Revenue Estimating: Evolving Toward Conflict or Consensus?

Is International Taxation Becoming Backdoor Protectionism?

Remarks by the Honorable Lloyd Bentsen
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The Halloran House
New York City
November 29, 1989
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Partner  
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The Tax Foundation held its 41st Annual Conference in New York City the afternoon of November 29, 1989. The subjects we chose to address — one domestic issue, revenue estimation, and one international issue, taxation of multinationals — are ones that the Tax Foundation feels need more attention from the fiscal policy community.

I would like to thank Kendyl K. Monroe, a partner in the firm of Sullivan & Cromwell, for helping to assemble and then moderating the excellent panel on revenue estimating. "Revenue Estimating: Evolving Toward Conflict or Consensus?" served as the panel's theme. The Gramm-Rudman-Hollings imposition of revenue neutrality on proposed legislation has multiplied many times over the number of revenue estimates requested by Congress and changed the resulting estimates from a vague guide to a pass-fail grade. This heightened importance means increased scrutiny of the revenue estimating process by Congress and the private sector.

I would also like to thank David Milton, retired, formerly Vice President and Chief Tax Counsel of Shell Oil, for conducting the panel on international taxation: "Is International Taxation Becoming Backdoor Protectionism?" The onerous complexity of complying with U.S. international taxation was a key theme of the panel, with arguments for several different systems presented. The fear of foreign investment in the U.S. came in for a fair amount of ridicule.

A major accomplishment of the conference was the lively exchange between the public and private sectors on issues of vital importance to both government and industry. The publication of these proceedings will bring these important viewpoints to a wider audience, promoting understanding of these critical issues.

Wayne Gable
President
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Gail Fosler is currently Chief Economist and Executive Director of the Economics Program at the Conference Board. Previously, she was Chief Economist and Deputy Staff Director for the Senate Budget Committee. Prior to her eleven years on Capitol Hill, Ms. Fosler served as Assistant Vice President and Economist for the Trust Division of Manufacturers Hanover.

David R. Milton is retired, formerly Vice President and General Tax Counsel of Shell Oil. Mr. Milton is active in many tax and fiscal policy related organizations. A member of the bar in numerous states, he holds B.S. and J.D. degrees from the University of Minnesota and an LL.M. degree from Southern Methodist University.

William Modahl is Director of Tax Affairs for Digital Equipment Corporation. A graduate of Dartmouth College with law degrees from Harvard and Georgetown, he has written extensively on domestic and international tax issues. He is currently chairman of the tax committee of the National Foreign Trade Council, and has served as chairman of the tax committees of the National Association of Manufacturers and the Computer and Business Equipment Manufacturers Association.

Kendyl K. Monroe is a Tax Partner at Sullivan & Cromwell in New York City, having served as the managing partner from 1981 to 1985. Mr. Monroe serves on the Policy Council of the Tax Foundation, as well as on the tax committees of various professional associations, both domestic and foreign. Mr. Monroe graduated from Stanford University and the Stanford University Law School. He is the current chairman of the Board of Visitors at Stanford.

Philip Morrison is International Tax Counsel for the U.S. Department of the Treasury. In this capacity he serves as the principal legal advisor to the Assistant Secretary for Tax Policy and the Secretary on international tax matters, including legislation, taxation of foreign income and investment, and negotiation of tax treaties.

Kathleen O'Connell is Deputy Assistant Director for Tax Analysis at the Congressional Budget Office. She oversees all of CBO's five-year baseline revenues, estimation of revenue effects of some proposed legislation, analysis of executive branch estimates, and revenue scorekeeping for the budget process. She has been on the CBO staff for nine years. Prior to her CBO experience, she spent several years doing business and macroeconomic forecasting at private consulting firms. She is a graduate of Smith College and Duke University.

Alan Reynolds, chief economist of Polyconomics, Inc., was previously vice president at the First National Bank of Chicago and senior economist at Argus Research. Mr. Reynolds' articles on eco-
nomic policy issues have appeared in *The Wall Street Journal, Forbes, National Review*, and other widely read journals. He was a member of the Reagan Administration inflation task force and OMB transition team and is one of the “Blue Chip” forecasters.

**Bernard Schmitt** is currently the Associate Chief of Staff - Revenue Analysis for the Joint Committee on Taxation, U.S. Congress. He received his Ph.D. in economics from Florida State University and served as an economist for the Department of Commerce for the State of Florida. He joined the staff of the Joint Committee on Taxation in 1977.

**John Wilkins** has held the position of Senior Advisor for Economics in the office of the Assistant Secretary for Tax Policy since 1984. His career at Treasury has included service under six different Presidents and eleven Treasury Secretaries. He has directed the Office of Tax Analysis, with responsibility for revenue estimating, policy studies, depreciation analysis, and tax treaty negotiations. This year he received the Presidential Rank Award from President Bush.
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Kathleen O'Connell

As I thought about how to address the topic of "Conflict versus Consensus in Revenue Estimating," it occurred to me that this is a somewhat unusual way to frame a discussion about a highly technical topic. The terms "controversy," "conflict" and "consensus" almost seem to suggest a political or social debate, rather than a discussion of econometric modeling, microsimulation, effective tax rates, and fiscalization of payment patterns. One reason, of course, that we discuss revenue estimating in these terms is that it is, in fact, part of a political process and some of the terminology and mindset carry over. But, why does the perception of conflict in revenue estimating exist? Is there all that much conflict?

I'd like to address three areas today. I'll tell you in advance that my conclusion is that considerably less conflict exists than may appear, and that I think we really are, with some bumpiness along the way, evolving toward consensus both about specific methodologies and about the general framework into which revenue estimating fits.

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Why is there the appearance of conflict in revenue estimating, and is it real? One reason is that you can't tell the players without a scorecard. The government seems to speak with many voices
these days. There’s been a proliferation of commentators on the tax legislative process and on revenue estimation in particular. The predominant ones are the Department of Treasury, the Joint Committee on Taxation, CBO, the Congressional Research Service, the House and Senate Budget Committees, the House and Senate tax writing committees, and at times the General Accounting Office. When you add to that private sector consulting firms, it certainly can seem chaotic. It can seem as if there are dozens of answers to a single question. I assure you that it really is not as bad as it seems.

First of all, many of these groups do not actually prepare conventional revenue estimates. Many of them present excellent economic analyses and other viewpoints on tax legislation, but they are not responsible for the official estimates on which political decision-making takes place. As you all know, Treasury represents the Executive branch in that area and the Joint Committee on Taxation represents the Congressional branch. The underlying budget estimates — the deficit estimates on which decisions are made about how large a tax bill should be, as opposed to the estimates of the marginal effects of changing specific provisions — are done by Treasury for the Executive branch, and by CBO for the Congressional branch. The number of official estimates is far smaller than it may seem.

Many of the estimating groups, including the three represented here today, use similar analytical techniques, similar modeling techniques, the same data sources, and much of the same institutional knowledge. They share technical information. The technical goal is simply to get the answer right, not to further any specific policy over another. So, at a staff level, considerable agreement and consensus exist. The confusion that appears to reign when several government commentators address a single issue really is much less than meets the eye. It does not imply considerable conflict in the area of revenue estimating. There’s far more consensus than conflict.

A second reason for this perceived conflict that some of you may have heard discussed at the Tax Council’s revenue estimating seminar a couple of months ago has been described as a “lack of sunshine.” There seems to be the perception that revenue estimating is a topic that no one wants to discuss, that it is done in the dark of night, and no one really knows how it is done except those who do it. I can only speak for my own organization: CBO’s position has always been to “let the sun shine in.” We publish
documentation of our methodology for estimating aggregate tax collections and other methodologies unrelated to tax estimation. We include technical appendices in many of our special studies, which detail the complicated procedures that underlie conclusions more simply expressed in the body of the special study. Our formal cost estimates, the outlay-side equivalents of the Joint Committee's

"Some critics of revenue estimation feel that this is one of its shortcomings, that revenue estimates should be as fully dynamic as possible. I think that is a misunderstanding of their purpose."

revenue estimates, are always accompanied by lengthy description of the basis for the estimate, the data sources used, and the assumptions made along the way to the final answer. CBO's own revenue baseline includes information from industry sources and experts in many areas. We need and appreciate that kind of advice. Even if we don't use the data in the same way in which you might use it yourselves, we think our estimates are improved because we have information from people who know more about these areas than we do. So, please, continue to call us. There is actually more "sunshine" than may be apparent, and there are opportunities for being heard in Washington.

A third reason why conflict may seem to prevail is that revenue estimates are often discussed out of context and without reference to their real purpose. Revenue estimating is, after all, just one of many elements in a larger budget estimation process. The unified budget is really only an accounting system designed to measure the cash inflow and outflow of the federal government. It is not designed to measure the full impact of government on the economy. That is a very important question. It is one that should be asked, and for which good and serious analysis is being done. But the answers to that question are found elsewhere, not necessarily in revenue estimates. Some critics of revenue estimation feel that this is one of its shortcomings, that revenue estimates should be as fully dynamic as possible. I think that is a misunderstanding of their purpose.

The federal budget estimates measure the effects of proposed legislation in a way that allows lawmakers to compare alternative policies. That is the purpose of a conventional revenue estimate and of an outlay estimate. In order to do that,

"The baseline tells them where they are starting; the estimates of legislation done as additions or subtractions to the baseline tell them where they are going; and finally a revised baseline tells them where they have come out."

the budget is measured in very specific ways and estimated according to very specific conventions. These estimation
rules may seem mysterious but in fact are relatively simple.

Both the Administration’s proposed budget and the Congressional budget

“*Estimates need not include all potential macroeconomic effects in order to serve their purpose. That information is important, but it is available elsewhere. How can a single number or series of numbers represent everything that should be taken into account when deciding the policies of the United States?”*

ultimately agreed upon are based on macroeconomic forecasts. These forecasts are used by budget estimators to generate a budget baseline. That is a critical part of the process because it tells the lawmakers where they begin. Are revenue collections large enough to fund the programs they want them to fund? (Of course, the large federal deficit indicates that they’re not large enough to fund current programs.) The baseline allows lawmakers to know where they’re starting. They are able, then, to make decisions about how large a deficit they wish to live with and what policy changes they wish to enact. Proposed legislation is measured as an addition or subtraction to that baseline deficit, to the baseline revenue total in the case of tax legislation. That is done with specific reference to the underlying macroeconomic forecast, if relevant for the provision in question, and with specific reference to the underlying level of baseline revenues expected without this given change. That kind of estimate allows the lawmakers to compare alternative policy changes and decide among them. The baseline tells them where they are starting; the estimates of legislation done as additions or subtractions to the baseline tell them where they are going; and finally a revised baseline tells them where they have come out. The revised baseline calculations are done frequently along the way, since the goal is a target deficit.

One very important aspect of this system is that estimates be measured consistently, allowing for fair comparison of alternative legislative options. Accuracy is extremely important, too. I think we all would favor any suggested improvements. But, something that my first boss at CBO told me nine years ago is that it is better to be approximately correct than to be precisely wrong. I think that reflects the real purpose of a revenue estimate — to allow the lawmakers to know the relative sizes of specific provisions, consistently measured, so they can decide what particular policy change they want to make.

Revenue estimates shouldn’t be expected to carry the burden of “being all things to all people.” Estimates need not include all potential macroeconomic effects in order to serve their purpose. That information is important, but it is available elsewhere. How can a single number or series of numbers represent everything that should be taken into account when deciding the policies of the United
States? Broader economic questions, such as the impact of a provision on the macroeconomy, are answered in special studies by various groups including the Congressional Budget Office. These studies are not revenue estimates. Both kinds of analysis are necessary for good decision making.

Another point on the subject of dynamic versus static estimation deserves mention. The macroeconomic forecasts that underlie the budget baselines do assume some moderate amount of deficit reduction. The tax legislation enacted in recent years, with the exception of tax reform, has not included provisions with large enough budget effects to significantly affect a $5 to $6 trillion economy. Most tax bills in recent years have raised $4 or $5 or $6 billion per year in an economy that's a thousand times that size. So the kind of tax increases enacted have been anticipated generally in the underlying macroeconomic forecast. The forecasts have not been invalidated by the size of fiscal policy changes that have passed. The revenue estimates are consistent with the macroeconomic forecast that underlies them.

In conclusion, there's considerably less conflict in revenue estimation than one might think. Many actors in the budget arena generally agree with one another and they use similar techniques and information. (Indeed, we often bemoan the lack of more and better information.) There is more sunshine in the process than may appear. There's very little conflict between the way estimates are done and what they're supposed to address. I do think they serve their purpose, even if that purpose is different from what some may wish it to be.

So, if I had to choose whether revenue estimating is evolving toward conflict or consensus, I would choose consensus, acknowledging that there is conflict along the way. This process will produce better results in the end.

