The Tax Treatment of Foreign Income:

Issues and Options

Testimony submitted to

United States House of Representatives
Committee on Ways and Means
Subcommittee on Select Revenue Measures

May 9, 2002

William G. Gale*

*Arjay and Frances Fearing Miller Chair in Federal Economic Policy, Brookings Institution.

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 off-shore 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 fisc 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 inversions. Some businesses would see their tax liabilites 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.

[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.

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 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 US 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 US 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 Rate	Country of residence	Location of Production/Operations	Location of Sales
T1	US	US	US
T2	US	US	FC
T3	US	FC	FC
T4	FC	FC	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, US 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

$$Y = C + S + T, \tag{1}$$

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:

$$Y = C + I + G + X - M, \tag{2}$$

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

$$X - M = (S - I) + (T - G). \tag{3}$$

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 US 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 percent 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 US 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 US 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

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 incentives, 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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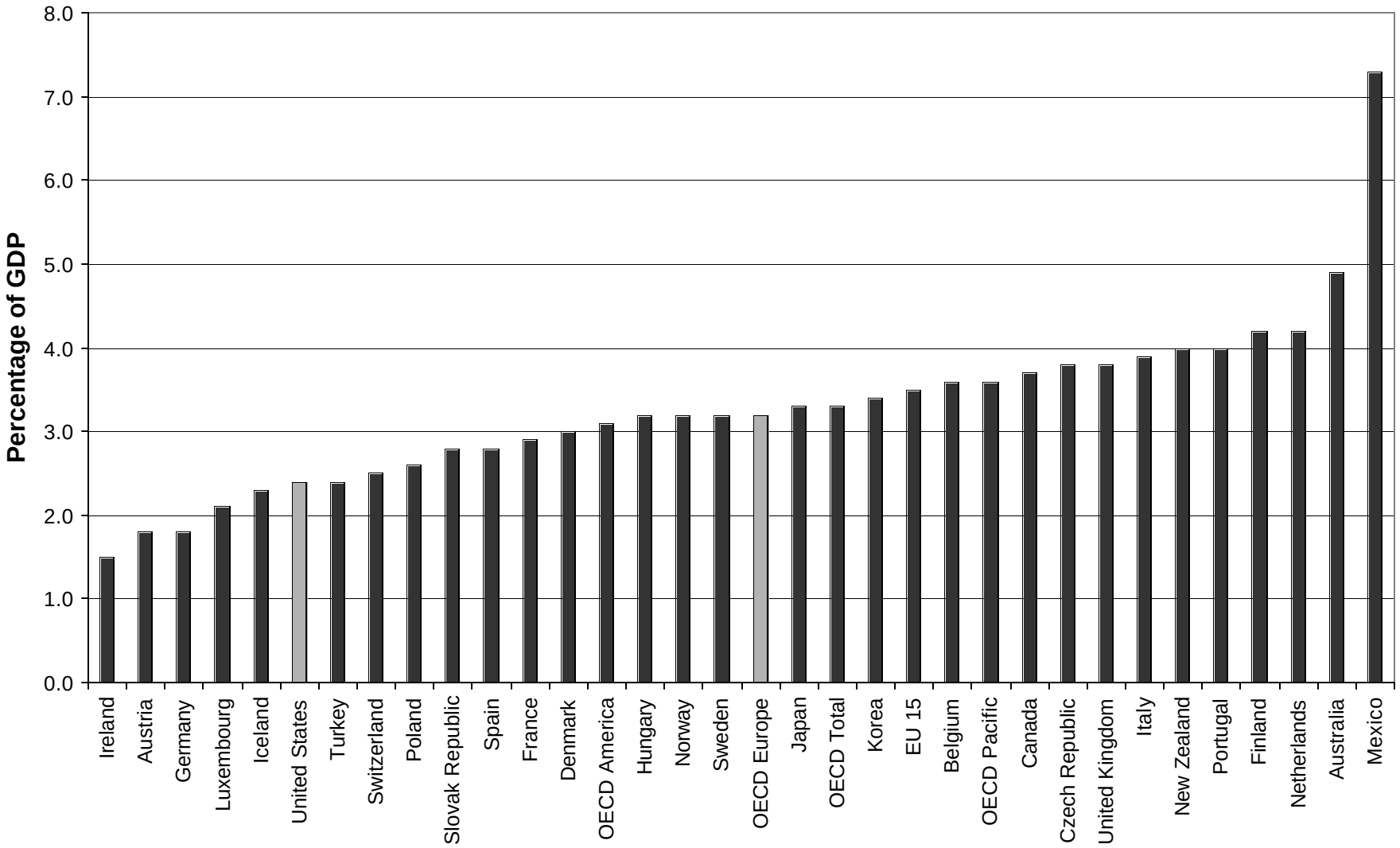
Table 1

