

Comments for the Record

U.S. House of Representatives Committee on Ways and Means

Hearing on President Obama's Trade Policy Agenda with U.S. Trade Representative Ron Kirk and a Second Panel on the Future of U.S. Trade Negotiations

Wednesday, February 29th, 2012, 10:00AM
1100 Longworth House Office Building

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Chairman Camp and Ranking Member Levin, thank you for the opportunity to submit comments for the record on this issue. We will leave it to the Administration witness to discuss their plans and will instead concentrate on how our tax reform plan impacts trade in general and trade with China in particular. These comments are similar to those submitted regarding our relationship with China last October. As you know, the Center for Fiscal Equity has a four part proposal for long term tax and health care reform. The key elements are

- a Value Added Tax (VAT) that everyone pays, except exporters,
- a VAT-like Net Business Receipts Tax (NBRT) that is paid by employers and includes the employer contribution to OASI, but, because it has offsets for providing health care, personal retirement accounts, education benefits and family support, does not show up on the receipt and is not avoidable at the border,
- an employee payroll tax to for Old Age and Survivors Insurance (OASI) and
- an income and inheritance surtax on high income individuals so that in the short term they are not paying less of a tax burden because they are more likely to save than spend – and thus avoid the VAT and indirect payment of the NBRT.

A Value Added Tax (VAT) is suggested because of its difficulty to evade, because it can be as visible to the ultimate consumer as a retail sales tax and **because it can be zero rated at the border for exports and collected fully for imports**. As such, it is superior to proposals for a FairTax or 9% National Sales Tax. As many others, particularly Michael Graetz, have pointed out, resorting to a VAT rather than imposing trade sanctions has the effect of imposing higher costs on imports and lower costs on exports, without provoking retaliation from our trading partners – mostly because our trading partners **already use such a regime**. By not adopting a similar tax structure, we essentially tie the hands of our exporters in the fight for international market share. There can be no retaliation when using VAT is already the international standard.

In short, if the U.S. adopted a VAT, China would have no countermove as the use of VAT is part of global trade structures.

It is also important is to exercise care in delineating what is funded by a VAT. We believe that VAT funding should be confined to funding domestic discretionary military and civilian spending. Zero rating a tax supporting such spending is totally appropriate, as foreign consumers gain no benefit from these expenditures. Likewise, making imports fully taxable for this spending correctly burdens the consumers who fully benefit from these services. As importantly, making such a tax visible provides an incentive to taxpayers to demand less of such spending.

The NBRT would not be border adjustable because it is designed to pay for entitlement costs which benefit employees and their families directly, so that it is appropriate for the foreign beneficiaries of their labor to fund these costs. Additionally, the ultimate goal of enacting the NBRT is to include tax expenditures to encourage employers to fund activities now provided by the government – from subsidies for children to retiree health care to education to support for adult literacy. Allowing this tax to be zero-rated at the border removes the incentive to use these subsidies, keeping government services in business and requiring higher taxation to support the governmental infrastructure to arrange these services – like the Committee on Ways and Means.

If the NBRT is enacted in this way, the United States should seek modification to our trade agreements to require that similar expenditures not be funded with taxes that are zero rated at the border. As foreign consumers benefit from subsidies for American families, American consumers benefit from services provided to overseas workers and their families. This benefit should be recognized in international tax and trade policy and American workers should not be penalized when other nations refuse to distribute the cost of benefits to foreign workers to the American consumers who receive the benefit of these services. If our trading partners do not match this initiative, some items of spending could be shifted from NBRT funding to VAT funding, so that we are not making unilateral concessions in this area.

Separation of Old Age and Survivors Insurance Payroll taxes from the NBRT is necessary unless the employee contribution is to be totally eliminated with a uniform benefit or uniform. A separate payroll contribution is required as long as benefit levels are set according to income. If a uniform benefit is desired, then payroll taxes can be discontinued and the NBRT expanded.

Employee contributions could not be zero rated at the border. If employer contributions are equalized and contributed to a public system, however, they could be incorporated into a VAT rather than an NBRT. This allows the Social Security system to benefit from foreign labor where outsourcing has occurred. Indeed, it would be an essential expansion of the tax base if globalization is to continue unabated.

The prospect of Personal Retirement Accounts can also be considered, although doing so is like holding a lightning rod in a thunderstorm. I do agree with President Obama that such accounts should not be used for speculative investments or even for unaccountable index fund investments where fund managers ignore the interests of workers. Investing such accounts in insured employee-ownership of the workplace would have an entirely different outcome, especially if voting shares occurred on an occupational basis with union representation. **The impact at the**

international level of such employee-ownership if extended to subsidiaries and the supply chain is also potentially profound, especially in regard to transfer pricing and the international growth of the union movement.

Personal accounts invested in index funds do not have that feature, although they do serve to support American retirees who because of them have a financial interest in firms utilizing foreign labor, particularly low-wage Chinese labor. The proposed USA accounts proposed by President Clinton had the same feature, although as a supplement to the Social Security benefit rather than a partial replacement, although this feature would be muted by enactment of value added taxes. The flaw in using foreign investment to make up for lost worker revenue is that eventually foreign workers either radicalize or become consumers and demand their own union rights.

