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Impact of Tax Reform on International Competitiveness

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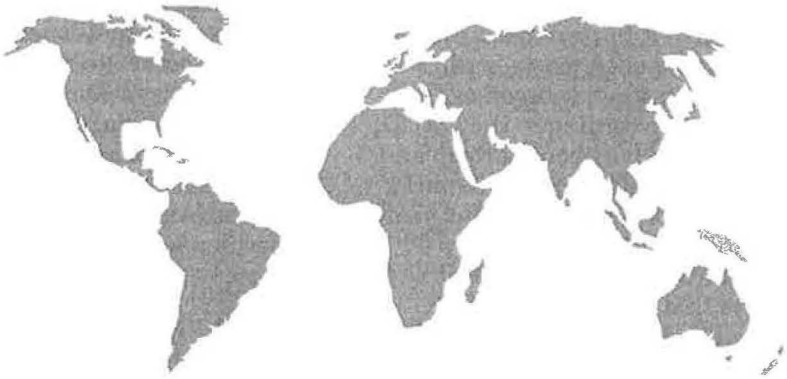
Opinion and Analysis



Impact of the Proposed Replacement Tax Systems on the International Competitiveness of U.S. Workers and Businesses[1]

by the Tax Reform Study Group[2]

The Tax Reform Study Group was formed in October 1995 and consists of individuals from business, state, and local government, and academia who are interested in studying the proposals for reform of the federal and state tax systems and tax reform in general and the impact on Silicon Valley. The group provides objective forums for people in Silicon Valley to learn about tax reform and how it affects them and their employers. The group maintains a Web page where interested people can obtain objective information on tax reform: http://www.svi.org/jointventure/tax/taxfed.html

Joint Venture: Silicon Valley Network is a dynamic model of regional rejuvenation with a vision to build a community collaborating to compete globally. Joint Venture brings people together from business, government, education, and the community to act on regional issues affecting economic vitality and quality of life. One of its initiatives is the Council on Tax & Fiscal Policy.

The views expressed in the comment letter represent the collective views of the Tax Reform Study Group within the Council on Tax & Fiscal Policy of Joint Venture: Silicon Valley Network, and not necessarily the views of any individual members of the study group, the Council, or Joint Venture.

I. Global Facts Must Be Considered in Reforming the Federal Income Tax System

In reforming the federal income tax code, it must be kept in mind that the code was created, and despite regular modifications works best for an era that no longer exists. The Internal Revenue Code (IRC) is based on the industrial age in which tangible goods—easy to track and measure—were the key commodities. We are now living in the information age which requires a different perspective and set of rules than the industrial age.

Today, businesses and workers must deal with a global economy. While we still hear the term "international business," such a term is outdated because all business today is involved in or influenced by the global economy in some fashion. A new business

[1]These comments were submitted to the House Ways & Means Committee at a hearing held on July 18, 1996, on the impact of the proposed replacement tax systems on the international competitiveness of American workers and businesses For related coverage of hearings, see *Tax Notes Int'l*, July 29, 1996, p. 333 or *Doc 96-20445 (4 pages)*. The Tax Reform Study Group previously submitted comments for the written record of the May 1996 hearing on the impact of tax reform on state and local governments. The Tax Reform Study Group is also working on a more comprehensive comment letter to submit to the tax writing committees at a later date.

[2]The primary drafter of these comments was Annette Nellen, professor, San Jose State University; substantive contributions and review were provided by William C. Barrett, director: Tax, Export & Customs, Applied Materials, Inc.; Dan Kostenbauder, general tax counsel, Hewlett-Packard Company; Larry R. Langdon, vice president—Tax, Licensing & Customs, Hewlett-Packard Company; David W. Mitchell, Hoge, Fenton, Jones & Appel, Inc.; Jerry Nightingale, financial advisor, Royal Alliance; Donald J. Scott, director: Tax Compliance, Oracle Corporation; Dean Smith, Ireland, San Filippo & Company; John Webb, vice president-Taxes, National Semiconductor Corporation.

formed in the United States may engage in international transactions in its early years, rather than later when it becomes "big enough." According to the OECD, the "period between start-up and internationalization is becoming shorter—often three or four years compared to five to 10 years a decade ago." The OECD also reports that about 1 percent of small and medium-sized manufacturing businesses (about 40,000 firms) are "truly global." Such firms produce about 26 percent of OECD exports and about 35 percent of Asian exports.