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		

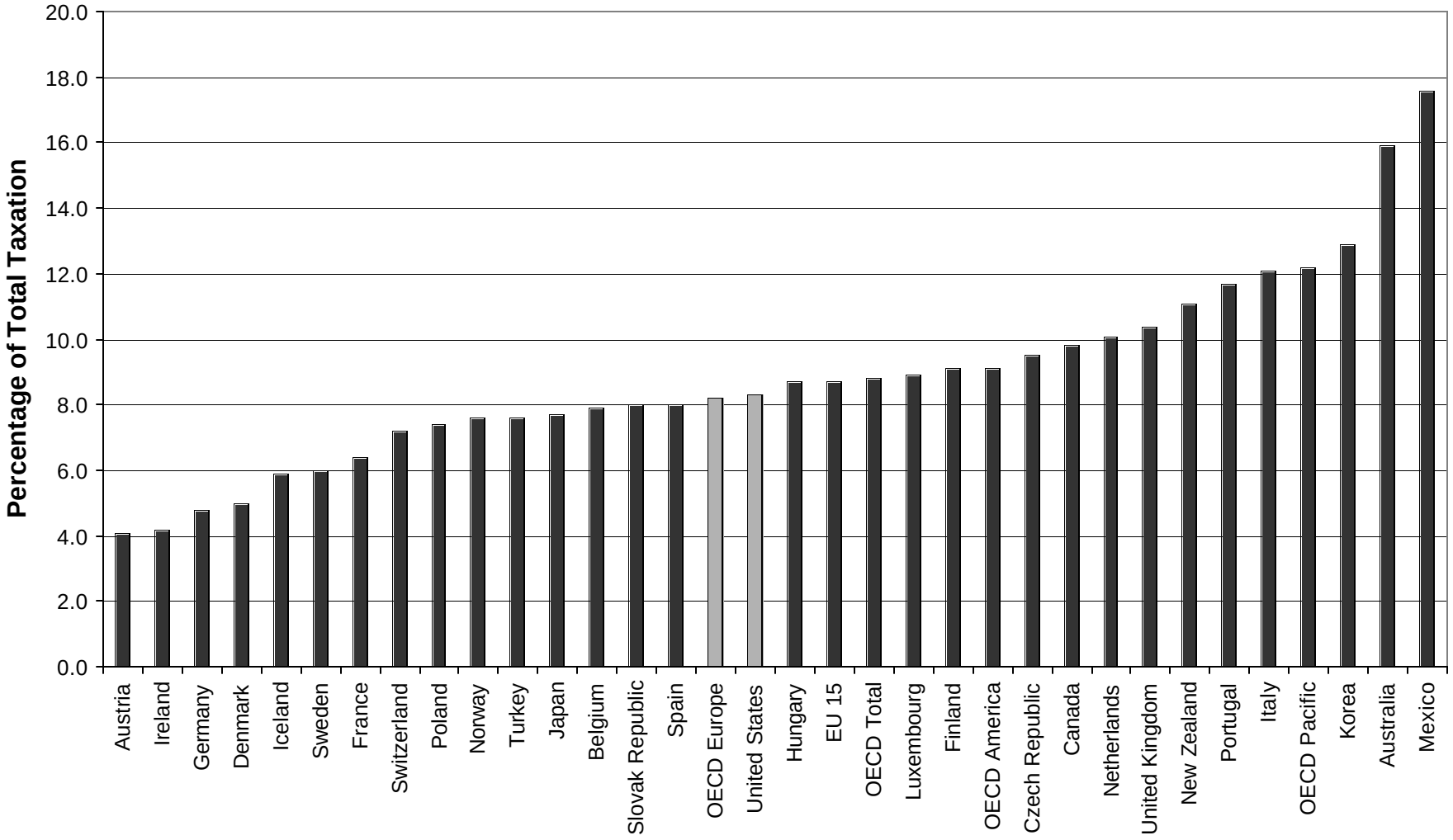
Sources: Organisation for Economic Co-operation and Development. *Revenue Statistics 1965-2000*. OECD, 2001., and Slemrod, Joel and Jon Bakija. *Taxing Ourselves: A Citizen's Guide to the Great Debate Over Tax Reform*. 2nd edition. Cambridge, MA: The MIT Press, 2000. Table A.2.

