# INCREASING U.S. COMPETITIVENESS AND PREVENTING AMERICAN JOBS FROM MOVING OVERSEAS

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# HEARING

BEFORE THE

## COMMITTEE ON WAYS AND MEANS
## U.S. HOUSE OF REPRESENTATIVES

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FIRST SESSION

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# CONTENTS

# INCREASING U.S. COMPETITIVENESS AND PREVENTING AMERICAN JOBS FROM MOVING OVERSEAS

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**TUESDAY, MAY 23, 2017**

U.S. HOUSE OF REPRESENTATIVES,
COMMITTEE ON WAYS AND MEANS,
WASHINGTON, DC.

The committee met, pursuant to call, at 10:03 a.m., in Room 1100, Longworth House Office Building, Hon. Kevin Brady [chairman of the committee] presiding.

[The advisory announcing the hearing follows:]

WAYS AND MEANS
CHAIRMAN KEVIN BRADY

# Chairman Brady and Subcommittee Chairman Roskam Announce Hearing on Increasing U.S Competitiveness and Preventing American Jobs from Moving Overseas

*How Border Adjustment and Other Policies Will Boost Jobs, Investment, and Growth in the U.S.*

House Committee on Ways and Means Chairman Kevin Brady (R-TX) accompanied by Tax Policy Subcommittee Chairman Peter J. Roskam (R-IL) announced today that the Full Committee will hold a hearing entitled "Increasing U.S. Competitiveness and Preventing American Jobs from Moving Overseas." **The hearing will take place on Tuesday, May 23, 2017 in 1100 Longworth House Office Building, beginning at 10:00 AM.** The hearing will focus on border adjustment and international tax modernization as a core element of comprehensive tax reform and the implications of these policies for increasing jobs, investment, and economic growth in the United States.

In view of the limited time to hear witnesses, oral testimony at this hearing will be from invited witnesses only. However, any individual or organization may submit a written statement for consideration by the Committee and for inclusion in the printed record of the hearing.

**DETAILS FOR SUBMISSION OF WRITTEN COMMENTS:**

Please Note: Any person(s) and/or organization(s) wishing to submit written comments for the hearing record must follow the appropriate link on the hearing page of the Committee website and complete the informational forms. From the Committee homepage, http://waysandmeans.house.gov, select "Hearings." Select the hearing for which you would like to make a submission, and click on the link entitled, "Click here to provide a submission for the record." Once you have followed the online instructions, submit all requested information. ATTACH your submission as a Word document, in compliance with the formatting requirements listed below, **by the close of business on Tuesday, June 6, 2017**. For questions, or if you encounter technical problems, please call (202) 225-3625.

**FORMATTING REQUIREMENTS:**

The Committee relies on electronic submissions for printing the official hearing record. As always, submissions will be included in the record according to the discretion of the Committee. The Committee will not alter the content of your submission, but we reserve the right to format it according to our guidelines. Any submission provided to the Committee by a witness, any materials submitted for the printed record, and any written comments in response to a request for written comments must conform to the guidelines listed below. Any submission not in compliance with these guidelines will not be printed, but will be maintained in the Committee files for review and use by the Committee.

All submissions and supplementary materials must be submitted in a single document via email, provided in Word format and must not exceed a total of 10 pages. Witnesses and submitters are advised that the Committee relies on electronic submissions for printing the official hearing record.

All submissions must include a list of all clients, persons and/or organizations on whose behalf the witness appears. The name, company, address, telephone, and fax numbers of each witness must be included in the body of the email. Please exclude any personal identifiable information in the attached submission.

Failure to follow the formatting requirements may result in the exclusion of a submission. All submissions for the record are final.

The Committee seeks to make its facilities accessible to persons with disabilities. If you are in need of special accommodations, please call 202-225-1721 or 202-226-3411 TTD/TTY in advance of the event (four business days notice is requested). Questions with regard to special accommodation needs in general (including availability of Committee materials in alternative formats) may be directed to the Committee as noted above.

**Note**: All Committee advisories and news releases are available at http://www.waysandmeans.house.gov/

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Chairman BRADY. The committee will come to order.

Welcome to the Ways and Means Committee hearing on increasing U.S. competitiveness and preventing American jobs from moving overseas.

Before we get started, I want to take a moment to speak about the evil terror attack that occurred last night in the United Kingdom. Our deepest condolences go out to the victims, to their families, and their loved ones. Please know that you are in our prayers.

Today, we are continuing our work on pro-growth tax reform that will improve the lives of all Americans. This morning's hearing is focused on strengthening America's competitiveness and preventing American jobs from moving overseas.

For years, Americans have watched as our manufacturing plants, middle class jobs, and longstanding U.S. companies have moved overseas, devastating communities and the families that depend upon them. Hundreds of thousands of good-paying American jobs have left and continue to leave to China, Mexico, Ireland, and other foreign countries. Some of our communities have never recovered, because when these plants and companies move overseas, the local businesses, housing values, and local tax revenue disappear with them.

I have watched as 17 key Texas companies have relocated their headquarters to England, Canada, Bermuda, Ireland, the Cayman Islands, Switzerland, and the Netherlands. Americans are being hurt because our Nation is saddled with one of the most costly, unfair, and uncompetitive tax systems on the planet. According to the nonpartisan Tax Foundation, when it comes to competitive tax codes, America is ranked nearly last among our global competitors, 31 of 35.

The good news is, we are edging out Greece. The bad news is, nearly everyone else is eating our lunch, along with our jobs, manufacturing plant, and research facilities. The urgency for bold, permanent pro-growth tax reform has never been greater.

We gather today because, with our current Tax Code, the playing field for American workers is not level, not even close. Over three decades have passed since the last time we reformed America's Tax Code. While Washington has been on the sidelines, our foreign competitors have been improving their tax systems for their businesses and their workers.

Today, it is clear our Tax Code is failing American workers, families and businesses in three crucial areas: First, our corporate tax rate, now the highest in the industrial world at 35 percent, is at least 10 to 15 points higher than our competitors. This makes it much harder for our businesses to compete globally and create jobs here at home.

Second, our tax system discourages U.S. businesses from bringing home foreign profits to grow middle class jobs and middle class paychecks. Instead, our Tax Code encourages global U.S. businesses to keep profits abroad, to grow foreign jobs and foreign paychecks. At last check, more than two and a half trillion dollars of U.S. profits are stranded overseas, unable to be affordably reinvested back here in America.

Addressing these two issues is important and would be good enough to move America back to average, somewhere in the middle of the pack. But tax reform only happens once in a generation. Is our vision merely to be average? Given all that is at stake for middle class families, our goal in tax reform should be to vault America from dead last among our global competitors back into the lead pack, back among the top three best places on the planet for that next new job, manufacturing plant, or research facility.

To do this, we must take action on a third crucial competitive issue: Ending the Made in America tax. Today, the vast majority of our international competitors apply taxes on products that are sold in their country no matter where the product's made. And they remove taxes from products that are exported, including products that are sold into the United States. This is called border adjustment. Taxes are adjusted when products cross the border.

Over 160 of our competitors border-adjust their taxes. These are all the blue countries on the map on the screens. America is one of the very few who don't, along with countries like Cuba, North Korea, and Somalia. In our country, we apply taxes only on products that are made in America and Washington imposes that Made in America tax on our products no matter where they are sold, including overseas. As a result, Made in America products are at a major tax disadvantage here at home and around the world.

So why is Washington providing special tax breaks for foreign products over American-made products? Why should Chinese steel get a tax break over American steel? Mexican auto parts and agriculture over American auto parts and agriculture? Foreign oil over American made oil? This doesn't make sense, especially since this is a big reason our current Tax Code drives U.S. jobs and companies overseas.

In the tax reform blueprint, we propose to end the Made in America tax and instead tax all products and services equally when they are sold in America at a low rate of 20 percent. No special tax breaks for foreign products, everyone treated the same, true competition for the first time.

And we lift the tax on Made in America products and services when they are sold abroad, and for the first time leveling the playing field for American workers, businesses, and farmers. Our goal is not simply to eliminate any tax reason to move American jobs overseas, but to reestablish America as a 21st century magnet for new jobs and investment. And for the first time, companies will no longer gain by moving their headquarters to Bermuda, their manufacturing plants to China, or their intellectual property to Ireland.

As a result, for the first time in decades, companies and industries are coming forward to describe how, under the Republican blueprint, they can bring a large part of their supply chains back to America. These are the good-paying jobs, manufacturing plants, research labs, and technology centers that house cutting-edge intellectual property like patents. The current Tax Code told them to move these activities oversees. The House blueprint allows them to bring them back to the United States.

We recognize this is a significant change from our current Tax Code. We know there are legitimate concerns, including from some of our witnesses here today and our colleagues on the other side of the aisle, about how it will affect American workers, businesses, and consumers; and we are committed to working with all of you to address these concerns. We have to get it right, and we will.

It is time for a Tax Code that rewards Americans' hard work rather than pushing American jobs out of our communities. The Tax Foundation estimates the House blueprint as a whole will create 1.7 million jobs over the next decade and grow paychecks for middle class American families by roughly $5,000. Imagine how successful American consumers will be when they have a secure good-paying job and a Tax Code that allows them to keep more of their paycheck. It is time for Washington to get off the sidelines and back into the game, fighting for our businesses, workers, and consumers.

I want to thank all of our witnesses for being here today. We have a stellar field, and we look forward to hearing your ideas on how we can level the playing field for American workers and unleash a new era of American prosperity.

Before I recognize the ranking member, I want to announce that we are joined here today by Bill Thomas, who chaired this committee from 2001 through 2006.

Mr. Chairman, welcome back.

I now yield to the distinguished ranking member, Mr. Neal, for the purposes of an opening statement.

Mr. NEAL. Thank you, Mr. Chairman. And we fully share the sentiments you expressed on the events that took place last night in Manchester, Great Britain.

First, let me thank you, Mr. Chairman, for holding today's hearing on increasing U.S. competitiveness and preventing American jobs from moving overseas. It is an important topic and I look forward to a productive conversation.

As we continue with this series of hearings on comprehensive tax reform, I want to reiterate my support for reforming the Tax Code. There is certainly strong bipartisan support for simplifying the tax system and making it more fair.

We on the Democratic side are willing partners in those efforts. However, we will support tax reform on a comprehensive basis that will ease financial burdens on the middle class and working families. We will not support tax cuts for those at the top of the income scale at the expense of those of the middle class. Our primary focus and top priority in tax reform needs to be putting the middle class first.

I also believe that a key component of tax reform is ensuring that American businesses remain competitive in the global economy and that we prevent American jobs from moving overseas. Achieving this includes providing incentives to companies to conduct research and development here in the United States. We also need to improve our Nation's infrastructure so that it is in line with other developed nations. That includes meaningful investments to repair and enhance our Nation's roads, rails, bridges, harbors, sea and water harbor opportunities as well. These reforms can be done through the Tax Code and would also jump start economic growth and create thousands of jobs.

Another key component of international competitiveness is investment in well-trained and skilled workforce opportunities. A 2015 report by the Manufacturing Institute estimated that over the next decade 2 million manufacturing jobs in this country could go unfilled due to a skills gap.

The New England Council recently estimated in a 2015 report that thousands of high-paying advanced manufacturing jobs, some with salaries well over $80,000 a year with full benefits, go unfilled because employers are struggling to find candidates to meet the needs of these open positions.

At a time when families across the country are trying to reach and stay in the middle class, our Nation cannot afford to have factories and workers sit idle. To remain competitive, we need to invest in workforce development.

Let me shift to another focus of today's hearing, the border adjustment tax. I think that the border adjustment tax proposal is certainly interesting. As my past support of an innovation box demonstrates, I am no stranger to innovative tax ideas and am willing to look outside the box for smart tax policy and certainly encourage others to do the same.

Some argue that a border adjustment tax would create such an incentive for companies to make things in the U.S. that it would drive up demand for American-made goods. We certainly are supportive of American manufacturers. However, there are many unknowns about the border adjustment tax. Given the many significant economic uncertainties and risks associated with the border adjustment tax, the committee must evaluate its merits thoroughly and methodically.

There are many very important questions that must be answered in order to evaluate the proposal. So I applaud the chairman for holding today's hearings to do just that. For example, what will the impact be on consumers? The retailers tell us that the cost of products, like food, clothing and medicine, will go up for consumers by more than $1,700 a year, gas prices could increase by 35 cents a gallon. Also, I have been told that a 20 percent BAT would increase the average home heating oil cost for a New England family by up to $400 per winter.

Middle class families can't and shouldn't have to sustain these types of increases in consumer prices as a result of tax reform. Is that a risk with an adjustment border tax? Will the dollar strengthen to offset increases in consumer prices? If so, how long will it take and will it, indeed, be complete? And how much certainty is there with respect to currency fluctuations and other implications of an increased dollar?

And the border adjustment tax, is it WTO compliant? Is there the risk of retaliation? What would the BAT's impact be on American jobs? Who will be the winners and losers as a result of a border adjustment tax?

Another important question that I have is the impact on small businesses. Unfortunately, we don't have a small business witness with us today. But I think understanding the potential impact on small business is key. The owner of Dave's Soda and Pet Food City in my district, who is quite successful, tells me that his imported products would certainly provide the margin for him to operate the rest of his business as currently constructed. He says that if his costs go up, he can't rent out utilities, he can't rent out other places to cut the payroll; in fact, he has to absorb the cost.

He also is very concerned that if consumers have to pay more for gas and other essentials, he will sell less of the pet accessories that keep his business afloat. I hope we can continue to examine the impact of the BAT on small businesses.

Mr. Chairman, I hope you will consider holding a hearing in the near future on how to best use revenue from a deemed repatriation tax as we discuss tax reform. I support using repatriation dollars to pay for infrastructure and/or other productive purposes for the middle class.

Mr. Chairman, thanks for your leadership in calling today's hearing, and I am hopeful that we can dive into this topic of the BAT and get our questions answered. I hope that this will continue to be a productive conversation, and thank the witnesses for their participation.

Chairman BRADY. Thank you, Mr. Neal. Without objection, other members' opening statements will be made part of the record.

Today's witness panel includes five experts: Juan Luciano is the president and chief executive officer of the Archer Daniels Midland Company; Brian Cornell is the board chairman and chief executive officer of the Target Corporation; William Simon is the former president and chief executive officer of Walmart U.S.; Lawrence B. Lindsey is the President and chief executive officer of The Lindsey Group; and Kimberly Clausing is the Thormund A. Miller and Walter Mintz professor of economics at Reed College.

The committee has received your written statements. They will all be made part of the formal hearing record. You each have 5 minutes to deliver your oral remarks.

We will begin with Mr. Luciano. Welcome, and you may begin when you are ready.

## STATEMENT OF JUAN LUCIANO, PRESIDENT AND CHIEF EXECUTIVE OFFICER, ARCHER DANIELS MIDLAND COMPANY

Mr. LUCIANO. Thank you. Chairman Brady, Ranking Member Neal, members of the committee, thank you for the opportunity to testify about comprehensive tax reform. ADM began as a linseed-oil processor in Minneapolis 115 years ago. Today, we employ nearly 20,000 employees in the United States, serving customers in 160 countries. Our network allows us to source crops, to transport them to our facilities, to transform them into food, feed, renewable fuels and chemicals, and to deliver them to customers on six continents.

We support U.S. farmers and businesses in significant ways. In 2016, we purchased $25.9 billion in goods and services from farmers or vendors in all 50 States. I am pleased to say we have employees in 25 of the 26 States represented on this committee. And, Congressman Neal, we hope to have the opportunity to invest in Massachusetts too.

ADM's reach opened global markets for America's farmers who have run a trade surplus for 50 years. But U.S. companies like ADM now compete with well-capitalized non-U.S. companies, who often enjoy a tax system with lower rates and border adjustments that create a competitive advantage for them.

ADM only thrives when America's farmers thrive. For us to serve America's farmer while creating jobs and contributing to growth, we must have a globally competitive U.S. Tax Code. We must encourage the return of capital to the U.S. and enable companies like ADM to create and maintain jobs here in the United States.

The proposal we are discussing today will help accomplish those goals. First, reducing the corporate rate to 20 percent will allow companies like ADM to operate more competitively.

Today, many competitors have a substantial tax advantage. Our effective tax rate is approximately 30 percent, and we must compete with firms with tax rates at 20 percent or in the teens.

Second, the proposal will level the playing field by moving from worldwide taxation to territorial taxation. A territorial tax system will remove the burdens of high corporate tax rates and address the capital restrictions that hinder U.S. companies, but not global competitors. This will facilitate our ability to enable American crops to reach the world.

Third, a destination-based cash flow tax will level the playing field for our exports when we must go toe-to-toe with competitors we enjoy significant BAT rebates or exemptions when they export. Unlike a BAT, the U.S. income tax system has no offset for exports. This systematically disadvantages our own producers. A destination-based cash flow tax corrects this imbalance.

The U.S. market share of global exports has fallen precipitously in major commodities over the past five decades. The U.S. is no longer number one in soybeans and wheat. From 1965 to today, U.S. world share of soybeans exports has fallen from 90 percent to 39 percent, with Brazil taking the lead. Over the same period, our world share of exports of wheat has fallen from 40 percent to 20 percent, with Russia taking the lead. The U.S. world share of corn has fallen from 65 percent to 34 percent.

America's antiquated tax system may not be the only reason for this decline, but it clearly contributed. We need to modernize our Tax Code to allow us to keep up with the rest of the world. This proposal creates the climate which will support the reinvesting in America and will result in millions of American jobs.

It will help stop the decline in our market share and enhance our ability to serve the world. Other countries have responded to our inaction. We have the opportunity, with tax reform, to give American farmers and workers the chance to fairly compete and provide American products to customers around the globe.

[The prepared statement of Juan Luciano follows:]

# Testimony of Juan Luciano
Chairman, President and CEO
Archer Daniels Midland Company
U.S. House of Representatives
Ways and Means Committee
May 23, 2017

## About ADM

Chairman Brady, Ranking Member Neal, and Members of the Committee:

Thank you for the opportunity to testify today about comprehensive tax reform—an issue that is critical if we are to continue to create and maintain American jobs.

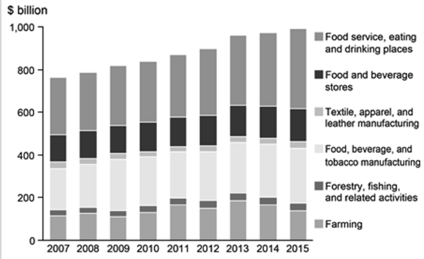
ADM began as a linseed-oil processor in Minneapolis 115 years ago. Today, we are a team of 32,000 employees worldwide serving customers in 160 countries. Our global operations include 750 crop-procurement and ingredient-manufacturing facilities; more than three dozen innovation centers; and a transportation network comprising railcars, barges, trucks, trailers and oceangoing vessels. With this network, we are able to source crops from farmers around the world; transport them to our processing facilities; transform them into thousands of food and feed ingredients, renewable fuels and chemicals; and deliver them to customers on six continents.

ADM has a broad impact on our nation's economy going far beyond the brick and mortar of our physical facilities. Our presence in the communities in which we operate brings reliable and sustainable economic support to farmers, service providers and other businesses both large and small. In 2016, we purchased $20.5 billion in goods and services from vendors or farmer suppliers in the 26 states represented on this committee. We have employees in 25 of the 26 states and 14 of the Congressional Districts represented on this committee. We employ nearly 20,000 people directly in the United States, and our operations support tens of thousands of other American jobs.

