THE REBATE OF VALUE-ADDED TAXES AT THE BORDER AND THE COMPETITIVE DISADVANTAGE FOR US SMALL BUSINESSES

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WEDNESDAY, JULY 7, 2004

HOUSE OF REPRESENTATIVES,
COMMITTEE ON SMALL BUSINESS
Washington, D.C.

The Committee met, pursuant to call, at 2:05 p.m. in Room 2360, Rayburn House Office Building, Hon. Pat Toomey, presiding.

Present: Representatives Toomey, Bartlett, and Chocola.

Mr. TOOMEY. Good afternoon, everyone, and welcome to the Small Business Committee. The hearing today is on the topic of the rebate of value-added taxes at the border and the competitive disadvantage for U.S. small businesses.

Today, the Committee will hold a hearing to examine the effect primarily on U.S. small businesses of international trade rules administered by the World Trade Organization that permit the rebate of value-added taxes at the border while denying comparable treatment for other types of taxes such as income taxes.

European countries impose value-added taxes as high as 25 percent, depending on the specific country. These taxes are imposed whether the goods are manufactured in Europe or imported from abroad. However, the VAT is rebated at the border when goods are exported from Europe.

In contrast, current trade rules administered by the WTO do not properly recognize the ability to rebate other types of taxes, such as income taxes at the border. Because the United States does not impose value-added taxes, goods exported from the United States to Europe bear the full brunt of U.S. income taxes and the value-added taxes in Europe while goods exported from Europe to the United States enjoy a full rebate of VAT tax at the border.

As Congress examines this apparent comparative disadvantage, this hearing will discuss various options to deal with the issue.

We have got an excellent panel of experts with extensive experience to testify on the subject today:

Dr. Gary Hufbauer, Professor of Economics at Georgetown and a Senior Fellow at the Institute for International Economics, has written extensively on U.S. international taxation. Claude Barfield, a Resident Scholar and Director of Science and Technology Policy Studies at the American Enterprise Institute similarly is well published on issues of trade. Bill Jones, Chairman of Cummins-Allison

Corp, he will give us his perspective as a business negatively impacted from this practice. And lastly, we will hear from Maya MacGuineas—am I mispronouncing that?

Ms. MACGUINEAS. MacGuineas.

Mr. TOOMEY. MacGuineas, Executive Director of the Committee for a Responsible Federal Budget.

I look forward to the testimony of all the witnesses. On behalf of the Committee, I wish to thank all of you for being here today, especially those who have had to travel far. I would be happy to yield to either of my colleagues if they would like to make an opening statement.

If not, then I will introduce the first witness.

Let me welcome Gary Hufbauer. Gary Hufbauer is the Reginald Jones Senior Fellow at the Institute for International Economics. Mr. Hufbauer is no stranger to this Committee having testified before the Committee just this last year on international tax issues. We welcome—

[Pause.]

Mr. TOOMEY. There we go, we are back. We do in fact want to hear what you have to say.

We welcome you again before the Committee, and we look forward to your comments. We will go with five minutes for the statement from each witness. The clock, we have a light there that indicates that. I imagine everybody knows how that works. Orange is the one minute mark, is it not, and red means the time is up, and then we will proceed to questions.

So at this point welcome, and I entertain the testimony from Mr. Hufbauer.

STATEMENT OF GARY CLYDE HUFBAUER, INSTITUTE FOR INTERNATIONAL ECONOMICS

Mr. HUFBAUER. Well, thank you very much, Mr. Chairman. As you know, small business faces numerous disadvantages when selling abroad, and many of them or most of them can be traced to the substantial overhead costs of mastering a new environment.

Mr. TOOMEY. Could you bring the microphone a little closer, please?

Mr. HUFBAUER. Sure. Is this better?

So small business faces disadvantages when selling abroad, but it also faces larger firms generally competing in the United States, in the U.S. market, and they are able to spread their overhead cost. But in addition to that we have the tax issues, which you described, and the foreign competitors enjoy the benefit on their value-added tax and kindred taxes, such as the Canadian GST.

The international rules, which are codified in the WTO, on border tax adjustments have a long history and they have attracted a lot of scholarly discourse, but just in brief, the rules work to the disadvantage of firms based in a country that does not use a VAT

or GST as a source of public revenue, but instead relies on direct taxes—particularly social insurance and corporate income taxes, and of course, that is the United States.

Now, over the past 40 years, governments worldwide have turned to VAT-type taxes to pay for public needs, particularly entitlement programs, and amongst OECD countries, VAT revenues typically amount to between four and eight percent of Gross Domestic Product.

In economic theory, border adjustments for uniform businesses taxes are equivalent to exchange rate adjustments of approximately the same magnitude. So given that theoretical equivalence, the classic answer to national differences in business tax systems is that exchange rate adjustments will eventually offset any tax differences, such as the ones that you noted, Mr. Chairman, and wash away any permanent effect on business location, decisions or competitive disadvantage.

So according to the classic logic, business firms in neither the exporting country nor the importing country should care where their business taxes are adjusted at the border. But there we have the theory. On the other hand, we have the practice, and the practice is they do care, and they care a lot.

No country has imposed a VAT, or at least no country of any significance, without adjusting at the border. If they believe their classic theory, they would say, hey, the exchange rate will take care of it, no need to adjust. They do not believe it, and they have adjusted instead.

Now, American firms as you know have complained about these adjustments since the early 1970s, and one reason, but not the only reason, is that border tax adjustments are immediate and certain. You know they are there. You get them. The exchange rate adjustments are distant and problematic.

Research on fundamental forces that supposedly determine exchange rate, the research shows that they do an exceedingly poor job. You will not make money using fundamental forces to predict exchange rates. You would do better to flip a coin.

So if fundamental forces cannot explain exchange ranges, then what confidence can you place in the classic prescription that any benefit on border adjustments will be offset by exchange rate changes? I suggest you cannot place much in that.

My suggestion, if the Congress repeals the FSC, which it seems about to do, that it should pass yet another resolution calling upon the European Union and other WTO members to abolish their preferential border tax adjustments for indirect taxes. They should cease exempting these taxes when they export and cease imposing them on their imports.

Now, I know that sounds pretty academic and pretty theoretical, but what I would suggest if a last call to the WTO members falls on deaf ears, the Congress should seriously consider for this and other reasons scrapping the corporate income tax in its entirety and replacing it with a business tax that can be adjusted at the border. U.S. firms can then enjoy tax parity with their foreign competitors, both at home and abroad.

Thank you, Mr. Chairman.

[Mr. Hufbauer's statement may be found in the appendix.]

Mr. TOOMEY. Thank you very much, Mr. Hufbauer.

Our second witness is Claude Barfield, Resident Scholar of the American Enterprise Institute. We look forward to drawing on your experience with international trade law. Welcome.

STATEMENT OF CLAUDE BARFIELD, AMERICAN ENTERPRISE INSTITUTE

Mr. BARFIELD. Thank you very much, Mr. Chairman.

Because one of the other panelists, my colleague, Gary Hufbauer, is an acknowledged expert in the tax side, I am going to confine my testimony, at least my oral testimony, to the larger and the broader implications of a whole series of FSC decisions, ending with the decision that would allow you to invoke $4 billion worth of damages against the United States.

I would like to point just to four issues, three problems, and then some suggestions for reform of the system.

First, the question of national sovereignty versus the reach of WTO rules into domestic policy. And I should say as a footnote, I am a strong supporter of the WTO. You may not think so by the time I finish my testimony.

The FSC/ETI decisions raise troubling questions about the reach of multilateral trading rules versus the right of national governments to determine fundamental tax policy. Because these decisions cannot be overturned short of a unanimous agreement by WTO member states, they also highlight a constitutional flaw in the WTO that is already operating in this and other cases to undermine its legitimacy; that is, the imbalance between the highly efficient and virtually unchecked dispute settlement system and the inefficient and practically unworkable consents of rule-making procedures.

In the final appeals before the WTO appellate body in these cases, the Bush administration clearly recognized the gravity of the issue or issues raised by the earlier decisions, and starkly warned the appellate body of the consequences of an adverse ruling. In an unprecedented move, they sent not a career USTR lawyer, but the Deputy Secretary of the Treasury, Ken Dam, to the hearing.

And Dam said the following: "Few things are as central to a country's sovereignty as how it raises revenue. The necessary implications of the panel's analysis is that the WTO may second guess the reasonableness of a member's decision regarding the most basic elements of the tax system."

Now, in almost every aspect, I would argue the final judgment of the appellate body of the earlier panel reports despite protestations to the contrary ignored Dam's warning, and in my judgment, the Bush administration should have taken a much stronger stand, at least verbally, after the decisions, and even raised the question that the United States ought to be rethinking its relationship with the WTO. We can talk about that later.

Secondly, the problem of the WTO as what I would call an incompetent world tax court, and here I am not going to go into details, but my point is that if you get into the details of the decisions you can see that the reasoning and the conclusions of both the panels and the appellate body—there were two panel decision and two

appellate body decisions—really were or at least showed a stunning ignorance of international tax law.

And I point out in the final ETI ruling, the appellate body posited the necessity for clean, bright lines between domestic and foreign source income, ignoring the impossibility of finely tuning such divisions when attributing income from transactions related to R&D, manufacturing, marketing, advertising, and transportation.

In the complex and shadowy world of international taxations, systems aim at avoiding double taxation inevitably allows some income to escape all taxation, and in most countries these fine lines are the subject of endless haggling between the government and its corporations.

Thirdly, the WTO as avenger, this was the—the damages that were levied, the $4 billion, is being called by some international tax experts as outrageous, and I think that is true. Remember, the WTO is a reciprocity-based organization, or the rules, and thus it has been a standing practice since the early days of the GATT the retaliation for a breach of obligations should be limited to the trade effects of that breach. There are also WTO subsidy rules that have the obligation that retaliation be proportionate.