Q & A

Q: You have emphasized that there's not a conflict, that you have consensus. As I see it, you have conflict within your own office, or within the Joint Committee staff, or within Treasury. Let's take the ESOP proposal. One week you come up with a two billion dollar revenue loss on the repeal of the partial interest exclusion. Ten days later it's four billion dollars. In three months, it would eventually turn out to be about eight or ten billion. I don't know whether you want to address that conflict within. Is it because you've done more studies, had more input and received more information?

Kathleen O'Connell: Since the ESOP estimates were done by the Joint Committee, I will let Mr. Schmitt speak about them, but I'm happy to talk about the implications of changing estimates over time.
The conventions of the budget process are poorly understood. At the beginning of every budget season, generally the springtime, the Budget Committees review the Administration’s proposed budget which has been submitted to them in January or February, and they review what the various committees in the Congress have submitted to them. These might be thought of as “wish lists.” The Budget Committees determine and the Congress votes on what the Budget Resolution will be. They vote on a set of macroeconomic assumptions that they wish to underlie the budget discussion for the year. They vote on an underlying budget baseline that they wish to be the starting point for the deficit discussion. They vote on committee assignments, for example, how much revenue should be raised by the Ways and Means and Finance Committees. The process requires that estimates be frozen from that point forward. In fact, I’m often asked the opposite question, “Why hasn’t the number changed, now that we have newer information?”

The process actually takes longer than some people think it should, or can understand. Because it takes that long, the rules of the game can’t change along the way. So, estimates done in July or August or even October are supposed to be relative to the budget baseline which was prepared ten or eleven months earlier, published in February, and voted on in April or May. Even if considerable new information comes to light after that, most of the time it is not incorporated.

There are other vehicles, though, for incorporating the newer information. For instance, the baselines are updated every summer. The updated ones don’t underlie the budget discussion, even though the discussion may go on for three months after the release of these summer estimates. These revisions to the estimates generally would not be used as part of the budget package discussion. But there’s an element of political negotiation as well. There are times when the Budget Committees and other involved committees simply must admit that newer information is better and ought to be used. They may switch estimates midstream. The repeal of the catastrophic health care surtax and benefit program is a good example. The estimates upon which the recent decisions were made were updated more than once since the winter budget estimates that underlie the rest of the budget.

From a budget process point of view, there should be less change in the estimates than newer information may imply. There may be more than one estimate for any given proposal, but that may be a difference between the Administration and the Congress.
Rather than leave that ESOP question unanswered, I will address it before beginning my prepared remarks.

The ESOP provisions are similar to the vacation pay provisions, so we can use them to draw an analogy. Vacation pay provisions of a previous time were open, as opposed to being closed, and like the ESOP provisions, they came out early in the legislative process, when people are looking for revenue raisers.

"The most difficult thing that we do is to try to determine the behavior of both corporate America and individuals."

These are both areas in which there were not good data available and we admitted that, but Congress didn't wait for us to do surveys and collect data. Instead, we were forced to put out what, at that time, was our best estimate. Typically, we have a tendency to put out a smaller number at first rather than a multi-billion dollar number until we have some proof that the money is out there.

As the vacation pay process went on, people immediately came to us and told us that there certainly was a lot of money out there. And so, along the way, we changed our estimates.

It was not because of any political pressure. While the pressure is there, we're isolated from it and we're not forced, in any sense, to increase our numbers because of the Members' pressure or any outside pressure. In both cases, we took into account new information, we researched that information, and it was obvious that there was much more there than we had thought there was.

I want to tell you what my staff is and its relationship to the Congressional process and the Joint Committee itself. Out of a staff of 45-50 professionals, approximately 20 are attorneys. They deal in drafting legislation, and writing for both the Finance Committee and the Ways and Means Committee. My group of revenue analysts has eight economists and two computer specialists. My task in the next two or three months will be to go out and recruit. Because of the pressure on us and the amount of our workload, we are going to expand significantly. Academically, we seek people with advanced degrees in Economics and specialties in Public Finance, Quantitative Methods and Econometrics.

"... to the extent that we use actual taxpayer information — and our staff and Treasury staff are the only ones that have access to actual taxpayer information, the actual tax forms for both individuals and corporations — to the extent that we use those, we cannot make them public."

Whenever I speak on revenue estimating, I like to emphasize the fact that
our staff is totally independent. We're independent even from our own committee in a lot of cases. We're even housed in a different building. We do work closely together because we need our legal staff

"... many of the estimates we do, usually the most contentious, are ones that affect a relatively small group of taxpayers, often very large corporations..."

in order to understand the implications of how various provisions are going to interact within the code. My people tend to be economists, micro-economists, who analyze problems that require a knowledge of how a corporation works and how individuals react. The most difficult thing that we do is to try to determine the behavior of both corporate America and individuals.

There is a similar group at the Office of Tax Analysis at Treasury. They look at the Administration's provisions in some of the Administration's big proposals that come to the Hill. That is what distinguishes us. We are on the Hill, and we get the last call. Congress does make decisions based on the number that we put on a provision. Their decisions are never made early and they're never made easily. They always wait until the last minute, and along the way we have many chances to look at things, relook at things, and gain information from the outside.

There are four or five reasons why our visibility as revenue estimators has increased and, with it, our importance to this process. The Budget Act in 1974 established the fundamental framework for the current process. Probably more important were the high federal budget deficits of the 1980s, which were coincidental with, or partially the result of, the Economic Recovery Tax Act in 1981, with its significant tax cuts and indexing changes. Third, the implications of Gramm-Rudman, and fourth, the tax reform itself in 1986, which dictated absolute neutrality within tax provisions and tax proposals—anybody that wants to spend some money has to come up with a way to pay for it.

In the legislative context, the one aspect of our job that has significantly changed in recent years is the workload. Last year we went back to look at just what our workload was and to track it over the last few years. During tax re-

"Certainly, we hope that people will come in and talk to us, but for the most part, it's not the behavioral assumption that we'd like to debate. We would like to have some basic data so that we can discuss behavior that would take place, but not, in effect, be told what the bottom line should be."

form in 1985, we had formal written requests from Congressmen and Senators for about 350 estimates. In 1986, 475; last year between 700 and 800, and this year we're up to 1,200 written requests
from Congress. So, you can see the workload has increased tremendously, and the emphasis on tax laws and their changes is an important reason for that increase.

One subject that I want to address is the question of secrecy within the estimating process. I know that a lot of questions about it come up, and possibly I can straighten out misunderstandings and misconceptions.

A number of people participating in the October Tax Council seminar in Washington discussed the problem of secrecy. They had the feeling that all of our data and methodologies should be fully disclosed from the beginning and that public scrutiny would improve the process. In many situations where a process is out in the open, public comments can be solicited and it’s very likely to improve the product. That certainly is good in theory, and for the most part we cannot argue with that. But there are a variety of reasons why it’s very difficult to follow that path in our situation.

First of all, with the ever-expanding workload, the number of requests has just become staggering. If we took the time to go out in the public forum every time we received a request from a Congressman, there would never be any decisions made. As I said, Congress holds off to the last week of the session to make decisions anyway. If we were out in the public debating each of our estimates, it would just be a never-ending process.

Secondly, to the extent that we use actual taxpayer information — and our staff and Treasury staff are the only ones that have access to actual taxpayer information, the actual tax forms for both individuals and corporations — to the extent that we use those, we cannot make them public. We’re confined by law. It is extremely important that we observe those laws and do not let out any information. It’s very difficult to talk about certain proposals that would affect very limited groups, without revealing just who we’re talking about and how much money it is.

A third reason is that many of the estimates we do, usually the most contentious, are ones that affect a relatively small group of taxpayers, often very large corporations, a select group of corporations, or a certain sector of the economy. Very often they are interested in knowing the details about our analyses, not necessarily details about the data, but to know details about what the behavioral assumptions are that we’ve factored into

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"Some people seem to think that the whole analysis is very simple. Take a tax base, take a tax rate, multiply two together and find out exactly what’s going to happen."
the estimates. This gets into the static versus dynamic argument.

Our estimates are certainly not static. They’re very dynamic in that we incorporate in our estimates what behavior will be brought about by a certain tax change. Naturally, this part of the estimate is an assumption. These things have not been tested because the law has not been changed yet, so it is simply a best judgement. People, corporations, and lobbyists would like to come in and know exactly what our assumption is so they can go out and build up their best case to come back and argue that legislation. Certainly, we hope that people will come in and talk to us, but for the most part, it’s not the behavioral assumption that we’d like to debate. We would like to have some basic data so that we can discuss behavior that would take place, but not, in effect, be told what the bottom line should be.

The fourth aspect of the secrecy issue is the problem of the confidentiality of a Member’s request. For every proposal that a Congressman would like to get for his district, but that would lose money, he’s forced now, in almost all cases, to come up with something that will pick up that amount of money and offer a neutral amendment. It’s easy to change tax rates and come up with billions of dollars, but the small revenue raisers, ones that are usable, are harder to come by. To a great extent, the Members do not want everyone in the world to know what their proposals are, and to know what proposals they’re going to offer. Therefore, it is vital for us to work on a confidential basis between our staff and the Congressmen. If they get to the point where they propose the amendment or they want to release the amendment, then it’s out there and we can discuss it. But that’s often the reason why people think we’re being very secretive. We will not tell people that we are working on a certain proposal, because of this confidentiality agreement with the Congressmen themselves. We will not tell people that we’ve helped their staff come up with a proposal, and that we have a good idea whether it is neutral or not, until he has a chance to move forward with the legislation.

Lastly, there are many misunderstandings and misconceptions about the system itself. Some people seem to think that the whole analysis is very simple. Take a tax base, take a tax rate, multiply two together and find out exactly what’s going to happen. But in fact, because of the behavior and the tremendous amount of interaction among various sectors of the economy, it is extremely difficult. Even a well-informed observer might think that a certain proposal would obviously have a big effect when, in fact, because of behavior, taxpayers exercise options which, in effect, cut into the revenue gain or loss we would otherwise be looking at.

I will conclude with one classic example of misunderstanding which comes up all the time. People look at our revenue tables and they notice that the first year effect on almost all proposals is
much smaller than the second, third or fourth years. And they'll come to us and say, "You're stupid, because there cannot be that kind of growth in this activity," when the only reason for this kind of jump is that we are not looking at calendar year liabilities. We're looking at the way Treasury receives the money, that is, looking at the fiscal receipts of the government. The effect of a proposal on a certain calendar year, even if the proposal is effective for the whole year, will often not be fully counted until the following year when you take into account the fiscal years of the government and of some taxpayers, and refunds which do not arise until the end of a taxpayer's year and are thrown over into the following year. That's just a common misunderstanding.

It's unfortunate that we can't put on more programs for large groups to explain subtleties like that, and let people understand that we're not trying to hide anything.
John Wilkins

Kathleen O’Connell mentioned in her talk who the players in revenue estimating are: CBO; OMB, which does the Administration’s spending forecast; and, of course, the Council of Economic Advisers on whom we rely because they are mainly responsible for the macroeconomic forecast that our receipts estimates for the Administration are based upon. Also on the scene are the Joint Tax Committee; Treasury, which I represent; and we have a new phenomenon, the accounting firms. Almost all the large accounting firms are now doing revenue estimating work. So the players are expanding.

“All of tax policy, I suspect, is going to be driven by the budget, and that means driven by the revenue estimating process.”

Prior to the 1974 Budget Act, there was no CBO. Prior to about 1984, I don’t believe any of the accounting firms were in this kind of business with us. This, by itself, is creating a kind of competition, if you will, and is probably leading to a better product from all of us. You may view this as a conflict, but I suspect it’s a helpful conflict.

There’s a new emphasis on revenue estimating. This is going to last, not only for the next couple of years, but for many years to come. Revenues are driving the entire tax policy business nowadays. Budget reconciliation, the bill that just passed, is probably a good example. It was a genuine effort at reconciliation and raised some $6 billion in revenue in 1990. But next year, the process is clearly going to be much tougher. Next year aims at a $64 billion deficit, and all the efforts we went through this year are going to be doubled and tripled. All of tax policy, I suspect, is going to be driven by the budget, and that means driven by the revenue estimating process.

We’ve gone through all of the easy ways of finding revenues. This process really started in 1982, with the Tax Equity and Fiscal Responsibility Act, where we tried to raise revenues, to pick up some of what was lost in the 1981 act. But, the main concern there was, “What loopholes can we close? What are the easy ones where we can get a lot of money?” These simply don’t exist anymore, at least not the easy ones. The easy ones are all gone. The big money ones are all gone. In today’s world, a congressman can’t offer a revenue-losing amendment unless he can pay for it. This leads to some rather strange matches. It would be my guess that some enhanced child care proposal will come out next year, and some people are talking about paying for it by extending the telephone excise tax. There’s no nexus there, no relationship between the one that raises money and the other one that loses money. This constraint is going to hit some very important policy issues, important to
Congress, important to the Administration. For example, corporate integration is something that the Administration is interested in, and capital gains, which the President is very keen on. The same constraints, where are you going to pay for it if it loses money, are going to be what drive the policy.