## Broad Perspective on Food and Agriculture

ADM's global reach offers America's farmers access to markets far beyond the United States. The U.S. enjoys the good fortune of being a resource-rich nation in agricultural production. As a result, America's farmers are able to produce more than we consume at home. Therefore, exports are a vital part of the U.S. agricultural and rural economy.

U.S. agriculture has run a trade surplus for nearly 50 years. Agriculture exports $130 billion in products each year which when combined with $169 billion in related export activity, creates $300 billion in annual agriculture related economic activity. This has an impact on farm income and much more. Agriculture and related food industries provide 21 million jobs—representing 11% of total U.S. employment—and support 18.4 million additional jobs in related industries. Exports alone support 1 million jobs, including 750,000 non-farm jobs. Agriculture and food together contribute $992 billion to our nation's GDP. (Source: USDA, Economic Research Service.)


**Value added to GDP by agriculture, food, and related industries, 2007-15**

Note: GDP refers to gross domestic product.
Source: USDA, Economic Research Service using data from U.S. Department of Commerce, Bureau of Economic Analysis, *Value Added by Industry* series.

Exports match our nation's agricultural production with global demand, reflecting the 95 percent of consumers who live outside the U.S. These are our current and potential customers, and we are proud to work to supply them safe, high quality, American-grown products. Exporting also allow us to achieve the important goal of providing food to the 90 percent of the world's population who live in developing countries – a group whose rapid change in economic circumstances alters the global market for agriculture on a yearly basis. Consider how the lives of these people—and global markets for U.S. products—are changing:

- Global poverty has fallen faster in the past 20 years than at any time in history.
- In 1993, almost 2 billion people around the world lived on less than $2 a day. By 2012, that figure had been cut in half. By some estimates, it fell further to about 700 million in 2015.
- During this time, the share of people living in chronic hunger also has been cut nearly in half.
- The global infant mortality rate also fell 50 percent between 1990 and 2015.
- Average incomes in developing countries have almost doubled after controlling for inflation. (Source: Radelet, Stephen, "Progress in the Global War on Poverty," Christian Science Monitor, Feb. 7, 2016)

When family incomes increase, moving from subsistence to more stable circumstances, people desire more food. And beyond an increase in demand for calories they also quickly target food of higher quality and safety, with a specific focus on protein. American agriculture is perfectly positioned to meet this demand.

But we have competition: the United States is no longer the sole agricultural powerhouse in the world. South America has surpassed North America in oilseed production. Brazil's second corn crop has turned the country into our largest export competitor in the global corn market. The Black Sea region is now a major force in wheat production as U.S. acreage has steadily declined to early 20th century levels. China recently has ended its corn-stockpiling program which impacts global markets.

In this new environment, U.S.-based global agricultural companies like ADM compete with well-capitalized, non-U.S. companies. These are sophisticated competitors with deep regional and often global reach. These companies often enjoy tax systems with lower rates and border adjustments that give them a competitive advantage. When investment in agriculture moves to other countries, jobs move there too.

In order for us to continue to create jobs and contribute to economic growth, while serving America's farmers and our employees, we must have a U.S. tax code that is globally competitive. A competitive tax code will help us continue providing American-made food and feed to our customers in the United States and abroad in the face of robust and, from a tax perspective, ever strengthening competition from abroad. We need your help to level this playing field and we stand ready to work with this Committee to achieve needed tax reform.

## The Need for Tax Reform

Decades ago, when much of the world had a tax system that resembled the U.S. tax code of today, there was little competitive disparity. That is not the case any longer. Over time, tax systems changed country-by-country, while the U.S. system remained the same. Unlike so many other areas where the U.S. has been the global leader in innovation, we have allowed our tax system to stagnate.

U.S.-based companies face a high tax rate on worldwide income, while non-U.S. companies pay taxes at a lower rate and pay on income only in the countries in which it is earned. The higher rate on worldwide income inhibits our ability to compete effectively. The result is a competitive advantage for our non-U.S. competitors, not because they are more efficient or understand the marketplace better, but because they often enjoy greater capital mobility and greater operational flexibility thanks to territorial systems that do not limit or tax the flow of capital to locations with highest rewards. This advantage is magnified because a territorial system can reflect lower overall tax rates that, in turn, support higher margins and investment returns.

This combination puts U.S. companies at a distinct and significant competitive disadvantage. We can have the best engineering, the best business plan, the best customer service and the most efficient operations, and still be challenged to compete with tax-advantaged non-U.S. firms. We have strengths we can't realize and potential we can't fulfill.

Many foreign jurisdictions supplement their revenue needs with Value Added Tax (VAT) systems. A VAT shifts the tax base from domestically produced products that are taxed under an income tax system—including products that are ultimately exported—to a focus on domestically consumed products regardless of where they were produced. American-based companies with foreign operations like ADM are taxed both in foreign countries (where we also pay VATs), as well as in the U.S. under the worldwide system of income taxation.

This is not a debate about U.S. companies simply wishing to pay less; it is a discussion about the need for a transformative, competitive, and modernized U.S. code that, at a minimum, levels the playing field between U.S. and non-U.S. businesses so that we encourage the return of capital to the U.S., lessen the penalty on capital mobility that hurts U.S. firms but not our foreign competitors, and enables companies like ADM to create more jobs, grow at home and compete more fairly. Tax reform will enable us to be a stronger seller of our nation's agricultural bounty, help us create jobs and invest in new products, and allow us to better meet the needs of our customer and suppliers.

**How the Tax Reform Proposal Helps**

Responsible and comprehensive tax reform that addresses the competitive needs of American companies will stimulate investment and job creation in America. Since U.S. agriculture production outpaces U.S. consumption and the industry therefore is a net exporter, and since our company exports $10 for every $1 we import, this proposal is appealing. It makes three key reforms that go a long way toward leveling the playing field between us and our global competitors:

1. Reduces the corporate tax rate to 20 percent.
2. Converts the worldwide system of taxation to a territorial tax.
3. Creates the Destination Based Cash Flow Tax, also called the Border Adjustable Tax.

*Rate Reduction:* Rate reduction is a critical component of the proposal for ADM. A reduction in the corporate rate would allow ADM to evaluate prospective investments based on an after-tax rate of return that is on par with non-U.S. competitors. Today, competitors have a substantial tax advantage—even if we are a more efficient company. That means they can make investments and create jobs more cheaply in other countries than in the U.S. ADM routinely has an adjusted effective tax rate of approximately 30 percent, while our non-U.S. global competitors frequently enjoy effective tax rates that are at least 10 percentage points below us, and some with a tax rate below 20 percent.

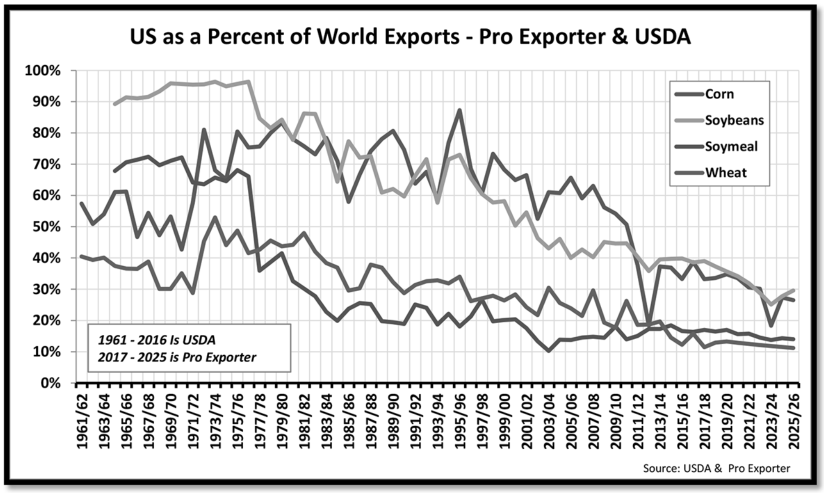
*Territorial Tax System:* Our foreign operations are penalized under our current worldwide system. Foreign operations are an important element in the linkage of American crops to non-U.S. customers. An overseas processing facility is a reliable destination for American agriculture exports, helping ensure that the product best reflects the local tastes and requirements. We support a territorial tax system, like the one in this proposal and similar to those that have been widely adopted around the world. Our antiquated, overly complex anti-deferral rules result in high corporate tax rates on income that would only be subject to additional local taxes under territorial systems. Moreover, the current worldwide system strands capital abroad and places a de facto tax on capital mobility, a burden on ADM that our global competitors do not have. The worldwide tax system creates incentives to locate jobs, facilities, and research and development outside the United States.

*Destination Based Cash Flow Tax:* Many of the markets in which we operate are commodity focused and in those markets we compete largely on price. The economic impact of tax disparities is profound. One of the reasons ADM supports this proposal is because it eliminates tax disparities on exports that arise due to differences between the U.S. income tax system and the border-adjusted VATs of OECD countries. Transactions between nations that operate on the same tax system are relatively tax neutral, because imports are subject to tax in the importing country and there is typically an offsetting exemption through the refund mechanism for exports. However, because the U.S. operates on a pure income tax system, there is no corresponding offset for exports from the U.S. Stated simply, by being the only major country on a pure income tax system, our exports are systematically disadvantaged because they bear more tax. The Destination Based Cash Flow Tax addresses this imbalance and begins to level the playing field between our tax system and the VAT systems of the rest of the world. If we can eliminate this imbalance, more investment, and more jobs, should come to the U.S.

## Conclusion

According to the Tax Foundation, the proposal under discussion today would increase GDP by 9.1 percent over the long-term, would grow wages by 7.7 percent and would create 1.7 million full-time equivalent jobs in the United States. This is the type of tax reform that will make us more competitive and create and maintain jobs here in America.

As we look back on the U.S. agriculture industry's performance from 1961 to today, the U.S. share of world trade as a percent of exports in key agricultural products has fallen significantly. For corn, soybeans, soymeal and wheat, America is no longer the dominant player.


US as a Percent of World Exports - Pro Exporter & USDA

*1961 - 2016 Is USDA*
*2017 - 2025 is Pro Exporter*

Source: USDA & Pro Exporter

While a variety of factors have contributed to this decline, our antiquated tax system is clearly a major factor. A modernized, innovative, competitive tax system could be an important step toward helping to correct and eventually reverse these trends. Compared to many other crop-producing nations, the U.S. has well-developed infrastructure. Our farmers have access to first-class technology, from tractors to computers to drones. We have property rights, enforceable contracts, and modern legal systems that market participants trust. Despite these advantages, we have lost market share over the past 40-plus years. While we cannot point to tax policy as the single driving factor underlying this decline, this decline occurred during the time of growing tax policy divergence. We need to modernize our tax code to ensure it does not create an obstacle to our ability to keep pace with the rest of the world.

This tax reform proposal offers a great chance to provide a climate for reinvesting in America and American agriculture, helping to stop the decline in our loss of market share, once again grow our agricultural footprint, and create millions of American jobs. Other countries have responded to our inaction. This proposal offers the chance to give American farmers, American workers and American agriculture the chance to compete fully and to continue providing American products to customers around the globe.

Thank you again for inviting me to share my observations, and for your efforts on this important issue. I look forward to your questions.

**Committee on Ways and Means**
Witness Disclosure Requirement – "Truth in Testimony"
Required by House Rule XI, Clause 2(g)

| | | |
|---|---|---|
| Your Name: **Juan Ricardo Luciano** | | |
| 1. Are you testifying on behalf of a Federal, State, or Local Government entity?<br>a. Name of entity(ies).<br>b. Briefly describe the capacity in which you represent this entity. | Yes<br>☐ | No<br>☒ |
| 2. Are you testifying on behalf of any non-governmental entity(ies)?<br>a. Name of entity(ies).<br>**Archer Daniels Midland Company**<br>b. Briefly describe the capacity in which you represent this entity.<br>**Chairman, CEO, President** | Yes<br>☒ | No<br>☐ |
| 3. Please list any Federal grants or contracts (including subgrants or subcontracts) which you have received during the current fiscal year or either of the two previous fiscal years that are related to the subject matter of the hearing:<br>**No** | | |
| 4. Please list any grants, contracts, or payments originating from foreign governments which you have received during the current calendar year or either of the two previous calendar years that are related to the subject matter of the hearing:<br>**N/A** | | |
| 5. Please list any offices or elected positions you hold.<br>**None** | | |
| 6. Does the entity(ies) you represent, other than yourself, have parent organizations, subsidiaries, or partnerships you are not representing? | Yes<br>☐ | No<br>☒ |
| 7. Please list any Federal grants or contracts (including subgrants or subcontracts) which were received by the entity(ies) you represent during the current fiscal year or either of the two previous fiscal years, which exceed 10 percent of entity(ies) revenues in the year received. Include the source and amount of each grant or contract. Attach a second page if necessary.<br>**N/A** | | |
| 8. Please list any grants, contracts, or payments originating from foreign governments which were received by the entity(ies) you represent during the current fiscal year or either of the two previous fiscal years related to the subject matter of the hearing. Include the source and amount of each grant or contract. Attach a second page if necessary.<br>**N/A** | | |

Chairman BRADY. Mr. Luciano, thank you very much for your testimony.

Mr. Cornell, welcome, and please proceed.

## STATEMENT OF BRIAN CORNELL, BOARD CHAIRMAN AND CHIEF EXECUTIVE OFFICER, TARGET CORPORATION

Mr. CORNELL. Good morning, Chairman Brady, Ranking Member Neal, and members of the committee. Thank you for the opportunity to be here today.

Let me begin by saying that we strongly support tax reform. At Target, we have a very high effective tax rate, an average of 35 percent over the last decade. So we are as motivated as anyone to bring that rate down. We recognize our current Tax Code is broken. The status quo is unacceptable.

Mr. Chairman, we will put every tax benefit we currently receive on the table, every single one, in order to pass tax reform, to lower that rate, to spur investment, to create jobs, and to grow the American economy. However, we have concluded that the new border adjustment tax would undermine the progrowth principles in the blueprint.

And it is not just us; more than 500 companies and associations feel the same way. I am talking about Main Street coffee shops, car dealers, grocery stores, gas stations, and restaurants. From large companies like Target to small American businesses, we have all come to the same conclusion: Under the new border adjustment tax, American families, your constituents, would pay more so many multinational corporations can pay even less.

Eighty-five percent of America shops at Target every year. We believe this new tax would hit families hard, raising prices on everyday essentials by up to 20 percent. We are not talking about luxury items here, but instead the basics American families need. Moms in Cincinnati would pay more for back-to-school clothes. Parents in Houston would pay more for their groceries. Seniors in Philadelphia would pay more for medicine. Every time your constituents fill up their gas tanks, they would pay more. The people who shop at Target are middle class, hardworking families whose budgets are already stretched. For them, this new tax would be a budget-breaker.

Mr. Chairman, we are investing in America. We are hiring. We recently announced we are investing $7 billion in communities across this country, $7 billion to build new stores, to renovate hundreds more, and to transform our distribution network, all right here in the United States.

These investments will create thousands of new jobs at Target and thousands more for engineers and electricians, plumbers and painters across the country, and we are doing that today. But under the new border adjustment tax, our rate would more than double, from 35 percent to 75 percent. And we, like many others, would be left with only bad options. It is pretty simple math. If the government takes nearly $4 out of every $5 we make, 4 out of 5, there is no capital to invest and no prospects for growth, and that matters a lot, both to us and to the American economy. Instead of investing and creating jobs, we would be pushed in the other direction.

Mr. Chairman, I have a responsibility to more than 320,000 employees, 99 percent of whom are based right here in the United States. That is hundreds of thousands of American families who depend on me every day. I know there is an academic theory that says currency markets will adjust, that families won't be harmed under this plan. Well, that might work in a textbook, but I can't tell my employees that their paychecks and Congress shouldn't tell American families that their budgets are being wagered on an unproven and untested theory.

So in closing, Mr. Chairman, members of the committee, we have a historic opportunity to simplify the Tax Code, to spur economic growth, and to create jobs. Many parts of the blueprint will do just that, but I can't sign up for a plan that would stick American families with that bill or a plan that would double our tax rate, a plan that would stifle our investment in America. Mr. Chairman, I want to thank you again for your leadership.

I know this is challenging and I want to help. Let's move past the new border adjustment plan and get tax reform done. It is too important. That is why we are here today. So thank you.

[The prepared statement of Brian Cornell follows:]

**House Ways & Means Committee Testimony**
**Brian Cornell**
**5/23/17**

Good morning Chairman Brady, Ranking Member Neal and members of the committee. Thank you for the opportunity to be here today…

Let me begin by saying that we strongly support tax reform. At Target, we have a high effective tax rate – an average of 35 percent over the past decade. So we're as motivated as anyone to bring that rate down.

Our current tax code is broken. The status quo is unacceptable. Mr. Chairman, we'll put every tax benefit we currently receive on the table – every single one – in order to: Pass tax reform. Spur investment. Create jobs. And grow the American economy.

However, we've concluded that the new border adjustment tax would undermine the pro-growth principles in the Blueprint. And it's not just us. More than 500 companies and associations feel the same way. Main Street coffee shops. Car Dealers. Grocery Stores. Gas Stations. And restaurants. From large companies like Target – to small American businesses. We've all come to the same conclusion. Under the new border adjustment tax, American families – your constituents – would pay more so many multinational corporations can pay even less.

85 percent of Americans shop at Target every year. We believe this new tax would hit those families hard. Raising prices on everyday essentials by up to 20 percent. We're not talking about luxury items here, but instead the basics that American families need…Moms in Cincinnati would pay more for back-to-school clothes. Parents in Houston would pay more for groceries. Seniors in Philadelphia would pay more for their medicine. Every time your constituents fill up their gas tanks, they would pay more. The people who shop at Target are middle-class working families, whose budgets are already stretched. For them, this new tax would be a budget breaker.

Mr. Chairman, we're investing in America. We're hiring. We recently announced we're investing $7 billion in communities across the country. $7 billion. To build new stores… To renovate hundreds more…And to transform our distribution network… All right here in the United States. These investments will create thousands of new jobs at Target, and thousands more. For engineers, electricians, plumbers, and painters all across the country. That means new stores and new jobs in America. Today.

But under the new border adjustment tax, our rate would more than double, from 35 percent to 75 percent. And we – like many others – would be left with only bad options. It's simple math. If the government takes nearly four out of every five dollars we make. Four out of Five. There's no capital to invest and no prospects for growth. And that matters a lot. Both to us and to the American economy. Instead of investing and creating American jobs, we'd be pushed in the other direction.

Mr. Chairman, I have a responsibility to more than 320,000 employees – 99 percent of whom are based right here in the United States. That's hundreds of thousands of American families who depend on me. I know there is an academic theory that says currency markets will adjust. That families won't be harmed under this plan.
Well that might work in a textbook. But I can't tell my employees that their paychecks. And Congress shouldn't tell American families that their budgets. Are being wagered on an unproven and untested theory.