In this case the United States argued, after it lost the case, that the damages should be no more than $1 billion for the subsidy effects, not even the trade—beyond even the trade effects. The EU argued, however, that the amount of the subsidy should be the amount of the worldwide subsidy, the worldwide effect, and astonishingly the arbitrators had bought this interpretation.

They did so on the basis of what they called the "gravity" of the breach and the nature of the upset of the balance of rights and obligations, ignoring the mandate for portionality. To reach this conclusion, the arbitrators invoked international law normally used for political and human rights violations, arguing that the U.S. breach represented an ergo omnes process. That is against all members and not against the EU.

This decision went far beyond anything that had been negotiated or that had been present in the WTO.

Finally, stepping back from the details of these cases, I would argue that what is needed is a major change in the mindset in intellectual isolation of the WTO dispute settlement system.

In the FSC/ETI cases, both the panels and the appellate body demonstrated a stunning technocratic determination to barrel forward with their own pet legal theories and ignore the political history in the context of the issues at hand. I have suggested, not just for this case but in other forum because I think this case represents a kind of classic and extreme reach of what can happen when you go beyond the negotiated rules, I think this is happening in other areas, in anti-dumping, in safeguards, in environmental rules.

There are two things I think we should consider in terms of the future of the WTO dispute settlement.

One, and this is a legal term that they manage to invoke it sometimes, is "non-liquet,' and that phrase is just a Latin phrase. It means "it is not clear."

Given the widespread agreement that WTO tax are replete with lacunae and contradictory provisions, and given the questions con-

cerning the legitimacy of judicial decisions are magnified at the international level, the panels and the appellate body should be instructed to use this doctrine more frequently and throw decisions back to the WTO general council or to trade—that is C-O-U-N-C-I-L, not counsel—or to trade round negotiations.

The critics of non-liquet argue that it is prohibitive because international law is necessarily complete, or that is, the duty of judges to step in and fill gaps, and particularly in contentious areas. WTO rules by common consent are certainly not complete, and arguments for gap-filling by judges reflect a dangerous and even anti-democratic myopia.

Alternately, you could have the invocation of a doctrine that we have used in the United States, the so-called political issues doctrine developed by the U.S. Supreme Court. The doctrine is meant to provide a means by which the judiciary can avoid decisions that have deeply divisive political ramifications and thus in the opinion of the court should be settled through judicial democratic processes involving both the legislature and the executive.

In this case, it would involve trade negotiations, and not have the appellate body and the panels get out ahead of those negotiations.

In summary, the proposition advanced here is that heading off corrosive conflicts between the United States, the EU, and other WTO members in the future will necessitate the forum of international trading rules that have now enmeshed and entrapped both trade superpowers.

Thank you very much.

[Mr. Barfield's statement may be found in the appendix.]

Mr. TOOMEY. Thank you very much.

Our next witness is Bill Jones, Chairman of Cummins-Allison, located in Mount Prospect, Illinois. In addition to heading up a small manufacturing business, he also serves as the chairman of the United States Business and Industry Council.

Mr. Jones, welcome.

STATEMENT OF WILLIAM JONES, CUMMINS-ALLISON CORPORATION

Mr. JONES. Also Cummins-Allison is an Indiana corporation founded by the Allison family, which you may be familiar, Mr. Chocola.

But Mr. Chairman and Committee Members, my name is William Jones, and I am Chairman of Cummins-Allison, a privately held manufacture company based in Chicago. As you said, I also serve as the chairman of the United States Business and Industry Council this year, and I am a member of the National Association of Manufacturers.

I appreciate the chance to be here today to talk with you about an issue that is extremely important to me, namely, the crisis in American manufacturing, and the way the rules of the game in international trade are stacked against American companies.

The subject of this hearing, which is the disparity of the treatment of U.S. and foreign taxes in global trade, constitute a blatant

example of how American manufacturers are currently disadvantaged and how policymakers must become more aggressive in the defending of U.S. interests.

Cummins-Allison is one of the world's leading producers and innovators in the manufacture of equipment that scans, sorts, denominates, and authenticates currency for national security issues. This is an area that is quite literally essential to America's economic and national security, providing the critical function and deterrence of counterfeiting and the preservation of the dollars, the world's preeminent currency.

Unfortunately, we, like so many manufacturers in this country, have been dramatically and negatively affected by an uneven playing field in the global trading system.

Twenty years ago American companies accounted for 90 percent of the U.S. requirements in the field of currency authentication. Today, that percentages is down to 30 percent, and we, Cummins, are the only surviving U.S. producer. This is a story that could be repeated for any number of American manufacturer industries and their workers.

What is happening? You hear a lot of talk about cheap foreign labor and lower costs abroad, about the inability of an advanced economy to compete against low-cost developing world, but what we consistently fail to recognize is how much of our problem has nothing to do with the cost or the competitiveness or wage rates, and everything to do with the rules that literally make no sense and serve no readily apparent purpose other than to artificially punish U.S. manufacturers.

No issue is more illustrative of that point or more important to the bottom line of American companies and workers than the one that the Committee is considering today. I do not come here as an expert on the legal niceties relating to the border adjustability of taxes, but I can tell you that I understand the fundamental business importance of this issue.

The problem is as simple as it is unbelievable, and amounts to essentially the double taxation of U.S. producers selling abroad while our foreign competitors sell largely tax-free in this market. Let me illustrate.

If our company, Cummins, or any other American company wants to sell a product in China or Europe where the value-added taxes predominate, we get no refund or rebate of U.S. income taxes, but we do have to pay the foreign VAT. Meanwhile, foreign producers export to America get their domestic VAT rebated while picking up no income tax here.

While there are complexities in calculating the exact effect of this practice, including issues relating to the effects of state sales tax in the United States, it has been estimated that this results in as much as a 25 percent difference in the price they can sell for here versus what we can sell for there.

What is astonishing is that, as far as I can tell, the international rules that allow this to go on have no legitimate economic basis whatsoever. The rules are based on an artificial distinction between so-called direct taxes and indirect-like VAT taxes, even though economists have shown that these taxes tend to have the same incidence and effect. Allowing indirect but not direct taxes to

be rebated on exports are imposed on imports makes no sense from a policy or economic standpoint, but I can tell you that it makes the task of keeping jobs and businesses in the United States far more difficult.

How does something like this happen? Apparently this was just an obscure line squirreled away in the original agreement of the General Agreement on Tariffs and Trade, something that never made any sense in a situation where our negotiators just simply got out-foxed.

For decades, Democrats and Republicans, Congress and administrations, and commentators and economists have all agreed that this rule is ridiculous. Every fast-track bill says we should make it a priority to fix it, and yet nothing is ever done.

From a business standpoint, I have to implore you, stop the madness. We have lost 3 million manufacturing jobs, we have a trade deficit that is literally unprecedented in the history of the universe, and we have been the most important market in the world for many, many years.

How is it that we do not seem to have the leverage to get the issue like this taken seriously? Of course, we do. We only have to be willing to use it and to play hardball the way our trading partners do so well and so effectively. The prescription is quite simple. We should make clear that we will not agree to any new multilateral trade agreements that does not fix this problem, and more, we should make clear to our key trading partners that we intend to see this accomplished in the short term, say the next year to 18 months. After that, we should make clear that we are willing to take more aggressive steps, including possible limitations on market access here until we see a resolution.

The rest of the world has had more than five decades to reap the benefits of this absurd inequity. They have had their unfair advantage, and enough is enough. It is time to stand up for our manufacturers and change the rules.

Thank you, Mr. Chairman.

[Mr. Jones' statement may be found in the appendix.]

Mr. TOOMEY. Thank you very much, Mr. Jones.

Our concluding witness this afternoon is Maya MacGuineas, Executive Director of the Committee for Responsible Federal Budget. We welcome you before this Committee, and look forward to your comments.

STATEMENT OF MAYA MACGUINEAS, COMMITTEE FOR A RESPONSIBLE FEDERAL BUDGET

Ms. MACGUINEAS. Thank you. Good afternoon, Mr. Chairman, Members of the Committee. I should actually just clarify, I am not speaking as executive director of the Committee for a Responsible Federal Budget, but rather as a director of the Fiscal Policy Program at the New America Foundation.

As you are all aware, it is the case that while European exporters benefit from rebates on their value-added taxes at the border, parallel tax relief for U.S. companies has been ruled illegal by the WTO. This is due to the distinction international trade law draws

between the value-added taxes used by most nations and the corporate income tax that U.S. firms are subject to. Accordingly, the FSC/ETI benefits for U.S. companies appear to be on track to be repealed.

There is considerable debate about whether border adjustments affect the competitive trading positions of nations. On the one hand, general economic theory holds that in a system of floating exchange rates, changes in tax levels are offset by changes in exchange rates. Under this line of thinking even for countries without floating exchange rates rebates are not believed to make differences in the long run.

However, on the other hand, if this were true, it would not matter to our trading partners whether their VATs were rebated, yet it does matter and they are rebated.

In the real world, exchange rate movements can be quite sticky, and not only are relative exchange rates affected by a variety of economic factors, the timing of exchanges can be quite unpredictable.

So, as is often the case when it comes to theoretical reductions, we cannot know for sure whether the economic relationship between border adjustments and exchange rates holds true, nor can we know for sure the extent to which U.S. companies will actually be harmed by the WTO ruling. Either way, the current bill making its way through Congress is premised on the belief that U.S. companies will be severely disadvantaged by the change, and the bill therefore includes compensatory measures.

It is true that the corporate tax bill does little to help small businesses in particular, which are less able to absorb general overhead cost, and do not benefit from the economies of scale that many of their larger competitors do. From the perspective of this Committee, that may well be problematic.

Similarly, it is true that the benefits of the bill are spread quite unevenly with some sectors benefitting a good bit more than others. No matter the extent to which U.S. companies will be harmed by the tax law change, I would argue that the targeted tax relief, which is included in the FSC/ETI bill, is not the right approach to remedying the problem.

Already the cost of the bill is quite expensive and it is likely to be more expensive than current projections since many of the expiring provisions would undoubtedly be renewed. Since the costs will increase budget deficits, thereby decreasing government saving, the effect could actually be to worsen our trade balance and harm small businesses.