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I would like to discuss in some detail exactly what it is we’re trying to accomplish when we make revenue estimates. In particular, I want to talk a bit about this notion of dynamic estimates versus static estimates. This is something that I think is not well understood by people outside of our business.

One could say that the only meaningful estimate must include all behavior and macro responses, allowing the answer, “Here is the effect of a policy change on the entire budget, on the budget deficit, and because of feedthrough, all the effects on the economy.” People who make that statement also often believe Treasury doesn’t make meaningful revenue estimates by that definition. I want to argue the point that we do. With respect to capital gains, there’s at least one newspaper where if you read the editorial page, you get one impression about what we do, but if you read the business page, you get another impression entirely. But using capital gains as an example, because everyone’s familiar with it, consider something like a permanent 30% reduction, which would be the Jenkins-Archer made permanent. By our estimates, that has a static revenue cost of about $12.2 billion a year. That’s the static cost. That’s not the estimate we put out. It’s not the kind of estimate the Joint Tax Committee puts out. Some people would have you believe that’s the way we estimate things.

Next we look at the behavioral changes, and it’s pretty clear that when the tax rate on capital gains is lowered,

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there will be a number of induced realizations. By our estimates on this particular proposal, as an illustration, we would pick up $16.9 billion in tax revenue. So at
this point, there's a net gain of $4.7 billion per year.

Next, we can look at what the macroeconomic response would be. We have estimated, and so reported in testimony, that there would be roughly a $3-5 billion increase in revenues from an increase in real national income if we had a similar kind of permanent capital gains tax reduction. This doesn't happen immediately. It doesn't happen in the next three, four, or five years. It happens as a result of lowering the cost of capital, which a capital gains tax cut would do, and crea-

changes, it's probably not going to have a great influence on the decision of people to have larger or smaller families. It's just not the kind of money that's going to influence people's behavior in that re-

spect.

To take another example, if we had corporate integration of some sort and took away the double taxation we have now — incidentally, we're probably one of the few countries in the western world that has that — how would that affect behavior? Clearly, dividend behavior would change. Tax on dividends pay-

outs would go down. We would expect dividend payouts to increase. We would expect retained earnings to decrease relative to the current situation.

Another easy example: how would charitable giving change if the tax rates changed? What if we put a floor or ceiling on the amount one could deduct? Clearly, that kind of behavior is built into the estimates we do, and the estimates the Joint Tax Committee does. Returning to the example of capital gains realizations, they would be changed, sped up if you will, if the rates dropped. We don't
have the identical estimate that the Joint Tax Committee has, but we have very nearly the same estimates. We both believe there is going to be a large increase in the amount of gains that will be realized, so these are the behavior changes that we always try to put in the estimates. They're not always significant. If they are, we hope we capture them. That's part of what we're trying to do.

The macro responses are worth talking about. What I mean when I talk about the macro response, as opposed to behavior, are things that change the basic elements of the macroeconomic forecast. For example, when we lower the marginal tax rates, what will be the response of the labor force, particularly among married women who are probably the most responsive group when we change the tax rates. This kind of response, most experts will tell you, is there, but it probably takes five to seven years before you notice it. How do we handle that? We handle that through the macroeconomic forecast. When we propose something

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like tax reform, it’s built into our budget forecast. Our budget forecast of how the economy will perform is always conditioned upon the Administration’s proposals on the spending and the tax side becoming effective. So if something is being proposed, then that is ground into the forecast. I’m not claiming it’s always done accurately. We can make mistakes, but in principle we always have those kinds of responses in the forecast.

Another example: how would economic growth be affected if we changed depreciation policies? Real investment, we expect, would change. Again, we put that in the macroeconomic forecast that gets into the revenue base in that respect.

Why don’t we make these kinds of estimates each time we make a revenue estimate? Apart from the reason that sometimes you only have half a day to do it, there are some other reasons. First is the level of detail. When you’re painting with a broad brush, it’s difficult but possible to capture these macroeconomic responses. In other words, when there’s a big policy change, a clever macro-modeler can get that into the model and he can see four, five, maybe even six years out, how that’s going to affect the economy. But when you’re painting with a fine brush, it’s nearly impossible. Even the best models are just too blunt an instrument to detect minor changes. We simply can’t model them. What we’d
essentially be doing is putting in the output from the model. The model would not be telling us the right answer, and what we would inevitably end up doing is grouping proposals into policy packages. That's not a bad idea, and in fact, that's exactly what we do today.

A second problem, which in the broad sense is a political problem, is that there would be room for enormous mischief if Congressman A can claim that his $10 billion tax cut raises more of these feedback revenues than Congressman B's $10 billion tax cut. Of course, he'd say, "Don't take my word for it. Look at my computer output. I paid a lot of money for it." The problem is that generally Congressman A's policy is going to be considered by the Committees as a substitute for Congressman B's policy and, in fact, they're going to have the same macro responses. So the question is, are we really serving policymakers by serving up this kind of "blue smoke and mirrors," or are we better off looking at these in isolation?

The last problem with putting a macro response on each individual estimate is the double-counting problem which is probably as important as any of the others I've mentioned. Fiscal policy aggregates are often set rather early in the game. For example, Gramm-Rudman-Hollings might be setting the stage for how the budget is going to look next year, or we may have one of these independent deficit reduction summits between the Administration and the key leaders on the Hill, where they would say, "This is what we will be doing. We're going to set the deficit and this is going to be the answer." On the other hand, we just may have the President's budget which prescribes a certain fiscal policy goal. Then Congress, while they may be willing to aim for that deficit goal, will substitute different policies for it.

In any of these cases, the debate is really on the alternative ways of getting to a revenue target. Therefore, differential macro impacts are probably not the important focus in this kind of debate. Indeed, as I've hinted, to add a macro feedback to the President's budget deficit from a package of proposals Congress is looking at, when that package is really a substitute for what the President may have proposed, would clearly lead to double counting on the deficit side.

Returning to the theme of conflict versus consensus in revenue estimating, conflict can be seen among estimators or between estimators and taxpayers. Either way, though, as people better understand what we are doing, and what our product is, I would conclude that we are evolving toward consensus. On the other hand, a greater emphasis on revenue considerations in making policy decisions will cause greater conflict, particularly with private interest groups who have an interest in how that policy ought to be coming out.

Within government, consensus is probably the norm. Much of the apparent conflict between CBO or Joint Tax, which uses the CBO forecast, and Treasury are often explained by divergent
economic forecasts. Again, capital gains is a good example. There are differences between Treasury and Joint Tax Committee on the capital gains. But the difference, if examined closely, is really fairly minor. Agreements are the norm, rather than differences. The sharp focus of this whole policy issue on revenue estimating, in the capital gains area, is unfortunately on our differences. While rather minor, they are switching the sign on the bottom line with respect to the President's program. Because of the magnitude of the numbers we're involved with, this has turned a rather small difference into the kind of disagreement that will continue to make headlines.
In my former role on the Senate Budget Committee, I was a consumer of revenue estimates, so my view on the balance between consensus versus conflict is a little bit different. We were the ones who would be confronted by a Member saying, "I want to introduce this amendment. This is the number that the Joint Tax Committee is giving me. How can this possibly be true when there's only one corporation in my district that produces the product that falls under this provision?" So, I can easily understand the genesis of our topic, and I think the Tax Foundation has raised a relevant issue.

I'm going to make a few points today on the budget outlook, then move on to the fact that, irrespective of great discussions about raising or lowering taxes, we're likely to see a tax level that is not going to vary much in terms of the overall tax burden for the foreseeable future. One problematic result of this is a series of tax bills that tend to be small in terms of the aggregate amount of revenue that they raise. They are usually composed of many individual provisions, and yet tend to have a disproportionate impact on one business or one industrial sector or one set of business decisions. It is from the nature of these tax bills that a lot of the conflict surrounding revenue estimates and tax policy emerges. I'll conclude with a few observations as to what I think might be a positive program business might undertake to improve the overall situation.

First, looking out to the 1991 budget, there is much consensus that the 1991 target of $64 billion is going to be difficult to hit, but it will not necessarily be difficult for the numbers to appear to reach the bottom-line target. I would be surprised if the Administration, given its economic forecast and its assumptions with respect to implementation of policy, would begin from a baseline deficit level, in 1991, of much in excess of $100 billion. This would make the task in 1991 not appreciably different than it was in 1990, with one exception. We have introduced into the political arena defense cuts which substantially take the pressure off the need, real or perceived, for tax increases, both from the Administration's point of view and from the Congressional point of view."

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all tax burden for the foreseeable future. One problematic result of this is a series of tax bills that tend to be small in terms of the aggregate amount of revenue that they raise. They are usually composed of many individual provisions, and yet tend to have a disproportionate impact on one
tion's point of view and from the Congressional point of view. It is certainly true that the Congressional Budget Office will come out with a much higher deficit estimate. I might argue that that is a more realistic estimate than the Administration's in some regards, but the fact is that the Administration's estimates are binding for Gramm-Rudman pur-

poses. Given that we have this new pool of potential savings in the defense area and the clear reluctance of either the Congress or the Administration to fight to anything other than a stalemate on the tax issue, we're going to see defense take the brunt of the deficit savings in 1991. The tax issue, or the need for major structural change in tax policy, will be set aside for yet another year. Does that mean we won't have a tax bill in 1991? That is certainly not the case. As a matter of fact, in the "grand old days," when I first came to the Congress, we did a tax bill once every two years. Now, we've started doing a tax bill once every year, and it appears that since the extenders are now only good for nine months, we're going to do two tax bills a year. I'm not sure that yields better tax policy; in fact, it probably doesn't, but it certainly is a grand business for many colleagues who have gone into the accounting firms. We will have a tax bill next year, and a replay of the capital gains fight. We also will have the need to acquire another pool of small provisions, many of which will make up the bulk of some small revenue-raising package. This means that under Gramm-Rudman, given the focus on timing, and given the relatively small size of these tax bills, budget policy has virtually driven out tax policy. That is to say, tax policy has become essentially tactical rather than strategic. We have many complex changes relating to LBO activity rather than something that represents an economic judgement about the need to equalize effective tax rates across industries, as was the case in tax reform.

The second major aspect of this process is the importance of timing. Because of Gramm-Rudman, it's not necessarily what you tax, but when you collect it. I refer to that as a form of "just in time taxation." We used to have a process of regularly deferring taxes on current income. We're getting into the position in the budget process where we're really tempted to begin to collect taxes before people have earned the income.

The third point is that both of these developments, the predominance of tactical tax policy and the importance of timing under Gramm-Rudman, are driving us into areas that are more and more difficult to estimate. In the late 1970s, early 1980s, even through about 1985, and maybe even through tax reform (in fact, tax reform might constitute the break in this), we were estimating things for which there was a lot of publicly available data. There were some generally
accepted models for estimating the investment tax credit, depreciation, rate cuts and the like, that were the usual stuff out of which a tax bill was made.

Now we have these various provisions relating to LBO activity, all of which rely on judgments as to how much LBO activity there is out there, what the behavior is going to be of people in response to the changes in these provisions, and the revenue that is likely to result. Those are very, very difficult judgments to make for as disaggregated and dispersed an economy as we have.

A second good example is the movement, or merging, of environmental policy and tax policy. The current reconciliation bill has a tax on ozone depleting chemicals. This kind of thing represents a movement forward of the technology of taxation without a concomitant move forward in the technology of revenue estimating. The bottom line is that while these things are difficult to estimate, the burdens that result fall heavily on one business or another. An example is the alternative minimum tax, very difficult to estimate, yet the burden falls very heavily on a selected set of businesses. As long as we have the kind of parameters that are guiding the budget process and the kind of political stand-off that is creating this tendency to have more and smaller tax bills, rather than fewer and larger tax bills, we’re going to continue to have this intense type of conflict within the revenue estimating process.

In terms of a positive program for business, one of the things that business can do is to try and provide pools of public data in some of these areas, which are very difficult to estimate. To some extent, the accounting firms have served that function because they have a cross-section of clientele. They can come to the Treasury and the Joint Tax Committee and represent a very broad cross-section of information as to how a particular provision will affect a group of companies. But, still, given the restrictions on freedom of information in terms of taxpayer information, we cannot argue these things in the open as we can with generally available macroeconomic data, such as come from the Statistics of Income.

Of course, the second and related opportunity for business is to help the revenue estimators understand the interactions and administrative problems with a lot of these provisions. The most recent changes in the alternative minimum tax is a good example. It may have been that

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some of these problems are presented
and not heard, but it is a good example of
Congress having to go back and do some
retracking in an area where they've
implemented things that are just simply
very difficult to administer.