The current global environment that must be the model in the minds of tax code reformers is shaped by many realities, including the following.

A. Increasing Importance of Foreign Markets

The level of both U.S. exports and imports continues to grow. In 1980, exports represented 8.5 percent of the U.S. economy, and 12 percent in 1994. DRI/McGraw-Hill has predicted that the current growth in exports will be $1 trillion by 1998. Foreign markets are growing, and many U.S. companies are ready to provide goods and services to them. The Computer Systems Policy Project (CSPP) predicts that by the year 2000, about 70 percent of the demand for information technology will come from foreign markets. The importance of the global economy to the computer industry was summarized by the CSPP as follows:

> The ability to sell products and access technology worldwide is essential to the continued competitiveness of the U.S. computer industry and its success around the world. The industry must grow globally or die!
>
> Continued success of the U.S. computer industry around the world depends on its ability to bring competitive products to market quickly. To do that, it is essential that companies be able to source technology globally—wherever it can be found—to maintain the industry's competitiveness and productivity. No country can have a monopoly on technology—its flow across international boundaries is a business reality.

B. Global Competition for Technology Jobs and Tax Dollars

Many foreign countries actively compete for U.S. businesses to locate operations in their countries, particularly those bringing technology-based jobs. Incentives include tax holidays, low tax rates, direct funding from the government, and duty rate reductions. This reality must be considered in efforts to improve the international competitiveness of U.S. companies and workers. The OECD has undertaken efforts to deal with international business and tax competition to prevent competition that may be harmful to governments and businesses. A June 1996 economic communique of the G7 leaders noted that business and tax competition can distort trade and investment and "lead to the erosion of national tax bases."

> While we still hear the term 'international business,' such a term is outdated because all business today is involved in or influenced by the global economy in some fashion.

C. Services Sector Is Growing While the Manufacturing Sector Is Declining

The Department of Commerce reports that by the 21st century, telecommunications and information-based industries will represent about 20 percent of the U.S. economy. In 1995, the "Fortune 500" was changed to include both industrial and service firms. The reasons for this change include the fact that a "new economy" has emerged with the line between manufacturing and service activities more blurred; "the digital revolution has made the distinction between manufacturing and services increasingly theoretical." The services sector of the economy showed job growth from 1989 to 1991 (almost 3 million jobs added), while the manufacturing and construction sectors showed job decline (about 1.5 million jobs). In 1950, services represented about 31 percent of GNP, while tangible goods represented about 55 percent of GNP. In 1990, these percentages had changed to 52 and 40 percent, respectively.

The growth in the services sector is not a U.S. phenomenon. In France, job growth in financing, insurance, real estate, and business services grew at double the rate of overall employment. At the same time, manufacturing jobs fell from 36 to 29 percent and agricultural jobs fell by about half. Similar patterns have occurred in the OECD countries.

D. Intangible Assets—Information, Intellectual Property, and Human Capital Are Key Assets

With the decline in the manufacturing sector and the increase in the services sector, tangible assets have somewhat declined in importance relative to intangible assets and knowledge. However, financial and economic reporting is still driven by tangible capital. U.S. Department of Commerce data reports capital expenditures by industry, but not investment

in workers and intangible assets. Certainly, tangible assets are much easier to measure than intangible assets, but without a focus on intangible investment in intellectual property and human capital, economic perspectives will be distorted. A tax reform focus on a system to increase capital investment (in tangible/measurable items) is not by itself appropriate. Instead, consideration also must be given to what tax and fiscal policies are appropriate to a business environment in which developing human capital and protecting intellectual property is key to survival and improved growth.

