Mr. Chairman, thanks you for this opportunity to testify before the Committee. My name is J.D. Foster and I am the Executive Director and Chief Economist of the Tax Foundation. The Tax Foundation is a non-partisan, non-profit research and education institution. It was established 63 years ago to provide the American people and policy makers with relevant, timely, and accurate information and analysis on fiscal policy matters at the federal, state, and local levels.

The sustained interest in tax reform should come as no surprise. More than any other aspect of government the federal income tax directly and repeatedly influences Americans’ lives. We may be most aware of this now during the tax season, but every week our lives are touched and our decisions colored by the income tax: How much should I save in my 401(k)? Should I sell some stock and pay the capital gains tax to buy the stock I would prefer? Should I go to college, to graduate school or night school to get a better job and earn a higher salary if it means a much higher tax rate? Should I take out a home equity loan to buy a car? Should I buy a home or rent? If I rent and lose the home mortgage interest deduction, can I afford to make as big a charitable contribution to my church, synagogue, or mosque?

The income tax is like an old machine tilling the fields of the economy, reaping a harvest of revenue for the federal government. Fourteen years ago the Congress performed a major overhaul through the Tax Reform Act of 1986. In the intervening years the Congress has passed hundreds of changes in the nature of ongoing maintenance. But it has also passed scores of changes asking the old machine to do even more: To supplement welfare spending, to encourage saving for education, and so on. Meanwhile the fields have changed steadily as has the pressure to produce, putting ever greater demands on the tax machine. Even under ordinary circumstances, another major overhaul would be past due today.

Circumstances are far from ordinary, however. The growing breadth of the economy combined with the rapid escalation of computing power have spawned a degree of complexity in the tax code affecting both individuals and businesses that was unthinkable not long ago. This complexity has led to a growing animus and distrust of the tax system, the Internal Revenue Service, and the federal government in general.

It is unwise to impose upon citizens any system that is torturously complex and affects so many areas of their lives. This complexity of the code leads to a sense of imbalance and unfairness. Some instances are obvious, like the marriage penalty which the Congress is seeking to address this year. Others are a matter of perception. We come to believe our neighbor knows of some twist to the tax code that allows him to pay less tax than we do.
There is a growing sense that an income tax is not the best type of tax for any country. ... When the income tax was adopted, it was well understood that it overtaxed saving and investment and reduced economic growth, but this was considered a reasonable price to pay for the redistribution of income and wealth for which the income tax is so adept. Today, the prosperity foregone is unacceptable and the transfer of income and wealth can be achieved by other means.

Neutrality and Saving

One distinguishing feature of fundamental tax reform is the meaning of the word “neutrality.” Does one mean neutral within the framework of a classical income tax, or neutral in some other sense? Our current system is a mutated income tax that often taxes the returns to saving even more heavily than would be appropriate under a normal income tax. The unintegrated corporate income tax, the capital gains tax, and the gift and estate tax are monuments to excessive taxation. On the other hand, the federal income tax contains many features consistent with a consumption tax, such as the pension and savings provisions that effectively ensure that only one level of tax is paid at the individual level on labor income that is saved.

Given its current usage, at the individual level “neutrality” today clearly means taxing all labor income once and only once, uniformly and consistently. In other words, for individuals fundamental tax reform means shifting the tax base from a combination of labor and capital income, to labor income. For businesses, it means taxing only profits earned in the United States. Neutrality for businesses also means only taxing economic profits rather than financial profits, which is achieved by allowing businesses to expense their purchases of plant and equipment. Thus, it means changing a fundamental principle on which the tax system is based.

Neutrality and Education

Neutrality also means imposing no higher a tax burden on human capital income than on physical capital income. In the e-world, a well-educated work force is vital. The “e” in e-commerce could just as well represent “education” as “electronic.” The New Economy is
built on technology, communications, and information, all of which have value only to the extent employees, investors, entrepreneurs, and managers can use the technology to communicate and process the information.

The principle of tax neutrality means that businesses should be able to expense their physical capital acquisitions. It also means individuals should be able to deduct in full the costs associated with their education. Productively. In other words, it depends on people with the education to use the tools effectively.

The tax code should not create a bias in favor of education, neither should it have a bias against education as it often does today. Neutrality means businesses should be able to expense their physical capital acquisitions. It also means individuals should be able to deduct in full the costs associated with their education. We already do this to an extent insofar as local school systems are funded with federally tax-deductible property taxes. This same treatment should extend to all reasonable expenses incurred by individuals seeking to invest in their own human capital.