Finally, I would argue that while
there are many justifiable concerns that
go into the making of tax policy, both
with respect to distributional issues and
equity issues, it is appropriate for busi-
ness to raise the issue that if we are going
to have a given level of tax burden in the
economy, or if the tax burden is going to
be allowed to rise somewhat over time,
then we ought to try to maximize the
growth potential of that overall tax bur-
den. That is, in terms of the taxes that we
select to impose and in terms of the tax
provisions that we choose to change, we
ought to give a priority to economi-
growth. It is the key
decision element that Congress ought
to be looking at when it is evaluating
capital gains versus IRA provisions,
versus integration, versus a lot of
other issues. As long as we
continue to have this particular set of
forces at play in budget making, which
is, in effect, driving tax policy, we will
have a kind of guerilla warfare going on
within the lobbying, corporate and reve-
 nue estimating community. The guerilla

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warfare is going to continue because most
of even the small increases in the tax
burden are going to be borne by busi-
ness, and it's not going to be borne equally
across business, but rather by those spe-
cific businesses and sectors that are af-
fected by this labyrinth of provisions.
Questions & Answers

Q: The government officials on the panel seem a little peeved at the growing workload and how it’s becoming more difficult to do these revenue estimates, and Mr. Wilkins spoke about the positive competition from within the private accounting firms, many of whom have hired former JTC officials. Won’t it become practical some time in the future for the government to go so far as to commission some of these private firms? That might mean that the government would turn over sensitive information to these private firms.

Mr. Bernard Schmitt: The other approach, rather than asking the outside, the private sector to do the work, is just to expand ourselves and that’s what we’re trying to do right now. I think that there is a place for interaction with the outside, and we’re trying to do that more and more. I’ll let John speak to that and expand on what he was saying, but to the extent that there is a competition with the outside, or our being peeved about there being more work, I don’t see that as a problem. I listed some of the reasons why we were thrown out front here, and are now perceived to be much more important than we were a few years ago. We didn’t do that ourselves, it was thrown upon us. But now that it’s here, I don’t think that it bothers us. It would be nice to have more people, and, to some extent, I get tired of training people to go out and work for some of the accounting firms.

Mr. John Wilkins: Just to briefly add to that, I think it is safe to say that we feel that we don’t have the same kind of bias that somebody that’s being paid by a specific client might have. So in that respect, I think it is nice to have it done by Treasury or by Joint Tax. That’s not to say we’re not afraid of hearing the competition, if they have different views. We’re always interested in hearing those views and learning more information. But to answer your question, quite seriously, I think it would be unfortunate if the government privatized revenue estimating because I think that’s something that we do want to keep, in the broad sense, the political process out of. We’re here to provide the best answers, the most unbiased answers we can for policy-makers to make decisions. And as Bernie said, despite the political atmosphere Joint Tax has, there is not political pressure brought to bear on the revenue estimators, and I can say the same applies with respect to Treasury. The folks in the private sector are very clever. They’re at least as good as we are. I’m not saying that’s not a good thing. But certainly there would be the perception that they have an axe to grind that we don’t.

Q: In Mr. Wilkins’ and Ms. Fosler’s case, I don’t know whether I detect a conflict or a poorly concealed consensus. Mr. Wilkins, I heard you saying that revenues are driving tax policy these days. Ms. Fosler, you said that tax policy
these days is tactical rather than strategic. Is this a conflict between the two of you or am I missing something?

Ms. Gail Fosler: I think it's a consensus that with the budget driving tax decisions, people are not asking the question, "What is the appropriate tax policy for the economy? And, by the way, let's look at what the revenue implications are of that particular policy." They're saying, "O.K. We have to get $5.623 billion in revenue for the next fiscal year. And, by the way, we only need it for the next fiscal year because Gramm-Rudman only looks at one year at a time." And then, "Where is it that we get that particular revenue?" Usually the first place examined is timing changes. After evaluating timing changes, there may be some other policy issues like the concern about LBOs and whether or not tax policy doesn't foster LBOs. So, that might be a subset of the revenue raisers.

But, in fact, rather than going out and asking the question, "How should we structure the corporate tax system so that it," as John said, "equalizes the taxation on sources of capital and that kind of thing?" and then implementing that kind of tax policy, we are taking a piece of that in a very tactical way. In fact, we are precluded by revenue considerations from even asking the broader questions.

Q: What about the dramatic change in Europe and the future understanding that may come from Malta. That seems destined to provide a peace dividend. How do you see that in taxing? One, the budget deficit, two, the tax rates or revenues.

Ms. Kathleen O'Connell: That kind of information is generally factored in, indirectly, to budget estimates through the macroeconomic forecast. And, I think, at this stage, many years in advance of the actual result itself, even the factoring into the macroeconomic forecast is probably being done in a fairly qualitative fashion, rather than in a highly-sophisticated econometric fashion. So, I don't really have any view about how it will impact the budget, and I suspect its impact is pretty indirect at this point.

Ms. Gail Fosler: I'll just make a quick comment. The Administration has talked about $180 billion worth of defense cuts. Of course, that's from their assumed baseline. But that would be consistent with something on the order of, maybe, $10 billion of cuts in the first year. And that's going to take an important amount of pressure off the need to raise revenues. In some ways, the Congress has handed the Administration an advantage by not passing capital gains, because the Administration can serve up capital gains next year with a few of the revenue raisers we've been looking at for some time. Combine that with the defense cuts, and many of the spending cuts that they've proposed, and you reach the Gramm-Rudman target. But I think the most important long-term result is that while there has been a tremendous amount of pressure to raise taxes in order to raise domestic spending, and although it's often talked about in terms of reduc-
ing the deficit, this peace dividend, over the long run, opens up the opportunity to finance domestic spending. Given the fact that the Congress and the President really have been unwilling, for the decade of the 80s, to fight out the tax-raising issue, I think that's really going to be what happens.

Q: Do you think that the revenue estimating process could be improved if the factual information used more closely followed the way business accounts for its own profit? I have to assume that the underlying economic data is coming directly from business, in one way or another. But, you've got a considerable gap between the rules mandated for financial reporting purposes and those mandated for tax reporting purposes. I was just interested in whether the process of taking data and converting it into a revenue estimate would be an easier and more accurate process if the data used conformed to those that are used for financial reporting purposes.

Mr. Bernard Schmitt: My first gut feeling is that it would not have a significant effect. I think I understand what you're getting at, and there's a tremendous amount of differential rules in the code and the actual behavior, I mean the behavior of the firms, the way they actually have to operate. But for the most part, those are the kinds of things we can translate back and forth. The tougher part is getting that basic raw number of just how much money is involved, not how it's accounted for or how quickly it comes in.

Mr. Kendyl Monroe: So, it's your view that major differences between accounting rules for financial reporting purposes, which is what the published information is, and tax rules don't significantly affect revenue estimates?

Mr. Bernard Schmitt: They would not significantly affect the pain that we go through, although I'm sure that it almost kills you. I can understand the things that we see, and for political reasons, or whatever, it's got to just cause you a ton of heartache. I just don't think it would have a big effect on the accuracy of our estimates.

Ms. Kathleen O'Connell: I think that, while I don't disagree with Bernie on the bottom line, I think one thing that it would do is to make publicly available data sources more accessible and more applicable to revenue estimating. But, that in and of itself, is not a panacea.

I might take this opportunity to address the earlier question about the government contracting with consulting firms for revenue estimating. There are lots of occasions for the government to contract with private companies to purchase data sources, including the kinds of data sources that would be applicable to revenue estimating, but that wouldn't really answer some of the very hard questions that one has to answer in order to compute an estimate.
Let me first respond to the basic theme of today's panel discussion, "Is the U.S. approach to international taxation becoming backdoor protectionism?" The short answer is no. It has long tended in that direction and I'm going to focus on the kind of protectionism that impedes overseas investment of the U.S.

During the early 1970s the tax protectionist movement became quite explicit when organized labor, particularly the AFL-CIO, organized a major campaign for these ends. As a principal constituency of the party that has long dominated Congress, labor had little trouble in putting their program on the legislative agenda in the form of the Burke-Hartke legislation. This initiative would have delivered a 1-2 knockout punch to U.S. multinational industries. The plan was to accelerate the tax on unremitted overseas earnings and subject them to double taxation by substantially eliminating the foreign tax credit.

The effect would have been to dramatically reduce after-tax returns on the overseas investment of U.S. multinationals, that is, raise their cost of capital to levels that would make it impossible for them to compete in global markets. Had that legislation been adopted, I doubt that you would now be listening to me. Instead, you might be hearing the representative of a Japanese or German company complaining of tax rules affecting their U.S. subsidiary.

The underlying belief behind the protectionist campaign was the idea that a dollar invested overseas was a dollar lost to U.S. investment and that a loss in U.S. jobs and exports would follow. The implicit vision is of an isolated U.S. economy whose interaction with other economies is limited to the export of finished goods, importing nothing and running a large trade surplus.

If this sounds familiar to you, it should. It is the same idea of national economic welfare as that propounded by the 17th century mercantilists. It is an
interesting historical fact that the tax protection campaign shares the assumptions of the mercantilist group that there is only so much trade and investment to go around and that nations have to fight for a bigger share of a fixed pie.

"Had [Burke-Hartke] been adopted, I doubt that you would now be listening to me. Instead, you might be hearing the representative of a Japanese or German company complaining of tax rules affecting their U.S. subsidiary."

Of course, these assumptions are utterly wrong. Global investment is today highly mobile across borders. Experience has shown that those companies that invest overseas also invest more at home. Those which create jobs overseas create jobs at home, and they increase exports as well. These facts have been repeatedly supported by academic studies, and they represent the experience of my own and many other companies.

In fact, U.S. economic welfare is best served by participating in international economic integration. In Europe this is well understood as evidenced by Europe 1992, the campaign for economic integration. European politicians are trying to help their domestic economies by facilitating trans-border investment and economic activity of all kinds.

Fortunately, the Burke-Hartke debate took place when Congress used to hold hearings before enacting drastic legislative measures affecting the economy, and Members took an interest in matters reaching beyond the Gramm-Rudman snapshot. While Burke-Hartke provoked an avalanche of criticism and could not get in the front door, the underlying assumptions, nevertheless, have continued. A revenue-driven series of incremental changes has brought us a long way toward what was originally sought—tax rules that tend to isolate the U.S. from the world economy. This has occurred just as the foreign competition has come up to full competitive speed and as impediments are coming down elsewhere.

Let me first discuss the progress made toward the Burke-Hartke objective of eliminating the foreign tax credit as an effective device to prevent double taxation.

First, the reasonable proposition that costs related to international income should be allocated to it in calculating the foreign tax credit was blown up to produce quite unreasonable results in many instances. The Section 861 Regs.
issued in 1977 allocate large pools of domestically-incurred expense to foreign income under rather nebulous and indeterminate standards drawn mainly to

"... the most severe damage to the foreign tax credit's ability to prevent double taxation was inflicted by the 1986 act."

maximize U.S. tax revenue rather than to produce a roughly equitable result. Often the effect is to swamp the limitation formula and produce double taxation. This is particularly apt to happen where foreign income of an enterprise is only a fraction of its total operations.

Second, the baskets approach artificially divides up overseas operations so as to limit credit. Under these rules the taxpayer must separately calculate the foreign tax credit for various types of income, rather than consider the taxes incurred by the overall business activity.

From the businessman’s point of view, his integrated business activities will necessarily involve a variety of transactions that generate a combination of high and low effective rates. If he cannot average, he pays more U.S. tax on low-tax items but does not get credit for those high-tax items. The result is double taxation of a sort as compared to foreign business firms who suffer no such rules.

There were many other changes, too numerous to list, put forth under varying partial rationales, but generally designed to dilute and reduce credits. However, the most severe damage to the foreign tax credit’s ability to prevent double taxation was inflicted by the 1986 act.

First, capital cost recovery on domestic operations was sharply lowered, and many deductible items were henceforth required to be capitalized or inventoried. These and other changes artificially expanded the domestic corporate taxable base far beyond international norms. A small amount of this expansion was offset by reducing the nominal rate from 46 to 34%.

Presto, the credit evaporates, although the U.S. burden on domestic income is higher than before. Because other countries maintain higher nominal rates albeit on much lower bases, foreign taxes paid appear to be in excess of the U.S. 34% rate and cannot be credited.

The second part of the Burke-Hartke protectionist agenda was the plan for accelerated taxation of unremitted earnings, the so-called “deferral issue.” Over the years there has been a continual expansion of Subpart F rules for current taxation of overseas earnings. But the real joker may turn out to be the one-line commensurate-with-income amendment to Section 482 that appeared in the 1986 act. It was reportedly adopted to deal with certain abuses in the royalty area, and inserted without hearings, without testimony, Member sponsorship, or, perhaps, even understanding.

The measure was inserted under a revenue estimate so low as to suggest that nothing of consequence was occur-
ring. Under this amendment the staff has effectively overturned the entire field of arms-length international practice. Although the authors claim not to have done so, many domestic and foreign commentators are of the view that such is the effect of that amendment.

The Treasury-IRS White Paper, issued last year, sets forth the meaning, as they see it, of that amendment. Pursuant to the White Paper we learn that any product that makes above a nominal profit is presumed to involve intangibles of great value. The White Paper would deny any more than a nominal overseas profit to genuine economic inputs under a complicated methodology referred to as the basic arms-length return method.

