



## **The International Components of Tax Reform: Tax Policy that Serves the National Interest (Part 2)**

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Before border tax adjustments can be contemplated seriously as part of tax reform, they must first be disassociated from the VAT and the popular misconceptions that surround that particular form of European tax.

This is the second and concluding installment on how the current tax system puts U.S. companies at a disadvantage in their efforts to compete internationally. Part 1 covered even-handed choice of market, basic concepts and quantities, and history and perspective on international components of reform.(1) Discussed below are the structure and policy of the international components of reform, territorial vs. worldwide taxation, border tax adjustments, breaking out of the VAT syndrome, cross-border adjustments for inbound transactions, and importing a tax base and cutting tax for Americans.

### **Structure and Policy of the International Components of Reform**

As an example of a tax system designed to address the international components of reform, consider the business cash-flow tax in H.R. 134, which was introduced in the 106th Congress as the "Simplified USA Tax Act." H.R. 134 is a comprehensive proposal that includes a reformed personal tax as well as a reformed business tax but, for present purposes, the focus will be solely on the business tax and its two international ingredients.(2)

The business cash-flow tax in H.R. 134 recognizes the benefit to the U.S. economy that arises when U.S. companies compete and win in the global marketplace. It then sets out to equip them with the kind of tax system that will be most conducive to that success.

First, it says that the foreign-source income of U.S. persons should not be taxed. Second, it says that in an export sale, both the manufacturing profit and the sales profit should be treated as foreign-source income, the same as if the product had been manufactured and sold abroad. Third, it says that when a U.S. company succeeds in a foreign market, it should be allowed-indeed, encouraged-to bring its profits home, without penalty, for reinvestment in the U.S.

The business cash-flow tax also says that the U.S. tax burden should no longer be concentrated solely on U.S. labor and U.S. capital as it is today. Instead, foreign companies that participate in the U.S. market should be brought into the U.S. tax base and required to

share in the U.S. tax burden in a WTO-consistent way.

### **Territorial system**

The business cash-flow tax adopts a territorial system whereby all foreign-source income of U.S. citizens and their corporate alter egos is excluded from U.S. tax (thus, the deferral exception and the FSC-II/ETI provision would be repealed as superfluous). U.S. companies would be able to make direct foreign investment and operate in foreign markets, either through a branch, U.S. subsidiary, or controlled foreign corporation, without incurring U.S. tax on the profits from these investments and operations—and without regard to whether the profits are reinvested abroad or repatriated to the U.S. All foreign-source interest, dividends, and royalties would be excluded from U.S. tax as well. Under the fully territorial regime in the business cash-flow tax, U.S. companies would be subject only to the taxes of the host country where they compete in foreign markets. For the first time in history, they would be on equal tax footing with their competitors abroad. U.S. companies would pay no U.S. tax on their foreign-source income, so the foreign tax credit would be repealed.

### **Export income excluded**

Because the business cash-flow tax classifies export income as foreign source, the model tax excludes export income from tax and, therefore, the model makes U.S. tax treatment a neutral factor in a U.S. company's decision to service a foreign market from a U.S.-sited plant or from a foreign-sited plant. Therefore, the business cash-flow tax cuts the logic out from under the traditional argument that a territorial tax system would cause U.S. companies to locate their plants abroad to take advantage of a zero U.S. tax rate on foreign-source income.

To the extent that existing U.S. taxes may be embedded in the price of some particular exports under current law, the exclusion of export income from tax will tend to alter the terms of trade in favor of those products, but that is not the primary function of the export exclusion. In most instances, the trade effect probably would be minor. Even if it were wiped out completely and quickly by adjustments in exchange rates, the export exclusion under the business cash-flow tax would still be a vital part of the international component of tax reform because it enables territoriality to be enacted and to function without any concern about "runaway" plants.