Intangible assets are often difficult to fit into the taxing schemes of the current tax laws. Again, this difficulty stems from the fact that our tax rules are structured to address the industrial age, not the information age. For example, the tax law does not provide a simple answer as to whether a software developer who only transfers its software over the Internet has to deal with inventory rules, or whether software duplication and packaging is considered manufacturing. Also, the current tax law cannot clearly label a software transaction as being a sale of goods, a rental, or royalties. This failure leads to difficulties applying domestic and foreign tax rules and leads to much cost and confusion.

II. What is Meant by 'International Competitiveness?'

The term "international competitiveness" has different meanings to different people. To some, it may mean a focus only on exports (trade competitiveness), and not on investment outside the United States (multinational competitiveness). To others, it may mean only looking at how tax rules may encourage or discourage certain activities. However, in debating how international competitiveness is impacted by major federal tax reform, a broad perspective should be taken. This perspective should consider how domestic policies, with respect to savings incentives and fiscal problems (such as the U.S. debt and budget deficits) impact global investment and competitiveness. It also should consider the costs that businesses face in terms of a complex tax system and uncertain tax rules and how they can hinder a firm's ability to effectively compete in the global economy. (The debate also should consider the factors described in the next section.)

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A 1991 Joint Committee on Taxation report includes a detailed discussion on the competitiveness of the U.S. economy. The report looks at this concept in terms of trade competitiveness, standard-of-living competitiveness, and multinational competitiveness. It also discusses different measures of competitiveness and various policies, such as government regulations, technology, and investment, that can impact competitiveness.

III. Many Factors Impact International Competitiveness and Trade

While a nation's tax rules and tax infrastructure impact a company's cost of doing business and many of its decisions, many other factors are important. These factors, some of which are briefly explained below, must be considered along with the tax rules in any reform designed to improve the international competitiveness position of U.S. companies and workers. For example, a tax rule designed to encourage exports will not help a technology company facing outdated export controls. Similarly, the rapid technological pace at which products advance requires a legal infrastructure that can deal with this pace so that companies are not left behind in marketing their products worldwide because competitors are not subject to outdated trade restrictions and other legal obstacles.

Briefly described below are some of the factors that must be considered in the entire debate on improving the international competitiveness position of U.S. workers and businesses. The tax reform process should consider these factors to develop a cohesive set of policies that do not conflict with each other and thus defeat the overall goals of improving international competitiveness.

A. Education and Worker Training

With the increased importance of intellectual and human capital of many businesses, relative to the importance of machinery, workers must be adequately prepared. The CSPP reported that in 1993, 74 percent of computer companies' revenues were derived from products that were not even in existence two years earlier. Clearly, workers in such environments must be prepared for lifelong learning and adaptability and have a solid technological

foundation from which to grow. Development of these skills should begin in primary and secondary education, not just in college or trade schools.

B. Cross-Border Worker Mobility

We are accustomed to workers moving from state to state to find better jobs or to move when their employer expands. Such moves are relatively simple—visas and other paperwork are not required. In a global economy, attention should be given to making worker moves from one country to another a simpler proposition as well. The United States should work with other countries to streamline worker transfers, because such mobility is part of doing business in the global economy.

C. Intellectual Property Protection

Clearly, protection of intellectual property of U.S. companies is an important part of being able to compete effectively in the global economy. While this is true for all types of companies with patents, copyrights, trade secrets, and trademarks, it is particularly important in the software industry. Without international respect for intellectual property rights, a software company's ability to compete is greatly diminished. Software piracy must be controlled for U.S. software companies to be able to compete globally. Because software is one of the fastest growing industries, attention needs to be given to this difficult problem.

D. Savings and Investment

The United States, its businesses, and its workers could be slowed down due to impediments to savings and investment, such as:

- a high national dissavings in the form of our $5 trillion national debt and continual annual budget deficits;
- double taxation of corporate earnings;
- tax depreciation rates that are slower than those of other countries and the actual obsolescence rates of some high-technology equipment;
- high tax rates on capital investment, and lacking or distorted savings incentives (current savings incentives tend to favor home ownership relative to other types of investments);
- reduced R&D incentives and government investment in private R&D relative to other countries; and
- anti-deferral tax provisions, such as IRC section 956A and the PFIC rule's overlap with controlled foreign corporation rules, which encourage U.S. multinational firms to invest offshore.

