Comments for the Record

United States House of Representatives
Committee on Ways and Means

Tax Reform and the U.S. Manufacturing Sector

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1100 Longworth House Office Building

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Chairman Camp and Ranking Member Levin, thank you for the opportunity to address these topics, which were also submitted to the Senate Finance Committee in March. In our comments, we will address how our four part tax plan relates to these issues, specifically how investment expenses are paid for in a consumption tax environment, the impact of lower tax rates on productivity and jobs, how corporate ownership may be impacted under various scenarios for Personal Accounts in Social Security and the impact of tax reform on globalization.

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 OASI employer contributions but, because it has offsets for providing health care, insured 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.

In a VAT and Net Business Receipts Tax environment, tax is paid to the suppliers of plant and equipment when services are invoiced. VAT is receipt visible, while NBRT, as a vehicle for deductions, is designed not to be (hence the need for a second tax). Those providers then pay taxes to the taxing authority based on those sales. How these assets are accounted for in the price of the product, however, is open for debate.

The credit against VAT and NBRT collections resulting from purchasing investment assets might be applied in the year the purchase is made or, if Congress so desires, the credit can be applied over the useful life of the asset. Extending the credit allows the taxpaying business to even out tax payments over time and will cause less disruption along the supply chain so that the entire price of the item is not a VAT credit at the next stage in the production process. How other nations deal with these questions is dealt with in the VAT literature and is beyond the scope of these comments. Should the Committee desire a more complete treatment of this issue, a separate hearing would be appropriate.

Separate rules could conceivably be adopted for VAT and NBRT, as VAT is collected on a transaction basis, similar to Sales Taxes, while NBRT can be calculated on a period basis, like Corporate Income Taxes. This is especially the case if NBRT collections are not "receipt visible" due to their purpose as a vehicle for claiming offsets for the Child Tax Credit, the health insurance exclusion and other tax expenditures.

As important as how capital expenditures are treated as a factor of production is how dividends and capital gains are taxed. Prior to 1981, tax rates at the highest income levels were confiscatory, especially between 1956 and 1965 when the tax rate was 91%. During this era, special tax benefits were necessary so that when combined with state taxes, the effective tax rate was not over 100% of income. Beginning in 1981, tax obligations for these forms of income declined in several steps, including the 1986 tax reform, the 1997 decrease in capital gains tax rates to the current permanent rate of 20% and the 2003 tax legislation which dropped these rates to 15%.

While technology exploded during this period, as we moved from the mainframe computer to Cloud Computing, robotic and the iPad, much of this explosion was incentivized by the ability of owners to keep an ever increasing percentage of the resulting productivity gains, as well as productivity gains from taking advantage of the expansion of free trade due to the North American Free Trade Agreement, other trade actions and the opening of China as a source of cheap assembly. If the gains from these investments were all kept by the government, they might not have been made. The downside of such gains, however, is the loss of manufacturing jobs, as well as a greater incentive to engage in union busting and the threat of union busting to keep wage increases low, essentially excluding the middle class from enjoying the benefit of these gains through wages, although some might realize them to the extent that they have accumulated either pension assets or participated in defined contribution plans.

Studies have shown that dividend payouts of these productivity gains are generally at the level of normal profit. Dividend levels have not substantially increased due to these gains. Instead, they have gone mainly to CEO bonuses and stock grants and options. While CEO leadership is, of course, important to the adoption of innovation and investment, it is not so great that this factor deserves the lion's share of reward.

It is rather unseemly that fiscal policy has had what amounts to a causal effect on what can be described as disastrous levels of inequality, leading most consumers to borrow to maintain their standard of living and partake in the rise of advanced consumer electronics that in another form has reduced their wages. This overleveraging has led us to the financial situation now plaguing this nation, which can best be described as a long term Depression, even though there are periods of recession and recovery within this era.

Tax reform can ameliorate these effects. Adoption of consumption taxes like a VAT and NBRT impact labor and capital equally. In Europe, this allows for the adoption of lower rates for capital gains taxes. While profit is theoretically taxed by the Corporate Income Tax, such taxation is uneven given the maze of special tax provisions favoring some industries and businesses over others, leaving profit untaxed in many cases, except as part of personal income taxation. Given the probability of evasion, lower rates are not justified. This Center opposed these rate cuts in 2003 and we continue to oppose them.

In the area of personal income taxation, the Center favors a single rate structure for dividend, capital gain, wage and inherited income (rather than inherited assets that are not yet liquidated – with the only exception being that proceeds from sales of these assets to a broad based Employee Stock Ownership would remain tax free). Tax rates could range from 4% on at the $100,000 a year level for joint filers or widows ($50,000 for individuals) to a top level of 28% - which is roughly the effective rate for the NBRT (to discourage income shifting). While fewer, less graduated rates are possible, most middle income taxpayers would not find them desirable. As tax tables will only have a single rate for each income level, the existence of multiple rates does not increase complexity for the taxpayer.