"It appears that an effort is being made to issue something of a blank check to IRS auditors to decide, backed up by the usual formidable procedural presumptions, what profit, if any, shall be allowed to remain to overseas operations, particularly in those countries that have chosen to develop their economies by not taxing capital."

A prominent authority on the economics of transfer pricing, Dr. Irving Plotkin, describes the methodology as economic nonsense. It appears that an effort is being made to issue something of a blank check to IRS auditors to decide, backed up by the usual formidable procedural presumptions, what profit, if any, shall be allowed to remain to overseas operations, particularly in those countries that have chosen to develop their economies by not taxing capital.

What is often overlooked is the way that audit and enforcement activities bolster the agenda. Suffice it to say that last year the IRS raised $9.6 billion from the approximately 1,500 taxpayers in the large case coordinated examination program, an increase of 30% over the prior year. Nearly all of it was in foreign tax credit disallowance and intercompany pricing adjustments.

From taxpayers representing what I estimate to be about 2% of the U.S. taxable income, more than 50% of all audit adjustments were made, mostly from issues over which reasonable men usually can differ. Huge adjustments are proposed and must be negotiated in an essentially standardless environment. In these circumstances, businessmen cannot reasonably predict the economic results of their international operations. This uncertainty is itself a significant disincentive to global competition.

Query: how much revenue raised by this means is meaningful enforcement, and how much is simply the use of the uncertainties of nebulous law and overwhelming procedural advantages to extract large amounts of revenue from companies that have often made every reasonable effort to comply?

Tax auditors in foreign countries generally look to local economic inputs to see that a reasonable income is being earned under all the circumstances. If so,
International Taxation

that is usually the end of the matter. In contrast, U.S. auditors look all over the globe to try to find earnings and then seek to develop rationales as to why it

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should be taxed by the U.S., currently and without offsetting foreign tax credits.

Much of the U.S. approach could perhaps be characterized as an unpredictable surtax on international operations. Efforts are under way to increase this already heavy concentration on the few as part of a revenue-inspired conception of tax administration that badly needs rethinking.

The consequences of these trends is the achievement, partially, perhaps substantially, of the original objectives of the tax protectionist movement. Today the U.S. has the most complex and extraterritorial system in the world for the taxation of international operations. No other industrial nation comes close. One would think that this fact alone would give pause to any reasonably open-minded person concerned about U.S. economic welfare in today's rapidly integrating global economy.

The work of the tax protectionists is increasingly dangerous to U.S. economic welfare because other nations have rapidly closed the competitive gap. We are in a neck and neck race and can no longer afford to handicap ourselves with a unique approach to international taxation that is out of line with the norms of other nations. Our system serves only to drive up the cost of capital and increase the risk for precisely those industries that are on the leading edge of technological innovation and are in the forefront of our nation's struggle to keep up to speed competitively. Such a system will not really work to achieve its ostensible objectives. It will simply cause economic development to shift elsewhere. If the system is made airtight as to U.S. multinationals, then foreign multinationals will be the beneficiaries.

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We are not merely talking about U.S. competitiveness in foreign countries. We are talking about economic survival at home. That we should be
doing ourselves so much harm with our
tax policy for such trivial ends is amaz-
ing. It is ironic that while we have made
considerable progress in reducing trade
protectionism through GATT and other
negotiations, tax protectionism is proba-
bly at its high-water mark.

Foreign retaliation to the White
Paper and increasing treaty overrides
will not be long in coming. Harry Tru-
man once said, “The only new thing in
the world is the history you haven’t tread.”
In this case the history that’s being ign-
ored is what Adam Smith and David
Ricardo and David Hume had to say
about international trade, including di-
vision of labor and comparative advan-
tage.

Also being ignored are current
events, including the global economic
integration that is taking place in front of
our noses. Yet only recently, a prominent
government tax economist said that it
made no difference to the welfare of the
United States if Digital could make and
sell computers in foreign countries. This
is like saying it makes no difference in
Massachusetts, Digital’s home state, if
we can sell computers in Connecticut or
California.

If we don’t succeed overseas we
won’t long survive at home. Leading
edge industries are global, not local, and
have to be in order to survive. In fact,
more than half of Digital’s sales are over-
seas.

George Orwell once said, “We have
come to the point where the first duty of
every intelligent person is simply to point
out the obvious.” To put it in the simplest
possible terms, just ask yourself what the
U.S. domestic economy would look like
if something like the national rules were
applied by each state. Our economy grew
to what it is today because of national
economic integration, a transition from
isolated colonies to a great national
market.

Today, borders are shrinking and
the U.S. itself is like one of those colonies.

“Our economy grew to what it is today
because of national economic
integration, a transition from isolated
colonies to a great national market.”

As George Malone of The Wall Street Jour-

nal has pointed out, “Political grand-
standing on behalf of fortress America
makes little sense when the rest of the
world is busy taking down barriers,
harmonizing and integrating.” We need
to complete the process of tax reform
with a major overhaul of corporate taxa-
tion in the direction of a border-adjust-
able system that eliminates both domes-
tic double taxation of capital and inter-
national double taxation of earnings.

We urgently need to assure that our
leading industries carry no heavier a
global burden than do their foreign
competitors. For the Bush Administra-
tion and Congress and for our future
economic welfare, there should be no
higher priority than reversing the slide
into parochialism that has characterized
our international tax policy.
This means pulling back from extraterritoriality and unilateralism, with all the risk on the back of the U.S. taxpayer. We must move toward an approach which relies on consensus within the business community, and with the tax authorities of other nations in developing equitable rules based primarily on U.S. taxation of U.S. source income, whether accomplished by a source approach or an effective global credit system.

This is the sort of regime that will enable the global economy to prosper and U.S. firms to have a fair shot at success.
Philip Morrison

First, I want to make clear that I do embrace Treasury's and, I think, most economists' general policy of promoting open foreign trade and open foreign investment. As stated quite well recently by Deputy Treasury Secretary Robson, "We continue to welcome market-driven foreign investment in the United States and seek to liberalize investment policies abroad. Our policy rests on the beliefs that capital must be free to flow to its most efficient use. That free capital movement maximizes productivity, fosters economic growth and enhances standards of living throughout the world. And that economic nationalism should not undermine the optimum allocation of resources."

This policy, with some important divergences, dates back in the Treasury Department, at least, to Alexander Hamilton. It's based as Hamilton said, "not on theory or sentiment but on economic self interest." As the world does better, the United States does better. What this policy portends for tax policy, however, is not always clear.

Taxes, when viewed in isolation from what they pay for, are always going to increase the cost of capital and reduce profits. Unlike historic trade barriers like tariffs, an income tax is not fundamentally and purposely aimed at distorting the free-flow of capital and forcing, for a transitory local benefit, global economic inefficiencies.

Trade protectionism by design intends to alter economic choices that would be made differently in the absence of those trade measures. What is termed by some as tax protectionism has no such design. Indeed, the opposite is what is generally intended. The argument is really whether it achieved it or not.

The intention is to take taxes out of decisions that should be driven by economic efficiency, not to put them into it, and to leave economic choices where they would be in the absence of taxes. Investment in plant and equipment and jobs, either in the United States or offshore, should be based on economic efficiency, not on whether taxes are higher or lower in a given location.

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In a world where different countries may set radically different effective tax rates, however, business decisions may be based on taxes, thus taxes appear to be put unwillingly back into the calculus. This phenomenon causes tax neutrality to mean different things to different people.

A representative of a U.S.-based multinational, for instance, will complain that the U.S. tax system is biased against
U.S. multinational investment overseas, particularly in tax havens, to the detriment of such a company's competitive advantage vis-a-vis a multinational from another country. For example, in Switzerland the earnings of a foreign subsidiary, even when repatriated, are generally exempt from home country taxation.

A representative of a foreign-based multinational, on the other hand, will complain that the U.S. tax system is increasingly hostile, or at least threatens to be hostile, towards foreign investment in the United States. While I have some sympathy for both positions, I have somewhat greater fears, with respect to the current potential, for irrational damage to foreign investment in the United States. The conscious, and actually stated, disregard shown by Congress in recent years has hindered our attempts to harmonize international taxation through tax treaties.

This greater fear on the inbound side is also based on my belief that such harmonization, elusive though it may be, is the best path to solutions to both the inbound and the outbound complaints. It more adequately recognizes the growing globalization of the marketplace. This doesn't necessarily mean that I believe tax treaties are the chief means to achieve a desired end. Perhaps more important is the unilateral rationalization of the U.S. tax system to invite, and more importantly to enable, greater harmony.

The criticisms that are leveled at the current system by a U.S.-based multinational are probably well founded. Acceptable transfer prices, particularly for intangibles, are, at least under today's scheme, guess work, both by taxpayers and by the IRS. The multiplicity of the foreign tax credit baskets; the discontinuity of those baskets with other credit systems like the per country approach that many take; and the complexity and occasional inequity of the U.S. allocation rules create some real potential for double taxation. Finally, Subpart F does not always work in predictable or rational ways. All of these conspire to make some U.S.-based multinationals less competitive than some of their foreign competitors. These admitted problems do not lead one to the conclusion that the U.S. should abandon residence-based taxation, however, and move to a territorial system. To understand why, let us review what I call the three basic theories of international taxation: capital export neutrality, national neutrality and capital import neutrality.

Capital export neutrality argues that tax issues should not affect the U.S. multinational's decision to invest either in the U.S. or overseas, lest inefficiently large amounts of capital are invested in
low-tax or no-tax jurisdictions. It strives to achieve the same worldwide economic allocation of resources that would occur in the absence of any taxes. Thus, under capital export neutrality, all of the U.S. multinational’s income worldwide should be taxed by the U.S. If deferral were repealed, our present system would come close to a capital export neutrality.

National neutrality was put forward in the Burke-Hartke Bill in the early 1970s. It argues that the decision between overseas or U.S. investment should be neutral, not from an economic perspective, but from the U.S. fisc’s perspective.

"Therefore, tax policy makers are reluctant to start down what they consider a slippery slope of exempting activities from taxation simply because it's considered a good to the U.S. economy."

Thus, this approach would not only repeal deferral but would also repeal the foreign tax credit so that Treasury collects nearly the same amount of revenue whichever way the investment decision goes, U.S. or foreign, even when the foreign tax rate is as high as the U.S.’s. This approach, while contending that it is aimed at maximizing U.S. interests, rejects the belief that many, including me, hold. The U.S.’s own interests are best served by rules that lead to global economic efficiency, not those that sacrifice global efficiency for an elusive and always temporary national advantage.

Capital import neutrality, the third approach, argues for a territorial tax system. Proponents of capital import neutrality do not agree that foreign activities take place at the expense of domestic ones. They cite considerable empirical evidence that in fact, the reverse seems to be true, that U.S. multinationals’ foreign activities may cause them to expand domestic employment and activity. Their conclusion is that it is a mistake to worry about a trade-off between domestic and foreign activities of U.S. multinationals.

Instead, if activities can most profitably be done in a no- or low-tax jurisdiction, some firm will do them there. Thus, the real trade-off, they argue, is whether they will be done by foreign-based firms or U.S.-based firms. It is self evident, at least to this school, that U.S. welfare is maximized if the latter occurs.

Although these arguments have been made by many business leaders for many years, they've only been partially successful in convincing U.S. tax policy makers. One problem may be their emphasis on maximizing U.S., as opposed to global welfare. This objective can just as easily lead to the opposite conclusion. Indeed in a national neutrality school, the Burke-Hartke folks also claim to achieve their goal. They recommend just the opposite approach, a drastic increase in the U.S. taxation of foreign direct investment abroad, rather than its elimination.

Another problem with capital import neutrality and territoriality may be
one of perception. One can interpret import neutrality’s call for a territorial treatment as saying that foreign direct investment of a U.S. multinational is good

"Territoriality . . . is only an incomplete and inadequate step toward addressing the competitive issue. A more complete response that doesn’t result in misallocations could gut the income tax. Indeed, this is why Japan and the U.K. have predominantly residence-based systems, like our own."

for the U.S. economy. Therefore, it should not be taxed by the United States. The problem is that tax policy makers hear this argument about many activities, including home building, oil drilling, venture capital, and even the provision of business lunches.

Therefore, they’re reluctant to start down what they consider a slippery slope of exempting activities from taxation simply because it’s considered a good to the U.S. economy. The difficulty lies in drawing the line at the truly deserving ones. Recent analyses of a recurrent international tax policy issue provide even a better example of the slippery slope problem.

The issue is the so-called runaway plant problem. The proposal would repeal deferral for income of U.S. overseas subsidiaries that produce for export back into the United States. The analyses in opposition to this proposal point out that foreign firms also produce for the U.S. market. They are not taxed currently or at all by their home countries if they locate in a low or zero tax location, at least not some of them.

Low-tax operations of U.S. subsidiaries should not face tax at the U.S. rate, therefore, the argument goes, because they would be put at a competitive disadvantage. The problem is that purely domestic U.S. companies also compete with lightly taxed foreign producers that import into the United States. Further, other domestic companies are exporters and they compete with foreign firms which may be lightly taxed.