> The rapid technological pace at which products advance requires a legal infrastructure that can deal with this pace so that companies are not left behind in marketing their products worldwide because competitors are not subject to out-dated trade restrictions and other legal obstacles.

E. Export Controls

While much debate has occurred on export controls, solutions are often slow in coming. While these are difficult issues, often involving issues of national defense and security, they must be resolved in the same rapidly changing environment in which exporting businesses are trying to compete. The CSPP places the estimated cost of current export controls on cryptography at $60 billion and 200,000 potential jobs through the year 2000. U.S. multinational firms should not have to suffer the consequences of politicized trade issues.

F. Antitrust Policies

Current antitrust policies should be reviewed and consideration given to what constitutes effective policies for U.S. companies competing in a global environment. While a company's actions are typically viewed in the context of how they affect U.S. competition, such actions also should be viewed as to how antitrust policy may impede the U.S. company from competing internationally. Again, difficult issues are involved, but they must be considered in the context of the topic of international competitiveness of U.S. workers and businesses.

G. Global Information Infrastructure (GII)

Issues that have arisen in the United States regarding the national information infrastructure (NII), such as protection of intellectual property, content control, and security, also will exist on the GII. The U.S. government should work with U.S. businesses and other governments to help ensure that the potential of the GII (including its business potential) is not hindered.

H. Global Legal Infrastructure

U.S. businesses have been burdened by a complex domestic infrastructure involving differing regulations and rules among the 50 states and often within each state as well. As the global economy grows and the above issues are addressed, consideration

should be given to standardization of some processes such as registration of intellectual property, business registration, payment procedures, settlement of tax disputes, and export and import procedures.

IV. Recognize How Other Countries Tax and Spend

The United States is only one of two OECD countries that does not employ a federal VAT. Thus, our tax system is "out-of-sync" with most countries. Current proposals for major reform call for replacement of the federal income tax with a consumption tax. Such a step also would keep the U.S. tax system out of sync with other OECD countries because they employ an income tax along with consumption taxes. Before taking a drastic step to completely eliminate the U.S. income tax system, careful analysis should be made as to:

- why other countries have both income and consumption tax systems;
- how government spending in other countries differs from the United States (e.g., many European countries have higher social spending on unemployment benefits, education, and health care) and how that impacts their taxing decisions;
- the ability to use the income tax system to reduce the regressivity of a consumption tax; and
- the impact to state and local governments of replacing the federal income tax with a consumption tax.

In addition, tax differences between the U.S. income tax system and those of other countries, such as territorial versus worldwide tax systems, sourcing rules, and foreign tax credit rules, should be considered in terms of how such differences may impede the competitiveness position of U.S. firms.

V. Importance of Identifying Policy Goals For the New Tax Rules

Arguably, some of the complexity of today's tax laws stems from the failure to ask the following question prior to making changes to the IRC: "Does the change support the underlying revenue and competitiveness policies of the U.S. tax laws?"

For example, international tax rules do not necessarily have similar policy objectives underlying them. This can lead to distorted incentives, such as where one rule encourages domestic investment, while other rules favor foreign investment (for example, current IRC section 956A which actually encourages foreign investment in offshore plants versus the research tax credit, which encourages domestic investment in R&D activities). Similarly, U.S. tax rules have not necessarily focused on the tax rules businesses face in foreign countries and how the U.S. tax rules on sourcing of expenditures, foreign tax credits, transfer pricing, and labeling of transactions (such as sale of goods versus royalties) can lead to double taxation, costly controversies, and non-neutrality of the tax rules (because tax implications can influence a business's investment decisions).

> Government needs to listen to the experiences that companies are having in dealing with tax issues in their worldwide activities.

In reforming the tax system, time must be given to discussing what the appropriate policies should be to support the tax rules with respect to international business transactions. For example, should the rules:

- encourage exports?
- be neutral as to where production occurs?
- follow a standard established by an international group, such as the OECD?
- or something else?