### **Import tax**

An import tax is the other part of the border tax adjustment procedure under the business cash-flow tax and it, too, performs multiple functions. Like the export exclusion, the first function of the import tax is to permit the territorial system to be enacted and to function without running afoul of a version of the "runway plant" argument that is concerned not with plants moving abroad to serve foreign markets (the problem addressed by the export exclusion), but rather with U.S. plants moving abroad and then selling back into the U.S. market from some assumed "tax haven" foreign manufacturing facility. Under the business cash-flow tax, if a U.S. company were to move its plant offshore and sell back into the U.S., it

would have to pay an import tax exactly equal to the U.S. business tax rate but without any deductions. Therefore, there would be no U.S. tax incentive for the company to move aboard.

The other function of the import tax has to do with the terms of trade but not in the way that most of us have been accustomed to thinking. Traditionally, because import taxes have been associated with VATs, import adjustments have been thought of as some kind of tariff designed to make foreign goods more expensive-but that imaginary process is not actually the trade-related function of the import tax under the business cash-flow tax regime. Rather than keeping foreign-made goods out (or causing U.S. purchasers to have to pay more for them), the primary function of the import adjustment under the model tax is to expand the U.S. tax base to include the foreign-based companies that sell into the U.S. market. Except for unique products for which there is no competition among foreign sellers into the U.S. market and little or no potential for competition from domestic-source products, the foreign companies who sell into the U.S. market will need to absorb all or part of the import tax and will, therefore, end up bearing part of the U.S. tax burden.<sup>(3)</sup> (The analysis by which the import tax can result in an expansion of the U.S. tax base and an implicit tax cut for U.S. labor and capital is discussed below).

### **Territorial Vs. Worldwide Taxation**

The distinction between territorial and extraterritorial worldwide taxation is, of course, exactly the distinction that exists under the current Code between domestic- and foreign-source income. The geographical location of the activity that produces the income is what counts, not the location of the customer. Thus, under current law, income from the production of goods and services in the U.S. is domestic-source even though the customer is a foreigner who pays from a foreign-sited bank. Conversely, income from the production of goods outside the territory of the U.S. or from services performed outside the U.S. is foreign-source income.

Taxing U.S. citizens on both domestic- and foreign-source income (worldwide) or only on domestic-source income (territoriality) produces different results simply because all countries do not have the same tax system (e.g., same rates, base). If they did, the end result to all national treasuries and to all businesses would be exactly the same under either a territorial system or a worldwide system.

### **Example**

A U.S. company earns \$100 in Germany that is taxable in both the U.S. and in Germany at the same rate under a worldwide system. If the U.S. immediately and fully allowed the company a credit for the tax paid to Germany, the result to all parties would be the same as if only Germany (not the U.S.) had taxed the \$100 of income derived from the U.S. company's operations in Germany.

Absolute uniformity of taxation across national boundaries would make taxes a neutral competitive factor-not only within a market but across or among all markets as well-and economists would say that such a condition would maximize economic efficiency, productivity, and the world's wealth. In the imperfect real world where tax rates and systems

around the world vary greatly, territoriality will not achieve uniformity of taxation across all markets, but it will tend to produce uniformity of taxation within the same market. For example, if the U.S. shifted to a territorial system, a U.S. company operating in France would pay exactly the same tax as the French companies alongside of which it competes in that market. While less than perfect, economists would say that achieving tax neutrality within markets by shifting to territoriality would greatly increase efficiency, productivity, and wealth.

In contrast, the worldwide tax system does not achieve neutrality of taxation within a foreign market and, in fact, is not intended to do so. There is an inherent assumption in the worldwide approach that the U.S. tax rate will be higher than the tax rate of the foreign country where U.S. companies are doing business and, therefore, that U.S. companies will pay a higher tax rate than their local competitors. For most of the post-WWII era, U.S. tax rates generally were higher than in most other countries. For example, if in 1975, a U.S. company earned \$100 in Country X and paid a \$20 tax, it would have been required to pay a \$48 tax in the U.S. minus a credit for the \$20 Country X tax, resulting in a \$28 competitive disadvantage for the U.S. company.

Today, a U.S. company that operates abroad may, in some instances, encounter a foreign tax rate that is lower than the U.S. tax rate and, in others, a foreign tax rate that is higher than the U.S. tax rate. In theory, of course, if the foreign rate were higher than the U.S. rate, and if the U.S. allowed a full and immediate credit for the foreign tax, the U.S. company would- after credit-bear only the foreign tax (the same as under a territorial system) and taxes would be a neutral factor. However, as a practical matter, the foreign tax credit is so limited today that the U.S. worldwide tax is a non-neutral factor to the disadvantage of U.S. companies without regard as to whether the foreign tax rate is lower or higher than the U.S. tax rate.