Furthermore, the general approach of targeted tax relief delevels the playing field between U.S. companies. Distorting the tax code to favor particular sectors of the economy may be politically appealing, but it is not good policy, nor does it help American consumers or the economy.

And finally, while I will not mince words here, this bill has become an egregious example of how effective special interest lobbyists have become filling the package with expensive, unnecessary, and unjustified corporate handouts, and any pretence that this constitutes good tax policy was lost long ago.

But out of the need to alter our tax policy does come an opportunity. The money saved from removing the illegal subsidy could be used to either reduce the deficit or help sweeten a comprehensive tax reform deal along the lines of what we saw in 1986, which would include eliminating many existing loopholes and subsidies while lowering corporate income tax rates.

Another desirable option would be to introduce a consumption tax, which could be adjusted at the border, to replace income taxes. Consumption taxes have a number of benefits, including, of course, that they would increase national saving. If we want to improve our trade balance, not to mention longer term economic performance, improving our national saving rate could play a critical role in this endeavor.

At the same time, most consumption taxes, such as sales taxes, tend to be highly regressive whereas the existing income tax at both the corporate and individual level is quite progressive. However, it is quite possible to institute a progressive consumption tax that would maintain existing tax burdens or even make them more progressive, if desired, rather than shift the burden down the income scale.

Since my time here is short today and I will not go into the details of how this might work, but a progressive consumption tax is desirable not just with regard to tax treatment and trade issues as we are discussing today, but in its ability to balance the oftentimes competing tensions between tax efficiency and tax equity.

Thanks for allowing me to testify today.

[Ms. MacGuineas' statement may be found in the appendix.]

Mr. TOOMEY. Thank you very much for your testimony. I would like to thank all the witnesses for their testimony, and I would like to begin with some questions, and I suppose, in fact, starting with a comment which some of you may disagree with, and I would appreciate perhaps starting with Mr. Hufbauer, your reactions to this thought.

It strikes me that there is a little bit of a irony in this whole discussion because the behavior that we are finding problematic, specifically the rebating by say European countries of the VAT when they choose to export their products, really amounts to European taxpayers subsidizing American consumers.

What we are saying is we really do not like it when European taxpayers allow American consumers to buy things cheap, which strikes me as a bit ironic.

For instance, if they instead of rebating the VAT, if they rebated twice the VAT or 10 times the VAT, and all European countries, for instance, did this, and they were all competing, American consumers would get things for free. That would be difficult for American manufacturers to compete with, obviously. But for American consumers, it would be an enormous windfall.

Do you agree that this current system amounts to foreign taxpayers subsidizing American consumers?

Mr. HUFBAUER. Yes, it does, and I think there is always a balance between welcoming the subsidy to consumers and thinking about your production base, and that is what all these inter-

national rules are about, trying to strike that balance, recognizing that consumers are also producers and that over a period of time that, you know, earn what you buy as a household or as a nation.

So your analysis is completely correct, and we have a number of laws in our trading system, and this area is one of them, where we say, well, you know, it might be great for consumers, but it is too hard on producers to have to compete essentially with the foreign treasury, which is what it comes down to, and that is going to be too detrimental to our productive apparatus over a period of time.

I would say in this particular case the balance has been struck at the wrong place. We are too welcoming of these, as you say, subsidies to consumers.

Mr. TOOMEY. Mr. Barfield, would you like to comment on that?

Mr. BARFIELD. I fully agree with what Gary said, and my instincts would normally be with the producer, it is a question of balancing. I think this just goes too far in terms of helping producers in Europe or other countries—not just Europe since you have the potential of VAT and then the rebate all around—against U.S. manufacturers.

I am normally skeptical if people talk about an uneven playing field, but I think in this case it is justified. The problem is that—I mean, we are not going to go in detail here, but if you look at the history, you know, the negotiators on both sides were aware of this, and it is very difficult to mesh the universal or the territorial system, and those who have a VAT, and those who have direct taxes, and that is why, you know, 20 years ago, 25 years ago there was a compromise. I mentioned this in my testimony. It was put together, and both sides would say—basically said—GATT panel said that both were wrong in terms of the way they were structured.

So both the EU and the United States said, well, we will just agree to live and let live, and that is the balance that was upset here, I think, after 25 years, and in a way, as I try to argue, that I think the panels and the appellate body were really just over the—this was an issue they know very little about. Somehow they were determined to teach a lesson to the United States, and ignored the possibility or even going back to look at the political history here, and that is why we are in the mess that we are in, I think.

Mr. TOOMEY. Thank you. This always just strikes me as a very peculiar debate that we engage in. It strikes me as irrational economic policy on the part of those countries that choose to subsidize exports instead of domestic consumption. I do not know why that is good for a given economy to engage in that, and yet they do. And then that manifests itself in lower prices for American consumers in this case, and we object strenuously to that, and for obvious reasons. There are some manufacturers that are hurt by that.

I have a question for Mr. Jones, which is, it strikes me that one way to address this, and I think somebody referred to this in the testimony, I have always been one that believes that corporations

do not pay taxes, they collect taxes, and corporate income taxes is counterproductive in many ways.

If we abolished corporate income taxes altogether, does that not solve this problem, do you think its some of the problem? Does it solve a problem for your company?

Mr. JONES. No, I would encourage you also to abolish the income tax and institute a VAT.

One of the problems you have as a—

Mr. TOOMEY. I am not necessarily advocating the institution of a VAT as a substitute, by the way.

Mr. JONES. It would help us tremendously because the fact is I have to sell against manufacturers from other countries that have a cost of no government. I have tremendous fixed cost. And what happens, and I think strategic planning, particularly on the part of certain Asian countries, they understand I have to have a certain capacity to cover all of my fix cost. Labor is only seven percent of my total cost, okay? Now, my R&D is almost 20 cents on a sales dollar. Now my fixed overhead is very substantial.

So if I can make all of my money in my home market like Japan at a much higher price, cover all of my total cost, I can sell in this market at a dumped price till the cows come home, and their strategy is to drive all of the U.S. production and get an industry out of business, which I have seen happen in many industries. And the consumer does pretty good in the short term, but when all of the U.S. industry is gone they then raise their prices.

So there is two losers in the end when we let them follow this kind of a strategy to its end. First, we lose our own industrial base. Second, the treasury loses the revenue, and we wonder why we have a huge federal deficit. Well, as our manufacturing goes down the tubes, you do not collect income. I do not care how you are going to do it, through a VAT or an income tax or whatever. But the fact of the matter is manufacturers produce and create wealth. Farming, mining, and manufacturing, that is what creates wealth. And if we do not do things to help that, the consumer is going to have no job.

I can tell you I talk to people that used to work for Motorola every week, and what has happened to that company through these unfair trade agreements, and the lost jobs and the lost income in Chicago, I spent several days with Mayor Dailey just a couple of weeks ago. He is beside himself. He does not know what he is going to do to fix the city's budget because the exodus of manufacturing, he says, his consumers cannot pay their taxes because the good jobs are going too. That is the reality.

You have got to think about it in a global situation, understand that these other countries are trading for advantage to advance their manufacturing because they know it creates wealth. If you want to know what a country looks like that is just a service economy, that is China before they woke up and realized they wanted to be a manufacturer.

Mr. TOOMEY. I may want to engage in continued discussion along these lines. I would come to some different conclusions than you have on a variety of these things.

Mr. JONES. A practical world and I know who I have to compete with, and I—

Mr. TOOMEY. I think comparing China to the United States in that way is an interesting comparison, but let me yield to the gentleman from Maryland for his questions.

Mr. BARTLETT. Thank you very much.

I would like to continue a bit of discussion on the issue that Mr. Toomey raised about corporate taxes, and make the argument that corporate taxes are a very bad idea, that they are the most regressive tax that we have, that they hurt poor people in two ways:

The first way that they hurt poor people is that they increase the cost of the products that poor people have to buy because, as Mr. Toomey says, businesses do not pay taxes. They collect them. Tax simply becomes a part of the cost of doing business and you add it to your cost, and you charge enough for your product so that you can pay the tax and still make a profit after the tax. And so poor people are now paying more for everything they buy because of corporate taxes, which is a very regressive tax. A rich guy can pay the increased cost. It does not hurt him. It hurts the poor guy.

The second way that the poor guy is hurt by this is that it makes our businesses less competitive in the global marketplace, which is what we are here talking about today.

Mr. JONES. Absolutely.

Mr. BARTLETT. And so the poor guy not only has to pay more for his product, and he does not even have a job now to get the money to buy the product because the job he would have had has now gone to the Pacific Rim or somewhere because of corporate taxes which among many other things has made our businesses in this country noncompetitive globally, and so it is gone.

So why is not the best idea—and by the way when I talk to my liberal friends, they understand this for about five minutes, and then beyond that, they say, gee, those companies are rich, let us collect taxes from the companies. I have to come back and tell them, gee, you cannot collect taxes from a company. All the company does is collect the taxes from the people that sells its product to, or its service, because if they do not do that, they are going to be out of business.

So why is it not the best solution to your problem just to do away with the corporate tax? Would not everybody be better off, you, and consumers, and everybody better off? And if the government needs more money, now, I think the government needs to cut its spending and stop doing unconstitutional things like philanthropy, like health care except for our military, like education, none of which, by the way, can you find any hint in Article 1, Section 8, are legitimate functions for the federal government.

But if you really need more money, would it not be less regressive to get it simply by an increased income tax so that rich people now pay more of it?

Mr. JONES. Who are you asking?

Mr. BARTLETT. Sir? Any of you, you know. But I just think that the corporate tax is a very bad idea for businesses. We have driven jobs overseas with it. We are making products cost more for our poor people, and why cannot we convince our liberals, who claim to love—by the way, I know they really love poor people because they make more of them so they have more to live, but why cannot we make that argument that corporate taxes are a bad idea?

Ms. MACGUINEAS. Could I respond to that?