Without first having this discussion, any replacement tax rules will lead to the same complexities and distortions that currently exist in the federal income tax rules. Similarly, any efforts made to reform our current income tax rules in the international tax area (prior to major federal tax reform) should follow these same principles of first identifying (1) what the policy goal of the international tax rules is, (2) whether the particular proposal will be within that policy goal, and (3) whether the proposal is the simplest and most effective method of reaching that goal.

Finally, more efficient tax policies could stem from a better dialogue between government and industry. Government needs to listen to the experiences that companies are having in dealing with tax issues in their worldwide activities. Many of these issues can only be solved by actions on the part of Congress and the administration to clarify or correct the U.S. tax laws, or in dealing with issues businesses face in applying both U.S. and some other country's tax laws to the same transaction.

Businesses have brought various tax rules that are not in the best interests of the U.S. econ-

omy to the attention of Congress and the administration. Two recent examples are the failure to clarify the IRC or regulations to enable software companies to obtain foreign sales corporation (FSC) benefits similar to that obtained by other industries, and the failure to hear U.S. companies' appeal that the passive asset rule of IRC section 956A and the PFIC rule's overlap with controlled foreign corporation rules actually encourage, rather than discourage, offshore plant investment. Given the rapid technological changes companies deal with today and the various complexities of doing business globally, a more efficient system must be developed for government and business to work together to maintain a set of tax rules that best serves the interests of the U.S. fisc and does not adversely impact U.S. companies and their workers. Multiyear delays in fixing problem areas in the tax law are not acceptable in the rapid technological and business development pace of today's global economy. Reform efforts should include creation of a system for quick resolution of costly tax issues and uncertainties as to how the law applies.

VI. Problem Areas With Current Proposals and Tax Reform in General

A. Determine Whether GATT Compatibility Is Important

Consensus does not exist as to how important it is for a tax to be GATT-compatible. Some commentators view it as unimportant under the theory that a border adjustable tax is not an effective tool in reducing the trade deficit. In a 1992 report, the Congressional Budget Office stated that border adjustments do not improve the balance of trade because of resulting changes in exchange rates. However, others, including Rep. Bill Archer, R-Texas, view GATT compatibility as an important goal for tax reform. The importance of GATT compatibility must be further analyzed and openly debated prior to instituting a tax that is not GATT-compatible, such as the Armey flat tax, or making an effort to ensure that a new tax is GATT-compatible if it makes no difference. This debate should consider the following:

- the effect of GATT compatibility under various trade-balance scenarios;
- the effect in the long-term versus the short-term;
- the impact of transitioning to a GATT-compatible tax;
- possible differences of impacts among industries; and
- trading partner acceptance of the taxing system as GATT-compatible.

> In reforming the tax system, time must be given to discussing what the appropriate policies should be to support the tax rules with respect to international business transactions.

B. Determine Whether a Subtraction VAT Is GATT-Compatible

If it is determined that GATT compatibility is important, careful attention must be paid to the new tax to be enacted to ensure that it is truly GATT-compatible. Most of the world using a VAT uses the credit-invoice VAT, which is more obviously an indirect tax, relative to the subtraction VAT. As noted by former Treasury Assistant Secretary Les Samuels, "Whether a subtraction method VAT would survive a GATT challenge is an untested issue." Also, per a 1991 Joint Committee on Taxation report: "There is considerable uncertainty as to whether a subtraction-method VAT would be legal under GATT. The distinction may be made that a subtraction-method VAT, unlike a credit-invoice VAT, is not imposed on particular transactions but directly on a business, where the tax base is equal to the business's value added. In this technical respect, a subtraction-method VAT may more closely resemble a corporate income tax than a sales tax." On the other hand, others believe that a subtraction VAT is likely to be GATT-compatible.

In the GATT compatibility debate, it is important to note that the current proposals call for a variation on a subtraction VAT. While a pure subtraction VAT might be shown to be GATT-compatible, the USA subtraction VAT is not a pure subtraction VAT because of its NOL carryforward and FICA credit provisions. These provisions may indicate that it is not an indirect tax. However, if this is true, these are fixable aspects of the proposal; the key will be to fix such problems prior to enactment, rather than on a later GATT challenge.

