment all the time that Mr. Cain raised. That is, if we could put a man on the Moon, why can't we do this? It is a darn good question, and the answer is, putting a man on the Moon is a technological problem that could be solved with everyone working together. Tax policy is not a problem where everyone works for the same goals. People have diametrically opposite goals, and half of the Congress feels like they have made their day when they have subverted the will of the other half. In a situation like that, you can't make unambiguous progress. So, I am very concerned about what you might call the political economy of tax reform, although I think if you put several economists and lawyers in the room and let us design a system that would be set forever, we could come up with pretty close to the same system.

Mr. JORGENSEN. Could I chime in at this point?

Chairman McCRERY. Yes sir.

Mr. JORGENSEN. I just wanted to agree with the general sentiment around the table that ETI is gone, and I don't think it should be greatly limited. I am glad you are having hearings about this and so on, but it is something that has disappeared and is probably better forgotten.

In terms of the issue that you have raised in these hearings, though, about where do we go from here, I think Bill has put it very well, and that is that basically you can try to retread the footsteps of predecessors who have focused on so-called fundamental tax reform—I am thinking in terms of these—the value-added tax or the flat tax or a national retail sales tax. We have already done that several times, and it always leads to the same conclusion, which Bill, I think has summarized for us very adequately.

So, I think that what I would recommend is the following and that is that we try to amend the existing income tax system. I think that is the direction for reform. It can be done in such a way that we would achieve the objectives that you and your colleagues have emphasized repeatedly in your questions.

What you are really concerned about, it seems to me, is to deal with the inequity in our tax system that arises from the differential treatment of corporate-source income. Corporate-source income, whether it is derived domestically or abroad, is double tax. That is what we have heard over and over again from this panel and which you raise this question over and over again in your questions. How do you deal with that? You have a system of taxation in which effectively you treat corporate-source income symmetrically with other kinds of income. Now, you might say, wouldn't it be better to have a hybrid system? That is what Michael Graetz has been raising throughout these hearings. I am going to tell you, and I think everybody here would agree with that, our current system is a hybrid system. What do I mean by that? Pension funds are consumption taxes. The way that we think about a 401(k), for example, is that we exempt the investment and we charge tax on the consumption when the benefits are finally paid during retirement. That is a growing part of our tax structure. The way that taxation of owner-occupied housing is structured under our system, it is effectively a consumption tax. So we have a hybrid system. The issue

is how can we use this existing hybrid system in order to achieve the goals that you have identified? Namely, to deal with the problems in the corporate sector. That is the issue which I think you can address using the scheme that I have placed before you.

Mr. CAIN. Mr. Chairman—and I will be brief.

Chairman MCCRERY. Thank you, Mr. Jorgensen. Mr. Cain.

Mr. CAIN. I have much more confidence in Congress' ability to make a bold move and get through the political barriers that will be needed to solve the long-term problem. Some suggestions have been made for the short-term issue that you deal with relative to the WTO, and I respect those suggestions, but the success of American businesses, the success of this country, starts with believing that you can do something. As long as we continue to believe that we can't change it in a big way and that our elected representatives will never take the big steps to change it dramatically, we have defeated ourselves. We will continue to have hearings and debates over who gets to get a cookie out of the cookie jar this time, driven only by more and more complexity and more and more debate.

So, I would encourage you, Mr. Chairman, and your colleagues, to begin to believe that, yes, we can make dramatic changes to the Tax Code.

Chairman MCCRERY. Thank you, Mr. Cain.

Mr. Engen, do you want to have some last shots here, or have you had enough?

Mr. ENGEN. I guess the one thing I would add is that it would seem to me if—Bill's point is a good one. We have gotten to the point where we are with the Tax Code now because of the system we have and all of us that operate within it. It doesn't necessarily seem to me that we should then be more optimistic that we are necessarily going to change the current system, say, an income tax in a more beneficial way, than we should be more optimistic that we could change to a system, say, like the X tax or Mr. Graetz's tax.

You know, my view is it would seem like the probability of going in any of those different directions—they are somewhat simpler—that there is no reason to believe that it would be easier to amend the income tax in a way that is more beneficial. So in that sense, I would say that is where the focus should be, even though in any direction it is going to be difficult, that those steps are well worth being taken.

I would like to say, yeah, I think the ETI should go. Those foreign subsidies I think don't have a place. There are some small things that can be done with the revenue from that, but the type of fundamental changes we are talking about here, whether it is broad-based income tax reform, whether it is an X tax, whether it is Mr. Graetz's hybrid, that is going to take a lot more effort for sure, but it is well worth it.

Chairman MCCRERY. Mr. Entin.

Mr. ENTIN. If you can do a fundamental reform, that would be wonderful. Many things fit together better if you are changing everything in a consistent manner than if you are trying to do it reform piecemeal. If you can't do a major reform, and you have only a few billion dollars, Ernie Christian suggested a gradual move to-

ward expensing at the business level or a lower-corporate rate, and to improve gradually the tax treatment of saving. Go far enough down that road and you will get to reform eventually. I will second his remarks on that.

Chairman MCCRERY. Thank you. I want to thank all of you for staying with us for 3 hours this afternoon. This is, as Mr. Gale said, a very interesting subject. To sum all this, it was illuminating in some respects, so I do appreciate the expertise that you bring with you, and your enthusiasm, Mr. Cain. We in Congress, sometimes I think, do get somewhat jaded and lose sight of the goals we had when we came here. So maybe after the elections, if the President does what Secretary O'Neill said yesterday he was going to do, which is promote fundamental tax reform, an overhaul of the tax system, maybe we can be rejuvenated here at the legislative level and move forward.

So, we will certainly consider your thoughts and ideas, and I am sure talk with all of you again before we proceed with such an undertaking. Thank you very much, and the hearing is adjourned.

[Whereupon, at 5:00 p.m., the hearing was adjourned.]

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