Mr. BARTLETT. Yes.

Ms. MACGUINEAS. I would certainly agree with what both of you said, that corporations do not pay taxes, people pay taxes. I think it is not quite clear that the corporate tax is so regressive. In fact, generally I hear it is one of the more progressive taxes because it is passed along both in the form of lower wages, higher prices as you talked about, and also lower returns on capital. And I think the distribution or the incidence of that tax probably changes during the different business cycle where different parts of the market are tighter or are looser.

But I agree with you that getting rid of the—I would agree with both of you that getting rid of the corporate income tax has a lot of benefits to it. One of them is that it is one of the least transparent taxes we have, and the world of bad budgeting, which is the world we live in right now. I think a lack of transparency on both sides of the budget is very problematic. You need to know the ways in which you pay taxes.

However, I think you can eliminate the corporate income tax if you keep the individual income tax in place, because then you have what amounts—

Mr. BARTLETT. Wait, if you would hold just one moment. I am no fan of the corporate—of the personal income tax.

Ms. MACGUINEAS. I had a feeling you would say—

Mr. BARTLETT. I would do away with that in a heartbeat and put in its place a consumption tax.

Ms. MACGUINEAS. Right.

Mr. BARTLETT. So I think do away with the corporate tax, put in place a consumption tax. Now, this is clearly not regressive. You clearly are now helping poor people.

Ms. MACGUINEAS. Well, and I think what I am suggesting when I talk about a progressive consumption tax or something like the

Nunn-Dominici tax that was brought up about 10 years ago is that consumption taxes are desirable for so many reason. And if we could sort of come to an agreement that there is a role for them, particularly in this economy, and then hammer out the details of how progressive to make them, and I might want a more progressive tax. I probably would want more of a progressive tax than you would overall, but we could argue about how to structure the tax burdens. But create a corporate tax, not a wage tax, but a corporate tax to replace both the corporate income and individual income tax. I think that there is a compromise there to be had.

Mr. BARTLETT. Is not any corporate tax regressive?

Ms. MACGUINEAS. Not—

Mr. BARTLETT. Because the consumer has to pay the tax. You just admitted that people pay taxes, corporations do not pay taxes.

Ms. MACGUINEAS. Absolutely.

Mr. BARTLETT. Does not that make any corporate tax a regressive tax?

Ms. MACGUINEAS. No. When it makes it progressive is when its shareholders who are paying the tax, capital owners who tend to be higher earners, and nobody knows for sure what the incidence of this tax is, but a lot of people believe that the corporate income tax is actually one of the more progressive taxes.

Mr. BARTLETT. I am having some trouble understanding that.

Mr. HUFBAUER. If I could, this is a very interesting debate, we could spend all afternoon on it. One of the vices, but it is also the great virtue of the corporate tax is that nobody knows, including economists who have spent their lives studying it, who actually pays it. So the non-transparency is kind of a legislative virtue because you can say the guy behind the tree pays it.

The second point that I would make is that the system for reasons that congressmen know better than anybody else, the corporate tax is a mess. I mean, it is unbelievable. And everybody kind of agrees that we ought to get rid of it.

I would not refer to the replacement tax—the government needs money—I do not refer to it as a consumption tax. It is a business tax, business pays it. When VAT is collected, the person who buys the good as an individual is not legally liable for paying that VAT.

Mr. BARTLETT. Sir, if you will excuse me for just a moment. When I talk about a consumption tax, I am not talking about VAT. I want taxes to be—I would like the tax to be in big, red numbers, bigger than the cost of the product, so when the American pays the tax he knows it. A VAT tax is hidden. I want that to be a consumption tax of something like 20 percent on everything you buy.

Every time you buy it, I would like you to know how much your government is costing you.

By the way, tomorrow is the first day this year you will be able to work to get any money for yourself. Today is cost of government day. You have worked all year so far to pay for the cost of government—

Mr. TOOMEY. And on that note—

Mr. BARTLETT. —state and local taxes and unfunded federal mandate.

Mr. TOOMEY. And on that note I will yield for a question to the gentleman from Indiana.

Mr. CHOCOLA. Thank you, Mr. Chairman.

Just quickly, before I got here I was—I lived in Mr. Jones' world. I was CEO of a publicly traded company that about 40 percent of our sales are outside the United States. We utilized the FSC and the ETI benefits. We have competed against companies importing here, they got VAT rebates.

Would you argue that the VAT rebate is in effect exactly the same as a FSC/ETI benefits?

Mr. HUFBAUER. No. The FSC/ETI was very small. It was very modest.

Mr. CHOCOLA. But in effect the same?

Mr. HUFBAUER. Well, you could say very roughly qualitatively similar, but in terms of magnitude, always much smaller, and it only applied on the export side, not on the import side. There are many companies that would not take advantage of the FSC/ETI for—well, basically small business had a hard time taking advantage of it. Not all small business, but many did.

Mr. CHOCOLA. Has anybody filed a claim with the WTO against the VAT rebates?

Mr. HUFBAUER. Well, if you go back to the time that Claude was talking about, this was a major issue in the early 1970s, and U.S. Steel Corporation then did bring a case, and for a combination of what I would call political, the alliance issues of the day, and economic reasons, the treasury department rejected that case and the treasury department's holding, the decision was upheld by the Supreme Court, not on the economics of it, but on the grounds of the competent administrator.

So yes, 30 years ago there was a very lively dispute in this country, and the United States went, for reasons that Mr. Jones thinks were quite misplaced, in the direction of accepting the rebate of the VAT.

Mr. CHOCOLA. Would it be your suggestion or recommendation that a claim be filed with WTO? And if so, what do you think the conclusion would be?

Mr. HUFBAUER. My suggestion, just to hog the microphone a little bit more, is that I would not pursue the litigation route because I think it is a loser given the ways the rules are now written. I am exactly with what Ms. MacGuineas and Mr. Jones have said.

We need to change the rules, and we have to make it a priority to change the rules. And if we cannot change the rules, then I suggest with this reason and others we change our own system, because the corporate tax is, I think—words cannot express what I think about the corporate tax.

Mr. BARFIELD. I would just like to add just on the trade side, I will defer to my colleagues on the intricacies of the tax side, it is also true, I think, that in the late seventies both the Europeans and the United States were told that the tax—this part of their tax system was GATT-illegal, and that is when they reached in 1981, what both sides at the time thought was a compromise. You will live and let live.

So the FSC cases came fifth, and then the United States, because it thought that what it had was still probably too egregious a change to the FSC. Then you had 15 years where nothing happened, including the Uruguay Round. One could argue about whether or not you should have been more specific, but as I say in my testimony, the panels and the appellate body had this history before them. They knew this, and they blew right through it, determined to put their own stamp on it in a way that I think was really incompetent and clearly ignorant of international tax rules.

Let me just go back and talk about the colloquy we have had for the last 10 or 15 minutes. You know, we have now—starting with the FSC and ETI decisions, we have now gotten into a debate about the U.S. tax system. That is a great debate to have, but the problem with it is to have that debate under the gun of the WTO and under the deadlines of retaliation means that you are not going to—you really are not going to have a good outcome.

And the lesson here from me is, and I have a great deal of sympathy with Chairman Thomas and with the administration. I think the reason that they did not raise more hell than they did when the series of decisions came down or were not really more firm is that—my view, my view is that both the administration and Thomas thought that they could use the decision to effect reform in the United States. And that is a bad—without criticizing, that is a—clearly we are seeing how, as Ms. MacGuineas has pointed out, a bill that is a Christmas tree bill that has been done because it is under the gun of retaliation and timing.

And so this judgment was, I think, a flawed judgment. And as a lesson for us not to think that you can just use a WTO decision and retaliation to somehow get a better economic policy. I think normally it is not going to happen because you cannot get over the particular interests, particularly in taxes.

Mr. TOOMEY. I have got another question if we care to do another round. I would like to pursue just a couple of ideas.

First, a question maybe either the economists could help us with this one, and I am one that thinks we do shoot ourselves in the foot with regard to our manufacturing in many ways—the level of

taxes, the litigation that we tolerate, the regulation that we impose—we systematically put ourselves at a competitive disadvantage.

Having said that, does anybody on the panel happen to know what the—where the total absolute value of American manufactured goods are today in relative terms to the past? What percentage? Are we at an all-time high? Are we at a many year low in terms of the dollar value, adjusted for inflation or not, of total manufactured output? Does anybody know?

Mr. HUFBAUER. Let me toss out a few figures. What has happened in manufacturing because of its very high productivity is that the labor force engaged in manufacturing has been on a very—

Mr. TOOMEY. Right.

Mr. HUFBAUER. —long-term downward trend.

Mr. TOOMEY. Right.

Mr. HUFBAUER. From about 30 percent in the early 1950s to about 15 percent today. However, the share of Gross Domestic Product accounted for by manufacturing has not fallen nearly by that percentage.

Mr. TOOMEY. Right.

Mr. HUFBAUER. About 22 percent of Gross Domestic Product is now in the manufacturing sector. And if you do the arithmetic, you can see that manufacturing workers produce more than their pro rata share of the labor force, and that is down somewhat.

We have a trade deficit, which has been alluded to, which is concentrated in the manufacturing sector, it is about $450 billion in manufacturing. And if suddenly we had a trade balance, and there is a lot of macro economics that goes behind that, you would increase the share of manufacturing in GDP by about three or four percent. Now, something else would go down in GDP, but that is a very rough survey of some numbers.

Mr. TOOMEY. That sounds—if I can just follow up because that is not exactly what I asked, and I understand and I agree with everything you have said. But given that the share of our total GDP has—that is comprised of manufacturing has declined somewhat, but of course total GDP has grown—

Mr. HUFBAUER. Oh, yes.

Mr. TOOMEY. —is it true that we manufacture more today than we ever have before?

Mr. HUFBAUER. Oh, yes, yes.

Mr. BARFIELD. Yes, yes.

Mr. TOOMEY. So total American manufacturing output is at a record high?

