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THE HOUSE TAX BILL: PENALIZING U.S. COMPETITIVENESS

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INTRODUCTION

At a time when the U.S. economy is being battered by tough foreign competition, the tax reform bill passed by the House of Representatives in December almost seems designed to make matters worse. In the name of reform, the House bill weakens existing tax measures that encourage capital investment, foreign trade, and research and development. The House bill, therefore, penalizes precisely those factors that would enable the U.S. to compete more successfully with foreign businesses.

The House bill cuts back on the foreign earned income exclusion for Americans working overseas, cuts back on the research and development tax credit, restricts use of the foreign tax credit, raises the cost of capital for American firms, and raises the capital gains tax.

The U.S. economy is now very international. Imports and exports amount to 15 percent of Gross National Product--roughly double that in the early 1970s. The flow of foreign capital into the U.S., moreover, is close to \$100 billion per year; this has important implications for interest rates and exchange rates. Any tax change, therefore, which affects the investment climate in the U.S. or the ability of U.S. firms to compete internationally can have consequences far greater than the dollar value of the taxes involved. These consequences must weigh heavily in any overall assessment of the House tax bill.

TAXATION OF AMERICANS ABROAD

The United States is the only major industrialized country that taxes its citizens without regard to their residence or source of income. When an Englishman moves permanently to the U.S. or some other country and earns income in that country, for example, he is no longer subject to British taxation. An American working abroad, however, must pay not only foreign taxes but U.S. taxes as well.

For many years the only relief granted was an exclusion of \$20,000 on foreign earned income and a credit for foreign taxes paid against one's U.S. tax liability on income above \$20,000. Even so, most Americans had to pay far higher taxes on foreign earned income than citizens of almost every other country.

By 1980 it was widely agreed that heavy taxation of Americans working abroad had a negative effect on the ability of U.S. firms to operate internationally. Among Jimmy Carter's points, in a message to Congress on September 9, 1980, were:

1) U.S. companies were replacing many of their American personnel with foreign personnel.

2) When American companies engaged in engineering or construction work abroad hired Americans because of their skills and reliability, these companies risked losing contracts for overseas projects because of the higher labor cost. The result was that U.S. exports were lost.

3) When these companies hired non-Americans, they may have won the contracts, but lost a good share of the valuable follow-up exports because foreign nationals favored foreign suppliers who were more familiar to them.

4) Foreign operations by American companies tended to create a need for exports from the U.S. and to generate substantial earnings that benefited the U.S. balance of payments. Some companies felt that they could conduct such operations more successfully if they were free to use American rather than foreign employees.

5) American companies operating abroad sometimes picked up or developed valuable technology. This technology was less likely to be lost in the case of American employees, who were less apt to move to foreign-owned companies when they changed employment.

6) The detriment to competitiveness had a snowballing effect as foreign companies gained strength at U.S. expense.

7) The special deductions allowed for foreign living costs and hardship conditions were insufficiently generous and too complicated.¹

A 1980 study by Chase Econometrics found that Americans overseas had to be paid significantly more than foreign workers to give them the same after-tax income. This was severely hampering the ability of American firms to compete internationally. They could not open foreign sales offices and staff them with American personnel, bid on foreign contracts, or properly service the products they sold overseas. Chase estimated that U.S. exports decline 10 percent for every 10 percent reduction in the number of U.S. workers overseas. The reduction in U.S. exports, in turn, raises U.S. unemployment and reduces federal revenue. The study concluded that "the tax on U.S. workers overseas costs the U.S. Treasury and the country many times more than it yields in revenue."² The Chase findings are confirmed generally by other studies conducted by the General Accounting Office and the Treasury Department.³

As a result of such analyses, Congress significantly changed the law in 1981 to allow Americans working abroad to exclude up to \$75,000 of foreign earned income from U.S. tax. This exclusion is scheduled to rise to \$95,000 in 1990. The House tax bill, however, freezes the foreign earned income exclusion at \$75,000. The House Ways and Means Committee's only rationalization for this is that "it is appropriate to reduce the maximum potential preference for Americans earning active income abroad."⁴

The amount of tax revenue to be gained by this is only \$22 million in 1986. At a time of grave concern about the trade deficit and U.S. export competitiveness, it makes no sense to penalize

1. "United States Export Promotion Policies," Public Papers of the Presidents of the United States: Jimmy Carter, 1980-81, 3 books (Washington, D.C.: U.S. Government Printing Office, 1982), Book II, pp. 1692-1693.