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



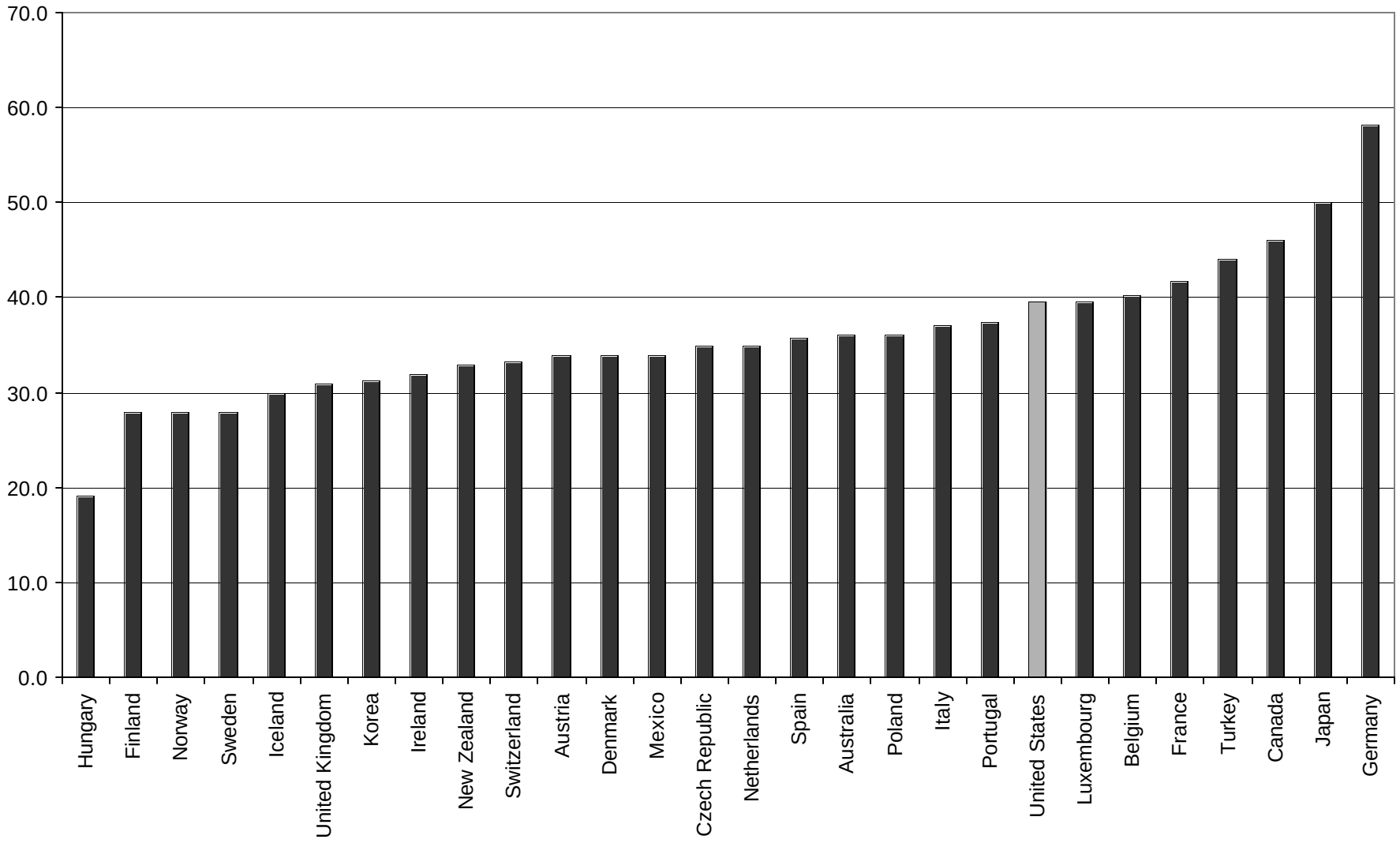
Source: Organisation for Economic Co-Operation and Development. *Revenue Statistics 1965-2000*. OECD, 2001.