Pursuing Fundamental Tax Reform

Defining the goal of tax reform leaves a remarkable number of options from which to choose. For example, one can "scrap the code" as many advocate, suggesting that remedial action is infeasible or impractical, and replacing the income tax with some apparently new system. I say apparently new because, in fact, none of the main proposals advanced to date are truly as new and revolutionary as their advocates would have us believe.

The Congress could achieve the essential substance of the Simplified USA Tax, for example, by allowing an unlimited Roth Individual Retirement Account and other pension savings, while allowing businesses to expense all of their purchases of plant and equipment. Similarly, while the Federal government has no experience with broad sales taxes, it collects numerous targeted excises while most states collect general sales taxes. Thus even a National Retail Sales Tax, clearly the most radical of the popular proposals, and the most problematic, is not entirely alien. The "revolution" in fundamental tax reform is not the novelty of the new tax system, per se, but the shift in the tax base from a mutated definition of income to consumption.

An alternative to "scraping the code" would be to "clean the code." It is entirely possible to achieve all the goals of fundamental tax reform by radically amending the existing system. For example, step one would be to allow people to save as much as they want in tax-deferred accounts, without regard to their current incomes or to when they choose to take the money out of the accounts for consumption. Alternatively, one could tax all labor income however employed, and forego taxing all forms of future capital income.

Step two would be to eliminate the Alternative Minimum Tax and all the other horrors of current law. The true source of complexity in the tax code is not the home mortgage and the charitable contribution deductions, and the others listed on Schedule A. For individuals the true complexity lies in the phase-in and phase-out of the Earned Income Tax Credit, the phase-out of the other tax credits and other bells and whistles enacted in recent years, the phase-out of itemized deductions, the phase-out of personal exemptions, the Alternative Minimum Tax, and the modern nightmare that is Schedule D for capital gains and losses. For businesses the true complexity lies in the system of depreciation allowances, the taxation of foreign source income, and the special rules and rulings that go into defining taxable income.

Step three would be to allow individuals a deduction for personal expenses associated with education - to put human capital formation on par with physical capital formation.

Step four would be to allow businesses to expense their purchases of plant and equipment.

Step five would be to tax only income earned in the United States, rather than seeking to cast an extraterritorial net in a feat of veiled protectionism.

A great many other steps would be needed to "clean the code" properly. The federal income tax is very much like a vast mansion that has collected dust and all manner of rubbish over decades of relative neglect, and in many areas may have fallen into disrepair. It is possible to clean the mansion again, to repair the walls, and to modernize the facilities. Whether one should level the income tax edifice and start over or just give it a thorough cleaning is a
tactical and political decision. The former may be more unsettling though more thorough; the latter may appear easier, but it is less certain to achieve the desired result.

**A No-Cost Tax Cut**

Some level of compliance and administrative costs are inevitable with any tax system. Any amount in excess of the minimum wastes the nation's resources. It is, in effect, a tax with no offsetting benefit. Reducing those costs is therefore equivalent to a tax cut in that it leaves more resources in the private sector. But it is a tax cut that, at worst, leaves the Federal government with no fewer resources than it had before.

Estimates of the compliance costs associated with the Federal income tax often reach into the hundreds of billions of dollars. Four years ago the Tax Foundation concluded that a lower-bound for such an estimate was $157 billion. Today, that figure might be closer to $175 billion. This is a lower bound, so the actual figure is almost certainly much higher. For argument's sake, suppose it is $200 billion.

Using the same methodology employed to find the lower bound for compliance costs for the income tax, in 1996 the Tax Foundation estimated the compliance costs associated with the Flat Tax and the National Retail Sales Tax. In both cases the analysis showed that compliance costs would fall by about 95 percent once the new plan was fully phased-in, assuming the new tax system was enacted in its pure form. The reduction associated with the Simplified USA Tax would be comparable. Thus, even if transition issues and political considerations caused the percentage reduction in compliance costs to drop to 50 percent, that still means an effective tax cut of $100 billion annually, or $1 trillion over 10 years. That is an enormous amount of saving and should by itself be enough to compel legislative action.

The International Dimension of Tax Reform

The foregoing discussion reveals many sound reasons for pursuing fundamental tax reform, including simplification, reducing compliance costs, improving the neutrality of the tax code so that it is less of a hindrance to economic growth, and reducing the intrusive aspects of the tax system into citizens' lives. Each of these has been discussed extensively in numerous forums, including this Committee. However, the international dimensions of tax reform, particularly the change in the tax treatment of foreign source income and the imposition of Border Tax Adjustments have until recently received far less attention than they deserve.