2. Testimony of Robert D. Shriner, Director of Washington Operations, Chase Econometric Associates, in U.S. Congress, House, Committee on Ways and Means, Advisability of a Tax Reduction in 1980 Effective for 1981, 3 parts, 96th Congress, 2d Session (Washington, D.C.: U.S. Government Printing Office, 1980), Part 3, pp. 1935-1937.

3. John Mutti, The American Presence Abroad and U.S. Exports (Washington, D.C.: Department of the Treasury, Office of Tax Analysis Paper 33, October 1978); Comptroller General of the United States, American Employment Abroad Discouraged by U.S. Income Tax Laws (Washington, D.C.: U.S. General Accounting Office, ID-81-29, February 27, 1981).

4. Tax Reform Act of 1985, House Report 99-426, 99th Congress, 1st Session, December 7, 1985, p. 430.

Americans working abroad. Indeed, to the extent it has any impact on the number of Americans working abroad, it will be a negative impact on the trade balance and federal revenues.

Ronald Reagan, by contrast, in his tax reform proposal, allowed the exclusion to rise to \$95,000 annually for Americans earning income abroad. Policy makers truly concerned about American competitiveness will support the President's approach to this matter.

RESEARCH AND DEVELOPMENT

Most economists agree that research and development (R&D) expenditures play a key role in competitiveness and productivity growth.⁵ As Table 1 indicates, the U.S. has been running a large trade surplus in R&D-intensive products and a deficit in non-R&D-intensive products. It is essential for the U.S. to maintain technological leadership, especially when there is concern over the trade deficit.

Table 1
U.S. Trade Balance in R&D-Intensive and Non-R&D-Intensive
Manufactured Product Groups, 1970-80
(in billions of dollars)

Year	R&D-Intensive	Non-R&D-Intensive
1980	52.4	-33.5
1979	39.3	-34.8
1978	29.6	-35.4
1977	27.1	-23.5
1976	29.0	-16.5
1975	29.3	-9.5
1970	11.7	-8.3

Source: National Science Board

5. See the literature cited in Rolf Piekarz, Eleanor Thomas, and Donna Jennings, "International Comparisons of Research and Development Expenditures," in John W. Kendrick, ed., International Comparisons of Productivity and Causes of the Slowdown (Cambridge, Massachusetts: Ballinger, 1984), pp. 235-240.

In the late 1970s, when it became apparent that the U.S. technological lead was slipping, it was widely blamed on a slowdown in U.S. R&D expenditures, coupled with a major increase in R&D spending by America's international competitors. Between 1964 and 1978, for example, U.S. R&D expenditures as a share of GNP fell by 25 percent, while R&D expenditures increased in Japan by 32 percent and in West Germany by 47 percent.⁶

Congress responded in 1981 by wisely instituting a 25 percent tax credit for boosts in R&D spending. The credit applies only to the extent that a company's qualified research and development expenditures in a given year exceed the average for the previous three years. The House tax reform bill, however, reduces the credit to 20 percent and restricts its use. No reason is given for the change. Reagan's tax reform proposal would retain the R&D tax credit at the 25 percent rate and extend it for another three years, subject to some redefinition of qualified research.