China is sitting on a time bomb, and this time bomb has nothing to do with its U.S. Treasury holdings. These holdings are secure as long as the Congress and Administration deal realistically with the expiration of the 2001/2003/2010 tax cuts at the end of next year by offsetting any cuts made permanent with spending cuts or and making sure that any tax reform raises the additional revenue required to cover the difference. Rather, their difficulties arise from their treatment of domestic migrants from rural areas working in Chinese factories. Eventually, these migrants will object to the locality system imposed upon them and demand the same level of pay, benefits and consumerism as is earned by those designated as urban. When this occurs, the valuation of the Yuan will occur, assuming that the Chinese Communist Party survives. We do not make this assumption, however.

It would be better for all concerned if American workers were already in an ownership position due to repeal of the Taft-Hartley Act prohibitions on concentrated pension fund ownership and the enactment of personal retirement accounts. If employee-owned firms extended this ownership to their overseas subsidiaries and purchased their supply chains, they could change the equality system in advance of revolution – however quick adoption of our suggestions to expand employee-ownership is probably less likely than revolution in China.

The tendency for consumerism to follow industrialization is why globalization is a poor substitute for expanding the domestic population, as the Center proposes with its expanded **Child Tax Credit, which we propose as an offset to the NBRT.**

In the long term, the explosion of the debt comes from the aging of society and the funding of their health care costs. Some thought should be given to ways to reverse a demographic imbalance that produces too few children while life expectancy of the elderly increases.

Unassisted labor markets work against population growth. Given a choice between hiring parents with children and recent college graduates, the smart decision will always be to hire the new graduates, as they will demand less money – especially in the technology area where recent training is often valued over experience.

Separating out pay for families allows society to reverse that trend, with a significant driver to that separation being **a more generous tax credit for children**. Such a credit could be “paid for” by ending the Mortgage Interest Deduction (MID) without hurting the housing sector, as housing is the biggest area of cost growth when children are added.

While lobbyists for lenders and realtors would prefer gridlock on reducing the MID, if forced to chose between transferring this deduction to families and using it for deficit reduction (as both Bowles-Simpson and Rivlin-Domenici suggest), we suspect that they would chose the former over the latter if forced to make a choice. The religious community could also see such a development as a “pro-life” vote, especially among religious liberals.

Enactment of such a credit meets both our nation’s short term needs for consumer liquidity and our long term need for population growth. Adding this issue to the pro-life agenda, at least in some quarters, makes this proposal a win for everyone.

The expansion of the Child Tax Credit is what makes tax reform worthwhile. Adding it to the employer levy rather than retaining it under personal income taxes saves families the cost of going to a tax preparer to fully take advantage of the credit and allows the credit to be distributed throughout the year with payroll. The only tax reconciliation required would be for the employer to send each beneficiary a statement of how much tax was paid, which would be shared with the government. The government would then transmit this information to each recipient family with the instruction to notify the IRS if their employer short-changes them. This also helps prevent payments to non-existent payees.

Assistance at this level, especially if matched by state governments may very well trigger another baby boom, especially since adding children will add the additional income now added by buying a bigger house. Such a baby boom is the only real long term solution to the demographic problems facing Social Security, Medicare and Medicaid, which are more demographic than fiscal. Fixing that problem in the right way definitely adds value to tax reform.

The fourth proposal is a surtax on high incomes from inheritance, wages, dividends and capital gains (essentially all income with the exception of sales to a qualified ESOP). It would fund overseas military operations, which are often debt financed, and net interest and debt repayment.

Explicitly identifying the high income surtax with net interest payments highlights the need to raise these taxes as a means of dealing with our long term indebtedness, especially in regard to debt held by other nations. While consumers have benefited from the outsourcing of American jobs, it is ultimately high income investors which have reaped the lion’s share of rewards. The loss of American jobs has led to the need for foreign borrowing to offset our trade deficit. Without the tax cuts for the wealthiest Americans, such outsourcing would not have been possible, **including the creation of Chinese industry designed to sell to Americans**. Indeed, there would have been any incentive to break unions and bargain down wages if income taxes were still at pre-1981 or pre-1964 levels. The middle class would have shared more fully in the gains from technical productivity and the artificial productivity of exploiting foreign labor would not have occurred at all. Increasing taxes will ultimately provide less of an incentive to outsource American jobs and will lead to lower interest costs overall

The final question is the repatriation of profit from overseas subsidiaries, including profits parked in China. Under a consumption tax regime, there would be no separate levy on profit. Value added taxes are already paid in the country where the product is sold and these taxes include both the contributions of labor and capital. For the purposes of businesses, profit should not be taxed again when repatriated, except to the extent that this profit results from value added in the United States. Use of VAT exemptions must not be allowed as a tax avoidance scheme. Products with parts that have been produced or developed in the United States, then sent elsewhere for assembly, must reacquire any obligation to pay that was shed at the border. Not providing for this contingency opens the door for a great deal of abuse.

The source nation of dividend income, meanwhile, must be irrelevant for purposes of collection of the proposed high income and inheritance surtax. The subject of this tax is not the income of the business, which has been shifted to the NBRT for individual filers, but the income of households for personal consumption and savings. The existence of this tax takes into account the decreased likelihood that this income will be spent and therefore taxed under NBRT and VAT regimes and to safeguard savings opportunities for the non-wealthy, who would otherwise be priced out of the market for investments by higher income individuals who, because they have greater opportunities to save, garner greater and greater shares of America's wealth. The proposed surtax is an attempt to level the playing field so that everyone can invest.

Thank you again for the opportunity to present our comments. We are always available to discuss them further with members, staff and the general public.

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This testimony is not submitted on behalf of any client, person or organization other than the Center itself, which is so far unfunded by any donations.