### **Theoretical case for territoriality**

Proceeding from the correct neoclassical view that all taxes-by whatever name called and by whatever means collected-are borne by the labor and capital that produces the income with which the taxes are paid, a strong theoretical case can be made that it is only the country where the labor and capital are employed that should tax the output that it produces. This argument in support of territoriality is strongest when applied to returns to labor. Indeed, it is generally only the country of location that taxes the returns to labor at all. (For example, payroll taxes, as such, are imposed only on a payroll within the jurisdiction. Further, even under the U.S.'s expansive worldwide income tax, a partial exemption is made for earnings from employment outside U.S. territory.)

Without question, territoriality is the simplest system and permits the U.S. government the least opportunity to interfere with the way that U.S.-owned companies can compete in foreign markets. (Both the foreign tax credit and deferral are creatures of the worldwide tax system and both have forced U.S. companies to conduct their business abroad in ways that have made them less competitive.)

### **Territoriality in practice**

Territoriality facilitates foreign direct investment (FDI)(4) and anytime U.S.-owned companies gain wealth by means of exploiting a foreign market, the nation is wealthier and everyone is better off. But that salutary effect, important though it is, is too indirect to satisfy some people. Their question is very specific: What does it do for U.S. output and U.S. jobs when a U.S. company manufactures and sells widgets in a foreign market?

There is plenty of anecdotal evidence to support the proposition that FDI by U.S. firms also enhances their U.S. operations and domestic job-creating capacities. Many companies have testified before the Congress to that effect. Some of their foreign operations use U.S.-made components. Others point out that once they have penetrated a foreign market by direct investment, their export sales to that market usually increase as well. There is also important statistical evidence that FDI by U.S. companies is complementary to U.S. production and jobs, not substitutional.(5)

### **Border Tax Adjustments, Tax Incidence, Related Matters**

Border tax adjustments for imports and exports are essential to a properly functioning territorial system, and provide other important advantages as well. But before they can be contemplated seriously as part of tax reform, they must first be understood and before they can be understood, they must be disassociated from the VAT and the popular misconceptions that surround that particular form of European tax.

### **Breaking Out of the VAT Syndrome**

The principal barriers to enactment of a border adjustable tax system in the U.S. have been 1) the mistaken belief that only a VAT can be border adjusted, and 2) the corollary misperception that any tax that is border adjusted must be a VAT even though it is not. These two propositions stem from the peculiar idea that the VAT is some kind of cascading tax where business A pays a tax that it passes on in price to business B, which also pays a tax and then passes on the cumulative tax to consumer C, who reimburses business B by paying the higher "plus tax" price that is inherent in the popular concept of "VAT." The resulting picture of a multi-stage sales tax, where businesses pass on their tax costs to one another and finally to the consumer, is so thoroughly ingrained that one need only mention "VAT" and economists and others who should know better immediately suspend logic by assuming-in the above example-that business B gladly will pay business A's taxes and that consumer C readily will pay the higher tax-inclusive price, all without curtailing demand, as if the demand for all products and all substitutes were price inelastic.

Any tax that is border adjusted is automatically classified as a regressive, consumer-borne sales tax, even though taxes without border tax adjustments are correctly understood to be borne by factor incomes, i.e., wages, gains, interest, and dividends.(6) This logical legerdemain-engaged in as often by misguided proponents of reform as by ill-intentioned opponents-is most often accomplished by renaming border adjustable business cash-flow taxes as "subtraction-method VATs."

### **Reality is quite different**

A cash-flow tax is collected from a business in direct proportion to its payments of wages (returns to labor) and dividends and interest (returns to capital). In effect, it is a tax on gross profit before payments to employees, shareholders, and debt holders. A business cash-flow tax bears no resemblance whatsoever to a sales tax-VAT or otherwise. Indeed, because it applies equally to returns to labor (wages) and returns to capital (dividends and interest), a business cash-flow tax is nearly identical to the combination of the current corporate income tax (which applies only to returns to equity capital but not wages) and the current FICA payroll tax (which applies only to returns to labor but not to returns to capital).