There is, to be sure, debate on the merits of the R&D tax credit. One problem in resolving the debate is that the credit has existed only three years. Because the credit is incremental in nature, the major benefits are to be expected in the future, not immediately. Nevertheless, the available empirical evidence indicates that the R&D tax credit did increase R&D expenditures.⁸

The best reform would be to make the R&D tax credit permanent. Explains the Congressional Budget Office: "It is generally recognized that research benefits the nation more than it benefits any individual company, and that private firms tend to devote less resources to research and development than the public interest would warrant; this is particularly true for the high-technology industries."⁹ Moreover,

6. National Science Board, Science Indicators, 1982 (Washington, D.C.: U.S. Government Printing Office, 1983), p. 197.

7. Tax Reform Act, op. cit., p. 177.

8. U.S. Congress, Joint Economic Committee, The R&D Tax Credit: An Evaluation of Evidence on Its Effectiveness, Joint Committee Print, 99th Congress, 1st Session (Washington, D.C.: U.S. Government Printing Office, 1985); Kenneth M. Brown, ed., The R&D Tax Credit: Issues in Tax Policy and Industrial Innovation (Washington, D.C.: American Enterprise Institute, 1984); Eileen L. Collins, An Early Assessment of Three R&D Tax Incentives Provided by the Economic Recovery Tax Act of 1981 (Washington, D.C.: National Science Foundation, 1983).

9. Federal Financial Support for High-Technology Industries (Washington, D.C.: Congressional Budget Office, 1985), p. xi.

as long as firms believe the tax credit is temporary they are unlikely to respond fully to it.

The amount of revenue that the House bill would raise by trimming the R&D credit is relatively small: \$474 million in 1986. For that amount the House is seriously risking further erosion in the U.S. technology lead.

FOREIGN TAX CREDIT

The foreign tax credit exists to prevent companies from being taxed twice on the same income--once by a foreign country and again by the U.S. A credit is allowed for foreign taxes paid on income derived from direct operations or investments in a foreign country. Companies may not use this credit to reduce their U.S. tax on U.S. income. This limit is calculated on the basis of the company's overall worldwide income. In effect, foreign taxes are averaged together.

The House, generally following Reagan's proposal, calls for limiting the foreign tax credit. In contrast to the current method of using the aggregate of all foreign taxes paid by a U.S. firm to calculate the firm's tax credit, the proposed change sets per country limits. The result is that a U.S. firm can offset only its earnings from a specific country with a tax paid to that country: high taxes paid to one country cannot be used to offset the U.S. firm's earnings from another country. The Administration argues that this change is necessary because the current system distorts firms' decisions whether to invest in one country or another.¹⁰

There are several problems with the per country limit. First, it is a complex method that mocks tax simplification. Corporations are seldom organized on a strict country-by-country basis. Explains Richard Rahn of the U.S. Chamber of Commerce: "A German manufacturing subsidiary of a U.S. company may well develop technology that it licenses to a Dutch or Japanese enterprise and will sell its products throughout Europe, Africa, and perhaps elsewhere and may do so through branches or subsidiaries."¹¹ The current averaging method is consistent with the approach normally taken by U.S. business to overseas investment.

Second, averaging mitigates some of the difficulties caused by rules in different countries for determining the tax base and the

10. The President's Tax Proposals to the Congress for Fairness, Growth, and Simplicity (Washington, D.C.: U.S. Government Printing Office, 1985), pp. 387-388.

11. Statement before the House Ways and Means Committee, June 26, 1985, p. 41.

timing of income and deductions. For this reason, virtually every other industrialized country uses the averaging method, exempts direct investment income, or uses a per country limit that permits a form of averaging.¹²

The per country limit would increase sharply the tax burden on companies with foreign operations. Losses in individual countries, for instance, could not be applied to reduce overall foreign income. Instead, companies would be required to carry losses forward against future income in the same country in which the loss was incurred. This would lead almost certainly to a sharp cutback in new foreign investment, especially long-term investments that might not yield profits for many years. Future investment probably would be limited to countries where companies already have profitable operations.