C. Expand the VAT Debate To Include the Credit-Invoice VAT

Almost all countries that use a VAT use the credit-invoice method VAT. However, current major tax reform proposals in the United States all call for some form of the subtraction-method VAT. Reasons for favoring a subtraction-method VAT over the credit invoice VAT include:

- the subtraction-method VAT is viewed as not tolerating any special rates or exemptions; so it will not suffer from the same

problems that the income tax has (such as having over 100 special preferences);

- in terms of computation, the subtraction-method VAT looks more like the income tax and thus will be better accepted in the United States.

Both of the above reasons for favoring a subtraction-method VAT have serious underlying problems. First, it is not politically reasonable to assume that preferences and special rates cannot be added to a subtraction VAT—someone will surely figure out a way! In fact, it has already been shown that a subtraction-method VAT can tolerate exemptions as evidenced by the Danforth-Boren business activities tax (BAT), a form of subtraction VAT introduced in 1985, which calls for an exemption for businesses with gross receipts under $100,000.

The fact that a subtraction VAT has similarities to our current income tax is both a plus and a minus. The plus is that it will rely on records businesses already have in place for state income tax and financial reporting purposes. The minus is the fact that it leads to confusion as to what is actually being taxed; it also leads to potential GATT compatibility problems. For example, one of the common complaints voiced about a subtraction-method VAT proposal, such as the USA tax, is that it is an unfair tax on labor because no deduction is allowed for labor. Such a comment likely comes about because when the tax looks so much like our income tax, we expect it to include "typical deductions," such as those for labor. However, a consumption-type VAT taxes "value added" to goods and services acquired from another business as the goods and services move through the production and distribution chain. The key element of that "value added" is the labor that a business applies to the goods and services as they move through the production and distribution chain (thus, there is no "deduction" for wages, because they are supposed to be taxed under a value added taxing scheme).

Under the credit-invoice form of a consumption-type VAT, it is more clear what (and who) is being taxed and the complaint that it is an unfair tax on labor is not typically raised. Yet, where there are no exemptions or special rates, both forms of VAT raise the same amount of revenue.

> The importance of GATT compatibility must be further analyzed and openly debated prior to instituting a tax that is not GATT-compatible, such as the Armey flat tax, or making an effort to ensure that a new tax is GATT-compatible if it makes no difference.

A subtraction VAT may lead to GATT-compatibility problems because it is proposed to look so much like a non-GATT compatible income tax (direct tax). For example, under the USA proposal, if a business has purchases greater than revenues, a net operating loss (NOL) is generated that can be carried forward for 15 years (very much like our income tax system). Under a VAT, a refund would be more appropriate when a business's purchases from other businesses exceed its sales for the year. Also, under the USA proposal, a business could transfer its NOL carryforward along with a transfer of its assets. These two features make the USA business tax look more like something imposed on the business (a direct tax) rather than on the consumer (an indirect tax). Under a credit-invoice VAT, these issues do not arise. A credit-invoice VAT makes it clear that the ultimate consumer is paying the VAT and if purchases exceed sales for a business, the business receives a VAT refund. Also, the credit-invoice VAT is known to be GATT-compatible, while the forms of subtraction VAT proposed in the current debate have not been tested under GATT (see earlier discussion).

For the reasons noted above, as well as the fact that a debate as significant as replacing the federal income tax requires an honest look at all possible options, all appropriate proposals should be on the table, including the credit-invoice VAT. This will lead to a more effective debate, allow for consideration of how most of the rest of the world taxes, and perhaps allow for a more honest perspective of what a consumption-type VAT is and how it does indeed differ from our current income tax.

D. Renegotiation of Tax Treaties

Current tax treaties deal with income taxes, not consumption taxes. Thus, the treaties will need to be renegotiated if the income tax is replaced. The time frame needed for this task, as well as whether other countries would be willing and interested in renegotiating treaties with the United States, must be considered in the tax reform debate.