Mr. BARFIELD. In the nineties, and I do not have the numbers right in front of me, but if you just take the absolute amount for 1990 through 2002, we increased the volume and the amount by much more than our trading partners.

Mr. TOOMEY. Right.

Mr. BARFIELD. Major trading partners.

Mr. TOOMEY. I just think that this is important because I think we often lose sight of the fact that we manufacture—our manufacturing today is at an all-time record high.

Now, it is true that other sectors of our economy have grown more rapidly than manufacturing, and so it is not at a record high in terms of percentage of GDP, and the productivity gains have been much greater there than in other sectors, so as a percentage of labor force it has actually declined significantly, but we make more stuff than ever in that sense.

The specific question that I had about this more narrow debate, my understanding is, Mr. Hufbauer, you are advocating one potential solution to this problem is to have the WTO change the rules so that it would ban the border VAT rebate. Mr. Barfield, do you agree that that is a viable solution?

Mr. BARFIELD. I think it is going to be very tough for this reason. This is another downside of the new so-called judicial system we have got there. The European Union has one big—when you have won, they will turn to us and say, what are you talking about, change our system. We just won. It not that they might not, but it is going to be very difficult, and the price we would have to pay in a trade negotiation might be quite high.

Mr. TOOMEY. So politically it is difficult.

Mr. BARFIELD. I would not—I do not disagree with you. I think you should try to get—we should—you know, we should get this changed because it is—you know, it is an inequity that hits us, but I think it is going to be very difficult.

Mr. TOOMEY. Do either of you have a comment about this?

Ms. MACGUINEAS. I think I would prefer to revisit the distinctions that exist between direct and indirect taxes, which I do not think make a lot of sense in this environment. But I am probably also less concerned about this issue as a whole in some ways—back to your initial point, which is there are so many tensions in tax policy, but one of them is that of the producer interest versus the consumer interest, and we are in a situation where the consumer interests are doing pretty well, and I tend to think we end up with better overall economic policy if we look at things from the consumer perspective.

So I am less concerned about those changes that are necessary to address this problem as much as the larger tax problems at hand.

Mr. TOOMEY. Mr. Jones, do you have anything you wanted to add?

Mr. JONES. Well, a couple of thoughts.

You asked earlier about the—you mentioned your company exported. About 25 percent of what we product is exported, and the offset we would get from the FSC is not equivalent to the offset that the—I would love to be a German manufacturer or a Japanese manufacture, I guarantee you. I do not know what it would be, but I believe we would export more, significantly more if we had an equivalent offset.

The second thing, in the WTO that always worries me is I do not know why we agreed to this, but WTO is one country, one vote, and you know, under the old system we had some leverage which reflects the size of our economy, and we certainly do not have one vote at the UN, we have a veto. And I do not know what you do about that, but it leads me back to what is practical it seems, it may be more practical for us to change our tax code which is, again, to eliminate the corporate income tax and have some kind of a consumption tax or a VAT. That is something we can do.

I just do not have much hope that the WTO is going to give us any relief from what I have seen in their decisions. I think the Europeans, as you say, they have had some very significant victories in this area, and you are going to have a hard time there.

Mr. TOOMEY. The gentleman from Indiana.

Mr. CHOCOLA. Just quickly following up on the—Mr. Jones, coming from a manufacturing background you are not gong to find a bigger fan of manufacturing or a bigger advocate, but also recognize realities of the global economy we live in, which provides a lot of opportunities, and I think we engage in a lot of hyperbole and a lot of rhetoric sometimes.

I think it is important when we talk about trade issues that we keep in mind—as Mr. Toomey just said, we essentially make more widgets that we ever have, personal incomes are up. And so when we say there are no good jobs, I think we compromise the effort of focusing on the real problems, and I have always said when I was with a company that we would never move our business for low wages. We are not intending to compete on low wages. What we might move our business because of all the taxation, regulation, litigation that we had to deal with.

Would you agree with that, that really if we only focus and talk about low wages we are really taking our eye off on the real problem, is the total cost of doing business?

Mr. JONES. I have not said anything about—

Mr. CHOCOLA. No, I am not saying you specifically, but is this issue as discussed as I hear it in my district and around the country—

Mr. JONES. I think this VAT inequity is a much bigger burden and a challenge for my company than the wage issue. I do not know if I am answering your question. I can only speak from my experience.

Mr. CHOCOLA. Well, I guess I am hoping to get some input as to how we can make sure that we focus on the real issues, which I think are things like this—fair trade policies and effective—

Mr. JONES. Right.

Mr. CHOCOLA. —enforcement, and that is why I was asking about whether the impact or the effect is the same of the VAT rebate as the FSC/ETI; not the quantitative impact. Because if it is the same, then maybe we should try to enforce it more effectively with the WTO effort. But I am concerned that we get into the hyperbole which distracts from really focusing on the problems that face small businesses and manufacturers in America.

Mr. TOOMEY. Well, I thank the gentleman from Indiana, and I thank the witnesses for testifying. Thanks for traveling here to be with us today. I really appreciate your input on this as my colleagues do, and the hearing is now adjourned.

[Whereupon, at 3:00 p.m., the Committee was adjourned.]

Opening Statement

Donald A. Manzullo, Chairman

The Rebate of Value Added Taxes at the Border
and the Competitive Disadvantage for U.S Small Businesses

Hearing before the U.S. House of Representative
Committee on Small Business

Wednesday, July 7, 2004, at 2:00 p.m.
2360 Rayburn House Office Building

Today the Committee will hold a hearing to examine the effect on U.S. small businesses of international trade rules administered by the World Trade Organization that permit the rebate of value-added taxes at the border while denying comparable treatment for other types of taxes such as income taxes.

European countries impose value added taxes as high as 25 percent depending on the specific country. These taxes are imposed whether the goods are manufactured in Europe or imported from abroad. However, the VAT is rebated at the border when goods are exported from Europe.

In contrast, current trade rules administered by the WTO do not properly recognize the ability to rebate other types of taxes, such as income taxes, at the border. Because the United States does not impose value added taxes, goods exported from the United States to Europe bear the full brunt of U.S. income taxes and the VAT in Europe while goods exported from Europe to the United States enjoy a full rebate of VAT at the border.

As Congress examines this apparent comparative disadvantage, this hearing will discuss various options to deal with this issue.

We have an excellent panel of experts with extensive experience to testify on this subject today. Dr. Gary Hufbauer, Professor of Economics at Georgetown, and a Senior Fellow at the Institute for International Economics, has written extensively on US international taxation. Claude Barfield, a Resident Scholar and Director of Science and Technology Policy Studies at the American Enterprise Institute, similarly is well published on issues of trade.

Bill Jones, Chairman, Cummins-Allison Corp., will give us his perspective as a business negatively impact from this practice. Lastly, we will hear from Maya MacGuineas, Executive Director of the Committee for a Responsible Federal Budget

I look forward to the testimony of the witnesses. On behalf of the Committee, I wish to thank them all for coming, especially those who have traveled far. I now yield for any opening statement by the gentle lady from New York, Ms. Velázquez.

STATEMENT
of the
Honorable Nydia M. Velázquez, Ranking Democratic Member
House Committee on Small Business
Hearing on "The Rebate of Value Added Taxes at the Border and the Competitive Disadvantage for U.S. Small Businesses"
July 7, 2004

Thank you, Mr. Chairman.

In today's fast-paced global market, we need to focus on improving the environment for our nation's small businesses. As proven job creators, Congress needs to ensure that small companies are given every advantage in producing their goods and services.

The globalization of the world economy means U.S. companies face stiff competition from foreign firms. Today's hearing will examine one aspect of how American businesses continue to face obstacles in their ability to sell products abroad, as well as maintain their marketshare within our borders.

Unfortunately, this problem is of one of the many growing concerns of American companies. This administration has created an economic environment that has encouraged our firms to either move their productions overseas or shut their doors altogether.

The administration's lack of sound economic policy has led to gas prices reaching record levels, skyrocketing healthcare costs, and increased federal regulations. The rising cost

of doing business in the United States has made it virtually impossible for small firms to compete against their foreign competitors.

The focus of the hearing is to examine the effect of the EU's VAT rebate. This comes on the heels of another important trade debate – the FSC/ETI legislation that was passed out of the House. Unfortunately, this legislation did nothing to help America's firms, particularly its small businesses.

Instead, Republican leaders continued on the reckless path of providing tax breaks for Corporate America at the expense of small business. Rather than moving forward with a bipartisan solution to provide a quick resolution to the FSC/ETI issue, Republicans produced a bill laden with special interest tax breaks. The result is an unworkable bill that means small businesses will continue to be hit with tariffs over the coming months.

This is something that could have easily been avoided, but Corporate interests won out. As a result, EU tariffs on American products will continue to climb – potentially costing American exporters over $4 billion.

I wish I could sit here and tell you there is a possibility that the issue of the European Union VAT rebate will be addressed by the administration. Unfortunately, President Bush's record on trade leaves much to be desired.

Rather than work with our trade partners, the United States has continued to alienate our allies. Despite representing the economic superpower of the world, the United States Trade Representative has consistently failed to negotiate and enforce favorable trade agreements that will aid U.S. small companies.

The failing of both our trade and domestic policies have made it difficult for U.S. companies to keep clients who are attracted to foreign companies. With the EU VAT rebate, it is even more difficult. Our foreign competitors are effectively having their goods subsidized by their governments. The U.S. equivalent was ruled in violation of the WTO and there is little hope that this problem will be fixed in the near future.

While I agree that we need to make sure foreign tax systems are not unfairly harming American businesses, I believe that Congress should first be concerned about taking care of the issues we have immediate control of. For the United States to see sustained job growth, we must provide our firms with the tools to compete.

We need to create an economic atmosphere where U.S. companies can purchase affordable health care, where they can spend more of the resources investing in their firms rather than complying with complicated paperwork burdens, and where reliable energy sources are available at stable prices.