One of the few bright spots in the U.S. trade picture is the foreign operations of U.S. companies. A recent study of total worldwide sales by U.S. companies, including foreign subsidiaries, indicates that the U.S. is far more competitive in international markets than the trade deficit suggests.¹³ Income from foreign investments, moreover, contributes substantially to the current account balance.

The problems presented by the foreign tax credit could be solved if Congress were to renounce its claim on the foreign income of U.S. taxpayers altogether. There is no justification for imposing U.S. tax on income legitimately earned in a foreign country. This would be true tax reform.¹⁴ Adoption of the per country limit on the foreign tax credit, as the House bill provides, on the other hand, would reduce foreign investment, increase the current account deficit, and unfairly penalize long-term investments and those in low-tax countries.

COST OF CAPITAL

The cost of capital--capital being the plant, equipment, structures, and financing needed to create goods and services--is a

12. Ibid., Appendix.

13. Robert E. Lipsey and Irving B. Kravis, "The Competitive Position of U.S. Manufacturing Firms," Banca Nazionale del Lavoro Quarterly Review, June 1985, pp. 127-154, also published as National Bureau of Economic Research Working Paper 1557, February 1985.

14. See J. D. Foster, The Taxation of Foreign Source Income: Tax Reform and Confusion (Washington, D.C.: Institute for Research on the Economics of Taxation, Economic Report No. 36, 1985).

key element in international competitiveness. If the cost of capital is higher in the U.S. than in other countries, the U.S. has a harder time competing in capital-intensive products. Capital also is critical to productivity growth. Nations that are able to provide their workers with newer, more efficient plant and equipment, in the long run, will enjoy higher productivity and will be better able to compete internationally. As Table 2 indicates, there is a close relationship between capital investment and productivity growth.

Table 2
Comparison of Capital Formation in Six Countries, 1971-1980
(percent)

Country	Gross Investment as Percent of GDP	Growth Rate of Output per hour in Manufacturing
Japan	34.0	7.4
France	24.2	4.8
Germany	23.7	4.9
Italy	22.4	4.9
U.K.	19.2	2.9
U.S.	19.1	2.5

Source: Organization for Economic Cooperation and Development

Lagging U.S. capital formation and productivity were key reasons why, in 1981, Congress sharply cut the tax burden on fixed capital by allowing accelerated depreciation. By all accounts, this 1981 strategy worked. Investment spending during the current economic expansion has been significantly higher than the average for postwar recoveries and expansions.¹⁵

15. See Michael J. Boskin, The Impact of the 1981-1982 Investment Incentives on Business Fixed Investment (Washington, D.C.: National Chamber Foundation, 1985); Stephen A. Meyer, "Tax Policy Effects on Investment: The 1981 and 1982 Tax Acts," Federal Reserve Bank of Philadelphia Business Review, November/December 1984, pp. 3-14; Leonard Sahling and M. A. Akhtar, "What Is Behind the Capital Spending Boom?" Federal Reserve Bank of New York Quarterly Review, Winter 1984-85, pp. 19-27; Allen Sinai, Andrew Lin, and Russell Robins, "Taxes, Saving, and Investment: Some Empirical Evidence," National Tax Journal 36, September 1983, pp. 321-345; Virgil Ketterling, "Capital Investment in the U.S. Economy: Current Recovery Compared to Previous Recoveries," in U.S. Industrial Outlook 1985 (Washington, D.C.: U.S. Department of Commerce, 1985), pp. 17-28.

The 1981 tax cut shortened depreciation schedules. Depreciation is the wearing out of plant and equipment. Firms are allowed to deduct from their gross income a percentage of this depreciation annually to allow them to build a reserve for replacing their plant and equipment when it wears out. The shorter the schedule, the faster the reserve accumulates. In theory, depreciation rates should correspond to the actual rate at which plant and equipment wear out. Some critics argue that the 1981 depreciation schedules are shorter than real economic depreciation rates. Thus, it is said, firms have had their capital investment subsidized by the tax code.