E. Industry Neutrality With Respect to a Destination-Based Tax

For a variety of reasons, certain financial factors differ among industries. For example, U.S. Department of Commerce figures for 1994 show the following for two different industries:

	Motor Vehicles and Car Bodies (SIC 3711)	Computers and Peripherals (SIC 3571, 3572, 3575, 3577)
Production workers	198,000 (est.)	67,000 (est.)
Average hourly earnings	$24.57	$13.01
Total employment	237,000 (est.)	191,000 (est.)
Capital expenditures	$2,774 million (1992)	$2,123 million (1992)
Value of shipments	$185,111 million (est.)	$70,500 million (est.)
Value of exports	$22,038 million	$30,393 million
Value of imports	$72,596 million	$46,833 million

This information indicates that these two industries vary in the amount of shipments that are exported and the amount of total workers who are production versus nonproduction workers. In addition, the capital expenditures for the two industries are close in amount although total shipments in the motor vehicle industry are over twice those for the computer industry. Differing exports, capital expenditures, and wage bases will exist among companies within each industry as well. These differences should be given some consideration in the design of a neutral tax system so that businesses are not unfairly and unjustifiably favored or penalized under the tax system.

For example, the current design of the USA tax for businesses imposes a separate tax on the value of imports (but at the same tax rate as imposed on domestic operations). The USA tax allows businesses to reduce their tax liability by a credit equal to the FICA taxes paid. However, this credit may not be used to reduce the import tax. A capital-intensive business, such as a chip manufacturer, may have zero tax liability under the business tax due to the expensing of capital equipment and the FICA credit. Such a company may likely generate NOL and FICA credit carryovers as well. At the same time, the company will owe an import tax. Thus, the tax system for such a company becomes one of zero domestic tax (with NOL and credit carryovers that may never be needed), with tax only paid in the form of an import tax. On the other hand, a company that does not rely on imports to the same degree and/or is not capital-intensive, will be able to claim benefit of its FICA credit because it does have a domestic business tax base. Thus, two companies could have equal domestic wage bases yet be subject to quite different tax bills. A remedy to allow for a more neutral tax would be to allow for the FICA credit to be used against any tax liability.

1. Destination-Based Versus Origin-Based Tax System

A common preference touted for a destination-based tax is that it will improve the balance of trade. However, many commentators state this is not true (see GATT discussion above). This issue is closely tied to GATT compatibility (discussed above) and should be debated with that similar issue. Included in that debate should be other factors, such as transfer pricing issues and rules, that may tend to justify one tax system over the other. For example, while transfer pricing issues would be reduced from a U.S. government perspective under a destination-based tax, transfer pricing remains an issue under an origin-based tax system. However, under a destination-based tax system, U.S. businesses may likely face heightened transfer pricing scrutiny from other countries because the pricing of U.S. exports receives no scrutiny under the U.S. tax laws, potentially making such values entering foreign countries more "suspect." State tax coordination with a federal consumption tax also should be included in this origin-versus destination-based debate.

2. Intangibles in Taxing Schemes

Transfers of intangible assets, such as information and software, are more difficult to tax relative to the transfer of visible tangible assets. Also, while tangible assets can be seen by customs agents when the goods cross borders, the same is not true of information, software, and telecommunications. With the increasing amount of revenues generated from transfers of intangibles, realistic tax schemes must be found. Such schemes should be coordinated with the rules of other countries to avoid double taxation, and unnecessary compliance burdens. For example, under the Armey flat tax, if the licensing of U.S. technology to a foreign entity is viewed as a taxable export and the foreign country also taxes the royalty income, the U.S. taxpayer will be subject to double taxation because the Armey flat tax does not allow for a foreign tax credit. As noted by the National Commission on Economic Growth and Tax Reform (Kemp Commission), attention must be paid to the "proper tax treatment of foreign source license fees, royalties, and other intangibles so as not to discourage research and development in the United States."

The current reform proposals and the tax reform debate have ignored the tax treatment of intangible assets for the most part. For example, the USA proposal

includes rules on sourcing goods and services for purposes of determining whether income and expenses are considered nontaxable export income, or a taxable import. However, it does not discuss how to source royalty income and royalty payments related to intangible assets, or whether such payments are considered to be for services.