Addressing these issues will go a long ways towards ensuring that the America continues to maintain its status as the world's economic superpower. Not only does our nation's small businesses depend on it, but the livelihood of the U.S. economy does too.

Thank you.

Committee on Small Business
U.S. House of Representatives

Hearing
July 7, 2004

"The Rebate of Value Added Taxes at the Border and the Competitive Disadvantage for U.S. Small Business"

Testimony by

Gary Clyde Hufbauer
Reginald Jones Senior Fellow
Institute for International Economics
Washington, D.C.

Chairman Manzullo and members of the Committee, thank you for inviting me to testify on the important subject of border tax adjustments for the value added tax.

As you know, small business firms face numerous disadvantages when selling abroad. Most of the disadvantages can be traced to the substantial overhead costs of mastering a new business environment. Learning customs procedures, adjusting to the standards of the local marketplace, establishing distribution and after-sale service networks – all these are overhead costs that must be spread over the volume of sales. Overhead costs per unit of sales, when selling abroad, are usually higher for small firms than large firms.

Small business firms also face disadvantages when competing with foreign suppliers selling into the U.S. market. For the reasons just mentioned, foreign competitors are usually larger firms. Like larger U.S. firms, they are able to spread their overhead costs over a greater sales volume. In addition – and this is the subject of today's hearing – small business firms must compete with foreign competitors that enjoy the benefit of rebates on their value added tax (VAT) and kindred taxes (such as the Canadian goods and services tax, GST).

The international rules, codified in the WTO, on border tax adjustments have a long history and have attracted much scholarly discourse.[1] Suffice it to say that the rules work to the disadvantage of firms based in a country that does not use the VAT or GST as a source of public revenue, but instead relies on so-called "direct taxes" – particularly social insurance and corporate income taxes. Under WTO rules, "indirect taxes" -- VAT, GST, retail sales and excise taxes -- can be rebated on exports and imposed on exports, but such adjustments cannot be made for direct taxes when goods and services cross international borders.

Over the past forty years, governments worldwide have turned to VAT-type taxes to pay for public needs, particularly entitlement programs. Until the late 1960s, the VAT was relatively unknown; it was introduced in Brazil and Denmark in 1967, and France and Germany in 1968. By 2003, only the United States, among OECD countries, did not have a VAT or GST as its main business tax. Among OECD countries, VAT revenues typically account for 4 to 8 percent of GDP.

In economic theory, border adjustments for *uniform* business taxes are equivalent to exchange rate adjustments of approximately the same magnitude. In theory, if a uniform 10 percent tax is collected on value added in each sector of the economy, and if the tax is neither imposed on imports nor rebated on exports, and if the tax does not cause a change in long-term capital flows, and if the country floats its exchange rate, then the exchange rate will depreciate by 10 percent. The 10 percent depreciation restores relative prices to the *status quo ante*, before the tax was imposed. If instead, the uniform tax is adjusted at the border, the exchange rate will remain the same. In that case the border tax adjustment restores relative prices to the *status quo ante*.

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[1] For a summary, see Gary Clyde Hufbauer and Carol Gabyzon, *Fundamental Tax Reform and Border Tax Adjustments*, Policy Analyses in International Economics 43, Washington DC, Institute for International Economics, January 1996.

To summarize: the classic answer to national differences in business tax systems is that exchange rate adjustments will eventually offset tax differences, and wash away any permanent effect on business location decisions or competitive disadvantage. According to this logic, firms in both the exporting and importing country should not particularly care whether business taxes are adjusted at the border.

But they do care. No country has imposed a VAT without adjusting it at the border. U.S. firms have complained about these adjustments since the early 1970s. One reason firms care so much is that border tax adjustments are immediate and certain; exchange rate adjustments are distant and problematic.

Indeed, extensive research shows that "fundamental" forces do a very poor job of explaining intermediate term exchange rate movements.[2] If broad forces such as the rate of inflation and the pace of GDP expansion do not reliably explain past exchange rate changes, what confidence can be placed in the classical proposition that exchange rate changes will necessarily offset any benefit that accrues to foreign competitors through the rebate of VAT and GST?

In the wake of adverse WTO decisions, it appears that Congress will soon repeal the FSC/ETI benefits.[3] In a small way, these benefits provided relief from the corporate income tax for U.S. exporters. If the Congress repeals FSC, it should also pass a Joint Resolution calling upon the European Union and other WTO members to abolish the preferential border tax adjustment rules for indirect taxes. U.S. trading partners should cease exempting their exports from VAT and GST taxes, and cease imposing those taxes on imports. That change would end the tax disadvantage that U.S. business firms, small and large, have endured for more than forty years.

If this call to WTO members falls on deaf ears, the Congress should seriously consider scrapping the corporate income tax and replacing it with a business tax that can be adjusted at the border, so that U.S. firms enjoy tax parity with their foreign competitors, both in home and foreign markets. Since the corporate income tax ranks among the worst taxes ever conceived, riddled with distortions and loopholes, it will be missed only by attorneys and accountants.

Thank you for the opportunity to testify.

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[2] See, for example: Kilian, Lutz Kilian and Mark P. Taylor, "Why Is It So Difficult to Beat the Random Walk Forecast of Exchange Rates?", *Discussion Paper No. 3024*, Centre for Economic Policy Research, London, October 2001; and Yin-Wong Cheung, Menzie Chinn, and Antonio Garcia Pascual. 2004. "Empirical Rate Models of the Nineties: Are Any Fit to Survive?", *IMF Working Paper WP/04/73*, International Monetary Fund, Washington D.C., April 2004.

[3] The history of the FSC/ETI debate is recounted in Gary Clyde Hufbauer, "The Foreign Sales Corporation: Reaching the Last Act?", *International Economics Policy Briefs Number 02-10*, Washington DC: Institute for International Economics, November 2002.

American Enterprise Institute for Public Policy Research

Testimony

TESTIMONY

CLAUDE BARFIELD
RESIDENT SCHOLAR
AMERICAN ENTERPRISE INSTITUTE

Committee on Small Business
U.S. House of Representatives
July 7, 2004

Hearing
"The Rebate of Value Added Taxes at the Border and the Competitive Disadvantage for U.S. Small Business"

1150 Seventeenth Street, N.W., Washington, D.C. 20036 202.862.5800 www.aei.org

The views set forth in this testimony are those of the author and should not be attributed to the American Enterprise Institute, which takes no positions on legislation or other policy issues.

SHOULD THE WTO DETERMINE U.S. TAX POLICY?

Mr. Chairman, I should like to thank you for the invitation to appear before the committee this morning for this hearing regarding the implications of the WTO decision regarding the U.S. tax system for the foreign income of U.S. corporations. Because one of the other panelists, Gary Hufbauer, is an acknowledged expert on the intricate details of international trade and tax law and practice, I shall confine my testimony largely to judgments on the broader implications of this episode for U.S. sovereignty and for the increasing reach of international rules into the domestic arena.

Background

In early 2002, the judicial arm of the World Trade Organization rendered a decision that potentially could have led to punitive 100 percent taxes on $4 billion of U.S. exports to Europe—on goods and services as diverse as semiconductors, Boeing 747s, insurance policies, grains, books, and cosmetics. Specifically, the WTO Appellate Body held that a U.S. law allowing corporations that pay U.S. taxes to exempt certain "foreign" income constitutes a prohibited export subsidy under WTO rules.

To understand the background and context of the WTO ruling, one must go well back into 20th century international tax law and the problem of double taxation—that is, the potential that a corporation doing business across borders would be subject to taxation on the same income in both the home country and a foreign tax regime. As early as the 1920s, two methods of avoiding such situations were recognized in agreements among

trading nations: granting a tax credit for foreign income taxes in the home country of the corporation and granting some kind of exemption from domestic taxation of foreign income. In both cases, because of the extraordinary complexity of individual national tax systems, it was acknowledged that the two systems would "shelter" some income that wasn't taxed by any jurisdiction and, indeed, that even determining the domestic vs. foreign source of income was fiendishly difficult.

Another complicating factor that must be recognized is that two fundamental approaches exist to taxing foreign source income. Under the first (utilized in a modified form by the United States), a country generally taxes the income of persons or corporations subject to its jurisdiction, regardless of where they earn their income. This is referred to as a worldwide system of taxation. Under a second system, known as the territorial system, countries tax income all income within their borders, but do not tax income earned by their citizens or corporations abroad. This system is common among European countries.

The tension between the taxation of foreign income and trading rules first surfaced in the 1970s. In order to compensate for the tax subsidy granted automatically through the VAT rebates, the U.S. Congress in 1971 granted a limited tax deferral for U.S. exporters through the establishment of special domestic subsidiaries for exporting activities. The European Commission challenged the new law; and in turn, the United States challenged the tax exemptions provided on foreign income by several European countries. Separate panels, operating under the old General Agreement on Trade and Tariffs, came to the conclusion that *both* the U.S. and the European foreign tax systems violated GATT anti-subsidy rules.

The matter remained in limbo—with all parties blocking acceptance of the panel reports—until 1981, when a political solution attempted to end the impasse. At that time, the reports were adopted by the GATT General Council, subject to an "understanding" that substantially amended the rules regarding export subsidies. In relation to the GATT Subsidies Code, the Council agreed that: foreign economic processes need not be taxed by an exporting country; that failure to tax such processes did not constitute a forbidden export subsidy under the GATT; and that a nation could adopt measures to avoid double taxation.

Specifically, the 1981 Understanding stated:
"The Council adopts these reports on the understanding that with respect to these cases, *and in general*(italics added), economic processes (including transactions involving exported goods) located outside the territorial limits of the exporting country need not be subject to taxation by the exporting country" and should not be regarded as a prohibited export subsidy (under Article XVI:4). It is further understood that Article XVI: 4 requires that arm's length pricing be observed...Furthermore, Article XVI: 4 does not prohibit the adoption of measures to avoid double taxation of foreign source income."