So in closing…Mr. Chairman…members of the Committee…We have a historic opportunity to simplify the tax code. To spur economic growth and create jobs.
Many parts of the Blueprint will do just that. But I can't sign up for a tax plan that would stick American families with the bill or a plan that would double our tax rate. A plan that would stifle our investment in America. Mr. Chairman, I want to thank you again for your leadership. I know this is challenging, and I want to help. Let's move past the new border adjustment tax. And get tax reform done. It's too important. That's why I'm here today. Thank you.

**Committee on Ways and Means**
Witness Disclosure Requirement – "Truth in Testimony"
Required by House Rule XI, Clause 2(g)

Your Name: Brian Cornell

1. Are you testifying on behalf of a Federal, State, or Local Government entity? Yes ☐ No ☒
   a. Name of entity(ies).
   b. Briefly describe the capacity in which you represent this entity.

2. Are you testifying on behalf of any non-governmental entity(ies)? Yes ☐ No ☒
   a. Name of entity(ies).
   b. Briefly describe the capacity in which you represent this entity.

3. Please list any Federal grants or contracts (including subgrants or subcontracts) which you have received during the current fiscal year or either of the two previous fiscal years that are related to the subject matter of the hearing: N/A

4. Please list any grants, contracts, or payments originating from foreign governments which you have received during the current calendar year or either of the two previous calendar years that are related to the subject matter of the hearing: N/A

5. Please list any offices or elected positions you hold.

Board of Directors positions included in attached résumé.

6. Does the entity(ies) you represent, other than yourself, have parent organizations, subsidiaries, or partnerships you are not representing? Yes ☐ No ☒

7. Please list any Federal grants or contracts (including subgrants or subcontracts) which were received by the entity(ies) you represent during the current fiscal year or either of the two previous fiscal years, which exceed 10 percent of entity(ies) revenues in the year received. Include the source and amount of each grant or contract. Attach a second page if necessary.

N/A

8. Please list any grants, contracts, or payments originating from foreign governments which were received by the entity(ies) you represent during the current fiscal year or either of the two previous fiscal years related to the subject matter of the hearing. Include the source and amount of each grant or contract. Attach a second page if necessary. N/A

Chairman BRADY. Thank you.

Mr. Simon, welcome today, and please proceed with your testimony.

## STATEMENT OF WILLIAM SIMON, FORMER PRESIDENT AND CHIEF EXECUTIVE OFFICER, WALMART U.S.

Mr. SIMON. Thank you, Chairman Brady, Ranking Member Neal, and members of the committee. It is really my pleasure to be here with you today and discuss the importance of U.S. manufacturing on middle class jobs. I am here representing myself as a private citizen. These are my views.

I would like to begin by noting that I have long been a supporter of U.S. manufacturing. In fact, the National Retail Federation hosted me at their annual meeting in 2013, where we launched Walmart's U.S. manufacturing initiative, which I would add has been quite successful.

Manufacturing jobs in this country and, really, around the world have always represented a pathway to the middle class. That is how it works. And we have seen it throughout our history. And there is a reason that the middle class has struggled in this country recently; and it is the same reason we have seen middle classes emerge in global markets, and that is, the manufacturing base has moved and, with it, the jobs have followed.

There was a time in this country when a job in the local factory was a ticket to the middle class. I grew up in Congressman Larson's district around Hartford, Connecticut. And we made Pratt and Whitney engines and Colt firearms, and everybody in the community was proud of that fact and if you got a job there you were set.

But in this country, it doesn't work that way anymore. You, the government, you lay out the rules like puzzle pieces, and then businesses like us take the tax, labor, and trade policies that you have given us and put them together and try to deliver the best results we can for shareholders. And over the past 30 years, when you assemble those puzzle pieces, virtually every scenario run by every company has resulted in the same outcome: Offshore manufacturing and a hollowed-out middle class with limited job progression. Something needs to change on this, everybody agrees. And I join my colleague in commending you for taking on this difficult issue.

Many ideas have been discussed in recent months, and of the most controversial, particularly for the retail industry, has been the border adjustment. And I have weighed the considerable challenges the proposal presents to retail—and they are considerable—with the significant benefits that it will deliver to the economy as a whole and have concluded that, if properly implemented, it is in the best interests of the country for this to be considered.

However, such a system would have to be implemented with careful consideration to the transitional challenges retailers will face. It has to allow for adjustments that are necessary to address the concerns that you have heard from the industry. For example, most of the manufacturing capacity that exists in the world outside of food products no longer is based in the U.S., as we have heard, so simply applying a 20-percent tax across the board on day one would have serious impact to the industry and consumer, and I know that is not being proposed.

I hope you see my point of view isn't completely at odds with the industry. I just look at it from a different perspective. That is, if we are to move forward, I believe it is important that retailers work with the committee and provide input on how to best transition. The industry, retail industry is already in flux. They are dealing with generational technology and trend changes, and I submit that it is all part of the same issue. The challenges that face the middle class today have put a damper on the power of the consumer and are now impacting retail broadly.

Resurgence in American manufacturing would result in a stronger U.S. consumer and a stronger retail industry over the long run. But in manufacturing and in supply chains, the long run is a long time. And a migration of manufacturing out of the U.S. took 30 years, and so it is critical that any proposed legislation understands and accounts for this. If you move forward with the border adjustment, I would recommend considering a long implementation period with a phase-in of the tax impact. And to guard against the currency fluctuations that some believe are just a textbook thing, economists forecasting those impacts would offset the change. And I would suggest that you peg or use the value of the dollar maybe to trigger or signal the next phase-in of the tax, or some other method that provides some security to the retail industry.

And there is also things that the retailers can do, the industry can to accelerate the transition. First and foremost is embrace U.S. manufacturers when they come online, and they will come online rapidly, because with the change American sourcing will become increasingly viable.

Also, being closer to the point of consumption shortens lead times, lowers transportation costs, and increases manufacturing flexibility.

Second, for some products, and apparel is a good example, competitively priced U.S. product won't be available for some time. In that case, they need to work with existing suppliers and look upstream as a way to drive down costs. For example, American cotton is readily available on the international markets and could be acquired by a retailer and then reimported to offset some of the impact of the adjustment.

With increased competition, obviously, prices will come down. Our current system isn't serving anybody well at all. But until we substantially change the puzzle pieces, the puzzle will continue to be assembled in a way that inhibits the development of our manufacturing base. It will continue to restrict the development of the American middle class, and it will not deliver the economic security that we need.

But, if we get the pieces right, we will see a rebirth of American manufacturing without the severe negative impacts on important sectors like retail. We will see more good middle class jobs, a robust U.S. economy, and an era of growth that will be led by a new industrial revolution.

Thank you.

[The prepared statement of William Simon follows:]

# WRITTEN TESTIMONY OF WILLIAM S. SIMON
# BEFORE THE U.S. HOUSE COMMITTEE ON WAYS AND MEANS
# HEARING ON INCREASING U.S. COMPETITIVENESS AND PREVENTING AMERICAN JOBS FROM MOVING OVERSEAS
# MAY 23, 2017

Chairman Brady, Ranking Member Neal and Members of the Committee, my name is Bill Simon and I am the former Chief Executive Officer of Walmart, US. I am privileged to be here today to discuss the importance of rebuilding U.S. manufacturing to protect and grow middle class jobs.

I am here representing my own views as a private citizen.

I'd like to begin by noting that I have long been a strident supporter of US manufacturing. Indeed, the National Retail Federation hosted me at their annual meeting in 2013 when we launched the Walmart US manufacturing initiative – which, I would add, has been quite successful.

Manufacturing jobs have always represented the pathway to middle class. We have seen that throughout our history.

There is a reason that the middle class in the US has struggled recently. It is the same reason the middle class in other global markets has emerged. The manufacturing base has moved and the jobs followed.

There was a time when a job in the local factory was a ticket to the middle class. I grew up in Congressman Larsen's district around Hartford, CT. We made Pratt and Whitney Engines and Colt Firearms. We were proud of that. If you got a job there, you were set.

But not anymore.

The government lays out the rules, like puzzle pieces. Those pieces are the tax, labor and trade policies that they believe best for the country. Businesses take those pieces, put them together and use them in order to maximize the return for their shareholders.

Over the last 30 years, when you assemble those puzzle pieces virtually very scenario ran by every company, results in the same outcome, offshore manufacturing and a hollowed out middle class with no job progression.

We need a new system.  Something needs to change.  On that, virtually everyone agrees.  I commend you for taking on this most important issue.

Many ideas have been discussed in recent months.  One of the more controversial for the retail industry is the Border Adjustment.

I have weighed the considerable challenges this proposal presents to retail with the significant benefits it will deliver to the economy as a whole and have concluded that *properly implemented*, it is in the best interest of our country for this to be considered.

However, such a system would have to be implemented with careful consideration of the transitional challenges that U.S. retailers will face.

It must allow for adjustments that may be necessary to address the concerns you've heard from the industry.

Most of the manufacturing capacity that exists in the world, outside of food products, is no longer based in the US. Simply applying a 20% tax on day one to those products would have a serious impact on the industry and the consumer.

I hope you see that my point of view isn't completely at odds with the industry. I'm just looking at this from a different perspective.

If we are to move forward, I believe it is important that retailers work with this committee and provide input on how to best transition.

The retail industry is already in flux. They are dealing with generational technology and trend changes. I would submit this is part of the same issue. The challenges facing the middle class have put a damper on the power of the consumer in recent years and are now impacting retail broadly.

Resurgence in American manufacturing would result in a stronger US consumer and a very healthy retail industry over the long run. But in manufacturing and supply chains, the long run is a very long time. The migration of manufacturing out of the US took 30 years. It is critical that any proposed legislation understands and account for this.

If you move forward with a border adjustment, I would recommend considering a long implementation period with a phase in of the tax impact. Economists forecast that currency impacts would offset all or most of these changes. If that is the case, use the expected value of the dollar to 'trigger' the next phase in the tax rates or some other trigger method.

There are also many things that the retail industry can do to accelerate the transition.

First, embrace US manufacturers as they become established. With the change, American sourcing will become increasingly viable. Additionally, being closer to the point of consumption, shortens lead times, lowers transportation costs and increases manufacturing flexibility.

Second, for some products, apparel for example. Competitively priced US product won't be available for some time. Working with existing suppliers, the industry should look up stream at the component parts to drive down costs. For example, American cotton is readily available and used throughout the world. A retailer could secure products made with US cotton for reimport to the US lowering the impact of a border adjustment.

With increased competition pricing will come down. As more American manufacturers come online, pricing all over the world should be lower.

Our current tax system is not serving any of us well. But until we substantially changes the pieces, the puzzle will continue to be assembled in a way that inhibits the development of our manufacturing base. It will continue to restrict the development of the American middle class and it will fail to deliver the economic security we all seek.

But if we get the pieces right, we will see a rebirth of American manufacturing, without severe negative impacts on important sectors like retail.  We will see more good middle class jobs, a robust US economy and an era of growth that will be led by a new industrial revolution.

Thank You

**Committee on Ways and Means**
Witness Disclosure Requirement – "Truth in Testimony"
Required by House Rule XI, Clause 2(g)

| | | |
|---|---|---|
| Your Name: William Simon | | |
| 1. Are you testifying on behalf of a Federal, State, or Local Government entity?<br>a. Name of entity(ies).<br>b. Briefly describe the capacity in which you represent this entity. | Yes<br>☐ | No<br>☑ |
| 2. Are you testifying on behalf of any non-governmental entity(ies)?<br>a. Name of entity(ies).<br>b. Briefly describe the capacity in which you represent this entity. | Yes<br>☐ | No<br>☑ |
| 3. Please list any Federal grants or contracts (including subgrants or subcontracts) which you have received during the current fiscal year or either of the two previous fiscal years that are related to the subject matter of the hearing:<br>None | | |
| 4. Please list any grants, contracts, or payments originating from foreign governments which you have received during the current calendar year or either of the two previous calendar years that are related to the subject matter of the hearing:<br>None | | |
| 5. Please list any offices or elected positions you hold.<br>None | | |
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| 8. Please list any grants, contracts, or payments originating from foreign governments which were received by the entity(ies) you represent during the current fiscal year or either of the two previous fiscal years related to the subject matter of the hearing. Include the source and amount of each grant or contract. Attach a second page if necessary. | | |

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Chairman BRADY. Thank you, Mr. Simon.

Mr. Lindsey, welcome to you as well and please proceed.

## STATEMENT OF LAWRENCE B. LINDSEY, PRESIDENT AND CHIEF EXECUTIVE OFFICER, THE LINDSEY GROUP

Mr. LINDSEY. Thank you, Mr. Chairman.

Chairman BRADY. Hit that microphone.

Mr. LINDSEY. I was told to do that. Can't teach old dogs new tricks, I guess.

Mr. Chairman, Ranking Member Neal, and members of the committee, thanks very much for having me here today.

I think we all have the same objective, and that objective is to grow this economy faster, improve our competitiveness, raise living standards, and, if possible, improve the distribution of income by making it more fair. I am here today because I believe that the basic blueprint that was outlined will accomplish all of these goals.

Forty years ago, when I was a graduate student, the basic structure of what was laid out in the blueprint was considered across the political spectrum to be the best way we could design a tax system. I quote in my testimony a paper written by a colleague of mine, Larry Summers, that points this out. He said: The welfare cost of capital income taxation is seriously underestimated. For reasonable parameter values, the annual welfare gained from a shift to consumption taxation is conservatively estimated at 10 percent of GDP. It is unlikely that that basic conclusion of this analysis would be altered. Capital income taxes are likely to appear very undesirable in any sort of realistic lifecycle formulation.

That is how broad the consensus was about how we should structure our Tax Code. There was a survey of 69 public finance economists by NBER that said that the 1986 bill, which was a pale imitation of what we are doing here, increased the long-run growth of the U.S. economy by a full point.

My work on the House blueprint suggests that we will have a growth rate of about 3 and a half percent for the first 4 or 5 years, and that will ultimately moderate to about 2 and three-quarters percent. If you work it out, this is almost identical to Summers' calculation of a 10 percent increase. The reason is that if you look at recent performance, our problem has been a lack of capital formation, which in the current recovery has fallen by almost 40 percent, and the collapse in productivity, which has fallen by two-thirds.

And by this, I am not counting the recession; I am counting the years after the recession. This has been the worst period of recovery ever, and that is why. And this bill targets both capital formation and entrepreneurship.

I think all of the extra growth that will show up will be in the form of increased labor compensation. It is not only because of the structure of the tax, which will give each worker more capital to work with, but because we are right now at roughly full employment. And so any expansion of the economy I think is likely to lead to higher real wage growth.

The last time we did anything like this, i.e., a capital formation-oriented supply side tax cut at a time of full employment, were the Kennedy tax cuts in 1964. And the takeoff in the economy and the rapid rise in capital—excuse me, rapid rise in wage income and improvement in the distribution of income occurred, just like I think will happen today.

Let me turn to the territorial system and the border adjustment tax. I think we need to move to a territorial destination-based system and away from our current global production-based system. Right now, our goods are taxed here when they are produced and are taxed there when they are imported.

On the other hand, their goods have a big tax rebate given to them when they leave there and are not taxed here. So, essentially, a good portion of our goods are taxed twice, while a good portion of our goods going there aren't taxed at all.

Let me turn to a few particular points. Border adjustment isn't complicated. It doesn't follow each good each time it crosses the border. It is a netting effect of exports minus imports.

Second, border adjustment will lead to a currency adjustment. We can argue about how much. But basically, when you put something like this in, you increase the demand for dollars and you decrease the supply of dollars. And higher demand and lower supply means a higher value of the dollar, it is as simple as that this.

One of my competitors, I guess, has estimated this. They actually have the lowest percentage of exchange rate adjustment that I know of, 65 percent, and they estimate that the effect of border adjustment on consumer prices will be a one-time probably over two years, a one-time increase of the total consumer price level of just 1 percent. That is what we are talking about here. Will there be transition costs to these changes? Absolutely.

And I agree with the other witnesses that that, in fact, is where the focus of our conversation should be. But the most important thing you can do is pass this bill. Thank you.

[The prepared statement of Lawrence B. Lindsey follows:]

# Growth-Oriented Tax Reform and International Competitiveness

Testimony by

Lawrence B. Lindsey

before the

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

Tuesday, May 23, 2017

Embargoed for Release until Delivery at 10:00 a.m.

## Growth-Oriented Tax Reform and International Competitiveness

Mr. Chairman, Ranking Member Neal, and other members of the committee, thank you very much for this opportunity to discuss one of the most important issues confronting our country – how to make its economy grow faster and how to increase our international competitiveness. For reasons I will discuss, faster growth will not only raise living standards, it is also likely to reverse the tendency over the last quarter century or so for the distribution of income to become less equal. Increasing growth is also crucial to facing our long-run fiscal challenges. I believe that the type of reform Chairman Brady and his colleagues are advancing is designed to target these objectives.

Forty years ago when I was in graduate school, the basic outline of the proposal now under consideration was thought to be the best type of structure America could have. It would end three major distortions that have created inefficiencies and bad incentives for our economy. First, it would end the tax bias on a cash flow basis against investing in long-lived plants and equipment. Second, it would end the tax bias in favor of debt over equity finance, one that enhances the riskiness of our financial structure. Third, it would reduce the incentives to invest overseas and import rather than produce domestically and export. In a sentence, the blueprint for tax reform before us, if enacted, would make America the best place in the world in which to invest and start a business.

This decades-long view in the public finance profession is neither ideological nor partisan. Allow me to quote from a paper authored by one of my colleagues in graduate school, Larry Summers. In 1981, he wrote, "…[T]he welfare cost of capital income taxation may have been seriously underestimated. For reasonable parameter values, the annual welfare gain from a shift to consumption taxation is conservatively estimated at 10 percent of GNP…[I]t is unlikely that the basic conclusion of this analysis would be altered. Capital income taxes are likely to appear very undesirable in any sort of realistic life cycle formulation." [1] While the proposal before us is not a shift to a consumption tax per se, it makes great strides in eliminating most of the biases in the current tax code that led to Summers' conclusion.

Tax reform can have big consequences. One survey of 69 public finance economists published by the National Bureau of Economic Research found a median estimate that the 1986 tax reform increased long-run growth of the U.S. economy by about 1 percent per year.[2] The reform that is now under consideration is even larger and will produce an even greater acceleration of growth.

My own work indicates that passage of something like the House blueprint would lead to an acceleration in real GDP growth to about 3 ½ percent for a period of four to five years before moderating to a longer-run rate of growth of about 2 ¾ percent. In my estimation, failure to pass such a reform would likely produce a slowing of economic growth to the 1 ½ to 2 percent range. Note that this does not produce a result much different from Summers' 10 percent of GNP estimate in the intermediate term.

Moreover, a look at the current economic recovery indicates that a lack of capital formation and entrepreneurship has been the chief cause of it being the worst recovery on record. From 1965 through 2010, real growth averaged 3.1 percent a year; note that this timeframe includes the negative effects of the Great Recession. From 2011 through 2016, a period of continuous recovery,

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[1] Summers, L.H. (1981) "Capital Taxation and Accumulation in a Life Cycle Growth Model", *The American Economic Review,* Vol. 71, No. 4, 533-44, September.

[2] Fuchs, V. R. et. al. (1997), "Why Do Economists Disagree About Policy? The Roles of Beliefs About Parameters and Values", *National Bureau of Economic Research*, NBER Working Paper No. 6151, August. http://www.nber.org/papers/w6151.pdf

real growth averaged just 2 percent annually. This is odd because recoveries from steep recessions usually involve faster, not slower growth. Employment was not the problem. Growth there in the last six years mirrored that of the previous 45 years – roughly 1 ½ percent a year.