It’s difficult, therefore, to know where to draw the line. On the competitiveness point, it is inadequate merely to adopt capital import neutrality and the territoriality it suggests. The competitiveness argument requires tax exemp-

"The recently defeated proposal to deny an immediate deduction for offshore R&D, a pro-U.S. located research bit of protectionism, is but an extension of the heretofore uncriticized, but equally protectionist denial of the R&D credit for offshore research. And the protectionist R&D credit is but the most-recent progeny of the protectionist investment credit, which was not permitted for property used offshore."
for foreign direct investment. At least for a large-market, industrialized country like the U.S., true capital import neutrality would result in marked erosion to the U.S. tax basis since anyone, i.e., nearly everyone who faces foreign competition, would have a good argument for a claim to exemption.

Territoriality, therefore is not a good answer. It's only an incomplete and inadequate step toward addressing the competitive issue. A more complete response that doesn't result in misallocations could gut the income tax. Indeed, this is why Japan and the U.K. have predominantly residence-based systems, like our own.

If territoriality is to be rejected, so should protectionist remnants of territoriality also be discarded, or at least new ones not adopted. While I would not go so far as to suggest the elimination of all source-based U.S. taxation of foreign investment in the United States, I will argue against the creation of any new source-based taxes, such as the recently rejected capital gains tax on foreign shareholders. I'll also argue against unilateral overrides of treaties which are intended to mutually reduce source-based taxation. And I'll also argue against discrimination against foreign persons investing here or discrimination in favor of U.S. persons.

These problems are the real evidences of the use of the tax system as a protectionist tool. While they're not really new, they have got a new focus recently because of the increasing competitive difficulties that U.S. firms seem to face abroad. Indeed, there are protectionist provisions strewn throughout the Code, some of which are quite old.

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"Economists increasingly write that multinationals' major contributions may be to undertake activities like research and goodwill development, that only large companies can successfully do, and equally importantly, to compete among themselves to make sure that these activities don’t occur at the expense of monopoly distortions."

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protectionist denial of the R&D credit for offshore research. And the protectionist R&D credit is but the most-recent progeny of the protectionist investment credit, which was not permitted for property used offshore.

It's also the progeny of the protectionist energy credit, same as the investment credit; the protectionism in denying accelerated depreciation for offshore property, much more important under ACRS but still an element; and the protectionism of denying higher rates for percentage depletion to offshore mines, to name just a few.

Assuming these protectionist pro-
visions can be eliminated and new provisions like them fended off, what more can be done? If one rejects territoriality, what does it mean for the future of U.S. international tax policy? Do I, Phil Morrison, advocate the repeal of deferral? And, if you disagree with me in rejecting territoriality and advocate the adoption of a capital import neutrality system, should you work for the territorial system of taxation?

The answer is that it doesn't really matter any more. Capital export neutrality and capital import neutrality are increasingly irrelevant in the increasingly globalized economy. To prove the point, I would like to look to the chief policy implications of the two theories.

The repeal of deferral, for example, was the biggest issue for capital export neutrality proponents for years, but it no longer is very significant in terms of increasing federal revenues. The latest estimates show that the revenue loss due to deferral is only about $100 million a year. Even this number may be too large, because it does not consider collateral issues that would be raised by a proposal to repeal deferral.

Repealing deferral in the purest fashion, for example, would require treating overseas subsidiaries just like branch operations. This treatment, of course, could reduce U.S. tax, since losses of overseas subsidiaries would be available to reduce U.S. taxable income, a situation not currently present. Even more important would be the effect on the allocation of interest expenses in the foreign tax credit calculation.

The Tax Reform Act of ’86 stacked the rules heavily against foreign subsidiaries in this regard. Treating subsidiaries as branches, however, would unstack the deck, effectively instituting the worldwide fungibility solution to this disparity. Worldwide fungibility was considered during the Senate deliberations on the ’86 act. Estimates done at the time show that it would cost several times the $100 million that the tax expenditure budget lists as the annual cost of maintaining deferral.

On the opposite side is the adoption of the sort of territorial system that Germany has, for example. The participation exemption system may have a detrimental impact on some U.S. multinationals and may not lose any revenue as a result even on a static basis, if collateral issues are decided in the fashion that I can assure you Congress will decide them.

First, those multinationals now in an excess foreign tax credit position, or at least those in an excess position in the general basket, and I think there are plenty, pay more than enough foreign tax on such income to offset all U.S. tax on that foreign income. These companies are not going to pay U.S. tax on foreign general basket income whether the law is changed or not.

Second and more important, consider the collateral issue of the allocation of interest expenses. One would think that a participation exemption would significantly reduce the effects of these
rules because they govern the foreign tax credit limitation, which no longer would be a major issue under a territorial system.

However, they could be brought right back into force by applying another principle of tax law that interest expense corresponding to tax-exempt assets should not be deductible (Section 265).

imply, many think, that multinational corporations no longer play a significant role, or at least not the dominant role, in allocating capital efficiently worldwide. Instead economists increasingly write that multinationals' major contributions may be to undertake activities like research and goodwill development, that only large companies can success-

“A useful starting point may be to consider what would happen if both the multinational's home country and the country hosting its activities had a tax system that was exactly like the United States'. If any of the multinational's income would be taxed twice, or if any would escape taxation completely, then the U.S. tax system would seem to be flawed as a model either for other countries to follow or as a starting point for negotiations for what we hope will be future harmonization. They should, therefore, be unilaterally changed by the United States.”

Assets in foreign branches and subsidiaries, which under a territorial system would be exempt from tax, account for a significant fraction of many U.S. companies' assets. A participation exemption proposal that disallowed a corresponding fraction of the U.S. companies' interest deductions almost certainly therefore would be a net revenue raiser.

The two major policy implications of the two basic competing theories really do not matter much any more based on this analysis. In this new environment discussions of tax policy toward foreign direct investment income should be based on a fresh approach. The presence of vastly expanded international capital markets over the past twenty years fully do, and equally importantly, to compete among themselves to make sure that these activities don't occur at the expense of monopoly distortions. International trade economics has made progress recently in studying these activities.

Unfortunately this work has not yet been applied to international tax policy issues. Preliminary speculation, however, seems to indicate that an important goal for tax policy toward multinational corporations may be to harmonize the tax systems of the major multinational corporation home countries. A useful starting point may be to consider what would happen if both the multinational’s home country and the country hosting its activities had a tax system that was exactly
like the United States'.

If any of the multinational's income would be taxed twice, or if any would escape taxation completely, then the U.S. tax system would seem to be flawed as a model either for other countries to follow or as a starting point for negotiations for what we hope will be future harmonization. They should, therefore, be unilaterally changed by the United States.

It's interesting to note that several of the most important new issues fail to meet this harmonizability standard. Again, taking interest allocation as an example, it can be shown that if both the host and the home countries use the current U.S. rules, some interest expense would not be allowed as a deduction anywhere.

Other aspects of U.S. law, either old or newly focused upon since tax reform, for example, the special source rule for income from exports, flunk the standard in the opposite direction. If both countries contain them, some income would escape taxation completely.

In short, it seems to me that this harmonizability standard may be a useful tool for identifying the aspects of current U.S. rules that require further analysis. It is this, and not a focus on the traditional capital export, capital import neutrality theories where the tax policy types like myself and others at Treasury should focus their attention.
I am going to focus on the rationale for some of the recent protectionist proposals that almost got in and their context. But the rationale behind efforts to abuse the tax code in order to distort allocation of investment keeps changing. It is a constant threat, and if we are going to fend it off, we have to fend it off with logic and evidence.

Going back to 1967, for example, *The American Challenge* by Servan-Schreiber predicted that by the 1980s the American multinationals would have bought up all of Europe. He was genuinely concerned about that, but of course it did not happen. Using the same excuse, the Latin American countries were so afraid of foreign investment that they actively almost banned and kept foreign investment out. Instead of getting foreign equity, they used government debt instead, and we know what happened after that.

In the United States throughout the 1970s, the big worry was that the American companies were building too many factories overseas, particularly in Asia, particularly in so-called tax havens. Now we’ve become a tax haven, and this problem keeps changing. If you remember the problem that Bill Modahl was primarily talking about, we were trying to keep U.S. companies inside the United States, not trying to keep foreign companies out. However, both of them are symptomatic of the same mindset. The mindset is that we want to stay out of the world economy.

In fact, in the 1970s U.S. investment opportunities looked so bad in this high tax, high inflation environment that Americans began looking for places to make investments and loans in such unpromising places as Poland and Peru. At that time, we were not a net debtor—we were a net lender. Some people still think that was a better situation, but I think it is safer to be a debtor than to make bad loans.

There is a tendency for those who object to foreign investment to equate it with debt even though much of it is equity. Using single entry bookkeeping thus means forgetting that there are assets to go along with these liabilities. The value of U.S. buildings and equipment, for example, went from $15.9 trillion in 1982 to $23.4 trillion in 1988. That far exceeded the increase in total debt, in-
cluding government debt. That does not even count land. It does not count the $2 trillion appreciation in the U.S. stock market.

Taking into account both assets and liabilities, net worth has gone up in the United States. The foreign investment is a goodly portion of that, and we should be glad to have it. The most fashionable anxiety today is not the old one of exporting jobs of the 1970s, but in fact the worry is that we are importing jobs, or at least by the same logic that must be the problem. Because instead of American companies exporting — doing their investing overseas — foreign companies are investing here.

Are we supposed to be concerned about Japanese factories producing cars and stereos in the United States? Are all of the many Swiss and German companies that dot the landscape of New Jersey also supposed to be a problem? All the foreign pension funds that are bidding up the prices of stocks and bonds in the United States are also alleged to be a problem, but I do not see why.

“There has always been a group in Congress that wanted to isolate and insulate the U.S. economy from foreign competitive pressure of any sort — goods, assets, anything — but no successful economy today can operate on the premise of isolationism.”

There has always been a group in Congress that wanted to isolate and insulate the U.S. economy from foreign competitive pressure of any sort — goods, assets, anything — but no successful economy today can operate on the premise of isolationism.

“There has always been another group of legislators, often the same legislators, that has been eager to protect the managers of poorly run companies from takeovers or buyouts of any sort, domestic or foreign, even though these takeovers might well enrich U.S. stockholders.

Both of these anticompetitive interests find common ground in thinly disguised efforts to discourage foreign investment by tinkering with the tax code or regulations. Several of the recent protectionist proposals were sneaked into the budget reconciliation process but most of them were finally booted out.

But the fact that they existed was indicative of the sort of thing that might be coming. One of them was an attempt to tax the capital gains on sales of stock in U.S. companies by foreigners who own more than ten percent of such stock. Since the wholly illusory estimate of tax revenue was no more than $5 million — that is million, not billion — obviously revenue was not the point. There was a hid-
den agenda at work, but the agenda was not too well hidden. *The Financial Times* caught it quickly with a headline that said “U.S. Plan Attacks Foreign Buyers.”

The proposal caused “considerable nervousness” among investors in the United Kingdom who happen to manage a lot of money. If the bill had passed I am quite sure that the collapse of interest in U.S. shares would have crashed the stock market, much as the mere hint of anti-takeover legislation on October 14, 1987, helped to crash both stocks and the dollar.

Retaliation against a proposal like that would be almost guaranteed. Why should other countries sit back and let us collect our hefty 28-33 percent capital gains tax on Japanese funds, European and other mutual funds that we buy. They would not do that very long. If we got into a kind of competition to see who could tax people who had never even set foot on their soil, there would be no capital gains revenue windfall anywhere.

“What conceivable problem could there be with foreign investment that requires such risky bullying of countries with which we have tax treaties — countries that do not do the same thing to us?”

because there would instead be capital losses everywhere as the efficient flow of capital around the world contracted.

Another amazingly provincial proposal would have disallowed deduction for research outside the United States. If that were enacted foreign parent companies would simply stop doing research in the United States, and instead license their research, and charge royalties to any surviving U.S. affiliates. Obviously, that would reduce U.S. corporate profits and therefore reduce corporate profit receipts.

There was another proposal dealing with earnings strippings which would have denied deductions for interest payments to a related foreign company, violating most existing treaties, as well as model income treaties, that deal with treating firms equally. Again, the real point of this sort of tax brutality is to penalize companies that have foreign parents.

What such proposals are making abundantly clear is that foreigners wishing to do business in the United States are not welcome. Among reporting requirements, there is already the witch-hunting committee on foreign investment which threatens slow and burdensome case-by-case disclosure on various national security grounds.

From this tendency in both regulations and taxes, it appears to me that some members of Congress want to build the tax and regulatory reporting equivalent of a new Berlin Wall around the United States. And this Berlin Wall is designed sometimes to keep foreigners out, or in the case of Burke-Hartke, to keep American investment in. Neither of those things are feasible and are certainly not desirable.
What conceivable problem could there be with foreign investment that requires such risky bullying of countries with which we have tax treaties — countries that do not do the same thing to us? Let's examine some facts of foreign investment.