Protectionism and the U.S. Tax on Foreign Source Income

Subject to a vast array of special provisions, tests, and rules, the essential features of U.S. international tax policy are that the U.S. imposes federal income tax on U.S. citizens' foreign earnings. The U.S. also allows a limited tax credit against any resulting tax liability for foreign income taxes paid. This policy goes under many names, the most common of which is "worldwide taxation," the most accurate of which, however, is "extraterritoriality." Most tax reform proposals wisely move away from extraterritoriality to a system whereby only economic profits earned in the United States are subject to U.S. taxation, a system known as "territoriality."

Extraterritoriality violates tax neutrality as the term is commonly used. A non-neutral tax system is hurtful to wage and job growth because it directs our national resources of land, capital, and labor away from their most productive and beneficial uses. A driving motivation for tax reform must be the recognition that a more neutral tax system is in our best interests, and this is true whether the issue is economic risk-taking, education outlays, the level of saving, the level of investment, the forms of investment, or the locations of investment.

The immediate effect of extraterritoriality is to distort the pattern of international investment by U.S. companies and therefore to reduce their competitiveness at home and abroad. This loss of international competitiveness translates into lower shareholder returns, but it also means a loss of jobs and lower wages at home. One obvious consequence of the global economy is that companies must
hire, invest, produce, and sell globally. The companies that are best able to integrate each of these activities across product lines, across functions, and across countries are the most successful. A U.S. tax policy that distorts the pattern of activity of U.S. companies inhibits them from maximizing their efficiency. Space limitations prevent me from elaborating on these points. However, I have written about these matters elsewhere in greater detail. (See "Promoting Trade, Shackling our Traders," Tax Foundation Background Paper, No. 21).

If extraterritoriality is so harmful to U.S. interests, it is reasonable to ask why it remains the basis for U.S. international tax policy. The answer is that its true nature has largely been hidden behind fear mongering claims and misleading statements. Extraterritoriality is a sophisticated, tax-based form of protectionism. The essential goal of extraterritoriality is to ensure that U.S. companies pay at least as much income tax on their foreign activities as they would if those activities had taken place in the United States. This sounds reasonable at first blush, but if this principle is reasonable, why should we not require U.S. companies to be subject to the same labor laws abroad as at home? Certainly our stricter labor laws protect our work force, but they also raise labor costs and therefore put U.S. workers at a competitive disadvantage. Why not subject these companies to the same environmental laws they face at home? Again, our more stringent rules generally protect the environment, but they also raise producers' costs. Indeed, we have in recent years heard calls for exactly such policies, and it is no coincidence that these same voices have also consistently been at the forefront of the fight against free trade.

Proponents of extraterritoriality will argue that if the U.S. fails to tax the foreign income of U.S. companies, then the tax code will create an incentive for those companies to shift their operations to lower-taxed, foreign jurisdictions. The proper way to express this, however, is that eliminating the tax would eliminate a disincentive for companies to invest globally and most efficiently, unfettered by U.S. tax policies.

Classic protectionism seeks to erect barriers to the importation of goods and services to protect jobs at home. Extraterritoriality seeks to erect barriers to international investment by U.S. citizens in the usually mistaken belief that this investment would otherwise occur at home. Thus this tax barrier to international investment is also intended to protect U.S. jobs.

Perhaps the most unfortunate aspect of the protectionism of extraterritoriality is not that it unfairly protects U.S. jobs, but that it may cost U.S. jobs, on balance, and reduce wages, on balance. As noted above, U.S. companies organize their operations on a global basis. Each element, subsidiary, and division performs a specific set of roles and company management strives to optimize the efficiency of each piece of the corporate whole. The effects of a lost or foregone opportunity in one area will negatively affect the efficiency of many of the company's operations, including those based in the United States. Sometimes these secondary effects are minor and can be overcome; sometimes they are highly significant. Thus a lost or foregone opportunity due to the U.S. imposition of a protectionist, extraterritorial tax
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policy will often reduce employment in a company’s other operations throughout the world, including in the United States.

The U.S. has one of the best educated, most productive work forces in the world. If a U.S. company were considering an increase in its foreign operations, it is very likely those operations would represent lower-wage, less productive jobs. On the other hand, the U.S. exporting company will often reduce employment in its trading partners, further enhancing our international competitiveness; and effectively to “import” tax base from abroad, thereby reducing the federal tax burden on U.S. citizens without reducing revenues to the Federal government. I will address each of these, briefly, in turn.