What collapsed was capital formation, which fell by almost 50 percent, from 3.2 percent to 1.7 percent, and productivity growth, which declined by nearly two-thirds, from 1.1 percent to 0.4 percent. The productivity collapse was reflected by poor showings in two of the best indicators of increasing productivity – the movement of workers to take new jobs, which has been the worst in decades, and the rate of growth of new businesses, which has been the worst on record. In fact, in recent years for the first time since such data were collected, more firms went out of business than were formed.

The tax reform blueprint targets both capital formation and entrepreneurship. It not only reverses declines in incentives created recently, it actually makes the incentives better than the long-term average. Hence, one would expect both productivity and capital formation to rise to exceed their long-term trends, at least in the intermediate term. This, in turn, will produce higher than average GDP growth.

All or nearly all of that extra growth will show up in increased labor compensation. The reason is two-fold: First, we are now at roughly full employment, the point at which bargaining power for workers strengthens, so labor's share of the economic pie will grow. Second, by expanding the capital stock and entrepreneurial activity at the same time, we are increasing the value of each worker. In the most simple formulation, when workers have more machines to work with, they are worth more. And when the growth of new businesses is healthy, workers' ability to find jobs best tailored to their skill set rises, along with their ability to produce. My estimates suggest that passage of tax reform like that presently under consideration will lead to the first sustained decline in income inequality in America since the 1960s. By the way, it was in the mid-sixties that we passed a similar bill, the Kennedy tax cuts, at a time of comparably low unemployment.

The magnitudes we are talking about are staggering. Real GDP will be nearly $2 trillion higher five years after the bill takes effect than it otherwise would have been. As labor's share of national income rises, workers will be getting an increasing piece of a rapidly growing pie. This will mean that annual real wage increases will rise to the 4 percent range. In recent years, they have been essentially flat. Even if one assumes, as some do – wrongly in my view – that all of the tax benefits will go to a relative few, the real wage increases for working individuals will dwarf the static magnitudes of tax cuts by a margin of five or six to one.

Let me now turn to one of the most misunderstood parts of the tax reform blueprint – the change in corporate taxation to a territorial system based on where goods are sold rather than where they are produced. We are one of the few major economies that currently follows the reverse system – global taxation with tax based on where goods are produced, rather than where they ultimately end up. This is the difference between a territorial destination-based system and a global production-based system.

At the simplest level, when you tax something, you discourage it. So, taxing goods by where they are produced discourages production. The result gets even worse when other countries tax based on goods' destination. Under the current system, when we produce something and ship it to Germany, we tax its production here, and the Germans tax its sale in Germany. Alternatively, when something is produced in Germany and shipped here, Germany rebates a portion of the tax on its production, and we impose no tax on its sale in America. Our exports are taxed in both countries, while their exports are taxed in neither.

In addition, taxing companies on a global system rather than a territorial one affects where the company is headquartered and where it chooses to have its intellectual property taxed. With global taxation, the value added by these two components of the company all end up being taxed in the country where the company is headquartered. With territorial taxation, only the portion consumed in that country is subject to taxation. Coupled with the fact that America has one of the highest corporate tax rates in the world, this double-whammy causes firms to consistently headquarter and shift production outside of the U.S. We lose both jobs and tax revenue as a result.

Border adjustment in a territorial system ends this by taxing goods on where they are destined, not where they are produced. Indeed, it is hard to picture territoriality without an attendant border adjustment. But, there are a few misunderstandings about the process.

First, border adjustment is not complicated; it is far simpler than our current system. With border adjustment, companies do not track each individual product as it crosses borders in the production chain; they simply subtract the total value of goods exported from the total value of goods imported. So, a product that crosses a border many times simply gets netted out.

Second, border adjustment will lead to a currency adjustment that will largely offset the tax. Claims that U.S. consumers will pay the cost of this border tax are simply not borne out by the facts. Some claim that this is theoretical; well, so technically are supply and demand, yet the world still works that way. In fact, currencies move *because* of changes in supply and demand. When we are incentivized to buy fewer imports, the supply of dollars to purchase euro, yen, or renminbi decreases. When taxes on our exports are reduced, the demand for dollars to purchase those goods overseas increases. Higher demand, lower supply means a higher price. Thus, under the proposed system, the dollar would be worth more.

Currency adjustment makes the border tax trade-neutral, so to the extent currencies adjust, the legislation is trade-neutral. This is not protectionism, but a stronger dollar increases the purchasing power of Americans in the global market. And there is an added benefit to levelling the playing field in this way. When the dollar appreciates, neither the domestic consumer nor the company importing the goods pays the tax. The tax is instead paid by the exporting country, because the dollar cost of the good must drop in order to retain its market share, even though the cost of the good in the exporting country's currency remains the same. So in essence, the bulk of the revenue collected from border adjustment would be paid by Chinese, European, and Mexican exporters, not American consumers. How much? One forecasting company, Macroeconomic Advisers, estimates that border adjustment will be 65 percent offset by a currency change, and this is one of the lower estimates around. Under this assumption, they foresee a one-time increase in the price level for consumers of 1 percent. On the other hand, foreigners would be paying nearly $800 billion of the $1.2 trillion estimated to be collected from the tax.[3] Frankly, it boggles my mind that some people do not consider this a good trade-off from the point of view of the American national interest.

Will there be transition costs in making these changes? Yes, though there are ways to mitigate them. Further, the long-run benefits to the U.S. economy are many times any short-term costs involved in transition. We can discuss these issues and ways to reduce their impact in detail if you wish. The proposal now before us represents a consensus view within the public finance profession on how taxation should be approached if our objective is to maximize U.S. economic

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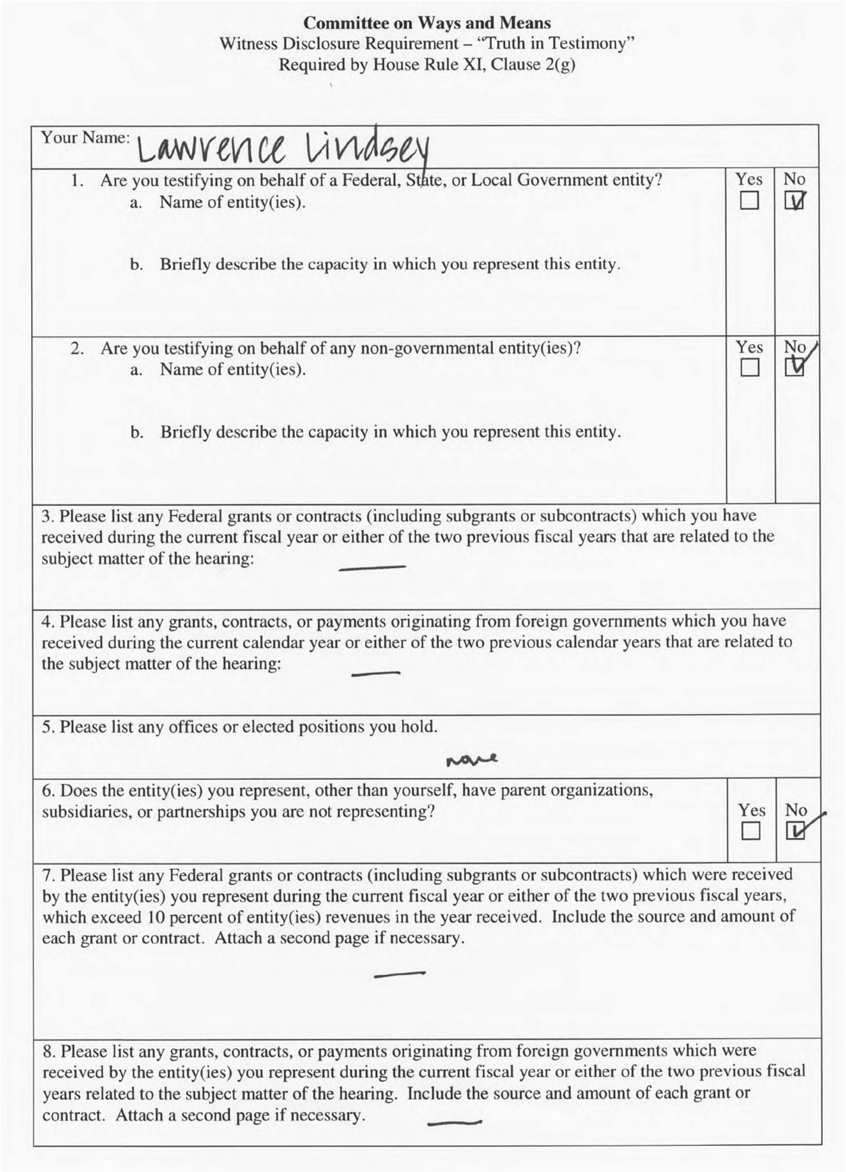
[3] Nunns, J.R. et. al. (2016), "An Analysis of the House GOP Tax Plan", *Tax Policy Center*, September 16. http://www.taxpolicycenter.org/publications/analysis-house-gop-tax-plan/full

growth and the welfare of our citizens.  It is also likely to produce an increase in real wages and a reduction in income inequality.  I sincerely hope that Congress does not miss this opportunity.



**Committee on Ways and Means**
Witness Disclosure Requirement – "Truth in Testimony"
Required by House Rule XI, Clause 2(g)

Your Name: Lawrence Lindsey

1. Are you testifying on behalf of a Federal, State, or Local Government entity? Yes ☐ No ☑
   - a. Name of entity(ies).
   - b. Briefly describe the capacity in which you represent this entity.

2. Are you testifying on behalf of any non-governmental entity(ies)? Yes ☐ No ☑
   - a. Name of entity(ies).
   - b. Briefly describe the capacity in which you represent this entity.

3. Please list any Federal grants or contracts (including subgrants or subcontracts) which you have received during the current fiscal year or either of the two previous fiscal years that are related to the subject matter of the hearing: —

4. Please list any grants, contracts, or payments originating from foreign governments which you have received during the current calendar year or either of the two previous calendar years that are related to the subject matter of the hearing: —

5. Please list any offices or elected positions you hold.

none

6. Does the entity(ies) you represent, other than yourself, have parent organizations, subsidiaries, or partnerships you are not representing? Yes ☐ No ☑

7. Please list any Federal grants or contracts (including subgrants or subcontracts) which were received by the entity(ies) you represent during the current fiscal year or either of the two previous fiscal years, which exceed 10 percent of entity(ies) revenues in the year received. Include the source and amount of each grant or contract. Attach a second page if necessary.

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8. Please list any grants, contracts, or payments originating from foreign governments which were received by the entity(ies) you represent during the current fiscal year or either of the two previous fiscal years related to the subject matter of the hearing. Include the source and amount of each grant or contract. Attach a second page if necessary. —

Chairman BRADY. Thank you, Dr. Lindsey.

Ms. Clausing, welcome to today's hearing. Please proceed.

## STATEMENT OF KIMBERLY CLAUSING, THORMUND A. MILLER AND WALTER MINTZ PROFESSOR OF ECONOMICS, REED COLLEGE

Ms. CLAUSING. Chairman Brady, Ranking Member Neal, members of the committee, thank you so much for inviting me today. In my testimony, I will talk about competitiveness, the Ryan-Brady plan, and alternatives to the plan that can keep the advantages but without the downsides.

First, competitiveness: In talking about competitiveness, many people emphasize tax. But competitiveness really has more to do with fundamentals, like worker education, like an economically secure middle class, like sound infrastructure. The investments that make the middle class prosperous will make our businesses successful.

But by most measures, our businesses are quite successful. Corporate profits are a higher share of GDP than they have been at any time in recent history. Profits in the last 15 years are 50 percent higher than they were in prior decades. Also, our companies dominate the Forbes list of the most important companies in the world. While our economy is about one-fifth the size of the world, our companies are one-third of the world's top companies.

While our corporate tax system has problems, most multinational firms face comparable effective tax rates as firms in other countries. In fact, our corporate tax revenues are lower than the corporate tax revenues of peer nations by about 1 percent of GDP.

Turning to the Ryan-Brady plan, there are good parts.

First, it tackles offshore profit-shifting, and this has become a huge problem. My research suggests that profit-shifting to tax havens is currently costing the U.S. Government over $100 billion every year. In fact, our profits are often shifted to tax havens such as those shown on the chart: Bermuda, Switzerland, and the Caymans.

However, there are some serious flaws with the Ryan-Brady plan. First, the plan is likely to generate large economic shocks, harming American workers and major parts of our economy. The plan taxes imported goods; and absent dollar appreciation, this will harm American businesses and harm American consumers.

In Oregon, a Nike executive called this plan the single biggest threat to the company in its history. Many practical considerations may get in the way of dollar appreciation, and the evidence we have suggests that there are some serious risks here. Do we really want to bet large sectors of the economy on this idea? The retail sector alone accounts for one in ten American jobs.

Second, legal experts argue that the plan is incompatible with the world trading system. Because of this, our trading partners will file suit; and when we inevitably lose, they will be authorized to retaliate with tariffs, reducing U.S. exports by hundreds of billions of dollars. Trade disputes of this magnitude generate uncertainty, an unstable investment environment, and a threat to a trading system that we spent 50 years negotiating after World War II.

Third, this plan loses revenue. The nonpartisan Tax Policy Center estimates that it loses $3 trillion over 10 years.

Although the border adjustment feature raises revenue, that revenue is simply borrowed from future taxpayers since trade deficits eventually turn to surpluses. Also, there is no intellectually coherent rationale for a lower rate on business income under this plan. Instead, the lower rate will cause revenue loss, as wealthy individuals mask labor compensation as business income.

Fourth, the plan is regressive at the proposed rates. The plan benefits the top 1 percent with a tax cut 1,000 times larger than the tax cut for the bottom 80 percent. Yet this plan follows several decades of increasing income inequality and middle-class wage stagnation. It used to be that income growth was higher for the middle class than for those at the top, but in the past 35 years, there has been very little income growth for the bottom 90 percent of the population. Because of these trends, tax policy should be moving in the opposite direction of the Ryan-Brady plan.

Fortunately, there are good alternatives to the Ryan-Brady plan. Congress should focus on a revenue-neutral reform that reduces the rate, but also eliminates loopholes. Most helpful would be repealing deferral, taxing offshore earnings in full. This will solve our huge profit-shifting problem and end the repatriation problem, but without the negatives of the Ryan-Brady plan.

Making our tax system compatible with the global economy is an important goal. We need a simpler corporate tax system that actually collects the tax that is due at a reasonable rate. Even more important, we need a tax system that reflects the real struggles of the middle class by giving tax cuts that are larger for the middle class than for the rich.

We should also work to solidify the fundamentals that are crucial to competitiveness. This requires responsible tax legislation with enough revenue for the priorities and education and infrastructure that we need.

Thank you for inviting me to testify today. I look forward to your questions.

[The prepared statement of Kimberly Clausing follows:]

Statement of

Kimberly A. Clausing
Thormund A. Miller and Walter Mintz Professor of Economics
Reed College

Before the
House Ways and Means Committee

23 May 2017

Chairman Brady, Ranking Member Neal, Members of the Committee: Thank you for inviting me to share my views on tax reform and competitiveness. Tax reform is an important priority, and it should reflect the revenue needs of our country. We need to meet those revenue needs without increasing the deficit, and we should do so in a way that is simple, fair, and efficient.

In my testimony today, I will talk about three broad issues related to good tax reform. First, I will discuss the concept of competitiveness, the contribution of our tax system to the nation's competitiveness, and other important features of national competitiveness. Second, I will address the business tax component of the Ryan/Brady tax plan, focusing in particular on the border-adjustment feature. Third, I will suggest alternatives to the Ryan/Brady plan that preserve the advantages of the plan without risking the substantial disadvantages of the plan. These alternatives will make our tax system better suited to a globally integrated economy. To be suited to the global economy, our tax system must serve the interests of American middle-class workers, workers too often been left behind in tax reform proposals.

## Competitiveness and Tax Policy

By any broad measure, our nation's businesses are incredibly successful. Corporate profits are a higher share of GDP than they have been at any time in history, whether one considers corporate profits in before-tax or after-tax terms. Profits in the last 15 years have been about 50% higher than they were in the closing decades of the prior century. (See Figure 1.) Also, our companies are dominant on the lists of the world's most important companies, as measured by the Forbes Global 2000 list. (See Figure 2.) While our economy is about one-fifth the size of the world economy (16% in purchasing power parity terms (PPP)[1] and 22% in U.S. dollar terms), we have larger fractions of the world's top 2000 firms: 29% by count, 31% by sales, 35% by profits (consolidated), 24% by assets, and 42% by market capitalization.

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[1] PPP numbers adjust for price differences across countries. This makes the United States a larger share of the world economy since price levels are lower in most developing countries. For example, India's economy is much larger in terms of PPP than in terms of USD, since a dollar of income can buy more goods and services in India than it can in the United States.