A modified form of border tax adjustment can be included in a business cash-flow tax, but that does not mean it is a sales tax-VAT-type or otherwise. In fact, but for its ability to qualify for a modified form of border tax adjustment, it would never occur to any proponent or opponent of tax reform to think of a business cash-flow tax as a sales tax.

Any tax that is neutral as between labor and capital-by whatever name called and however collected-can, under applicable treaties, be adjusted at the border for imports and exports. The reason that a sales tax (including the European VAT-type) can be border adjusted is because the final sales price of goods to which the tax applies includes the output of labor and the output of capital. Similarly, the cash-flow tax qualifies because it, too, includes the output of both labor and capital, but at the other end of the economic process where the goods and services are produced. The tax is measured not by the amount for which the goods and services are sold but, instead, by the amount of the wages paid to employees who produce the goods and services and the amount of dividends and interest paid to owners of the capital that the employees used in the production process.

The existing corporate income tax does not qualify for border tax adjustment because it applies only to the equity capital portion of the production process. Therefore, unlike the business cash-flow tax and the sales tax, which-while at opposite ends of the economic spectrum are neutral as between labor and capital-the current corporate income tax applies only to some capital income and not at all to labor income and is, therefore, non-neutral.

When the drafters of the GATT allowed "direct" taxes to be forgiven on exports, they had the European VAT-type tax in mind as the primary then-existing example. Further, consistent with the highly mechanistic approach to taxes that tended to prevail at that time (especially in Europe), they probably also viewed the VAT as being in economic substance exactly what its statutory structure implies: a retail sales tax collected at the final consumption end of the economy with an aggregate base equal to the total value of goods and services produced and sold. None of this means, however, that some other tax that has exactly the same base (although measured at the opposite end of the economy where goods and services are produced and expressed as the total amount paid to labor and capital for that production) cannot also be forgiven on export. Nor does it mean that everyone-most especially the Congress and President-must accede to some archaic, highly mechanistic approach to economic incidence and characterize business cash-flow taxes and all other border adjustable taxes as regressive levies borne by consumers in proportion to retail purchases when in fact, according to the most basic principles of economics, common sense, and the modern view of tax incidence, all such taxes (including the VAT itself) are ultimately borne by

labor and capital income.

### **Tax incidence**

The question of tax incidence (who actually bears the economic burden) is quite simple. A tax may be collected at any of three points in the economy:

1. When goods and services are produced and sold by businesses.
2. When employees and capital owners receive the wages, dividends, and interest paid to them by businesses for their labor and the use of their capital in producing the goods and services.
3. When consumers purchase the goods and services for their own use and benefit.

Properly calculated, the tax base is the same in each case, i.e., the dollar amount of goods and services produced and sold is equal to the dollar amount of goods and services purchased, and both are equal to the dollar amount of the returns to labor (wages) and returns to capital (interest and dividends) for producing them.

### **Extended Reach of Cross-Border Adjustments for Inbound Transactions**

When a country imposes a tax on inbound transfers of goods and services (an import tax), it extends its jurisdiction to apply to the income of noncitizens and foreign corporations from activities outside its own borders. This fact seems to have escaped the attention of most U.S. commentators, but it is known to the Europeans and others who--by means of border taxes--have been taxing the U.S.-source income of U.S. citizens and companies for many years.

Under the false rubric that their import taxes are taxes on the purchasers of imported products, the Europeans and others have been able to maintain the fiction that when they impose tax on imports, they are doing no more than taxing their own citizens in a way of their own choosing. In fact, however, when the Europeans, for example, tax imports of goods manufactured in the U.S., they are not just taxing their own citizens and companies who purchase those U.S.-origin products. Instead, for the most part, the economic burden of the import tax will fall on the U.S. labor and capital that produced the imported product. Thus, when Europeans impose import taxes on American-made products, they are, in reality, taxing the income of Americans as well.