Export Rebates

An export rebate allows a U.S. producer to exclude from taxable income the profits made on the export of domestically produced goods and services. If the United States adopted territoriality, then export rebates naturally address any remaining concerns that territoriality would induce U.S. companies to shift some operations overseas. If the United States adopted both territoriality and export rebates, then a company would pay no U.S. tax on goods sold abroad whether those goods are produced at home or abroad.

Business taxes are generally and ultimately borne by the factors of production, namely labor and capital. To be sure, there are instances in which a new tax can be shifted, at least temporarily, onto consumers. But in an increasingly global and competitive world economy, consumers have a great ability to opt for alternative, lower-priced goods and services, and this is especially true in the United States because there is very little we do not ourselves produce in quantity. Consequently, consumers can effectively resist bearing business taxes, and hence they are shifted back on to labor and especially on to the owners of capital.

Upon initial introduction, an export rebate would allow U.S. exporters either to enjoy higher profits on their exports or to charge lower prices in an effort to capture a greater market share. Once markets at home and abroad have adjusted to the new tax regimes, the relative prices of U.S. exports would largely return to their previous levels, and the value of the tax rebate would be shifted back to U.S. labor and U.S. capital. Any shift of the rebate to U.S. labor would be in the form of higher wages. Most of the shift of the rebate, however, would be in the form of higher returns to capital that the market would translate into a larger capital stock permitting more output for foreign markets. In other words, the export rebate would be immediately beneficial, but it would be even more so in the long run by raising wages, increasing jobs, and increasing the competitiveness of U.S. exporters.

Fundamental tax reform permits the adoption of Border Tax Adjustments (BTAs), in the form of a rebate upon export of the U.S. business tax and the imposition of the U.S. tax on the value of imports. BTAs are a common feature of many national tax systems and are an important feature of the Simplified USA Tax.

The Many Roles of Border Tax Adjustments

Fundamental tax reform permits the adoption of Border Tax Adjustments (BTAs) in the form of a rebate upon export of the U.S. business tax and the imposition of the U.S. tax on the value of imports. BTAs are a common feature of many national tax systems and are an important feature of the Simplified USA Tax.

The importance of BTAs to tax policy is better recognized today in the United States thanks to the recent World Trade Organization (WTO) ruling against the U.S. Foreign Sales Corporation (FSC) provisions. The FSC is an important, though relatively modest attempt to grant an income tax rebate on U.S. exports. Fundamental tax reform and BTAs solve the FSC problem by, in effect, making the export rebate total, universal, and WTO compliant. The role and consequences of BTAs, however, go well beyond replacing the FSC. Their major effects are to enhance prospects for U.S. companies and U.S. workers to compete globally; to offset similar provisions adopted by
Import Levies

The counterpart to the export rebate is the import levy on the full value of all imported goods and services. When first introduced, some of this rebate would doubtlessly appear as an increase in the price of imports. The vast majority of these price increases would quickly disappear, however, as U.S. consumers and U.S. businesses substituted domestically produced goods and services for foreign goods and services. In large measure, the ability to substitute domestic for foreign production would force foreign suppliers to absorb much of the tax.

As with the export rebate, once markets have fully adjusted, most domestic prices would return to their pre-tax reform levels at least insofar as the effects of BTAs are concerned. Once the adjustment has been completed, importers of foreign goods and services would have shifted some of their demand to U.S. producers, with obvious beneficial effects for domestic job and wage growth. Thus both the export rebate and the import levy have the same effects in terms of raising U.S. economic activity by increasing the international competitiveness of U.S. labor and U.S. companies.

On Offsetting Exchange Rate Adjustments

One counter-argument against the foregoing analysis is that exchange rates would adjust to offset any price effects of Border Tax Adjustments. I believe this argument is essentially correct. What I do not know, and what nobody knows, is how long this exchange rate adjustment would take to occur. It could be instantaneous or, more likely, it could take many years.

Economists know a great deal about the fundamental forces of exchange rate determination over the long run. They also know a great deal about many of the forces that cause exchange rates to evolve over time. For example, we know that exchange rates move to clear the markets for foreign exchange and that these markets are buffeted by changing international capital and trade flows, by changing expectations about how these flows will adjust in the future, by changes in tax policies, and by changing expectations of relative inflationary pressures.

Given all these factors it should not surprise that economists enjoy little success predicting exchange rate movements over the next day or two, and they do no better forecasting when exchange rate movements will take place and how far they will move in the short and medium terms. This is especially true within the context of fundamental tax reform. Whatever influences BTAs might have on exchange rates would almost certainly and for a long time be overwhelmed by the shifting patterns of trade and capital flows into and out of the United States in response to changes in the incentives to save and invest.