**Figure 1: After Tax Corporate Profits, 1965-2015**
**(as a share of GDP)**

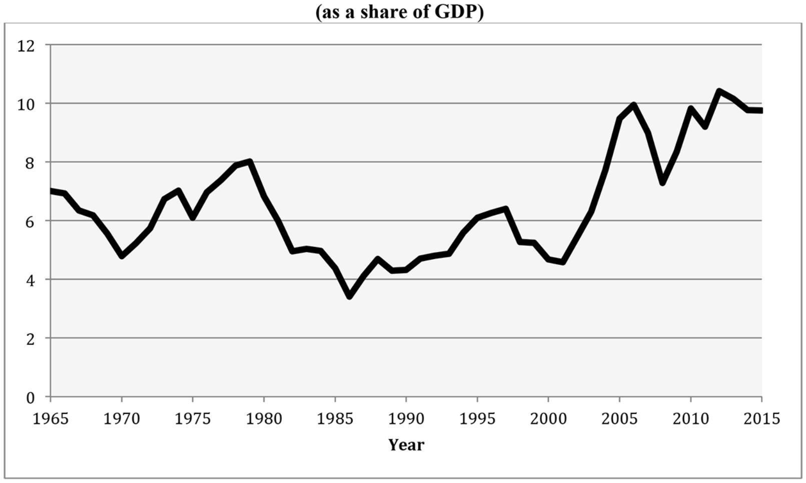
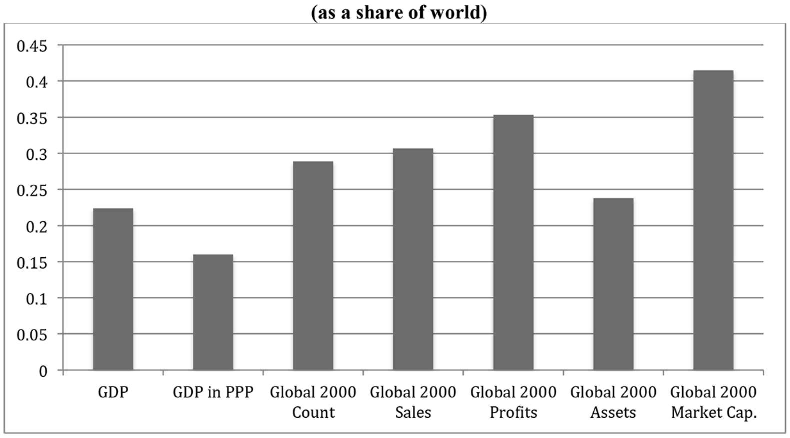
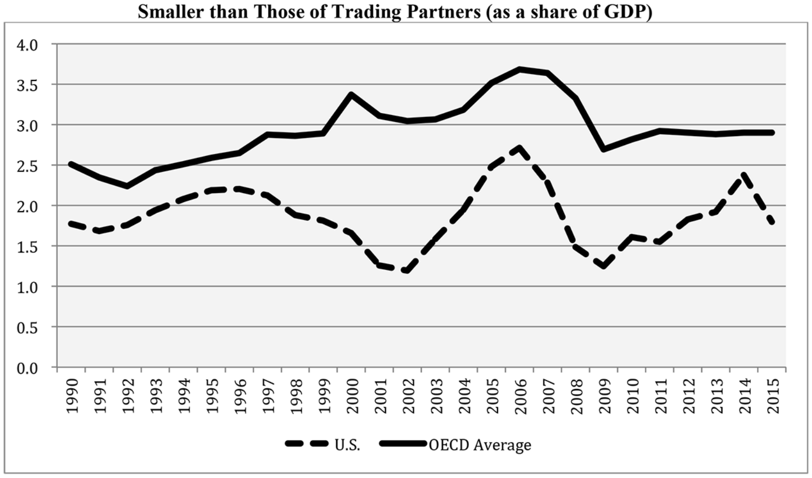


**Figure 2: U.S. Share of Forbes Global 2000 Firms**
**(as a share of world)**



Further, while our corporate tax system certainly has problems, high tax burdens for multinational corporations are not one of them. Due to the aggressive use of corporate loopholes, many U.S. multinationals have effective tax rates in the single digits, far lower than the U.S. statutory rate.[2] And, our purportedly "worldwide" system of taxation generates no revenue from taxing foreign income, while our trading partners that use purportedly "territorial" systems of taxation frequently tax more foreign income than we do, due to their tougher base erosion protections.[3] Further, U.S. corporate tax revenues are lower than the corporate tax revenues of our peer trading partners by about 1 percent of GDP. Part of the revenue shortfall is explained by profit shifting to tax havens, and there are also other reasons for weak U.S. corporate tax revenues.[4] These considerations do *not* mean that U.S. business taxation can not be substantially improved; I will discuss methods for improving business taxation below.

**Figure 3: U.S. Corporate Tax Revenues, Smaller than Those of Trading Partners (as a share of GDP)**



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[2] The U.S. statutory rate is indeed high relative to peer nations, but this is not the relevant measure of corporate tax burdens since most companies pay effective tax rates that are much lower than the statutory rate.

[3] The Joint Committee on Taxation provides detail on other countries' CFC laws. Some countries (e.g., France, Germany, Italy, and Japan) have very broad CFC laws that go beyond currently taxing passive foreign income; active foreign income is also currently taxed, when such income is insufficiently taxed in the source country. The French benchmark for insufficient taxation is less than half the French rate; the Japanese benchmark is less than 20%. Beyond CFC laws, many territorial countries have other provisions aimed at countering corporate tax base erosion that affect the taxation of foreign income, including thin capitalization (earnings stripping) rules, which are widely used. For details, see JCT, "Present Law and Issues in U.S. Taxation of Cross-Border Income" JCX-42-11.

[4] The U.S. tax base is notoriously narrow and there is also a preference in the U.S. tax code for non-corporate business structures. There are also important distortions within the corporate tax code. For example, debt-financed investments are tax-favored relative to equity-financed investments. This increased leverage creates financial vulnerability for the U.S. economy.

## Broader Notions of Competiveness

In discussions about the "competitiveness" of U.S. multinational firms, corporate interests often emphasize tax burdens as a determinative influence. Yet, for many companies, the U.S. statutory rate and our purportedly "worldwide" system have more bark than bite, and multinational firms are often able to achieve very low *effective* tax rates. In terms of the ability to generate after-tax profits and market dominance, U.S. multinational firms are already quite competitive.

But broader notions of competitiveness emphasize the fundamentals that determine the health and well-being of our broader economy. Are workers well-educated and do they have the skills required to earn high-wages in the global economy? Are customers economically secure and sufficiently prosperous that they are not overleveraged? Are standards of living for the middle class rising at a pace that is consistent with societal expectations and a healthy middle class? Is our infrastructure sound? Are our political and economic institutions stable? Are we avoiding fragility in our financial system and other weak spots that could lead to recessions or crises?

While we often take such things for granted, they are essential to the success of U.S. businesses and the workers within them.[5] In short, the attractiveness of a particular country as a location for production depends on much else aside from the corporate tax environment: labor productivity and education, consumer market potential, infrastructure, government services, legal institutions, and other factors matter. And, of course, some of these other factors require government revenue, to finance investments in education, infrastructure, and essential services. The investments in our economy that make the middle class prosperous will also make our businesses successful.

## Business Taxation Under the Ryan/Brady Plan

There are desirable features of the destination-based cash flow tax that is at the center of the Ryan/Brady Plan. First, by basing business tax liabilities on the destination of the customer, it becomes far more difficult for multinational firms to shift profits offshore. This is important, since offshore profit shifting has become a huge problem. My research suggests that this problem has increased dramatically over the past 20 years, and profit shifting to tax havens now costs the U.S. government in excess of $100 billion each year. These practices also hurt our trading partners.[6]

Figure 4 shows the dramatic increase in the revenue lost to profit shifting in recent years, and Figure 5 shows that most profit shifting is artificially directed toward tax havens. Indeed, the income booked in low-tax countries is implausibly high by any reasonable metric. As reported by Gravelle (2015), U.S. affiliate firm profits were 645% of Bermuda's GDP and 547% of the Cayman Islands GDP in 2004. As absurd as these numbers are, they increased by 2010, to 1614% for Bermuda and 2,065% for the Caymans. Further, estimates indicate that U.S.

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[5] Of course, there are many other variables that affect particular companies competitiveness, including, but not limited to, the exchange rate, the firm's financial constraints, and the unique advantages of particular companies.

[6] See Clausing, Kimberly A. "The Effect of Profit Shifting on the Corporate Tax Base in the United States and Beyond." 2016. *National Tax Journal*. December. 69(4). 905-934. Similar facts regarding the scale of the problem are reported by many sources, including Keightly (2013), Dowd, Landefeld, and Moore (2017), and Guvenen, Mataloni, Rassier, and Ruhl (2017).

multinational firms have accumulated over $2.5 trillion in permanently reinvested earnings in tax havens, over $1 trillion of which is held in cash.

**Figure 4: Estimated Revenue Loss to U.S. Government from Profit Shifting (in billions of U.S. dollars)**

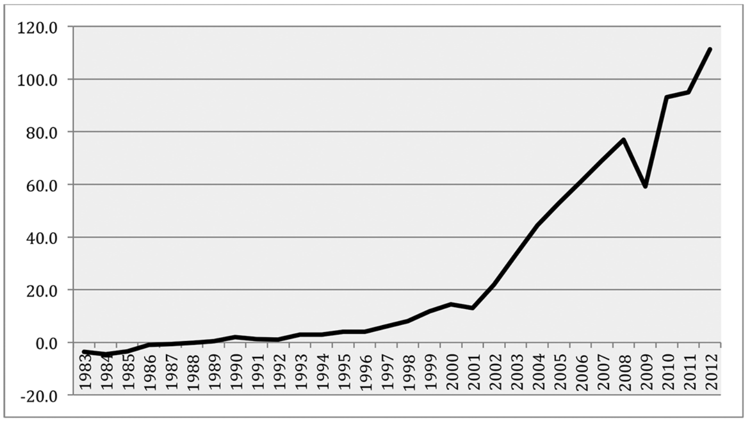
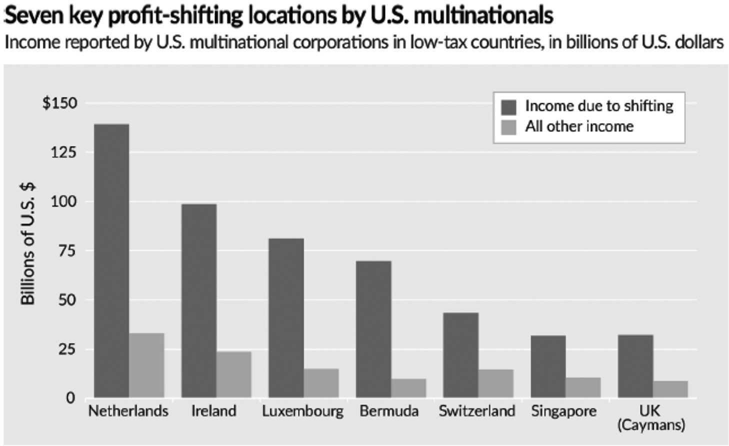


**Figure 5: Main Destinations for Profit Shifting**


Seven key profit-shifting locations by U.S. multinationals

Income reported by U.S. multinational corporations in low-tax countries, in billions of U.S. dollars

A second advantage of the Ryan/Brady plan is that the combination of expensing and eliminating the interest deduction for debt-financed investments eliminates the current tax-incentive favoring debt-financed investments. At present, our tax system actually generates a negative tax rate for investments financed with debt, whereas tax rates are positive for equity-financed investments, about 30% of which face double-taxation by the United States since they are also taxed through the individual income tax.[7] Eliminating the tax incentive that favors debt will reduce leverage in the United States, and this will make our economy less fragile, particularly in times of downturn.

However, there are five serious flaws associated with the Ryan/Brady plan.

1. In the short and medium run, the plan is likely to generate large economic shocks that would harm American workers and trade-dependent businesses.
2. It risks the world trading system, harms our trading partners and allies, and generates substantial risks to U.S. exporting firms due to possible retaliation and incomplete loss offsets.
3. At the proposed tax rates, the Ryan/Brady plan will lose tax revenue, increasing the budget deficit.
4. At the proposed tax rates, the Brady/Ryan plan makes our tax system less progressive, after several decades when the middle class has not benefited from economic growth.
5. This is an untested tax reform that is not ready for primetime. There are many important details that still need to be worked out. Absent several years to work on these issues, the system will function poorly, will lose revenue due to inadvertent tax planning opportunities, and will generate new distortions, such as tax-inefficient mergers between exporters and importers.

Because of these flaws, I recommend that Congress reject the Ryan/Brady plan. However, I offer several suggestions for alternative reforms that would retain the advantages of the Ryan/Brady plan without generating these substantial disadvantages.

### Serious Flaws of the Ryan/Brady Plan

1. Large Negative Shocks to Import-Intensive Industries are Likely

The Ryan/Brady plan includes a border adjustment that would exempt income from exporting while taxing imported goods at 20 percent. Many economists argue that, if the equilibrium trade balance is unchanged, this must generate either an immediate 25% appreciation of the dollar or a slower, subsequent reduction in the prices of imported goods. While this argument has solid theoretical background, in practice there are many factors that may interfere with quick exchange rate and price adjustment.

- Some countries fix their exchange rates so these exchange rates won't adjust quickly.
- Many traded goods are priced in dollars, so changes in these trade contracts will take time, or we will have to wait for price adjustment, which can be quite slow.

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[7] See Burman, Clausing, and Austin. "Is U.S. Corporate Income Double-Taxed?" May 2017. Forthcoming, *National Tax Journal*. https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2965188

- Exchange rates are notoriously difficult to forecast in reality. As many experts have noted, theoretical models of exchange rates do not do a good job predicting future exchange rate movements. Exchange rates can be misaligned for lengthy periods, and there is no guarantee that we will end up at the "theoretically correct" exchange rate.[8]
- There is some evidence that indicates that countries with VATs trade less (both imports *and* exports), although that evidence is incomplete.
- There are very few examples of countries similar to the United States adopting VATs under floating exchange rates (when market forces determine short run movements in exchange rates). In those cases, the exchange rate often did *not* appreciate as expected. And, of course a VAT is not exactly the same as the Ryan/Brady business tax.
- *Even if the dollar does appreciate by 25%*, that will create large redistributions of wealth away from Americans and toward foreigners, and it will also risk generating an emerging market crisis due to the presence of $9 trillion of dollar denominated debt in emerging markets.

For many of these reasons, the business community is understandably skeptical of smooth exchange rate adjustment, and the political support of various business groups indicates that exporters, including those that have been aggressive at profit shifting in the past, are far more likely to be in favor of the Ryan/Brady plan than importers. If the economists that emphasize the theoretical prediction that exchange rates will simply adjust were correct, these business people would be misunderstanding their own economic interests. While I suppose that is possible, I'm more inclined to suspect that businesspeople understand their own economic interests.

Thus, if we take as given that exchange rate adjustment may not be smooth or complete, this suggests that American workers could be hurt by large shocks to industries that use imports intensively, including of course the retail sector, which now employs 1 in 10 American workers.

## 2. Serious Risks to the World Trading System and to Exporting Companies

Most international trade lawyers are quite certain that the Ryan/Brady plan is incompatible with our trade obligations under the WTO (World Trade Organization). Our trade rules are quite clear that border adjustments are not allowed for direct taxes such as corporate income taxes. Since the Brady/Ryan plan allows a deduction for wages, and includes many other features that are common to corporate income taxes, it will be ruled a direct tax and our trading partners will be authorized to retaliate with tariffs.

The WTO incompatibility is no mere technicality, since the Ryan/Brady plan harms our trading partners in several ways. First, it generates an incentive to produce in the United States for exports to third markets. Second, it exacerbates the profit shifting problems of our trading partners, since the United States will appear like a giant tax haven from their perspective. For foreign firms, profit shifting to the United States will not generate extra tax liabilities in the United States, but it will reduce their profits in their home countries. From their perspective, the United States will function like a huge Bermuda! (Bermuda has zero corporate tax.)

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[8] See Kenneth Rogoff, *Perspectives on Exchange Rate Volatility in* INTERNATIONAL CAPITAL FLOWS 441-53 (Martin Feldstein ed.,1999). And more recently, Rogoff's op-ed in the Boston Globe. "Trump's Damaging Border Tax." 20 March 2017.

Since our trading partners are likely to be upset by the economic consequences of this plan, as well as the nationalistic way it was marketed, they are likely to bring dispute settlement suits to the WTO, and they are likely to win. At this point, there is no good outcome for the United States. It is possible our trading partners will retaliate with historically large tariffs; tariffs would be authorized in amounts sufficient to reduce U.S. exports by hundreds of billions of dollars.[9] Or, we will reluctantly amend our laws to make them WTO compatible by either dropping the border adjustment (which will reduce U.S. government revenues and generate large profit shifting problems) or dropping the wage deduction (which converts a progressive tax on business income into a regressive consumption tax, a simple VAT). Regardless of outcome, trade disputes of this magnitude are likely to generate substantial uncertainty, an unstable investment environment, and a threat to a trading system that has served U.S. interests well – a system we spent 50 years negotiating in the aftermath of World War II.

Exporting firms thus face large risks under the Ryan/Brady plan. Trading partners are likely to retaliate, and the world trading system may be permanently harmed. In addition, if the exchange rate does appreciate, that will reduce the gain from the export subsidy, yet losses are not fully refundable under the Ryan/Brady plan. This issue is also discussed further below.

### 3. At Proposed Tax Rates, the Ryan/Brady Plan Loses Revenue

According to the nonpartisan Tax Policy Center, the business tax features of the proposal are a large share of their estimated ten-year $3 trillion revenue loss. While the border adjustment raises revenue, that revenue is ultimately borrowed from future taxpayers, since it is the trade deficit that generates revenue from this provision. When trade deficits subsequently turn to surpluses in the future, the border adjustment would lose revenue.

The revenue loss is not inherently a result of the tax base under the Ryan/Brady plan, but rather the tax rates that were chosen, which are too low to generate revenue neutrality. Beyond that, the corporate rate chosen is intellectually incoherent. One of the advantages of this type of destination-basis cash flow tax is it curbs profit shifting by removing the incentive for shifting profits and activities abroad. The plan also exempts the normal return on capital from taxation, due to expensing.

Yet, if we are only taxing “above normal” profits – likely due to luck or market power – and the tax base is now immobile since it depends only on the location of immobile customers, why lower the tax rate below the top personal rate? The usual arguments for a lower rate do not apply.

Further, the discrepancy between the top personal rate and the business rate will create new avoidance opportunities as wealthy individuals seek to earn their income in tax-preferred ways, reducing their labor compensation in favor of business income. Companies would be inclined to tilt executive compensation toward stock-options and away from salary income, and high-income earners would be inclined to earn income through their businesses in pass-through form. Thus, tax revenue leakage in the personal income tax system is also likely.

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[9] See, e.g., https://piie.com/system/files/documents/bown20170201ppt.pdf

Increases in the budget deficit are likely to increase the trade deficit, since countries must borrow from abroad (and run a trade deficit) whenever their spending exceeds their income, and budget deficits increase the U.S. demand for loanable funds. This deterioration of the trade deficit, if not properly understood, could lead to more rounds of protectionist trade policies, further harming the world trading system.

### 4. Such a Regressive Tax Plan is Not Warranted in the Current Economic Environment

According to the nonpartisan Tax Policy Center, the Ryan/Brady plan benefits the top 1% with a tax cut that is 1,000 times the size of the tax cut for the bottom four quintiles of the income distribution. The top 1% receive a tax cut that averages $213,000. The tax cut of the bottom 80% averages $210. The average federal tax rate falls by about 0.4 percentage points for the bottom 80% of the population, but it falls by 3.4 percentage points for the top quintile, and by 9 percentage points for the top 1%.[10]

This tax plan follows several decades of dramatically increasing income inequality, sharply declining shares of GDP that go to labor, sharply increasing shares of GDP that go to corporate profits, and middle class wage stagnation. Because of these trends, in terms of progressivity, tax policy should be moving in the opposite direction of the Ryan/Brady plan.

### 5. Many Large Technical Problems

As one example, it is likely that many profitable firms would show losses under the Ryan/Brady plan. Exporters will not have taxable revenue, but they will have many deductible expenses. The Ryan/Brady plan suggests unlimited carry-forwards, but this doesn't solve the problem for businesses with losses that may not be offset. There would then be a large tax incentive for exporting companies to merge with non-exporters in order for the losses to be more useful. Should our tax laws encourage ADM and Target to merge? That seems perverse.

There are other technical problems that remain to be worked out. For example, it is very difficult to deal with financial institutions and financial flows.[11] There are likely to be very large impacts on state government corporate tax systems, since they will no longer be able to "piggy back" on the federal corporate income tax base, and these problems have also not been carefully considered. Also, there are large transition effects associated with moving to a destination-basis cash flow system that would need to be carefully considered.

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[10] See http://www.taxpolicycenter.org/publications/analysis-house-gop-tax-plan-0.

[11] The pure form of this tax leaves out financial flows entirely. An augmented form of the tax can capture financial transactions in the base, but this would introduce complexity as all companies would need to keep track of financial transactions, as well as whether the transactions occurred with foreign companies. There is also substantial ambiguity between what transactions are real and what are financial, and such ambiguity raises both technical considerations as well as opportunities for tax avoidance. For a more detailed treatment of these complex issues, see David Weisbach, *A Guide to the GOP Tax Plan – The Way to a Better Way* (Univ. of Chicago Coase-Sandor Inst. for Law & Econ., Working Paper No. 788, 2017). Also see Alan Auerbach, Michael Devereux, Michael Keen, and John Vella. *Destination Based Cash-Flow Taxation*. Oxford University Centre for Business Taxation. WP 17/01. January 2017.