"Japan, against whom most of the anxiety seems to be focused, is only the third largest foreign investor in the United States, way behind Britain and the Netherlands."

Foreigners hold about one percent of farm land, six percent of U.S. stock, thirteen percent of corporate bonds, and fifteen percent of government debt. U.S. direct investment in other countries still exceeds their investment here, although that is shifting some. Japan, against whom most of the anxiety seems to be focused, is only the third largest foreign investor in the United States, way behind Britain and the Netherlands. The Japanese mainly buy bonds or build factories. Real estate only accounts for five and a half percent of Japanese total investment. That is despite the nice resorts they have put in Hawaii, and some new hotels in New York, which is okay, too. In fact, if we did proper accounting and valued our U.S. investments in Tokyo real estate at current value rather than at what they cost ten, fifteen, or twenty years ago it may well be that we still own more there than they do here.

Half of Canadian manufacturing and a fifth of West German manufacturing is foreign-owned. They do not complain about that. In our case it is five percent. We worry about that. Foreign ownership accounts for a larger share of all major countries' stock and bonds. I mentioned it is thirteen, fifteen percent here, but that is true everywhere. That is just diversification. As pension funds and mutual funds offer people the ability to invest in various countries, everybody now owns more of each other's stocks and bonds. It is not a problem; in fact it minimizes risk.

There is even a Mexico fund listed on the New York Stock Exchange. Those who bought into it earlier in the year at $4 (it is now about 10 or 9 and a half), are going to have to pay capital gains to the United States, not to Mexico. Some 36 percent of German government bonds have been snapped up by foreigners in recent years although the share of U.S. government bonds has actually declined over the past ten years.

How could the fact that some foreign investors have a large share of a few companies mean they really control anything? They are not going to control our destiny. They can not force Americans to buy their products. They can not force us to buy their securities. They can not force us to work for them. They have to abide by the same environmental and
labor laws as any other firm.

Even if the proportion were much larger, if there were much more foreign investment in the United States, how could that hamper U.S. economic policy, which is sometimes said to be a concern? It supposedly means that the Federal Reserve cannot debauch the currency with impunity because if they did, foreigners would demand a higher interest rate to compensate for the exchange rate risk. That is equally true of American investors. If we debauch the currency, American investors will do as they did a decade ago — put their money in gold and Swiss francs. Therefore, losing the freedom to debauch the currency is not necessarily such a bad thing.

A lot of the confusion about foreign investment arises from zero sum thinking, namely the notion that the stock of U.S. capital is fixed, so that if some foreigners have more, we have to have less. Yet any American who sells stock or real estate to foreigners does not take the money and burn it. Instead they use the proceeds to provide equity or loans to some other business which they find more promising, and the total rises by the amount of foreign investment.

Recently a Japanese company bought a half interest in Rockefeller Center. To judge by some of the commentary, I think people really thought they were going to box it up brick by brick and take it back to Japan. There were some people talking about selling America cheap; it is just pure xenophobia. Letting foreigners bid for tangible and financial assets raises their value and makes Americans richer, not poorer. Restrictions on what assets foreigners can buy are also restrictions on what U.S. owners of assets can sell to the highest bidder. Imagine what would happen if we prohibited the Japanese people from bidding for Hawaiian homes, for example, and you will get some idea of what would happen to the U.S. stock and bond market if we discouraged European and Japanese investors from purchasing financial assets.

A lot of complaints about foreign investment are based on collectivist ideas about our property. We're selling our national property, as opposed to private property. The Rockefeller family has a perfect right to sell its real estate to the highest bidder. I have a right to sell my stock or my home to anybody I please, without checking their birth certificate. It's none of the government's business. It's what private property rights are all about. Some people even got anxious that Rupert Murdoch, an Australian, was buying up a lot of U.S. press. But then he became a U.S. citizen and that capital outflow suddenly became a capital inflow. He just put up his hand and changed the accounting.

"Many people are acquiring U.S. assets because they hope to settle here and bring with them great skills and capital. That has always been a source of strength, not weakness."
We are going to see a lot more of that. Many people are acquiring U.S. assets because they hope to settle here and bring with them great skills and capital. That has always been a source of strength, not weakness. It is a myth that the falling dollar from 1986 to 1989 made U.S. stocks and real estate a bargain for foreigners. In point of fact, if you believed what a lot of Harvard and MIT economists said, that the dollar would just keep nosediving ad infinitum, then that would also mean that the dividends and rents from U.S. assets would be devalued when converted back into yen or deutschmarks.

However, devaluing the income stream from an asset does not raise the asset's present value. In December 1977, The Economist headline read "America Going Cheap." This is an old story. The Dow Jones Industrial Average at that time was 823, and that was cheap, but it was cheap because few people, foreign or American, saw a bright future here. If that falling dollar had really made U.S. assets cheap, then the stock market would not have been at 823. Everybody would have been bidding up the price. That argument was not very good then, and with the Dow a whole lot higher than 823, it is a lot weaker now than it was in 1977. In fact, the interest of both American and foreign investors in the United States in the past seven years has persisted regardless of the exchange rate. Investment continued to flow to the United States with Americans repatriating and bringing back investments that they had previously put overseas.

In the first ten months of 1989, the dollar went up. But the U.S. stock market rose more than the German market, the Japanese market or the British stock market, and that is still true when measured in any common currency. What has happened is that the allure of U.S. investment opportunities has improved ever since marginal tax rates were cut in 1983 and 1988 and inflation tamed.

If a foreigner wants to invest in the United States, he has to acquire dollars, and he can only do that by selling off some of his goods or his assets. Since we do not want their assets as much as they want ours, they have to offer goods instead. And the result is a U.S. capital surplus and a matching current account deficit.

On the other side, countries that have a capital deficit, a phrase that should be used more often, the other side of their

"Many of the worries about foreign investment just simply involve naive identification of multinational firms with where their headquarters happens to be."

current account surplus, are choosing to invest some of their savings in the United States, rather than in their own country, thereby enhancing our future prospects. That means they expect, and they help create, better opportunities for profitable production inside the United States.

In a world where capital is free to
move with the speed of electronic communications, this whole mercantilist idea that current accounts should literally be balanced all the time really makes no sense. To have balanced current accounts, to have zero current account deficits, would mean zero capital flows. That's literally impossible. Impossible things should not be held up as goals. This quixotic quest for zero capital flows is the logic behind much of this effort to use taxation to drive foreign investment away.

The benefits from a foreign takeover of existing plants or hotels may not be as obvious as the benefits from brand new factories. But in point of fact, it is often more beneficial in providing new equipment, new management, and new capital to firms that are operating below potential. There was a piece in The New York Times not long ago that said that foreign takeovers of ailing U.S. firms "are creating serious competitive threats to American companies. For example, the Goodyear Tire & Rubber Company is threatened by the new more powerful Firestone." This is just special interest pleading. It is Goodyear's management, not American consumers, who feel threatened by a revitalized Firestone.

Bridgestone is a much smaller company, with much smaller sales than Goodyear. They plan to pour a billion and a half dollars into the old Firestone outfit in order to try to give Goodyear a run for their money. I wish them well. It is called competition, and it is not so bad. The alternative, probably, would have been to import more Bridgestone tires instead of fixing up the Firestone situation.

In an increasingly integrated world economy, it makes no sense to protect so-called American firms from so-called foreign firms within the United States, whether it's through tax policy or some other ways. Many of the worries about foreign investment just simply involve naive identification of multinational firms with where their headquarters happens to be.

Must we, for example, call Jaguar a U.S. firm because Ford bought it? And

"Honda is fast becoming mainly an Ohio-based producer, and if American investors bought a fifty-one percent share in American Honda, which they are quite free to do, in what sense would Honda be not just as American as, say, Ford?"

what about Ford itself? Ford imports the Scorpio from Germany, the Tracer from Mexico, the Capri from Australia. They also export the Ford Probe to Japan. But the Ford Probe is made in a Mazda plant in Michigan, and Ford owns twenty-five percent of Mazda. So are we to call Ford a U.S. company merely because its headquarters happens to be in Dearborn? Or, if that is the case, what would we call Mazda if they move their headquarters to Flint?

Honda is fast becoming mainly an Ohio-based producer, and if American
investors bought a fifty-one percent share in American Honda, which they are quite free to do, in what sense would Honda be not just as American as, say, Ford?

The British Chemical Company, ICI, produces about a fifth of its products in the U.S. They do not produce any more than that in the U.K. They are all over the world, and a fifth of its stock is owned by Americans. Mitsubishi runs “Buy American” ads. Why? Because most of its consumer electronics are produced in the United States. They have two semiconductor plants here. They have a popular new sports car called the Eclipse, all made in the U.S.A.

It is true that if we did not have so many of these foreign-financed enterprises, then we would not have to pay dividends. In fact, if we did not have any enterprises at all we would not have to pay anybody any dividends. Paying interest and dividends on investments and successful enterprises that are launched by investors in Zurich or London or Tokyo is no more a burden on the rest of us than if they lived in Peoria or Des Moines.

The U.S. has the labor income, which is vastly larger than the dividends. We have the resulting taxable corporate earnings, taxable personal income, taxable property and taxable sales. If investment is good, and it is, then more investment is even better, regardless who is clipping the coupons. Abusing the tax system in order to discourage such creation of taxable income, wealth and sales is a very fine way to reduce future tax receipts by tens of billions of dollars and to mark down the value of American assets in the bargain.

“Mitsubishi runs ‘Buy American’ ads. Why? Because most of its consumer electronics are produced in the United States.”
Mr. David Milton: As I listened to what I've heard this afternoon, it does sound to me as if we were slipping downhill away from free trade-oriented tax policies which I view as neutral tax policies. Now we have so many definitions of tax neutrality, though. I'm not sure where mine fits into that group.

I'm going to have to think more about Phil Morrison's comments. They're most interesting and do warrant a great deal of thought. It does cause me, however, to ponder why we shouldn't establish our foreign economic policy first; then fit our tax policy to it, rather than going at the tax pieces without knowing what our foreign economic policy might be. And, of course, if you look back to the 1940s, it seems that we did just that. But, there's a lot of thought in what Phil said, and we'll have to think about that.

I am a bit more familiar with what Bill Modahl was talking about. And, of course, protectionist sentiment always worries me because I can see it happening. Now, let's see if we have some questions.

Q: We've heard a great deal about capital export neutrality, but we haven't really focused very much on the impact of various foreign or international tax policies on U.S. GNP, U.S. welfare, and U.S. citizens' income. I was wondering if the three panelists might comment on which foreign tax system, or which U.S. taxation of foreign income would maximize U.S. welfare or U.S. income.

Mr. William Modahl: It's my belief that the definition of neutrality that will maximize the U.S. GNP is the one that facilitates global economic integration. And of the ones previously outlined, I tend more toward the capital import side, although not without qualification. I think if I might go on, I found some very interesting points in both of the other speakers. I wanted to comment about one or two points that Phil made.

I noticed when he discussed that these different things perhaps didn't make that much difference these days that his ensuing discussion was in terms of the macro level and in terms of the overall aggregate revenue impacts on the U.S. and so forth.

On the other hand, I think it's the micro level that's important. I think it's very important if a U.S. company which makes a certain critical component in a foreign country winds up with a vastly different tax rate than a U.S.- or foreign-owned competitor in that same circumstance. While it may not make much difference in terms of aggregate U.S. revenues, it may very well have a drastic effect on the economic fortunes of those two competitors.

And, if as Phil says, and I agree with this, we are not really talking so much in terms of the system to allocate capital internationally as we are the significance of the economic activities that are undertaken by the multinationals, then I think it's all the more appropriate to look at the
International Taxation

micro level. And so, I hope I haven't diverged too much from your question. But I think the point is that the GNP of the U.S. will be best under that system which enables effective competition in these crucial leading edge multinationals.

Mr. Alan Reynolds: I think this gets to my concern about neutrality in general. As a result of tax competition, i.e., the competition between New York and New Jersey, New York has somewhat reduced its marginal tax rates. The same thing happened internationally after Britain and the U.K. began to change the whole picture. And over fifty countries have substantially reduced their marginal tax rates, not their average rates, not their receipts which are often very strong, but their marginal tax rates. It's a more efficient way of funding government, and that's a good thing. That's a good thing internationally.

Mr. Philip Morrison: I think I'd like to take the Treasury Department's response to that, and perhaps more appropriately the Hill staff's response, and say that to an extent that's true. But does it really serve global economic well-being to drive, somewhat artificially I think one has to admit, production facilities to places like Puerto Rico, where outside of tax benefits there would be no economic reason to locate there, or at least little economic reason to locate there.

Although at the margin the argument makes perfect sense that a little bit of competition among taxing jurisdictions is probably a good thing. Unless you believe that there is no such thing as a public good and that taxes are not necessary to the well-being of the world and that we can do damn well without taxes altogether. I think it's a dangerous argument to say that totally tax driven or predominantly tax driven locational decisions are in general a good thing for global economic efficiency.