The Armey flat tax does not include sourcing rules at all. Guidance would be needed, for example, on how to determine whether licensing of an intangible asset to a foreign licensee should be viewed as a taxable export, nontaxable investment income, or nontaxable foreign income. Also, when development of an intangible occurs both inside and outside the United States and/or it is licensed both inside and outside the United States, guidance will be needed as to how the costs and revenues from the intangible factor into the taxpayer's U.S. tax liability.

3. Potential Problems if the United States Becomes a Tax Haven

In the flat tax, authors Hall and Rabuska note that with a 19 percent tax rate and expensing of investment, "foreign investment should pour into the United States." While this may sound great for the U.S. economy, consideration must be given to whether such an assumption is realistic (investment in the United States is not solely dependent on tax considerations). Should this assumption be a possibility however, the United States must then factor in what possible "retaliatory" actions other countries may take to try to keep investment within their borders. Such competition for business and tax dollars might not be a beneficial outcome for both businesses and governments.

VII. Conclusion

With respect to consideration of the impact of major federal tax reform on international competitiveness, we encourage Congress to:

- Recognize a changed business environment and the need for quick action to solve problems. Identify what the global economy of today and tomorrow looks like and how it differs from the world that shaped our existing tax laws and policies. Businesses should not be held back by unclear rules and the slowness of the government bureaucracy to fix roadblocks that hinder a business's ability to compete effectively in the global economy. If the debate is focused on what currently exists in the IRC and why rules were written the way they were years ago, it will be a useless debate.

A subtraction VAT may lead to GATT-compatibility problems because it is proposed to look so much like a non-GATT compatible income tax (direct tax).

- Think globally, not domestically. A key statistic cited in discussing international competitiveness is the level of U.S. exports and imports. This perspective by itself is outdated and limiting because it is easy for many high-technology companies to operate almost anywhere in the world, yet still provide benefits to the U.S. economy. Perhaps the focus should be on worldwide operations, whether a U.S. business is facing any legal obstacles that are impeding its worldwide growth, and how the United States can assist in reducing such obstacles.

- A focus on exports and imports (the trade imbalance) also may lead to "domestic tunnel vision," which similarly might lead to policies that impede the worldwide growth of a U.S. business. A decision by a U.S. firm to locate operations outside of the United States should first be viewed as a reasoned economic one which likely still provides some benefits to the U.S. economy. Today, application of "domestic tunnel vision" is likely to apply and lead to legislation to prevent or penalize such business decisions. Such actions should be considered in terms of whether they make sense in terms of the global economy in which businesses operate today.

- Work with businesses to better identify the appropriate policies that should underlie international tax rules. For example, should exports be encouraged? Should investment in foreign business activities be discouraged? Should taxes be a neutral factor in these decisions? Consideration also must be given to how other countries tax international transactions and how countries can work together in the global economy and collect tax revenues in an effective and cost-efficient manner.

- More than just tax rules need to be considered. Approach the task of improving international competitiveness as the broad proposition that it is. That is, consider the education and worker training of today's workers who must deal with rapid technological advancement and competition from skilled workers in other coun-

tries. Also consider how to protect intellectual property of U.S. businesses in the global economy, how U.S. savings and investment actions and policies impact the ability of U.S. businesses to compete globally, as well as the impact of export controls, antitrust policies, and how the global infrastructure in which businesses must operate might be streamlined through coordinated efforts of governments working together.

- Work to preserve and further encourage this country's entrepreneurship and technological expertise. Given the rapid changes in technology and the continuing growth potential for high-technology products, U.S. policies should focus on ensuring that students are provided the skills to enable them to work in and further advance high-technology industries.

- Various tax impediments to competition exist. Consider the broad realm of tax impediments to competition. This includes: complexity and its related compliance costs and costs of actions not taken due to tax uncertainty; lack of government commitment to R&D incentives; depreciation rates that serve revenue needs rather than business realities; double taxation of corporate income; hindrances to capital formation, such as rules that prefer debt over equity; and income tax differences between U.S. rules and those of its major trading partners.

- Start now. Realize that the international aspects of tax reform are likely the most difficult ones and the above tasks should begin now. ✦