Viewed from the standpoint of a U.S. company engaged in export trade with Europeans, the overall situation is as follows: Its U.S.-source income must bear the burden of both the U.S. income tax and the European import tax for which it will get no credit for U.S. purposes. Once understood, this extraterritorial reach of border taxes gives new and realistic meaning to the "destination" principle that confused lawyers and economists are so fond of in trying to explain the artificial distinction between direct and indirect taxes. By, in effect, taxing the U.S. producers of goods and services destined for Europe and using the revenues to pay for welfare programs in their own countries or to hold down the level of their internal budget

deficits while not increasing taxes on their own citizens and companies, EU member countries have managed to shift a large portion of their tax burden off their own citizens.

### **Conclusion--Importing a Tax Base, Cutting Taxes**

In addition to the many other benefits to be derived therefrom, tax reform could produce a result that is in effect a massive tax cut for U.S. labor and capital. At present, with only immaterial exceptions, U.S. labor and capital together bear the entire burden of the current U.S. income tax, and U.S. labor alone bears the economic burden of U.S. payroll taxes. But if part of that tax were to be replaced by an import tax that is borne primarily by foreign labor and capital, the U.S. would, in effect, have imported an additional tax base consisting of the wages, interest, and dividends received by foreigners who produce (outside the U.S.) the goods and services that they export into the U.S. market to the tune of \$1,244.2 billion each year.<sup>(7)</sup>

### **Example**

The U.S. replaces the current income tax, corporate and personal, with business and personal taxes similar to those in H.R. 134 that, among other things, imposed a 10% import tax. The H.R. 134 tax would raise the same \$1,086.6 billion of annual revenue for the Treasury as the current income tax but, under the H.R. 134 tax, \$124.4 billion would come from an import tax (10% x \$1,244.2 imports) and a good portion of that import tax would be borne not by Americans, but, instead, by foreign labor and capital. If, to be generous, it is assumed that Americans would bear as much as 20% of the import tax, that would still leave \$100 billion (80%) to be borne by foreigners. The result is to reduce the tax burden on Americans by at least \$100 billion per year.

There are many other reasons for tax reform, and perhaps many better ones. But the most politically powerful may be the "tax cut" that is inherent in tax reform.

### **Footnotes**

1. Christian, "The International Components of Tax Reform: Tax Policy That Serves the National Interest (Part 1)," 11 JOIT 48 (July 2003).
2. Under H.R. 134, an 8% or 10% cash-flow tax was imposed on incorporated and unincorporated businesses. The tax was territorial. Export income was excluded from tax. A tax was imposed on imports at the same rate as the business cash-flow tax.
3. The usual (and generally incorrect) way of looking at an import tax is the same as the usual (and generally incorrect) way of looking at a retail sales tax. The false premise is that if the import tax is 10%, U.S. purchasers of imported products will pay 10% more for all imports.
4. See Christian, Part 1, supra note 1.

5. See Wada and Graham, Appendix B, "Is Foreign Direct Investment a Complement to Trade?," in Graham, *Fighting the Wrong Enemy* (Washington, D.C.: Institute for International Economics, September 2000). See also Graham, "Foreign Direct Investment Outflows and Manufacturing Trade: A Comparison of Japan and the United States," in Encarnation, ed., *Japanese Multinationals in Asia: The Regional Operations of Japanese Multinationals* (Oxford University Press, 1997); and Graham, "U.S. Direct Investment Abroad and U.S. Exports in the Manufacturing Sector: Some Empirical Results Based on Cross Sectional Analysis," in Buckley and Mucchielli, eds., *Multinational Firms and International Relocation* (Cheltenham, England: Edward Elgar Publishing, 1997).

6. "Factor income" is defined on the website of the United Nations Statistics Division as "[c]ompensation of employees by, and operating surplus of, producers. The net domestic product is often valued at factor incomes." See [http://unstats.un.org/unsd/cdb/cdb\\_dict\\_xrxx.asp?def\\_code=256](http://unstats.un.org/unsd/cdb/cdb_dict_xrxx.asp?def_code=256).

7. For the statistics, see Christian, Part 1, *supra* note 1.

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