Based upon this understanding, in 1984, the United States repealed the DISC legislation and replaced it with the Foreign Sales Corporation (FSC). The FSC provided for partial tax exemption for the income of a foreign corporate subsidiary derived from handling U.S. export sales. The amount of income exempted was calculated by a formula aimed to approximate arm's length pricing (that is, dividing export profits between domestic and foreign sources). Though there was grousing from the EU, most considered that the issues had been settled through the political agreement. Then, in 1999, some fifteen years after FSC was created, the EU trade commissioner, in retaliation for U.S. victories in the bananas and beef hormones cases—and to attempt to create a bargaining chip to resolve these disputes—challenged FSC as a violation of the subsidies code negotiated in the Uruguay Round that ended in 1994.

In 1999 and 2000, successively, a WTO panel and the Appellate Body ruled against the United States. This produced an attempt to reconcile U.S. law with the WTO rules by passage of the Extraterritorial Exclusion Act (ETI) of 2000, which changed the definition of gross income by excluding a portion of export earnings and a portion of earnings from production abroad—with the stipulation also that such exclusion could only be utilized by corporations that did not claim foreign tax credits. In 2001 and early 2002, once again a panel and the AB ruled that the new U.S. law still did not conform to WTO rules. To complete the story, an arbitrator's panel (actually composed of members of the original WTO panel) then ruled that the EU was entitled to punitive damages equal to the entire worldwide impact of the U.S. law—100 percent tariffs on $4 billion worth of goods and services.

FLAWED LAW AND FLAWED PROCESS AND THE DANGER FOR NATIONAL SOVEREIGNTY

I should like to highlight four large issues that the series of panel and Appellate Body decisions raise.

1. *National Sovereignty and the Reach of WTO Rules into Domestic Policy.*

   The FSC/ETI decisions raise troubling questions about the reach of multilateral trading rules versus the right of national government to determine fundamental tax policy. Because these decisions cannot be overturned short of a unanimous agreement by WTO member states, they also highlight a major constitutional flaw in the WTO that already is operating in this and other cases to undermine its legitimacy: that is, the imbalance between the highly efficient (and virtually unchecked) dispute settlement system and the inefficient and practically

unworkable consensus rulemaking procedures. In the final appeals before the WTO Appellate Body, the Bush administration clearly recognized the gravity of the issue raised by the earlier decisions and starkly warned the AB of the consequences of an adverse ruling. In an unprecedented move, the administration sent Kenneth Dam, the Deputy Secretary of the Treasury—and not some career USTR lawyer—to make the U.S. case.

Dam stated: "Few things are as central to a country's sovereignty as how it raises revenue...The necessary implications of the Panel's analysis is that the WTO may second-guess the reasonableness of a Member's decisions regarding the most basic elements of its tax system. However, it is not the role of the WTO to substitute its judgment for the judgment of a Member's own lawmakers in this regard."

In almost every respect, the final judgment of the AB (and earlier panel reports), despite pious protestations to the contrary, ignored Dam's warning.

After the final decision of the AB in 2002, in my judgment, the Bush administration erred in not vigorously and bluntly warning that at a minimum the decision would cause the United States to rethink its commitment to the WTO. In retrospect, given a series of other decisions that clearly go beyond the negotiated rules—in antidumping, safeguards, environmental protection—not laying down the gauntlet represents a missed opportunity.

2. *WTO as (an incompetent) World Tax Court*

Delving deeper into the details of the decisions one can see that the WTO panels and the AB demonstrated an appalling ignorance of international tax law and practice. As evidence that the WTO was over its head in this area, it should be noted that the four judicial reports (two each for the FSC and ETI cases by a panel and the AB) each offered widely differing, and even conflicting, interpretations of

WTO rules and of international tax rules and law. In this testimony, I will only point to elements of the final panel and AB decisions.

In the ETI ruling, the AB posited the necessity for clean, bright lines between domestic and foreign source income, ignoring the impossibility of finely tuning such divisions when attributing income from transactions related to R&D, manufacturing, marketing, advertising, and transportation. In the complex and shadowy world of international taxation, systems aimed at avoiding double taxation inevitably allow some income to escape all taxation—and in most countries these fine lines are the subject of endless haggling between the government and its corporations. No knowledgeable international tax expert would have advanced such a naïve, simplistic interpretation.

In the earlier panel ruling, the panel arrogated to itself (i.e., the WTO) the determination of which exceptions a nation might introduce to the regular "normative benchmarks" of its tax system. And it did so in a way that inevitably discriminates against one prevailing form of international taxation—the universal system (U.S) by which a nation asserts the right to tax all income earned on a worldwide basis by its citizens and corporations. While the AB retreated from this sweeping language, in effect it also arrogated this power to the WTO.

WTO as Avenger: "Outrageous" Arbitrators Penalty Determination

At the time the arbitrators handed down their decision granting the EU the power to levy $4 billion in tariff retaliation for the ETI legislation, one leading international legal expert called the decision "outrageous." His point was well taken.

The WTO rules are reciprocity based, and thus it has been standing practice and doctrine since the early days of the GATT that retaliation for a breach of obligations should be limited to the trade effects of that breach. There is also in the WTO subsidy rules the obligation that retaliation be proportionate to the effects of the subsidy. In this case, the United States argued (correctly in my judgment) that the trade damage to the EU was about $1 billion. The EU, however, argued not only that the amount of the subsidy be used as the basis for the calculation of damages but also that it be allowed to assess damages as a surrogate for the entire WTO membership—that is, for the full $4 billion of the subsidy to U.S. companies. Astonishing, the arbitrators bought this interpretation. They did on the basis of what they called the "gravity of the breach and the nature of the upset in the balance of rights and obligations"—wholly ignoring the mandate of proportionality. To reach this conclusion, the arbitrators invoked international law normally used for political and human rights violations, arguing that the U.S. breach represented an *erga omnes* offense—that is, against *all* WTO members and not just against the EU. As the trade scholar mentioned above wrote at the time:

"This sort of theory, created in a different context and for different purposes, was meant to apply in situations such as human rights violations where there is no quantifiable damage to the state seeking to impose sanctions and the "crime" truly does offend all. It has no place in trade disputes covered by the specific treaty language of the WTO Agreements. But the arbitrators and their staff went out of their way to misapply (this language) in an apparent attempt to embarrass the United States. The real embarrassment, however, is to those who wrote the decision."

4. *Need to Reform and Retrenchment*

Stepping back from the arcane details of these individual cases, I would argue that what is needed is a major change in the mindset and intellectual isolation of the WTO dispute settlement system. In the FSC/ETI cases, both the panels and the AB demonstrated a stunning technocratic determination to barrel forward with their own pet legal theories and ignore the political history and context of the issues at hand. Legally, there was a strong case to uphold the 1981 Understanding that ended the 1970s standoff between the U.S. and the EU.

In other forums, I have argued for two potential reforms to the current system. In both cases, they would represent quite different instructions to the panels and AB.

A. *Non Liquet*

This legal term literally means "it is not clear." Given the widespread agreement that WTO texts are replete with lacunae and contradictory provisions, and given that questions concerning the legitimacy of judicial decisions are magnified at the international level, the panels and the AB should be instructed to utilize this doctrine much more frequently—and throw the decision back to the WTO General Council or to trade round negotiations. Critics of *non liquet* have argued that it is prohibited because international law is necessarily "complete," or that it is the duty of judges to step in and fill gaps, particularly in contentious areas. WTO rules, by common consent, are certainly not "complete" and arguments for "gap-filling" by judges reflect a dangerous—even anti-democratic—myopia.

B. *Political Question Doctrine:*
Alternatively, the WTO could adopt a variation of the so-called "political issue doctrine," developed by the US Supreme Court. The doctrine is meant to provide a means for the judiciary to avoid decisions that have deeply divisive political ramifications and thus, in the opinion of the court, should be settled through more traditional democratic processes, involving both the legislature and the executive. Once again, if such a doctrine is deemed important for preserving checks and balance at the national level, an even more cogent argument can be advanced for its introduction in WTO law—where the sources of legitimacy of judicial bodies are much weaker than within democratically constructed nation states.

In summary, the proposition advanced here is that heading off corrosive conflicts between the US and the EU in the future will necessitate reform of the international trading rules that have enmeshed—and entrapped—both trading superpowers.

Testimony of William J. Jones

Chairman, Cummins-Allison Corporation
Mt. Prospect, Illinois
And
Chairman, United States Business and Industry Council

before the

House Small Business Committee
July 7, 2004

Good afternoon and thank you for inviting me to speak with you today.

Mr. Chairman and Committee Members, my name is William Jones, and I am chairman of Cummins-Allison Corporation, a privately-held manufacturing company based in the Chicago area. I also serve as chairman of the United States Business and Industrial Council and I am an active member of the National Association of Manufacturers.

I appreciate the chance to be here today to talk with you about an issue that is extremely important to me – namely the crisis in American manufacturing and the way the rules of the game in international trade are stacked against American companies. The subject of this hearing – which is the disparity in the treatment of U.S. and foreign taxes in global trade – constitutes a blatant example of how American manufacturers are currently disadvantaged and how policy makers must become far more aggressive in defending U.S. interests.

Cummins-Allison is one of the world's leading producers and innovators in the manufacture of equipment that scans, sorts, denominates and authenticates currency. This is an area that is quite literally essential to America's economic and national security – providing a critical function in the deterrence of counterfeiting and the preservation of the dollar as the world's preeminent currency. Unfortunately, we, like so many manufacturers in this country, have been dramatically and negatively affected by an uneven playing field in the global trading system.

Twenty years ago, American companies accounted for 90 percent of U.S. requirements in the field of currency authentication. Today, that percentage is down to 30 percent and we are the only surviving U.S. producer. This is a story that could be repeated for any number of American manufacturing industries and their workers.

Why is it happening? You hear a lot of talk about cheap foreign labor and lower costs abroad – about the inability of an advanced economy to compete against the low-cost developing world. But what we consistently fail to recognize is how much of our problem has nothing to do with costs or competitiveness or wage rates – and everything to do rules that literally make no sense and serve no readily apparent purpose other than to artificially punish U.S. manufacturers.