What we can say is that if exchange rates move to offset fully the competitive benefits of BTAs, then the worst that can happen is that these benefits will not materialize. Such an adjustment would likely take a long time to occur, however, and unless and until it does the benefits will manifest themselves and they could be very substantial.

"Importing" Tax Base

The tax base is the amount that is subject to tax. In the case of the income tax, for example, the tax base is the total of labor and capital income generated in a year. The federal gasoline excise tax base is the amount of gasoline purchased by consumers in a year. The tax base is often manipulated to exclude certain items and in the case of the income tax to include others more than once. The net of these manipulations yields an amount which, when subjected to the tax rates, produces tax revenue. The growing Federal tax take in recent years primarily result from the growth in the economy, which is another way of saying it results from the growth of the tax base.

Repeating a basic principle, business taxes in most instances fall on capital and labor, the factors of production. If the U.S. were to impose an import levy in the form of a Border Tax Adjustment, this levy would also fall on the capital and labor of the countries producing the goods and services for importation into the United States.

If the U.S. were to impose an import levy in the form of a Border Tax Adjustment, this levy would also fall on capital and labor. However, it would fall on the capital and labor of the countries producing the goods and services for importation into the United States.
and foreign capital owners.

To give some idea of the magnitude of these effects, suppose once tax reform has been enacted with its Border Tax Adjustments that the U.S. imported $1 trillion of goods and foreign capital owners.

Fundamental tax reform can dramatically reduce complexity and compliance costs. It can free individuals from much of the intrusiveness that is the hallmark of the income tax. It can put people and education at least on par with machines by making the tax system neutral with respect to human and physical capital formation.

services a year. Assuming a 12 percent levy, that would imply $120 billion in import levy receipts. If, when all adjustments were completed, U.S. consumers resisted all efforts by foreign exporters to raise prices to compensate for the import levy, then the U.S. would have effectively imported $1 trillion of tax base and shifted $120 billion of tax liability onto foreign taxpayers.

Of course, in some instances foreign producers would be able to force U.S. consumers to bear some of the tax in the form of higher prices, and in rare instances U.S. consumers would bear all of the tax. Clearly, however, such situations would create powerful incentives for affected consumers to shift consumption toward lower-price domestic goods and services. Thus much of the expected decline in imports from imposing an import levy would occur in precisely those areas where consumer resistance to the tax-induced price hikes was incomplete.

Even if the net shift of tax liability to foreign taxpayers were only half the amount of the hypothesized upper-bound, this would still imply a reduction in taxes paid by U.S. citizens of $60 billion annually. Whatever the figure in a given year, the important point is that the Congress has within its means the ability to shift tax burden onto foreign taxpayers, providing U.S. citizens with a very significant effective tax cut, without reducing revenues to the U.S. Treasury one cent.

Given the reaction of many of our trading partners to our Foreign Sales Corporation provision, one might reasonably expect them to object to the adoption of Border Tax Adjustments. True, they would not likely be happy over this development, but they would have no cause for complaint. Many of our trading partners, especially the Europeans, have employed such BTAs for decades as part of their consumption tax systems. In other words, they have been importing tax base from the United States for many years, effectively imposing their tax burden on U.S. citizens. By adopting BTAs, the U.S. would simply be recapturing U.S. tax base these trading partners have claimed for all these years.

Conclusion

There is a great deal to commend comprehensive, fundamental tax reform. Most of the problems associated with the federal income tax are well established and virtually all of them can be effectively addressed through sound reform. Fundamental tax reform can dramatically reduce complexity and compliance costs. It can free individuals from much of the intrusiveness that is the hallmark of the income tax. It can put people and education at least on par with machines by making the tax system neutral with respect to human and physical capital formation. It can free the economy to create more and better jobs, higher wages, and more wealth.

Fundamental tax reform also creates a welcome occasion to abandon a counter-productive protectionist policy of taxing foreign source income in favor of a policy that will allow U.S. companies to maximize their international competitiveness and thereby contribute even more to the promise of greater prosperity at home.

It goes even further by creating the opportunity to consider implementing Border Tax Adjustments that would further improve the competitiveness of U.S. labor and U.S. companies.

And, not to be overlooked, it creates a powerful opportunity to provide American taxpayers with an effective tax cut, both in the reduction of compliance costs and in the importation of foreign tax base. This tax cut potentially could total in the hundreds of billions of dollars annually, without reducing receipts to the Federal Treasury. This is literally, money left on the table that the Congress can sweep up and bestow on the U.S. taxpayer.