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



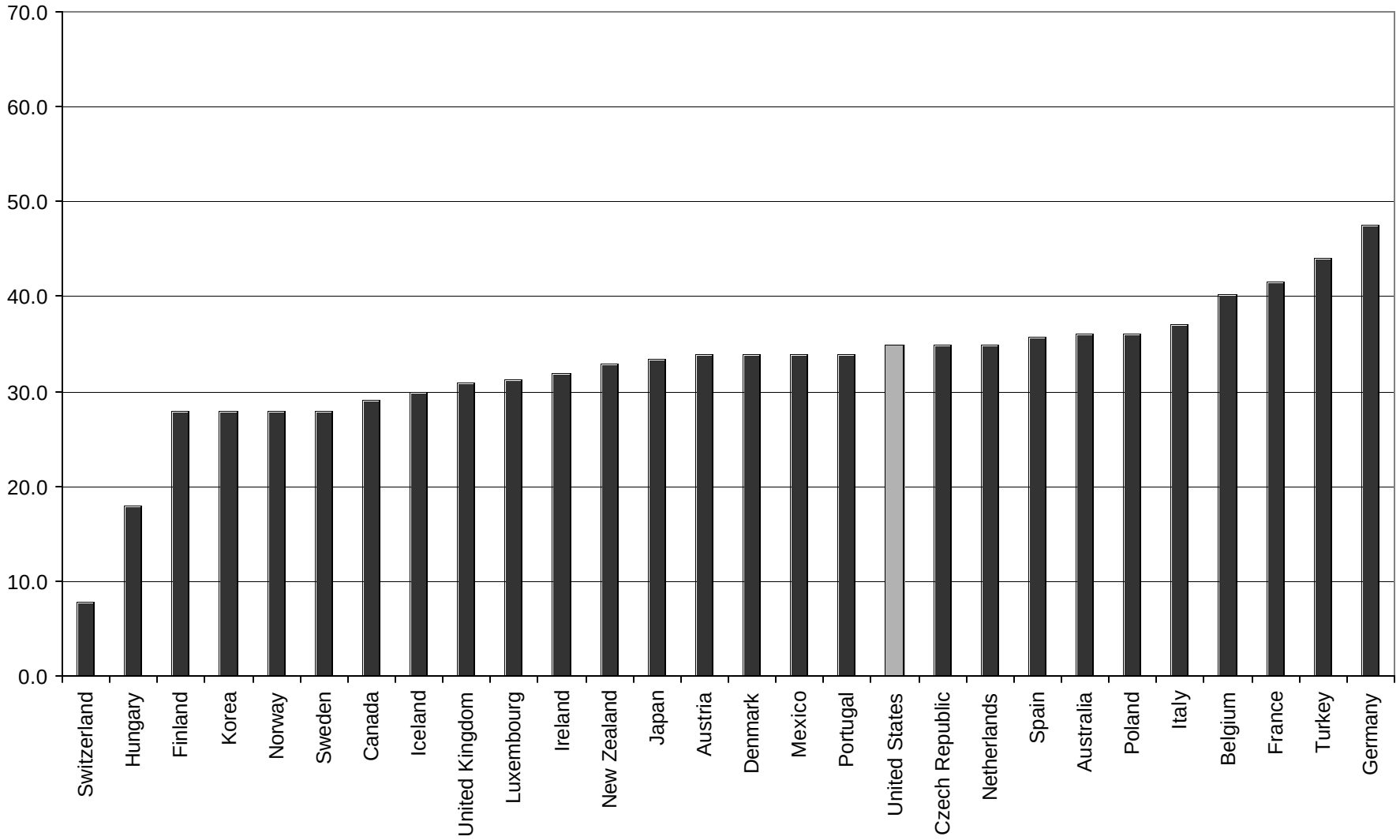
Source: Organisation for Economic Co-Operation and Development. *Revenue Statistics 1965-2000*. OECD, 2001.

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



Source: Organisation for Economic Co-Operation and Development. *Revenue Statistics 1965-2000*. OECD, 2001.

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



Source: Organisation for Economic Co-Operation and Development. *Revenue Statistics 1965-2000*. OECD, 2001.