Another option to ameliorate the maldistribution of wealth is the adoption of Personal Retirement Accounts for Social Security, although doing so is like holding a lightning rod in a thunderstorm. We 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.

A major strength of Social Security is its income redistribution function. We suspect that much of the support for personal accounts is to subvert that function – so any proposal for such accounts must move redistribution to account accumulation by equalizing the employer contribution.

We propose directing personal account investments to employer voting stock, rather than an index funds or any fund managed by outside brokers. There are no Index Fund billionaires (except those who operate them). People become rich by owning and controlling their own companies. Additionally, keeping funds in-house is the cheapest option administratively. We expect it is even cheaper than the Social Security system – which operates at a much lower administrative cost than any defined contribution plan in existence.

Safety is, of course, a concern with personal accounts. Rather than diversifying through investment, however, we propose diversifying through insurance. A portion of the employer stock purchased would be traded to an insurance fund holding shares from all such employers. Additionally, any personal retirement accounts shifted from employee payroll taxes or from payroll taxes from non-corporate employers would go to this fund.

The insurance fund will serve as a safeguard against bad management. If a third of shares were held by the insurance fund than dissident employees holding 25.1% of the employee-held shares (16.7% of the total) could combine with the insurance fund held shares to fire management if the insurance fund agreed there was cause to do so. Such a fund would make sure no one loses money should their employer fail and would serve as a sword of Damocles' to keep management in line. This is in contrast to the Cato/ PCSSS approach, which would continue the trend of management accountable to no one. The other part of my proposal that does so is representative voting by occupation on corporate boards, with either professional or union personnel providing such representation.

The suggestions made here are much less complicated than the current mix of proposals to change bend points and make OASI more of a needs based program. If the personal account provisions are adopted, there is no need to address the question of the retirement age. Workers will retire when their dividend income is adequate to meet their retirement income needs, with or even without a separate Social Security program.

No other proposal for personal retirement accounts is appropriate. Personal accounts should not be used to develop a new income stream for investment advisors and stock traders. It should certainly not result in more "trust fund socialism" with management that is accountable to no cause but short term gain. Such management often ignores the long-term interests of American workers and leaves CEOs both over-paid and unaccountable to anyone but themselves.

Progressives should not run away from proposals to enact personal accounts. If the proposals above are used as conditions for enactment, I suspect that they won't have to. The investment sector will run away from them instead and will mobilize their constituency against them. Let us hope that by then workers become invested in the possibilities of reform.

All of the changes proposed here work more effectively if started sooner. The sooner that the income cap on contributions is increased or eliminated, the higher the stock accumulation for individuals at the higher end of the age cohort to be covered by these changes – although conceivably a firm could be allowed to opt out of FICA taxes altogether provided they made all former workers and retirees whole with the equity they would have otherwise received if they had started their careers under a reformed system. I suspect, though, that most will continue to pay contributions, with a slower phase in – especially if a slower phase in leaves current management in place.

The international consequences of adopting personal retirement accounts which include employee-ownership are also interesting. As employees begin to own and control their workplace, they will find it in their best interests to include overseas subsidiaries and their supply chains in the same type of arrangement. They are also more likely to set transfer pricing so that all employees in an international enterprise receive the same standard of living from work, so that incentives to exploit other workers would be eliminated. This development would not only revive the labor movement, it would make it international in a way that trading agreements have not been able to accomplish. Recognition of this fact should make the possibility of personal accounts more attractive to progressives and the more populist members of the Tea Party, but not to the more corporatist members of either party.

International aspects are unavoidable in a discussion of tax reform. Indeed, one of the reasons for engaging in tax reform is to increase the competitiveness of American manufacturers. While VAT does not function as an explicit tariff, the lack of one while many of our trading partners have one essentially builds all of our tax costs into the cost of exported products, where competing nations exclude these costs at the border. The current regime violates the spirit, though likely not the letter, of constitutional provisions banning export taxes.

As the Committee is well aware, VAT is good for competiveness because it can be zero rated at the border for exports and collected fully for imports. Unlike a VAT, an NBRT would not be visible on receipts and should not be zero rated at the border – nor should it be applied to imports. While both collect from consumers, the unit of analysis for the NBRT should be the business rather than the transaction. As such, its application should be universal – covering both public companies who currently file business income taxes and private companies who currently file their business expenses on individual returns.

It is not appropriate for NBRT to be zero rated, as doing so would decrease the incentive to pass Child Tax Credit and Health Insurance tax benefits to employees. As importantly, the tax benefits and government services provided under this tax go to workers and their families. As such, overseas purchasers accrue benefits from these services and should therefore participate in their funding.

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.

The final question on capital investment is the repatriation of profit from overseas subsidiaries. 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 for the opportunity to address the committee. We are, of course, available for direct testimony or to answer questions by members and staff.

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