No issue is more illustrative of that point – or more important to the bottom line of American companies and workers – than the one the committee is considering today. I do not come here as an expert on the legal niceties relating to the "border adjustability" of taxes – but I can tell you I understand the fundamental business importance of this issue.

The problem is as simple as it is unbelievable – and amounts to essentially the double taxation of U.S. producers selling abroad, while our foreign competitors can sell largely tax-free in this market. Let me illustrate. If our or any other American company wants to sell a product in China or Europe or most of the rest of the world where value-added taxes ("VAT") predominate, we get no refund or rebate of U.S. income taxes, but we do have to pay the foreign VAT. Meanwhile, foreign producers exporting to America get their domestic VAT rebated, while picking up no income tax here. While there are complexities in calculating the exact effect of this practice – including issues relating to the effect of state sales taxes in the United States – it has been estimated that this results in as much as a 25 percent difference in the price they can sell for here, versus what we can sell for there.

What is astonishing is that, as far as I can tell, the international rules that allow this to go on have no legitimate economic basis whatsoever. The

rules are based on an artificial distinction between so-called "direct" (for example, income) taxes, and "indirect" (like VAT) taxes – even though economists have shown that these taxes tend to have the same incidence and effect. Allowing indirect, but not direct, taxes to be rebated on exports or imposed on imports makes no sense from a policy or economic standpoint – but I can tell you that it makes the task of keeping jobs and businesses in the United States far more difficult.

How does something like this happen? Apparently, this was just an obscure line squirreled away in the original agreements of the General Agreement on Tariffs and Trade – something that never made any sense and a situation where our negotiators just got outfoxed. For decades, Democrats and Republicans, Congress and Administrations, commentators and economists have all agreed that this rule is ridiculous. Every fast track bill says we should make it a priority to fix it. And yet nothing is ever done.

From a business standpoint, I have to implore you: stop the madness. We have lost 3 million manufacturing jobs, we have a trade deficit that is literally unprecedented in the history of the universe and we have been the most important market in the world for many, many years. How is it that we don't seem to have the leverage to get an issue like this taken seriously? Of

course we do. We only have to be willing to use it, and to play hardball the way our trading partners do.

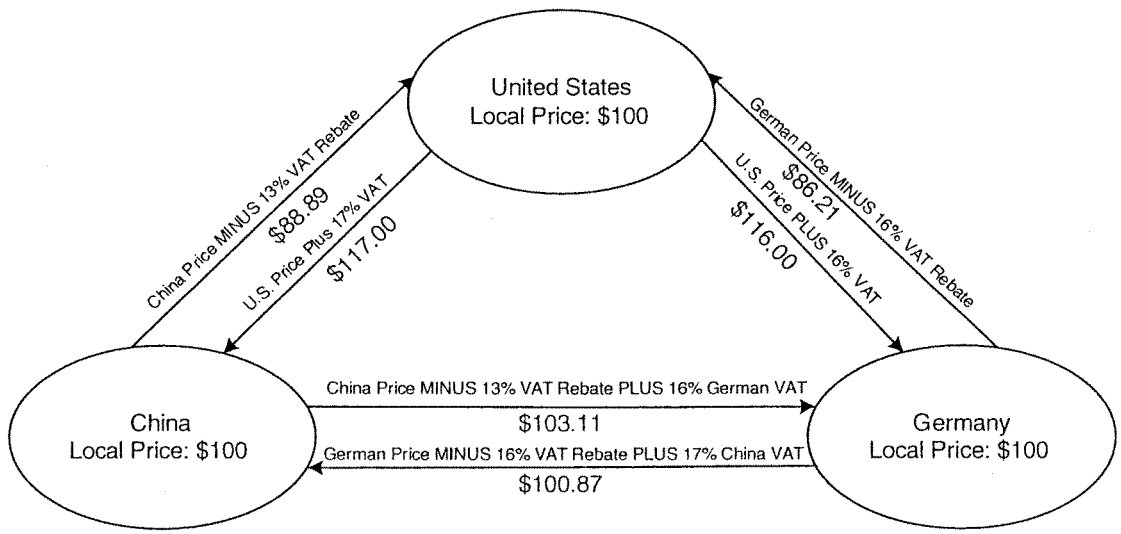
The prescription is quite simple. We should make clear that we will not agree to <u>any</u> new multilateral trade agreement that does not fix this problem. And more, we should make clear to our key trading partners that we intend to see this accomplished in the short-term – say the next year to 18 months. After that, we should make clear we are willing to take more aggressive steps, including possible limitations on market access here, until we see a resolution.

The rest of the world has had more than five decades to reap the benefits of this absurd inequity. They have had their unfair advantage, and enough is enough. It's time to stand up for our manufacturers and change the rules.

Thank you, Mr. Chairman.

VAT/Border Adjustability

Example of How Current WTO Tax Rules Harm U.S. Manufacturing



Note: Data for Germany and China VAT from the U.S. Council for International Business. See http:\\www.uscib.org.

NEW AMERICA
FOUNDATION

Testimony of

Maya C. MacGuineas
Director, Fiscal Policy Program
New America Foundation

On

The Rebate of Value Added Taxes at the Border and the Competitive Disadvantage for U.S. Small Businesses

Before the

Committee on Small Business
U.S. House of Representatives
July 7, 2004

The Rebate of Value Added Taxes at the Border and the Competitive Disadvantage for U.S. Small Businesses

Maya C. MacGuineas

Good afternoon, Mr. Chairman and members of the Committee. My name is Maya MacGuineas and I am the Director of the Fiscal Policy Program at the New America Foundation. I am also the Executive Director of the Committee for a Responsible Federal Budget, which is now housed at New America, and the Chair and Co-founder of Centrists.Org. Thank you for the opportunity to testify.

As you are all well aware, it is the case that while European exporters benefit from rebates at the border on their value-added taxes, parallel tax relief for U.S. companies has been ruled illegal by the World Trade Organization. This is due to the distinction international trade law draws between the value-added taxes used by most nations and the corporate income taxes that U.S. firms are subject to. Accordingly, FSC/ETI benefits for U.S. companies appear to be on track to be repealed.

There is considerable debate about whether border adjustments affect the competitive trading positions of nations. On the one hand, general economic theory holds that in a system of floating exchange rates, changes in tax levels are offset by changes in exchange rates. Under this line of thinking, even for countries without floating exchange rates, rebates are not believed to make a difference in the long run.

On the other hand, were this true, it would not matter to our trading partners whether their VATs were rebated at the border – and yet it does matter and they are rebated. In the real world, exchange rate movements can be quite sticky. Not only are relative exchange rates affected by a variety of economic factors, the timing of such changes can be quite unpredictable.

So, as is so often the case when it comes to theoretical predictions, we cannot know for sure whether the economic relationship between border adjustments and exchange rates holds true, nor can we know for sure the extent to which U.S. companies will actually be harmed by the WTO ruling.

Either way, the current tax bill making its way through Congress is premised on the belief that U.S. companies will be severely disadvantaged by the change and the bill therefore includes compensatory measures. It is true that the corporate tax bill does little to help small businesses in particular, which are less able to absorb general overhead costs and do not benefit from economies of scale that many of their larger competitors do. From the perspective of the Committee, that may well be problematic. Similarly, it is true that the benefits of the bill are spread quite unevenly, with some sectors benefiting a good bit more than others.

No matter the extent to which U.S. companies will be harmed by the tax law change, I would argue that targeted tax relief as is included in the FSC/ETI bill is not the right approach to remedying the problem.

Already, the cost of the bill is quite expensive. And it is likely to be more expensive than current projections since many of the expiring provisions would undoubtedly be renewed. Since the costs will increase budget deficits, thereby decreasing government saving, the effect could actually be to worsen our trade balance.

Furthermore, the general approach of targeted tax relief de-levels the playing field between U.S. companies. Distorting the tax code to favor particular sectors of the economy may be politically appealing but it is not good policy, nor does it help American consumers or the economy.

Finally – and I will not mince words here – this bill has become an egregious example of how effective special interest lobbyists have become, filling the package with expensive, unnecessary and unjustified corporate handouts, and any pretense that this constitutes good tax policy was lost long ago.

But out of the need to alter our tax policy comes an opportunity.

The money saved from removing the illegal subsidy could be used to either reduce the deficit, or help sweeten a comprehensive tax reform deal along the lines of what we saw in 1986, which would include eliminating many existing loopholes and subsidies while lowering corporate income tax rates.

Another desirable option would be to introduce a consumption tax, which could be adjusted at the border, to replace income taxes. Consumption taxes have a number of benefits including of course, that they would increase national saving. If we want to improve our trade balance, not to mention longer-term economic performance, improving our national saving rate could play a critical role in that endeavor.

At the same time, most consumption taxes, such as sales taxes, tend to be highly regressive, whereas the existing income tax at both the corporate and individual level is quite progressive. Efforts to reduce the regressivity of sales taxes by exempting certain goods deemed necessities such as food, clothing and medicine can cause tremendous distortions in consumer markets.

However, it is quite possible to institute a *progressive consumption tax* that would maintain existing tax burdens (or even make them more progressive if desired) rather than shift the burden down the income scale.[1] My time here is short today so I will not go into the details of how this might work, but a progressive consumption tax is desirable not just with regard to tax treatment and trade issues, but in its ability to balance the oftentimes competing tensions of tax efficiency and tax equity.

I would be happy to follow-up with you on any of the issues I have raised here today. Thank you again for inviting me to testify, I look forward to your questions.

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[1] For more details of a progressive consumption tax proposal, please see "Radical Tax Reform" by Maya MacGuineas in the *Atlantic Monthly*, January 20, 2004 and "A Tax Plan for Kerry" by Maya MacGuineas and Ted Halstead in the *Washington Post*, May 24, 2004. While this proposal focuses on using a progressive consumption tax to replace payroll taxes, the tax could instead be substituted for income taxes, or both income and payroll taxes.

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