**Alternatives to the Ryan/Brady Plan**

While the advantages of the Ryan/Brady plan are salutatory, the risks are simply too great. It does not make sense to risk the world trading system and the fate of many important industries. Large revenue losses that reward the top 1% with a tax cut 1,000 times the tax cut for the bottom 80% are not warranted. And, simply put, the plan is not ready for primetime; too many details need to be worked out; no country has tried a similar plan in the past.

Instead of moving forward with this plan, Congress should focus on a revenue neutral business tax reform that reduces the corporate tax rate and eliminates the major corporate tax expenditures including deferral, taxing accumulated offshore earnings in full. Eliminating deferral would eliminate the incentive to earn income in low-tax countries, by treating foreign and domestic income alike for tax purposes. Pairing that reform with a lower corporate tax rate need not raise tax burdens on average, although it would create winners and losers among corporate taxpayers. A more fundamental reform would require worldwide corporate tax consolidation; this would better align the tax system with the reality of globally-integrated corporations.

Taxing foreign income currently also eliminates the incentive to build up large stocks of unrepatriated foreign income, now estimated at $2.6 trillion. This income is often invested in U.S. capital markets, and it increases the credit-worthiness of U.S. multinational corporations, who can easily finance worthy investments. But corporations are inhibited from repatriation by the prospect of more favorable tax treatment if they delay, so this makes it difficult for them to return profits to shareholders. Indeed these concerns about repatriation give the multinational business community a large interest in corporate tax reform. Settling the future tax treatment of foreign income should be a key goal of these efforts.[12]

In terms of more incremental reforms, even a per-country minimum tax would be a big step toward reducing profit shifting toward tax havens and protecting the corporate tax base. A minimum tax would currently tax income earned in the lowest tax countries, and my prior work shows that 98% of the profit shifting out of the United States is destined for countries with foreign tax rates below 15%.[13] Other helpful incremental steps include stronger "earnings-stripping" rules and anti-corporate inversion measures such as an exit tax.

In general, making our tax system compatible with the global economy is an important goal. This involves several important changes. First, we need a simplified corporate tax system that actually collects the tax that is due. As it is, too many people waste their careers pursuing tax-related gimmicks and shenanigans. Profit shifting costs the U.S. government over $100 billion each year. Simple reforms like a per-country minimum tax – or better yet, ending deferral – would solve that problem and make our corporate tax system compatible with the global operations of multinational firms.

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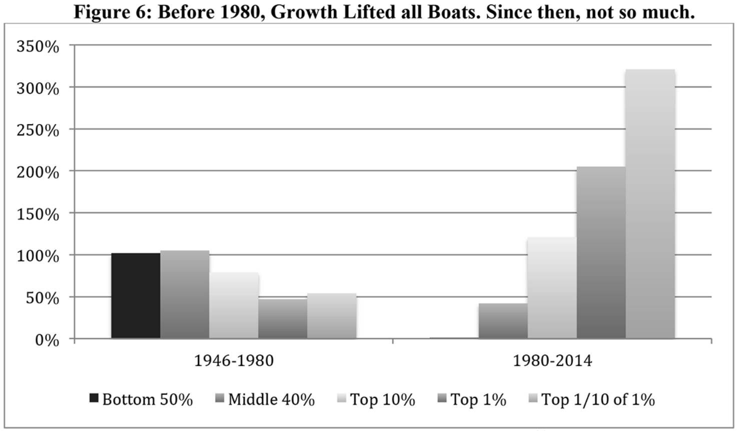
[12] Toward this end, the US Congress did a great disservice when they enacted a one-time holiday on dividend repatriation as part of the American Jobs Creation Act of 2004. American Jobs Creation Act of 2004, Pub. L. No. 108-357, 118 Stat. 1418. Ever since, companies have been more likely to delay repatriation in the hope of future holidays (or permanently more favorable treatment).

[13] *See* Kimberly Clausing, *The Effect of Profit Shifting on the Corporate Tax Base in the United States and Beyond*, 69 NAT'L TAX J. 905, 905-934 (2016).

Second, but even more important, we also need a tax system that reflects the real struggles of the middle class. Too much of the economic growth of prior decades has ended up in the hand of those at the top of the income distribution, and middle class wages have stagnated.

**Figure 6: Before 1980, Growth Lifted all Boats. Since then, not so much.**



Note: Figures compiled based on data from Piketty, Saez, and Zucman (2016).[14]

This was not always the case. Figure 6 shows that pre-tax income growth over the period 1946 to 1980 exceeded 100% for the bottom 90% of the population, and growth in incomes were actually lower for the top shares of the population. However, between 1980 and 2014, the growth of the bottom 50% is literally invisible in the chart, at 1%. Growth in incomes for the middle 40% is 42 percent, and it accelerates from there, with growth of the top 1% exceeding 200% and growth in incomes for the top tenth of the top 1% exceeding 300%. As a result, there has been an increasing concentration of national income at the top of the income distribution. The top 1% now have a fifth of national income, 50% more income than the bottom half of the income distribution. (See Figure 7.)

These figures help explain why typical American households are not content with the pace of economic progress. The standard expectation that every generation would be better off than the one prior has been disappointed. Nearly 90% of children born in the 1940s out-earned their parents, but that share has fallen steadily. For children born in 1970, only 60% out-earn their parents; for those born in the 1980s, only half do.[15]

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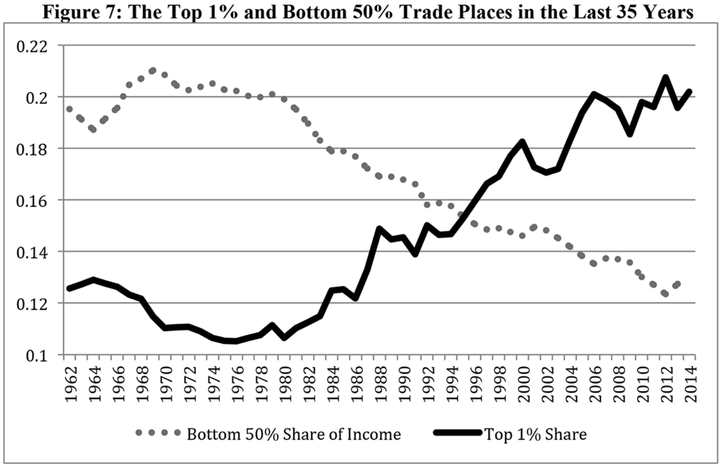
[14] See Thomas Piketty, Emmanuel Saez, and Gabriel Zucman. “Distributional National Accounts: Methods and Estimates for the United States.” December 2016.

[15] See Raj Chetty et al. “The Fading American Dream: Trends in Absolute Income Mobility Since 1940.” *NBER Working Paper No. 22910*. December 2016.

**Figure 7: The Top 1% and Bottom 50% Trade Places in the Last 35 Years**



Note: Data from World Top Incomes Database. Accessed 14 March 2017.

Our tax system needs to reflect these changing realities by making sure that tax cuts are directed to those that are *not* in the top 1%, focusing instead on the bottom 80% of the population that has been frustrated by our prior record of economic progress. The tax system can better serve American workers by expanding the earned income tax credit, by providing wage insurance for workers who have lost their job due to technological disruption or due to competitive pressures, and by making sure that tax cuts are larger for the middle class than for the rich. We also need to work to solidify the economic fundamentals of our economy. This requires responsible tax legislation that gives us the revenue we need for vital investments in education, infrastructure, healthcare, and other urgent priorities.

Thank you again for inviting me to testify today. I look forward to your questions.

Note: This testimony draws on other work by the author, and in some cases sections of text are excerpted. Interested readers are referred to the following articles by the author for more detail on the arguments above.

- "Problems with Destination-Based Corporate Taxes and the Ryan Blueprint." (with Reuven Avi-Yonah). 2017. *Columbia Journal of Tax Law*. 8. 229-255. https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2884903
- "Competitiveness, Tax Base Erosion, and the Essential Dilemma of Corporate Tax Reform." 2016. (6) *BYU Law Review*. 1649-1680. http://digitalcommons.law.byu.edu/cgi/viewcontent.cgi?article=3075&context=lawreview
- "The Effect of Profit Shifting on the Corporate Tax Base in the United States and Beyond." 2016. *National Tax Journal*. December. 69(4). 905-934. https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2685442
- "Labor and Capital in the Global Economy." *Democracy: A Journal of Ideas*. 43. 2017. http://democracyjournal.org/magazine/43/labor-and-capital-in-the-global-economy/
- "Strengthening the Indispensible U.S. Corporate Tax." Washington Center for Equitable Growth. August 2016. http://equitablegrowth.org/report/strengthening-the-indispensable-u-s-corporate-tax/

**Committee on Ways and Means**
Witness Disclosure Requirement – "Truth in Testimony"
Required by House Rule XI, Clause 2(g)

Your Name: KIMBERLY CLAUSING

1. Are you testifying on behalf of a Federal, State, or Local Government entity? Yes ☐ No ☑
   a. Name of entity(ies).
   b. Briefly describe the capacity in which you represent this entity.

2. Are you testifying on behalf of any non-governmental entity(ies)? Yes ☐ No ☑
   a. Name of entity(ies).
   b. Briefly describe the capacity in which you represent this entity.

3. Please list any Federal grants or contracts (including subgrants or subcontracts) which you have received during the current fiscal year or either of the two previous fiscal years that are related to the subject matter of the hearing:

n/a

4. Please list any grants, contracts, or payments originating from foreign governments which you have received during the current calendar year or either of the two previous calendar years that are related to the subject matter of the hearing:

n/a

5. Please list any offices or elected positions you hold.

n/a

6. Does the entity(ies) you represent, other than yourself, have parent organizations, subsidiaries, or partnerships you are not representing? Yes ☐ No ☑

7. Please list any Federal grants or contracts (including subgrants or subcontracts) which were received by the entity(ies) you represent during the current fiscal year or either of the two previous fiscal years, which exceed 10 percent of entity(ies) revenues in the year received. Include the source and amount of each grant or contract. Attach a second page if necessary.

n/a

8. Please list any grants, contracts, or payments originating from foreign governments which were received by the entity(ies) you represent during the current fiscal year or either of the two previous fiscal years related to the subject matter of the hearing. Include the source and amount of each grant or contract. Attach a second page if necessary.

Chairman BRADY. Thank you. And thank you all for your excellent testimony. We will now proceed to the question-and-answer session, and I will lead off.

So, Dr. Lindsey, based on your economic analysis, you see in the blueprint significant acceleration of growth, greater than even the Reagan reforms, which you know quite a bit about, but you see all this growth reflected in higher wages, which is exactly what we want to see with tax reform and why we need tax reform now.

And you have heard Mr. Cornell eloquently express concern the border adjustment element could result in higher prices for consumers and increase costs for retailers like Target that import a lot of the products that they sell. We don't want to see that happen.

Can you explain why you don't think that will be a result of the border adjustment provision and, more broadly, how increased wages can help grow the economy, including for importers, who are an important part of our economy?

Mr. LINDSEY. Absolutely, Mr. Chairman. I learned that time.

First of all, why will wages at this point increase? I think there are two elements, some of which are neglected in the long-run analysis, and that is the particular point of the business cycle that we are at right now. We are labor-constrained, but because of the free flow of goods into this country, effectively, we are not capital-constrained.

Now, if you have growth at this point and you keep that in place, what you are probably going to have is higher wages, but the cause will be a less competitive situation. I think what you will end up with is either an inflationary push, or you will have a recession, or possibly both. This is a very, very difficult time for the Federal Reserve, and I think they will actually be making the decision.

The only way you can extend this expansion, which, although anemic, has been going on for 8 years, the only way you can extend it once you get to full employment is to also increase the supply side of the economy. Because what you are basically doing right now is you are driving up and you are about to hit a brick wall. And I think what you have to do is you either hit the brick wall or you move the wall. And I think what this bill will do is move the wall. That will allow wages to rise as we continue to expand jobs at full employment.

I think any measure of how much wages will go up absolutely swamps any other distributional considerations. I think we will actually see for the first time in 50 years, actually for the first time since the Kennedy tax cut, a reduction in the measures of inequality we have.

Chairman BRADY. Thank you, Doctor.

Mr. Simon, you are a strong advocate for the retail industry, because of your work experience. You also have a passion for bringing manufacturing back to the United States, which will revitalize our local communities. And, as you say, with supply chains that are local, that will shorten lead times, lower transportation and transaction cost, but it will grow a middle class that is sustainable.

So your experience with global supply chains, can you share your thoughts on what kind of manufacturing capability and jobs can return to the United States; and, as part of that, how can manufacturing and retail work together, partner with us to make sure this tax reform works well for them?

Mr. SIMON. Thank you for the question, Chairman.

Based on experience, and we have had early successes with the Walmart program, and the early successes in repatriation were new lines at existing factory and reopening of old facilities that had closed. Investors in companies have been a little bit hesitant to spend major capex needed for a transformational change, and hopefully, this will bring that forward.

In order for the transformational change, we need some of the things that have been talked about today. Access to all the capital that is stashed offshore invested in the U.S. would be a huge boon for manufacturing. The expense versus depreciation issue would help, although for some small businesses you should potentially consider an either/or option. And, as the ranking member said, workforce transformation is really, really critical, because that is a limiting factor today.

Retailers need to do some things too. The way the P&Ls are structured and incentives are structured aren't aligned to think. We have been trained over 30 years to behave the way that we behave. An example of that would be imported goods. A retailer has to order a year ahead of time nearly and then take possession FOB at the foreign port, and they are on the water for up to 3 months. So a year lead time, 3 months you own the product where your cash is not doing anything for you.

Domestic products, when you order and the lead times could be as short as 14 or 16 weeks and you take possession when it hits your distribution center. So the cash flow is different. But most companies in their model don't incent buyers on cash flow; that is a Treasury function. It isn't until you look at the whole picture holistically that you start to realize that this can and does make sense.

And we can expect products to come back in this order, and we did this work: Large, heavy, big items, heavy cube items first, like furniture, lawn furniture can come back now once the plant's in place. With some of the changes you make, the line will go down. There are some products today that the economics don't suggest they could come back. Small items like microchips in some cases or heavy labor items like cut-and-sew apparel could be challenging.

But if we do the work, it is worth it. And I have toured towel factories in Georgia and bicycle factories in South Carolina where you can see the difference that it makes in people's lives. And more so, you can see the excitement and the energy and the transformation that occurs in the communities when these plants open, and it is worth every bit of the sacrifice that it might take to get there.

Chairman BRADY. Thank you, Mr. Chairman.

I now recognize the distinguished member Mr. Neal for any questions he might have.

Mr. NEAL. Thank you, Mr. Chairman.

Professor Clausing, as I mentioned in my opening statement, my priority as well as the minority's position here is in support fully of middle class relief. Would you talk a little bit about your ideas for what we might do with the Tax Code that would help with the middle class growth and aspiration?

Ms. CLAUSING. Absolutely. One of the key things we can do with the Tax Code to help the middle class is to expand tax relief to the middle class at a greater rate than for the rich. I also think expanding the earned income tax credit is a crucial policy tool. It rewards work for some of the people in our society who most need help with their wages. Those two would be great contributors.

I also think it is important to avoid tax changes that raise the deficit, because that hurts future generations of taxpayers and the fundamentals of our economy.

Mr. NEAL. Mr. Cornell, you seem to be a bit skeptical about the argument over dollar appreciation. Do you want to talk a little bit about that?

Mr. CORNELL. You know, we have spent a lot of time looking at this issue, and I am certainly not an economist. I am not a currency expert, but we have been studying what some of the experts have been saying. And, as you might know, there are very different opinions.

I have talked to many of our economists, economists at Goldman Sachs that support us. Their economists have been, there should be grave doubts that exchange rates will smoothly offset the effects of the border adjustment. We have been listening to Fed Chairman Yellen. Her quote was: The problem is, there is great uncertainty with how, in reality, markets will respond to these changes.

We worked very closely with the lead economist and FX trader at Bank of America, David Woo. He talks about this being the most difficult thing to forecast, and to build an intergenerational tax reform plan based on these assumptions of what FX will do is somewhat of a laughable notion.

So when I read comments and read reports like this, and think about the impact this can have on our business, on American families, I worry about the impact on those families, who for basic essential items, for clothing, for back-to-school essentials, for those basic family essentials, as we looked at it, would be paying prices that could be 20 percent higher.

So we have certainly looked at the currency adjustment. As we run our models, we factored in some currency appreciation and capture rates. But every time we run the models, we come to the same conclusion: Americans will pay more for basic essential items that they need today. And we don't think that is the right thing for American families, and I have a sense that many of you would agree with that.

Mr. NEAL. Professor Clausing, who might be the winners and losers as a result of the border adjustment tax?

Ms. CLAUSING. I think the big losers would be import-intensive industries and the workers in those industries and the consumers of their products, mostly because of this uncertainty about the exchange rate.

Many countries have fixed exchange rates. Much trade is priced in dollars. And, you know, as just mentioned, the exchange rate is very difficult to forecast. It is a $5-trillion-a-day market, 88 percent of which is in U.S. dollars. So we aren't sure the exchange rate is going to appreciate and, absent that, the import-intensive industries would be really hurt.

The export firms could win, but they also face some risks here, in terms of possible retaliation from trading partners and the like. So I would be happy to elaborate on those if you like.

Mr. NEAL. If you want, you have another minute.

Ms. CLAUSING. So, for instance, if we lose in the WTO, which most trade law lawyers think that we would, that will cause retaliation by our trading partners, and they would be authorized to have historically very large tariffs, enough to reduce U.S. exports by hundreds of billions of dollars. This has given a lot of exporting firms pause in thinking about the benefits of this proposal.

Another major downside for them is that they may not show tax liabilities under this proposal, but if the exchange rate adjusts, they would be due a credit back from the government. However, the plan doesn't include enough to fully offset these losses.

So they will find that they aren't able to use the losses that they are showing, which might lead to some silly outcomes, like ADM merging with Target. And it is not entirely clear that we want the Tax Code to induce those types of mergers, just because ADM can't use their losses and Target can.

Mr. NEAL. Thank you, Mr. Chairman.

Chairman BRADY. So, for the record, I am assuming ADM is not merging with Target. We can pretty much go with that today?

Mr. CORNELL. You can go with that today. Chairman BRADY. Thank you, Mr. Cornell. Mr. Nunes, you are recognized.

Mr. NUNES. Thank you, Mr. Chairman.

Dr. Lindsey, thanks a lot for being here. I just want to ask you, Chairman Brady talked about this in his opening statement, but it is interesting that the one thing that the United States, Mali, Libya, Syria, Iraq and Afghanistan and North Korea have in common is what?

Mr. LINDSEY. That we don't have any border adjustment.

Mr. NUNES. We don't do border adjustment. All the other major countries in the world do. I am going to come back to you, Dr. Lindsey, but, Mr. Simon, I know that you formerly worked with Walmart. You were a global company, so you operated in many of these places that weren't North Korea, Iraq, Syria, Mali. I think you have places—your big markets are where, Canada, Mexico?