It is true that some capital investment is subsidized, especially when depreciation allowances are combined with the investment tax credit (ITC), which gives firms a 10 percent credit against taxes owed for investments in machinery and equipment. But from the standpoint of international competitiveness, what matters is that U.S. depreciation rates must compete with those of other nations. Depreciation schedules are an important factor used by multinational companies to calculate the after-tax rate of return on their potential investment. If the U.S. after-tax rate of return is lower than elsewhere, the U.S. risks losing that investment.

In a recent survey, the international accounting firm of Arthur Andersen & Co. found that the present value of U.S. depreciation rates is not particularly generous by world standards. Table 3 summarizes the Arthur Andersen study.

The present value rates mean that, adjusted for the interest and the inflation rates, firms are able ultimately to deduct more or less than the full cost of a piece of equipment. A theoretically ideal capital cost recovery system would allow firms to deduct exactly 100 percent of the present value of equipment; no more, no less. Yet, as Table 3 indicates, only under the extremely optimistic assumption of zero inflation does the current depreciation system lead to a U.S. rate of at least 100 percent. Under both the Administration's depreciation proposals and the House bill, firms ultimately would deduct less than the full present value of their investment. This means they would have less capital to replace or modernize their aging plant and equipment. This translates directly into lower productivity and fewer jobs.

Both Reagan and the House would eliminate the investment tax credit, first introduced in 1962 by John F. Kennedy, lengthen depreciation rates, and cut corporate tax rates. These changes, it is claimed, will encourage firms to invest without regard to tax considerations. The different tax treatment of various forms of

Table 3
Comparison by Country of Present Value of
Cost Recovery Allowances

Country	Ranking	0% Inflation	5% Inflation	8% Inflation
Luxembourg	1	147.0	136.2	130.5
Spain	2	124.2	111.1	104.6
Belgium	3	116.2	105.8	100.3
Canada	4	104.8	96.3	91.8
U.S.*	5	105.3	92.9	86.6
France	6	92.8	85.1	81.1
Hong Kong	7	92.5	85.0	81.2
Denmark	8	87.7	84.0	81.9
U.S.**	9	87.1	83.4	81.4
Sweden	10	90.5	80.7	75.6
Italy	11	90.1	79.8	74.6
U.K	12	89.1	79.4	74.7
Germany	13	88.8	77.7	72.3
U.S.***	14	88.6	77.0	71.1
Switzerland	15	88.0	76.8	71.4
South Korea	16	86.7	74.9	69.2
U.S.****	17	75.1	72.4	70.9
Japan	18	82.3	69.0	62.8
Taiwan	19	82.3	69.0	62.8

*Current Law

**Reagan Proposal (May 1985)

***Current law without Investment Tax Credit

****Treasury Proposal (November 1984)

Source: Tax Notes, June 24, 1985, p. 1508.

investment is thought to induce considerable distortion in investment decisions, costing the nation billions of dollars in efficiency.¹⁶ But while evening out tax rates on different forms of investment and between different industries is laudable, this should not be accomplished at the expense of an overall increase in taxation on capital. The U.S. already double-taxes saving and investment. This disincentive to invest would be made worse under both the House bill and the Reagan proposal.

The House tax bill eliminates the ITC and makes the depreciation schedules longer than the Reagan proposal. This boosts effective tax rates on capital sharply. Amherst College economist Yolanda Henderson has calculated effective tax rates based on the House bill and finds that tax rates will rise steeply in almost every category. Table 4 summarizes her findings.

Table 4
Corporate Sector Tax Rates
(in percentages)

Category	Current Law	Reagan Proposal	House Bill
Equipment	-18.3	24.5	41.2
Structures	37.9	36.3	40.9
Public Utilities	29.5	29.7	43.5
Inventories	41.6	38.8	39.8
Land	49.9	41.9	43.0
Overall Corp. Rate	31.1	34.4	41.5

Source: Tax Notes, December 9, 1985, p. 1061.