Q: If I could just add a follow-up on that, I really wonder whether it's the proper role of U.S. policy makers to try to maximize global welfare. It would seem to me that the approach would be to maximize U.S. welfare. And, I'm not going to ask you from a protectionist point of view, but I think it raises certain interesting questions with respect to whether or not you adopt a territorial approach or an overall foreign tax credit approach, or what have you?

Mr. Philip Morrison: The premise of your statement, I would argue, is protectionist. And protectionism, in trying to focus on what I think is a temporary U.S. advantage, actually does the U.S. no good over the long term.

Q: It's clear that protectionist policy has an adverse impact on the welfare of
the protectionist country as well as its foreign trading partners, whereas it is not clear to me which foreign taxation of U.S. multinationals operating abroad, has the best effect on the U.S.

**Mr. Philip Morrison:** I think that the basis of our discussion today is that accepting, which I think everyone accepts, that the free flow of capital and the free flow of production is a good idea and that that global economic efficiency is what will lead to the greatest economic good to the United States.

How do we achieve that is the question. I don’t think you can focus your goal on what is best for the United States. Burke-Harkte can be argued to be best for the United States. Just to state that as a goal, I think, gets you into a meaningless set of discussions as to what is good for the United States.
REMARKS BY THE HONORABLE LLOYD BENTSEN
RECIPIENT OF THE TAX FOUNDATION’S 1989
DISTINGUISHED SERVICE AWARD FOR THE PUBLIC SECTOR

In a recent issue of Fortune there’s a picture of a smiling lawyer standing in a Houston McDonald’s with his lunch order. He didn’t phone the order in. He faxed it over. He’s standing beside the store’s fax machine, in front of the register set up just for faxed orders.

The article itself talks about how the fax is revolutionizing business and it’s pretty convincing. But then Fortune comes to the real point: “Like the TV or VCR,” it says, “the fax is another western invention the U.S. surrendered to Japan.” Xerox invented it. But now, it turns out, Xerox makes it only in Japan through a joint venture.

What’s happened with the fax is not an isolated incident.

Most of us learned in grade school about the geniuses of American industry who invented things, then made a fortune selling them: Eli Whitney assembling those first cotton gins; Henry Ford, watching those Model-Ts roll off the assembly lines in Dearborn.

"Americans are still inventing things. But these days, the fortunes are often made by others."

Americans are still inventing things. But these days, the fortunes are often made by others. Just look around your own home. American scientists at Raytheon developed that microwave in your kitchen. But Japanese and Korean companies make 90 percent of them. American scientists at RCA invented that color TV in your living room—but European and East Asian companies make 97 percent. American scientists at AMPEX invented the VCR next to your TV. Japan and Korea make almost all of them.

How significant is all of this?

There are those who would argue any time the United States loses market share, or that other countries beat us to the punch, that’s cause for alarm.

I don’t agree. In a very real way, the success of the economies of countries like Japan—or Germany or Korea—are the result of policies carefully designed by us after World War II. We wanted them to succeed. We got our way.

And could there be any more triumphant vindication of the American approach than events of the last few months in Beijing and Berlin and Prague? And, yes, in Moscow.

The Berlin Wall, it has been said, is now a speed bump between East and West; the iron in the Iron Curtain has rusted away.

It’s been incredibly quick. In the 1970s I was in Yugoslavia with Senator Schweiker, talking to Marshal Tito. Senator Schweiker asked: “What’s going to happen to this country when you are
gone?”
Tito glared at him. “Do I look like
I’m going somewhere?”
In those days — in fact only last year
— it looked like none of those eastern
talking about destruction. I’m talking
about erosion.

It’s disturbing.
The rest of the world believes that
the main confrontations of the next few
decades will be economic, not military. They believe it in the Soviet Union. That is
the meaning of Perestroika. They believe it in the 12 European countries
integrating their economies in what will become the world’s largest market and a
more challenging economic force known as EC 92. They are prepared for it in
Japan and along the Pacific Rim. But in this country it hasn’t sunk in. Not yet.”

European rulers was going anywhere. It
looked like erosion of the Iron Curtain
might take centuries. Now Hungarians
are pulling pieces of barbed wire fences
from the ground for souvenirs. Sections
of the Berlin Wall are being brought to
the United States to be cut up and sold for
Christmas presents. We have contested
elections in the Kremlin. And in Poland,
the Fiats that used to sit outside Lech
Walesa’s house with government spies
are still there. But they’ve been pulled
back a few blocks to give him privacy —
and they contain his bodyguards.

But whatever the success of our goals
in the years after World War II, today we
have a brand new problem. Many Ameri-
cans are convinced we cannot compete
abroad. Fifty-eight percent of Americans
believe Japan is the leading economic
power in the world today. They think the
West Germans and the South Koreans
and the Japanese are tough cookies.
They’re right.

Will we self-destruct? No. I’m not
decades will be economic, not military.
They believe it in the Soviet Union. That
is the meaning of Perestroika. They be-
lieve it in the 12 European countries inte-
grating their economies in what will
become the world’s largest market and a
more challenging economic force known
as EC 92. They are prepared for it in
Japan and along the Pacific Rim.

But in this country it hasn’t sunk in.
Not yet. We haven’t come to grips with
the realities of a world where 70 percent
of our products have to compete against
tough foreign competition; where sud-
denly we are threatened not by tanks but
by assembly line workers making slab
steel in Korea, or airbuses in Toulouse —
or by bankers putting together that re-
cent merger between Taiyo Kobe and
Mitsui to create the second largest bank
in the world.

Our economy has eroded. We need
to rebuild it. We need to keep America
number one.

And that’s what I want to talk about
tonight.

There's no question about the erosion.

Look at the indicators.

Debt: Our national debt has nearly tripled over the last decade — just the interest payments on it last year took the personal taxes of all taxpayers west of the Mississippi. Our foreign debt has tripled. In just three short years, we went from the world's largest creditor to its largest debtor nation.

Interest Rates: Real interest rates — the rates once we subtract inflation — have soared to record levels in the '80s. As a result the amount America invests in its economy dropped 25 percent in this decade.

Productivity: It's averaged a bare 1 percent — half or even a third of rates in countries like Germany and Japan.

Why can't we do better? One key is capital accumulation. Having enough money to invest is what has sparked the

“Real interest rates — the rates once we subtract inflation — have soared to record levels in the '80s. As a result the amount America invests in its economy dropped 25 percent in this decade.”

U.S. standard of living — and helped spur the success of western democracy.

Now, we don't have enough. And the main reason is our emergence as the world's leading debtor economy.

When Perkin-Elmer Corporation put its semiconductor unit up for sale earlier this year, no one expected them to have trouble finding an American buyer.

Everybody wanted that chip-making ability to stay in American hands. There's a $5 billion world tooling market. A $25 billion world semiconductor market. A $500 billion world market for final electronic products. We need equipment companies in order to compete.

“Productivity: It's averaged a bare 1 percent — half or even a third of rates in countries like Germany and Japan.”

That's why it was so disappointing to open up The New York Times on Monday and see this headline: “Key Technology Might Be Sold to the Japanese.”

The leading bidder for Perkin-Elmer's semiconductor equipment? Nikon. In the weeks ahead, President Bush may have no choice but to permit Nikon to buy them, leaving us, in the words of the Times, “almost wholly dependent on Japan for the chief tools used to produce computer chips.”

How did this happen? Too much debt. Too little capital.

Some scoff at the alarm over our debt, over the manufacturing losses, the decline in productivity growth.

They argue that the national debt isn't so bad, that we owe to ourselves — though we owe more and more of it to foreign investors. They argue that foreigners will cover our trade and budget deficits. And they will, but only as long
as our interest rates remain sky high. We now have a 10.5 percent prime compared to 9 percent in Germany — and 4.875 percent in Japan.

Some call that foreign investment a source of strength. It could be. In the 19th century English investment helped build much of the railroad that first connected the east and west coasts. But today that foreign investment is not being used to finance America's future.

It's being used to buy Rockefeller Center. And to finance consumption: Nissans and Mercedes.

Look at those interest rates. Does anybody think we can compete abroad with countries whose cost of capital is less than half the American rate?

Is there no way America can better compete abroad?

In fact, there is.

The key is to accumulate investment capital — and then use that capital to restore our manufacturing base from the

"Why can't we do better? One key is capital accumulation. Having enough money to invest is what has sparked the U.S. standard of living — and helped spur the success of western democracy. Now, we don't have enough. And the main reason is our emergence as the world's leading debtor economy."

21 percent of GNP it is today to about 25 percent.

We can't ignore that. We must do a better job of encouraging savings and investment in this country. As Chairman of the Finance Committee, I will ask the Finance Committee to take a serious, comprehensive look at how we can go about doing so. My goal would be to develop a bipartisan package of cost-effective savings and investment incen-

"We must do a better job of encouraging savings and investment in this country. As Chairman of the Finance Committee, I will ask the Finance Committee to take a serious, comprehensive look at how we can go about doing so. My goal would be to develop a bipartisan package of cost-effective savings and investment incentives. Will capital gains be on the table? No doubt."

tives. Will capital gains be on the table? No doubt. I don't want to approach negotiations on this issue with an inflexible posture. But any effort to enact a capital gains tax cut next year will have to answer a number of questions that were left unanswered this year.

You've heard a lot of sharply partisan rhetoric this year about capital gains and IRAs. Well, Congress is a rough place. It reminds me of that comment by Mark Twain when he visited Virginia City, Nevada, in its wildest days. "It was no place for a Presbyterian," Twain said. "And I did not long remain one."

Sometimes the argument gets pretty rough. But actually, both the IRA and the
capital gains proposals are rooted in the same question: How do we get Americans to save and invest more?

I believe that creating a savings incentive in the tax code would help. It would stimulate the economy and drive interest rates down.

For a while, people doubted that the IRAs worked.

Three years ago, when Congress curtailed them, there was considerable argument about whether the IRA makes people save more.

The new studies show that it does. One study cites numbers showing that for every dollar of revenue lost through IRA deductions, you get an increase of savings of three dollars. And those figures were for the old IRA rules, which allowed a 100 percent deduction for IRA contributions by all taxpayers. I believe that the figures would be even better for the IRA proposal I put forth this year, which allows a 50 percent rather than 100 percent deduction.

Canada is a good case study of the effect of an IRA on savings. The savings rates of the U.S. and Canada tracked each other closely until the mid-seventies. At that point, the Canadian rate jumped and the U.S. rate declined to less than one-half the Canadian rate this decade.

What accounts for this sudden divergence? Some economists believe it can be attributed to broader eligibility and higher limits for IRA plans in Canada.

In short, the IRA is a retirement plan that never should have been retired.

“In short, the IRA is a retirement plan that never should have been retired.”

Now, what about capital gains? Can’t a cut in the capital gains tax also influence behavior in a constructive way? Yes. That’s why I have argued for a capital gains reduction for years — though I must admit, I thought it was more important when the top income tax rate was 90 percent — or 70, or 50.

My problem this year wasn’t with capital gains in theory. My problem was with the particular proposals that we saw, the particular context, and the particular way that their supporters tried to pay for them. We saw a proposal in the House that cut the capital gains rate for a little over two years, and then raised the rate back up. Under the accounting conventions we follow, that proposal showed up as a revenue-raiser for the early years, by moving sales of capital assets into the two-year window period. After that, it began to lose enormous amounts of revenue. That House proposal was so fiscally irresponsible it was laughed off the table in the Senate.

But the fact that the House proposal — along with other proposals based on budget gimmickry — failed this year, does not mean that there is no room for
discussion of a wide-ranging set of responsible proposals next year.

The biggest problem for capital gains relief is the one that proponents of a capital gains tax cut refused to face this year: how do you pay for it?

I don’t know the answer to that question. Not right now. We would have

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to answer the virtually unanimous verdict of economists that after that first year such a cut drains the Treasury. We would have to make such a cut revenue-neutral. Most important, it would have to contribute to a comprehensive solution — one that has bipartisan support — to our problems with savings and investment.

You know, back in World War II, I remember taking off on one of my first missions as a bomber pilot. As we entered Yugoslavian airspace, the navigator reached over and tapped me on the shoulder. He said “Lloyd, see those black puffs of smoke?”

“Yep.”

“That’s flak.”

And with that he pulled out two big flak jackets, hunched down, put the flak jackets over his head — and that was the last we saw of him until we were almost back to base.

Well, a pilot doesn’t have the luxury of hiding — either piloting a plane or helping plot a course for this country.

To keep America strong, we have to make the tough choices when it comes to economic policy — even when we have to take some flak.

At this watershed moment in history, let’s make those tough choices. Let’s continue our moral leadership with an economy that’s in the lead as well. We can revitalize the American example. The steps are small — as small as the few dollars more each American should save every week. As small as the semiconductors made by Perkin-Elmer. As small as a McDonalds owner in Houston making a change with equipment invented in America — and made in America.

If we can do that, then we will make sure America remains the example it has been in the past. And that the final and most inspirational chapters in the history of this country remain to be written.