Mr. SIMON. Correct, U.K., China.

Mr. NUNES. U.K., China. In any of those countries, because they border-adjust, did you pay anywhere close to a 70 or 80 or 90 percent tax rate?

Mr. SIMON. I don't have that information at my fingertips, but my inclination is no.

Mr. NUNES. Dr. Lindsey, I will come back to you. In your opening statement, at the very end of your opening statement, you didn't get a lot of chance to expand on it, but the one economist who is your rival who disagrees with the exchange rate, could you go into that, how he only came up with a 1 percent change in price?

Mr. LINDSEY. Sure. Again, the consensus of the economics profession is that simply supply and demand is going to cause the dollar to appreciate. And their estimate, which is actually very much in the low end, was that the appreciation would only be 65 percent of what one would expect in terms of full appreciation. And if you plug that number into the model, what you are going to end up with is a total increase in consumer prices of just 1 percent, not 1 percent a year, 1 percent altogether.

Now, I know there are some concerns that have been expressed about the pace of it. The first thing I would point out is that markets move ahead of reality. That is how they make profits is market makers move quickly. So I wouldn't worry about things being delayed.

The second point I would make is, yes, some countries have administered exchange rates, notably China, but, if anything, an administered currency exchange rate is something that is quicker to move. And, in fact, the Chinese, as soon as November 9th, when it appeared that something like this might actually have a good chance of moving, the Chinese began the depreciation process quickly. They speeded it up.

Now that the market thinks that it is less likely, they have tended to slow it down. So I wouldn't worry about the administered exchange rate argument, because I think, actually, they will be the first to move their exchange rates.

Mr. NUNES. And you have worked on this, obviously, for a long time. And can you talk about the WTO argument, which is one of the main objections to this? Can you walk us through that?

Mr. LINDSEY. Congressman, when you say a long time, you mean it. I think you were seven when I first started working on it, so that is a long time. I have worked on it in every administration. I am going to be very candid. The WTO is dominated by Europeans. There is no question about it, most of the rulings are pro-European. And yes, it is an international body and we should respect the international body, but we should recognize that prejudice.

That is why European-style tax systems, one reason why European-style tax systems all had border adjustability declared legal. Now, there are technical arguments, and I would acknowledge that there are both lawyers and economists on both sides of this issue. I suspect that not even the WTO would be so boldfaced as to say it is okay for Europeans to do this, but not for Americans to do it.

It is such a transparent recognition of their bias that I don't even think they would do that. Now, if they were then I think maybe we should reconsider our situation with the WTO, but I don't think that is going to happen. I just don't think that is logical.

Mr. NUNES. So with the 30 seconds I have left, Mr. Lindsey, can you walk us through kind of maybe a possible phase-in approach of the border adjustment?

Mr. LINDSEY. Yes. I mean, I get that 20 percent is a big leap, and I can understand the issue of uncertainty very well.

I think one way of addressing that is to just do a portion of it. The first thing I would make sure I did was in the short run, maybe a year or two, you might want to say all dollar-based contracts are deemed to be domestic.

But secondly, I think—so phase it in, say, 30 percent. Have only 30 percent of exports and imports involved. I don't think anybody thinks that a 6 percent border adjustment is going to, you know, ruin the world. It is not going to cause the retail industry to go out of business. So sure, let's try it. Let's try something minor.

Chairman BRADY. All time has expired. Mr. Levin, you are recognized.

Mr. LEVIN. Thank you.

Welcome. I don't want to focus on this, Mr. Lindsey, but as someone who worked here with the WTO on like cases, I think there is a deep distinction between a VAT and a border adjustment tax, and I think we lost cases before the WTO and we would likely lose this one, with some very serious implications.

And I have worked on this; we lost the cases twice that had some similarities. We need tax reform, but I think we need to step away from some of the mythologies. By the way, one is that the vague benefit in terms of income growth will come from a further income tax break for the high-income.

And I would like to have introduced into the record a paper by Owen Zidar, who says: Stimulative effects of income tax cuts are largely driven by cuts for the bottom 90 percent, and that the empirical link between employment growth and tax changes for the top 10 percent is weak to negligible over a business cycle frequency. I would like that to be entered.

Chairman BRADY. Without objection.

[The information follows:]

Levin SFR #1

# Tax Cuts For Whom? Heterogeneous Effects of Income Tax Changes on Growth and Employment*

Owen Zidar
Chicago Booth and NBER

February 2017

## Abstract

This paper investigates how tax changes for different income groups affect aggregate economic activity. I construct a measure of who received (or paid for) tax changes in the postwar period using tax return data from NBER's TAXSIM. I aggregate each tax change by income group and state. Variation in the income distribution across U.S. states and federal tax changes generate variation in regional tax shocks that I exploit to test for heterogeneous effects. I find that the positive relationship between tax cuts and employment growth is largely driven by tax cuts for lower-income groups, and that the effect of tax cuts for the top 10% on employment growth is small.
(JEL: E32, E62, H20, N12)

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> There are two ideas of government. There are those who believe that if you just legislate to make the well-to-do prosperous, that their prosperity will leak through on those below. The Democratic idea has been that if you legislate to make the masses prosperous their prosperity will find its way up and through every class that rests upon it.
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> —WILLIAM JENNINGS BRYAN (JULY, 1896)

The consequences of changing tax policy for different groups are fiercely debated. Some policy makers maintain that tax changes for high-income earners "trickle down" and are the most effective way to affect prosperity. They argue that higher marginal tax rates for top-income taxpayers lead to large distortions in labor supply, investment, and hiring, so tax cuts for top-income taxpayers most effectively increase aggregate economic activity. Others, however, contend the opposite. They argue that lower-income groups have higher marginal propensities to consume and disincentives to work from means-tested benefits, so tax cuts for lower-income groups generate sizable consumption and labor supply responses, and thereby, more overall activity. Do tax changes for high-income earners "trickle down?" Would these effects be larger if the tax changes were less targeted at the top?

Variation in income tax policy in the U.S. can help us answer these questions and inform the debate on "trickle down" versus "bottom up" economics. In the early 1980s and 2000s, the largest tax cuts as a share of income went to top-income taxpayers. In the early 1990s, top-income earners faced tax increases while taxpayers with low to moderate incomes received tax cuts. This paper investigates how the composition of tax changes affects subsequent economic activity. The possibility that the impact of tax changes depends not only on how large the changes are, but also on how they are distributed has important implications for understanding macroeconomic activity, designing countercyclical policy, and assessing the consequences of many redistributive policies.

The main contribution of this paper is to use new data and a novel source of variation to quantify the importance of the distribution of tax changes for their overall impact on economic activity. I find that tax cuts that go to high-income taxpayers generate less growth than similarly-sized tax cuts for low and moderate income taxpayers. In fact, the positive relationship between tax cuts and employment growth is largely driven by tax cuts for lower-income groups and the effect of tax cuts for the top 10% on employment growth is small.

Establishing this result requires overcoming three empirical difficulties. First, many tax changes happen in response to current or expected economic conditions. Second, tax changes for low- and high-income taxpayers often occur at the same time, so separately identifying the effects of low- and high-income tax cuts is difficult. Third, the number of data points and tax changes in the postwar period is limited.

This paper uses variation in the regional impact of national tax shocks to overcome these empirical difficulties. Variation in the income distribution across U.S. states lead to heterogeneous regional impacts of federal income tax changes. For instance, Connecticut, whose share of top-income taxpayers is nearly twice that of the typical state, faced relatively larger shocks to high-income earners after the Omnibus Budget Reconciliation Act of 1993, which raised top-income tax rates. I focus on a subset of federal tax changes that are not related to the current state of the economy according to the classification approach of Romer and Romer (2010).[1] The interaction of (1) regional heterogeneity and (2) exogenous federal tax changes produces plausibly exogenous regional tax shocks, differently-sized shocks for different income groups, and more data on the economic consequences of tax changes.

I use individual tax return data from NBER's TAXSIM to quantify these tax shocks. For each tax change, I construct a measure of who received (or paid for) the tax change. The measure of the tax change is based on three things for every individual return: income and deductions in the year prior to an exogenous tax change, the old tax schedule, and the new tax schedule. For example, consider a taxpayer in 1992 whose income was \$180,000. Based on her 1992 income and deductions, she would have paid \$50,500 in taxes according to the old 1992 tax rate schedule and \$54,000 according to the new 1993 tax rate schedule. My measure assigns her a \$3,500 tax increase for 1993. I use the prior year's tax data to avoid conflating behavioral responses and measured changes in tax liabilities. I then aggregate these mechanical tax changes for each taxpayer in a state by income group, such as the bottom 90% and top 10% of national AGI respectively.

With these year-state-income group level tax shock measures, I investigate how responsive employment growth and economic activity are to tax shocks for different income groups. I estimate the dynamic effects of tax changes for different groups using event studies, distributed lag models, and more parsimonious two-year changes. Since federal tax changes differ in their progressivity, the tax shock from a given federal tax change differs regionally based on each

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[1] They use the historical record (such as congressional records, economic reports and presidential speeches) to identify tax changes that were taken for more exogenous reasons such as pursuing long run growth or deficit reduction. Doing so reinforces my ability to overcome endogeneity concerns. Appendix Table A1 lists each tax change and how it is classified.

location's income distribution. These regional differences in tax shocks enable me to identify the effects of tax shocks for both low- and high-income groups. For example, I identify the impact of high-income tax changes by comparing the responsiveness of employment growth in states like Connecticut to responsiveness in states with less exposure to high-income shocks. The empirical analysis has three components: (1) evidence of heterogeneous effects, (2) research design validation, (3) mechanisms and discussion.

First, I find that state employment growth and economic activity are substantially more responsive to tax shocks for lower-income groups than to equally-sized tax shocks for top earners. In particular, a 1% of state GDP tax cut for the bottom 90% results in roughly 3.4 percentage points of employment growth over a two-year period. The corresponding estimate for the top 10% is 0.2 percentage points and is statistically insignificant. Other measures of state economic activity, such as state GDP, payrolls, and net earnings, respond similarly, in that they are very responsive to tax changes for the bottom 90% and unresponsive to tax changes for the top 10%.

Second, I provide several pieces of evidence to support the validity of these estimates. I build and use new state-level microsimulation models of social insurance programs (AFDC, TANF, SNAP, SSI, and Medicaid) to show that the impacts of tax changes for lower-income groups do not reflect policy changes in social insurance programs. Event study evidence shows that tax shocks are not disproportionately favoring states that are doing poorly relative to how fast they normally grow. Similarly, differential state cyclicality as well as contemporaneous oil price shocks, interest rate shocks, or regional trends are not driving the results.

Third, in terms of mechanisms, I show how tax changes for different groups impact labor market outcomes and consumption. Tax changes for the bottom 90% have much greater impact on both the extensive margin and intensive margin of labor supply than tax changes for the top 10%. Specifically, a 1% of state GDP tax increase for the bottom 90% lowers labor force participation rates by 3.5 percentage points and hours by roughly 2%. Tax changes of the same size for the top 10% have no detectable impact on these margins. State-level consumption also shows larger impacts for bottom 90% tax changes. These estimates on labor market outcomes and consumption are reduced-form effects on equilibrium outcomes that reflect changes in both changes in supply and demand. I find that real wages increase after tax changes for lower-income groups. While the estimates are imprecise, they suggest that labor supply responses are an important mechanism for the results.

The empirical literature on these mechanisms – consumption and labor supply – is consistent with the possibility of heterogeneous aggregate effects of tax changes. One strand of evidence relates to heterogeneous consumption responses.[2] Many studies provide evidence that lower-income households tend to have higher marginal propensities to consume (McCarthy, 1995; Parker, 1999; Dynan et al., 2004; Johnson et al., 2006; Jappelli and Pistaferri, 2010; Parker et al., 2013).[3] A second strand of evidence relates to tax policy and labor supply responses of different income groups. On the extensive margin for lower-income groups, Eissa and Liebman (1996) and Meyer and Rosenbaum (2001) show that the Earned Income Tax Credit has strongly increased labor force participation.[4] For high-income earners, there is some evidence that the costs of raising taxes on top-income taxpayers in terms of labor supply and other margins may be limited (Saez et al., 2012; Romer and Romer, 2014) and largely reflect shifting in the timing or form of income (Goolsbee, 2000; Auerbach and Siegel, 2000). By focusing on the overall impacts of tax changes for different groups, this paper not only incorporates the effects of heterogeneous consumption responses, but also provides evidence on the heterogeneous effects of supply side policies that often do not assess the efficacy of tax changes for low- versus high-income groups.

The estimates in this paper build on the regional multiplier literature, which was recently surveyed by Ramey (2011). In particular, the empirical approach in this paper resembles that of Nakamura and Steinsson (2014), but for taxes (with heterogeneity) rather than government spending.[5] This regional approach complements the approach of Mertens and Ravn (2013) who

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[2] Many macro papers, which often have consumption responses as a key channel, also support the notion that heterogeneity matters in the context of fiscal policy. Monacelli and Perotti (2011) use an incomplete markets model with borrowing constraints to show that lump sum redistribution from savers to borrowers is expansionary when nominal prices are sticky. The main intuition is that while both borrowers and savers optimize inter-temporally, redistribution to borrowers *also* relaxes their borrowing constraint and results in a level of consumption that exceeds the amount that savers reduced their consumption. This higher level of aggregate consumption raises output and employment. Similarly, Heathcote (2005) finds that temporary tax cuts can have large real effects in simulated models with heterogeneous agents and incomplete markets. Galí et al. (2007) show that macro models with some cash-on-hand agents and sticky prices do a better job explaining observed aggregate consumption patterns than representative-agent models.

[3] Note that not all papers, e.g., Shapiro and Slemrod (1995), find significant differences in spending responses as a function of income. More broadly, Chetty et al. (2014) estimate that approximately 85% of individuals are rule-of-thumb spenders. Saez and Zucman (2016) also show total savings among the bottom 90% is roughly zero and has been flat since the 1980s.

[4] While evidence based on bunching (Heckman, 1983; Saez, 2010) suggests that intensive margin responses are small, other work, such as Kline and Tartari (2016), provides evidence that tax policy changes can lead to nontrivial intensive margin responses among low-income groups. Kosar and Moffitt (2016) provide evidence on the cumulative marginal tax rates of low-income households.

[5] See Suárez Serrato and Wingender (2011) for a paper estimating how high- and low-skilled workers respond to different types of government spending shocks. Chodorow-Reich et al. (2012) and Hausman (2016) use similar methods to analyze two important fiscal policy episodes – Medicaid payments to states in the Great Recession

investigate differences for personal income and corporate taxes as well as Mertens (2013) for top-income groups using a time series approach with national data on tax *rates*. Constructing a new measure of changes in tax *liabilities* based on micro tax return data also contributes to this literature because measurement error can partly explain large differences in the estimated effects of fiscal policy (Mertens and Ravn, 2014). In addition, the regional approach provides more power and variation in tax shocks for different groups, which enables me to separate and identify their effects on economic activity.

# 1 Data on Tax Changes and Economic Activity

## 1.1 Tax Data

This section describes how I construct a national time-series of tax changes by income group from 1950-2011. The following section then shows how this national series is distributed across U.S. states.

### 1.1.1 National Tax Changes by Income Group

I use tax measures from NBER when possible and rely on the Statistics of Income (SOI) tables to calculate changes before 1960.[6] To calculate tax changes occurring after 1960, I use NBER's Tax Simulator TAXSIM, which is a program that calculates individual tax liabilities for every annual tax schedule since 1960 and stores a large sample of actual tax returns. I construct my measure of tax changes by comparing each individual's income and payroll tax liabilities in the year preceding a tax change to what their tax liabilities would have been if the new tax schedule had been applied. For instance, consider the 1993 Omnibus Budget Reconciliation Act. For every taxpayer, my measure subtracts how much she paid in 1992 from how much she would have paid in 1992 if the 1993 tax schedule had been in place.[7] When calculating tax liabilities, TAXSIM takes into account every individuals' deductions and credits and their treatment under both the 1992 and 1993 tax schedules, resulting in a highly detailed measure of the mechanical,

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and payments to veterans in 1936, respectively. Important contributions also include Clemens and Miran (2012); Shoag (2010); Wilson (2012).

[6] See appendix A.1.1 for a description of how I calculate the four pre-NBER tax changes, which affected tax liabilities in 1948, 1950, 1954, and 1960. This approach is similar to that of Barro and Redlick (2011), who focus on *marginal rate* changes rather than *tax liability* changes.

[7] See appendix A.1.2 for a more detail on the 1993 example tax change calculation.

policy-induced change in tax liability at the individual tax return level.[8] After calculating a change in tax liability for each taxpayer, I collapse the data by averaging it for every income percentile of AGI.

Figure 1 shows the results for four recent, prominent tax changes. Based on this measure of tax changes, 1993 taxpayers below median AGI received a modest tax cut of less than one percent of AGI and only the highest-income taxpayers faced higher taxes. A similar pattern emerges in 1991 under George H.W. Bush. In contrast, high-income taxpayers received the largest cuts in 1982 and 2003 under Reagan and Bush, respectively.

To compute total changes in income and payroll taxes in a given year, I multiply the average change in liability for each percentile by the number of returns in that percentile and then sum up each percentile's aggregate tax changes to obtain total tax changes for the bottom 90% and top 10% groups. I define tax shocks as a share of GDP, i.e., $T_t^g \equiv \frac{\text{Tax Liability Change}_t^g}{GDP_t}$, where Tax Liability Change$_t^g$ is the sum of mechanical changes in tax liability for those in income group $g \in \{\text{Bottom } 90, \text{Top } 10\}$ in year $t$. As a robustness check, I compare my measure, i.e., the sum of tax changes for the bottom 90% and top 10%, to the Romer and Romer (2010) total tax change measure. They are quite similar.[9] Differences between my aggregate measure and their measure are partially due to tax changes that did not affect income or payroll taxes, such as corporate income tax changes, and are defined accordingly: $T_{NONINC} \equiv T_{ROMER} - \sum_g T_t^g$.

Exogenous tax changes occurred in thirty-one years of the postwar period.[10] In exogenous years, the average income and payroll tax change was -0.16% of GDP, or roughly $25 billion in 2011 dollars. It was -0.075% overall in the entire sample. On average, in exogenous years in which the top 10% taxpayers did not see a tax increase, the size of the tax cut for the bottom 90% and the top 10% was roughly the same size. In exogenous years in which the top 10% did see tax increases, the size of the tax increase as a share of output was an order of magnitude

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[8] Note that this method avoids bracket creep issues in the period before the Great Moderation since the hypothetical tax schedule applies to the old tax form data. Since inflation has been low during the Great Moderation, measurement error induced by this approach (due to inflation indexing) is quite small in magnitude. Also, it is not obviously correct to weight old tax data by CPI since median income growth has stagnated. As such, adjusting for the mild inflation of the Great Moderation may exacerbate measurement error rather than reduce it.

[9] Appendix Figure A7 plots both series by year. The Romer tax change measure is at a quarterly frequency, so I sum their measure to construct an annualized version.