16. For some recent estimates, see Charles L. Ballard, John B. Shoven, and John Whalley, "The Total Welfare Cost of the United States Tax System: A General Equilibrium Approach," National Tax Journal 38, June 1985, pp. 124-140; *idem*, "General Equilibrium Computations of the Marginal Welfare Costs of Taxes in the United States," American Economic Review 75, March 1985, pp. 128-138.

The U.S. taxes capital more heavily than most industrialized countries, and far more than Japan, its most successful competitor.¹⁷ It makes little sense to increase taxation on capital still further. Some economic forecasting firms are predicting a sharp slowdown in economic growth and a rise in unemployment if the House bill passes. The culprit, warn these forecasters, will be the increased cost of capital.

CAPITAL GAINS

Many analysts have argued that the economic stagnation of the 1970s was linked to the 1969 increase in capital gains taxes, since this tax hits most heavily the most dynamic, innovative sector of the economy. In 1978 Congress slashed the capital gains tax from a maximum of 49 percent to 28 percent. The result: a massive outpouring of venture capital, risk taking, and innovation that, among other things, sped the development of Silicon Valley and the computer revolution.¹⁸ At the same time, revenues from the capital gains tax increased.

The reduction in the top marginal individual tax rate in 1981 from 70 percent to 50 percent brought the effective maximum tax rate on long-term capital gains down to 20 percent. The House tax bill would increase the maximum capital gains tax on individuals to 22 percent. The maximum tax on corporate capital gains would jump from 28 percent to 36 percent. The House bill ignores all the evidence that previous cuts in the capital gains tax had an enormously positive impact on the economy and on federal revenues. Curiously, defying the historical record, the House Ways and Means Committee asserts that a hike in the tax actually would increase revenue.

A rise in the capital gains tax would impair U.S. competitiveness. The higher tax would hit high technology, the area

17. For a comparison of the U.S. and Japanese tax systems, see David Brazell, Aldona Robbins, Gary Robbins, and Paul Craig Roberts, The Cost of Corporate Capital in the United States and Japan (Washington, D.C.: Institute for Political Economy, 1985); George Hatsopoulos, High Cost of Capital: Handicap of American Industry (Washington, D.C.: American Business Conference, 1983); and U.S. Congress, Joint Economic Committee, Japanese Tax Policy, 98th Congress, 2nd Session (Washington, D.C.: U.S. Government Printing Office, 1985).

18. On the impact of the capital gains tax, see Report to Congress on the Capital Gains Tax Reductions of 1978 (Washington, D.C.: Department of the Treasury, Office of Tax Analysis, September 1985).

most stimulated by previous capital gains tax cuts and the area in which the U.S. is most competitive.

Congress should compare U.S. treatment of capital gains with that of this nation's toughest international competitors. This would reveal that even the current 20 percent capital gains tax in the U.S. is high by international standards, as Table 5 illustrates.

Table 5
Comparison of Individual Taxation of Capital Gains on
Portfolio Stock Investments, Industrialized and
Pacific Basin Countries
(in percent)

Country	Maximum Short-Term Rate	Maximum Long-Term Rate
U.S.	50	20
Australia	61	none
Belgium	none	none
Canada	17	17
France	16	16
Germany	56	none
Italy	none	none
Japan	none	none
The Netherlands	none	none
Sweden	50	20
U.K.	30	30
Hong Kong	none	none
Malaysia	none	none
Taiwan	none	none
Singapore	none	none

Source: Arthur Andersen & Co. and Securities Industry Association

CONCLUSION

The House tax bill manifests a remarkable misunderstanding of the realities of international competition. It appears almost to be designed to penalize and reduce U.S. competitiveness. When the Senate starts taking its long, hard look at the House bill, it should take into account the measure's impact on international economic competitiveness. If the serious flaws of the House bill are not corrected, this tax "reform" could hamper seriously the U.S. ability to counter the brutal global economic competition that it faces.