[10] Exogenous is defined as a year in which Romer and Romer (2010) show a nonzero tax change where more than half the revenue was from an exogenous change. Stricter definitions of exogenous, i.e., ways to categorize years in which there were both exogenous and endogenous changes occurring in that year, produced very similar results. For non-exogenous years, the tax change measure is set to zero. Appendix Table A1 lists exogenous tax changes used in this paper.

larger for the top 10% than for the bottom 90%. On average, tax changes have been negative for both groups, meaning that tax cuts as a share of output tend to be larger than tax increases as a share of output.

Panel A of Figure 2 shows how income and payroll taxes have changed by AGI quintile since 1960. There are a few notable features. First, tax changes for different income groups often happen simultaneously.[11] Second, the magnitudes of tax changes for the top 10% are larger in share of output terms since their income share is large and has been increasing. Third, tax increases have been rare since the 1980s, especially on the bottom four quintiles. Fourth, the earlier tax increases on the bottom 90% mostly came through payroll tax increases before 1980.

### 1.1.2 State Tax Changes by Income Group

National tax changes have disparate impacts across regions of the United States due to substantial variation in the income distribution across states. Panel B of Figure 2 shows the average share of taxpayers who have incomes in the top 10% nationally from 1980-2007. Based on this measure, a taxpayer in Connecticut is roughly three times more likely to be in the top 10% than a taxpayer in Maine.

Similar to the national changes, I define state tax shocks as a share of state GDP, i.e., $T^g_{s,t} \equiv \frac{\text{Tax Liability Change}^g_{s,t}}{GDP_{s,t}}$, where Tax Liability Change is the sum of mechanical changes in tax liability for all the residents in state $s$ and group $g$ in year $t$. Note that the income groups are defined on a national basis, so top 10% means a taxpayer's adjusted gross income is in the top 10% of national taxpayers (as opposed to a measure relative to others in their state). I am able to aggregate by state since TAXSIM has a variable indicating the state of residence for nearly all tax returns. However, taxpayers with AGI above $200,000 in nominal dollars have the state identifier removed in the IRS data.[12] This data limitation causes the first measure of tax changes to be approximated within TAXSIM for very high incomes at the state level.[13]

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[11] Based on Frisch and Waugh (1933) logic, a tax change that provides atypical changes to a given income group will influence estimates more strongly than proportionate tax changes. Appendix Figure A9 shows this point explicitly – years like 2003 provided disproportionately larger tax cuts to the top 10% given the size of the tax change for the bottom 90%.

[12] In 1975, the first year with state data available, the price level was roughly 25% of the 2010 level, so this cutoff amounts to roughly $800,000 of AGI. Put another way, $200,000 was between the 99.9% and 99.99% income cutoff in the 1975 AGI distribution. In 2010, an AGI of $200,000 is still well above the 95th income percentile (the cutoff is roughly $150,000).

[13] Due to the $200,000 censoring, I have to extrapolate part of the state shares for the top-income group. I determine the total number of income earners whose incomes exceed the $200,000 cutoff every year and allocate

## 1.2 Non-Tax Data

### 1.2.1 Non-Tax Data at the State Level

The main measures of economic activity are employment and income. I use two measures of employment – the employment-to-population ratio and the number of people employed.[14] I also use two measures of state income: state GDP and net earnings. Net earnings (which is state personal income less personal government transfers and dividends, interest, and rents) provides a measure of income that nets out components that are less related to regional tax shocks.

A limitation of the income measures, however, is that they are in nominal terms and converting them into real terms is difficult because state-level price indexes are imperfect. My preferred state price index is $P_{s,t}^{ACCRA}$, which is the average price index from the American Chamber of Commerce Researchers Association on cost of living in a state-year. It has been used in the local labor markets literature, e.g., Moretti (2013), to construct regional price indexes and is available for the full panel of states since 1980. I supplement this price index with $P_{s,t}^{Moretti}$, which follows the approach from Moretti (2013) to create a local price index based on state house prices and national CPI.[15]

To better understand mechanisms, I also analyze several labor market outcomes from the Current Population Survey (CPS) at the state level: labor force participation, hours, wages, and real wages.[16] I focus on labor force participation to analyze extensive margin responses, and on hours among full-time employed residents aged 25 to 60 to isolate intensive margin responses. Wages are wage income divided by hours among full-time workers. Finally, to remove the influence of compositional changes of labor market participants on average wages, I also construct composition-constant wages.[17] Appendix A.2 provides additional detail on

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them according to extrapolated state shares for that year. I assume that each state's share of the total number of U.S. income earners just below the cutoff (from $150,000 to $200,000) is the same as its share of national income earners whose incomes exceed $200,000. Very little extrapolation is required in the early years, in which more than 99% of incomes fall below the censoring cutoff. In 2010, more than 95% of income earners still earned less than $200,000.

[14] I use the Current Population Survey (CPS) to construct employment-to-population ratios, the Bureau of Labor Statistics (BLS) for employment, and Bureau of Economic Analysis (BEA) for GDP at the state level.

[15] Moretti (2013) uses a local price index based on rental payments and national CPI, but rental payments are only available in 1980, 1990, and the 2000s, so I use state house prices from FHFA in place of rental payments. Since house prices are asset prices that are forward-looking, I prefer the $P_{s,t}^{ACCRA}$ measure, but show results using $P_{s,t}^{Moretti}$ as well as $P_{s,t}^{BLS}$, which is a price index based on BLS city price indexes but is only available for roughly twenty cities. See data appendix A.2 for details.

[16] I also provide supplemental evidence on payrolls, which are from the County Business Patterns, as well as employment rates. The employment rate is the share of people in the labor force who are employed.

[17] I follow the approach of Busso et al. (2013) and Suárez Serrato and Zidar (2016) to construct composition-

variable sources and definitions. Real wages and real composition-constant wages are these nominal series divided by a price index, which is $P_{s,t}^{ACCRA}$ unless otherwise specified.

There are two main sets of controls. First, I include controls on oil prices and real interest rates from Nakamura and Steinsson (2014). Second, I use controls for contemporaneous policy and spending changes. I construct microsimulation models to measure social insurance policy changes in an analogous way to my tax shocks.[18] Specifically, I develop a state-specific, formula-driven mechanical change in spending for Aid to Families with Dependent Children (AFDC), Temporary Assistance for Needy Families (TANF), the Supplemental Nutrition Assistance Program (SNAP), Supplemental Security Income (SSI), and Medicaid. I then divide each mechanical spending change by state GDP. To supplement these controls, I also control directly for several other policy parameters that are enumerated in data appendix A.3.

### 1.2.2 Non-Tax Data at the National Level

Aggregate macroeconomic outcome variables come from the BEA. In particular, real GDP, consumption, investment, and government data are the chain-type quantity indexes from the Bureau of Economic Analysis' National Income and Product Accounts Table 1.1.3; the nominal GDP data come from the National Income and Product Accounts Table 1.1.5.

## 2 Econometric Methods

This section describes how I estimate the relationship between changes in taxes for different groups and subsequent economic activity. First, I fit distributed lag models and direct projections to look at the dynamic relationship between (i) tax changes by income group and (ii) subsequent changes in economic activity at the state level. I then consider a more parsimonious specification that estimates the relationship between (i) two-year changes in taxes by income group and (ii) two-year changes in economic activity. Second, I study these relationships at the national level using a specification that is similar to that of Romer and Romer (2010), but has tax changes that are decomposed by income group. The national approach, while inherently noisy and suggestive due to limited data, supplements the state results by quantifying aggregate effects.

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constant wages.

[18] Appendix C provides more detail on these microsimulation models.

## 2.1 State-level Effects of Tax Changes for Different Income Groups

### 2.1.1 Distributed Lag Model of Tax Changes for Different Income Groups

In a given state $s$ and year $t$, changes in the outcome $y_{s,t}$ between year $t-1$ and $t$ are decomposed into a state component $\mu_s$, a time component $\delta_t$, the effects of current and lagged tax shocks $T^g_{s,t}$ for income group $g$, an index of time-varying state-characteristics $\mathbf{X}'_{s,t}\mathbf{\Lambda}$, and a residual component $\varepsilon_{s,t}$:

$$y_{s,t} - y_{s,t-1} = \sum_g \left( \sum_{m=\underline{m}}^{\overline{m}} \beta^{g,m} T^g_{s,t-m} \right) + \mathbf{X}'_{s,t}\mathbf{\Lambda} + \mu_s + \delta_t + \varepsilon_{s,t}, \tag{1}$$

where $g \in \{\text{Bottom } 90, \text{Top } 10\}$ indexes the income groups and the time index $m$ for the lags of tax changes range from $\underline{m} = 0$ and $\overline{m} = 2$ in the baseline specification.[19] $T^{B90}_{s,t}$ is an exogenous tax shock as a share of state GDP for taxpayers who are in the bottom 90% of AGI nationally and $T^{T10}_{s,t}$ is defined analogously. Tax shocks are expressed as a share of state GDP to facilitate comparisons over time.

For OLS to identify the parameters of interest, tax shocks need to be exogenous conditional on fixed effects and controls, i.e., $\mathbb{E}(\varepsilon_{s,t}|T^{B90}_{s,t}, T^{T10}_{s,t}, \mathbf{X}_{s,t}, \mu_s, \delta_t) = 0$. Intuitively, this identifying assumption is that national tax shocks, which Romer and Romer (2010) define as exogenous, are not disproportionately favoring states that are doing poorly relative to how fast they normally grow. The validity of comparing outcomes of states with different income distributions relies on three key assumptions: (1) state tax shocks are exogenous, (2) targeted tax shocks are unrelated to targeted spending shocks, and (3) outcomes from less exposed states provide a reasonable counterfactual in the absence of the tax shock.

Since I control for state and year fixed effects in equation 1, the first assumption maintains that federal policymakers are not systematically setting tax policy to respond to *idiosyncratic state shocks.* Relying on variation from federal tax changes that Romer and Romer (2010) classify as exogenous makes it less likely policymakers are responding to idiosyncratic state shocks since the Romer and Romer (2010) changes are due to concerns about long-run aggregate growth and inherited budget deficits.[20]

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[19] Similar results with different lead and lag structures are also presented in the appendix.

[20] To support the exogeneity assumption by income group, I show that these federal tax shocks for each income group pass the Favero and Giavazzi (2012) orthogonality test, which amounts to showing that the raw series of tax shocks by group are similar to these series after partialling out macro aggregates.

Even if state tax shocks are exogenous, they may occur at the same time as other progressive policy changes. If progressive tax and spending policy systematically occur at the same time and both increase growth, then $\beta^{B90}$ would reflect both the true effect of tax changes for the bottom 90% and the effects of spending policies, resulting in upwardly-biased estimates. To address this concern, I directly control for government transfer payments as well as specific policy parameters. I first control for a comprehensive measure of total government spending on transfer programs, but this amount of spending responds to economic conditions. To isolate changes in policy parameters from changes in economic conditions, my preferred approach is to control for mechanical policy-induced changes in social insurance program spending. I include the mechanical policy-induced spending changes of several key transfer programs in the vector of controls $\mathbf{X}_{s,t}$ in the baseline specification, and then present estimates that control for additional policy parameters in robustness specifications.

I provide several pieces of evidence to support the third assumption that outcomes from less exposed states provide a reasonable counterfactual in the absence of the tax shock. I consider the possibility that states that disproportionately benefit from a given tax change may be generally more cyclical. I do so by replacing year fixed effects $\delta_t$ in equation 1 with $\delta_{q(s),t}$ where $\delta_{q(s),t}$ is each state's cyclicality-quintile-specific year fixed effect. The function $q(s) : \{AL, AK, ..., WY\} \rightarrow \{1, ..., 5\}$ gives the quintile of the state's sensitivity to national changes in economic conditions. I present a few ways to measure how cyclically-sensitive each state is, but the baseline approach follows the $\beta$-differencing approach of Blanchard and Katz (1992), which regresses changes in state economic activity on national changes in economic activity to estimate the state's average responsiveness to national shocks.[21] The resulting group-by-year fixed effect $\delta_{q(s),t}$ measures common year shocks in the 10 states with similar levels of cyclicality. Additionally, I consider regional trends as well as other controls used in the regional multiplier literature (e.g., state-specific trends and state-specific interest rate and oil price sensitivity). I provide further support for the third assumption by examining the path of economic activity preceding tax shocks for bottom- and top-income groups.

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[21] See appendix B.1 for details. I also show results using deciles instead of quintiles and using quintiles of each state's standard deviation in real GDP per capita $\sigma_{s,1963-1979}$ in the years preceding the sample period 1980-2007.

### 2.1.2 Direct Projections of Tax Changes for Different Income Groups

To examine how the path of economic activity evolves before and after tax shocks for bottom- and top-income groups, I run a series of direct projection regressions for different horizons $h \in \{-4, -3, ..., 5\}$:

$$y_{s,t+h} - y_{s,t-1} = \alpha_h^{B90}(T_{s,t}^{B90}) + \alpha_h^{T10}(T_{s,t}^{T10}) + \mathbf{X}'_{s,t}\mathbf{\Lambda}_h + \mu_{s,h} + \delta_{t,h} + \varepsilon_{s,t,h}, \tag{2}$$

where $s$ and $t$ index state and year, $y_{s,t+h} - y_{s,t-1}$ is a measure of growth in economic activity at horizon $h$, and $\mu_{s,h}$ and $\delta_{t,h}$ are horizon-specific state and year fixed effects.[22] The path of economic activity around the tax shocks for bottom and top-income groups is described by the sequences of coefficients $\{\alpha_h^{B90}\}_{h=-4}^{h=5}$ and $\{\alpha_h^{T10}\}_{h=-4}^{h=5}$, which quantify the impacts of these shocks on economic activity over different horizons. As noted by Jorda (2005); Stock and Watson (2007); Auerbach and Gorodnichenko (2013), using direct projections of tax shocks on outcomes is attractive because it does not impose dynamic restrictions on the estimates at different horizons. I use these specifications to estimate average outcomes before tax shocks to determine if tax shocks for different groups occur soon after unusually good or bad economic times. The direct projection approach also shows how the effects of tax changes vary over time and can potentially reveal anticipatory effects, which may vary by income group.

### 2.1.3 Two-Year Effects of Tax Changes for Different Income Groups

While the direct projection specifications are useful for examining how economic activity evolves around a tax change, I fit more parsimonious models that use two-year changes to show the cumulative effects of tax changes on employment and income for different income groups.[23] The two-year specification follows a similar specification to Nakamura and Steinsson (2014), but for tax shocks (by income group) rather than for government spending shocks:

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[22] In the baseline specification, I use cyclicality-quintile year fixed effects described in the prior section, i.e., $\delta_{q(s),t}$ formed using the $\beta$-differencing approach of Blanchard and Katz (1992), which are indexed by the horizon, i.e., $\delta_{q(s),t,h}$. I also include the mechanical policy-induced spending changes of several key transfer programs in the vector of controls $\mathbf{X}_{s,t}$ in the baseline specification as well. Specifically, the 5 distinct policy controls are the mechanical changes in AFDC, TANF, SNAP, SSI, and Medicaid spending as a percentage of state GDP.

[23] Note that each of the elements of the tax shock are normalized by the initial level of state GDP (i.e., $Y_{s,t-2}$). There is nothing special about two-year changes per se other than that this duration is somewhat standard in this literature (e.g., Nakamura and Steinsson (2014)).

$$\frac{Y_{s,t}-Y_{s,t-2}}{Y_{s,t-2}} = b^{B90}\left(\sum_{m=0}^{2} T^{B90}_{s,t-m}\right) + b^{T10}\left(\sum_{m=0}^{2} T^{T10}_{s,t-m}\right) + \mathbf{X}'_{s,t}\mathbf{\Lambda} + a_s + d_t + e_{s,t}. \tag{3}$$

In this case, the year fixed effects $d_t$ absorb common aggregate macroeconomic shocks and the state-fixed effects effectively control for different state trends in the outcome. An advantage of this specification is that the average effects of tax changes are captured by one parameter for each income group (rather than a parameter for each lag of each income group). I use $d_{q(s),t}$ instead of $d_t$ in the baseline specification (where $d_{q(s),t}$ is each state's cyclicality-quintile-specific year fixed effect) and also control for mechanical policy-induced spending changes.

### 2.2 National Effects of Tax Changes for Different Income Groups

I also fit specifications similar to equation 1 at the national level:

$$y_t - y_{t-1} = \sum_{m=\underline{m}}^{\overline{m}} \left(\gamma^{B90,m}T^{B90}_{t-m} + \gamma^{T10,m}T^{T10}_{t-m} + \mathbf{X}'_{t-m}\mathbf{\Gamma}_m\right) + \nu_t, \tag{4}$$

where $\gamma^{B90,m}$ and $\gamma^{T10,m}$ are the effects of changes in taxes as a share of GDP at lag $m$ and the time index $m$ for the lags of tax changes range from $\underline{m} = 0$ and $\overline{m} = 2$ in the baseline specification. $T_t^{B90}$ is an exogenous tax shock as a share of national GDP for taxpayers who are in the bottom 90% of AGI nationally and $T_t^{T10}$ is defined analogously. $\mathbf{X_t} = [T_{NONINC,t}]$ includes non-income and non-payroll tax changes that Romer and Romer (2010) classify as exogenous (e.g., corporate tax changes). One way to interpret equation 4 is that it decomposes the Romer and Romer (2010) exogenous tax change measure into three mutually exclusive and collectively exhaustive components: $T_t^{B90}$, $T_t^{T10}$ , and the non-income and non-payroll portion, i.e., $T_{NONINC,t}$.

## 3 Effect of Tax Changes for Different Income Groups

This section provides results on the effects of tax changes for different income groups on economic activity. Section 3.1 provides evidence on the effects of tax changes for different groups on employment and income growth. Section 3.2 provides results for mechanisms and highlights supplemental national results. Section 3.3 discusses the estimates and relates them to existing evidence. Finally, section 3.4 briefly describes additional support for the validity of the estimates and robustness tests.

### 3.1 Impacts on State Economic Activity

Figure 3 shows the evolution of the state employment-to-population ratio and state employment relative to the year before a tax change for different income groups. Panel A shows that the employment-to-population ratio exhibits little trend prior to tax changes and then gradually falls in the years following a tax change for the bottom 90%. Specifically, the estimates for the impact of tax changes in year $h$ for the bottom 90%, $\hat{\alpha}_h^{B90}$ from equation 2, and those for the top 10%, $\hat{\alpha}_h^{T10}$, are shown in blue and red respectively. The employment-to-population ratio is roughly 4 percentage points lower three years after a 1% of state GDP tax change for the bottom 90% relative to the employment-to-population ratio the year before the tax change (i.e., $\hat{\alpha}_3^{B90} \approx 4$). After four years, on average, the ratio improves slightly to be roughly 3 percentage points below the level prior to the tax change. Panel B shows similar patterns for state employment. State employment tends to be 2% lower in the year after the tax change for the bottom 90%, falls to 4% two years after the change, and then recovers somewhat to be roughly 2% lower four years after the tax change. Tax changes for the top 10%, in contrast, have no detectable impact on the state employment-to-population ratio and state employment in the eight-year window around tax changes.

Figure 4 shows the evolution of the state income and prices. Panel A shows that nominal state GDP sharply declines following tax changes for the bottom 90% and is roughly 8 percent lower than the year before the tax change. These declines are very large.[24] However, panel B shows prices also fall by roughly 6 percent. This price decline estimate is noisy, but indicates that the GDP declines are smaller in real terms. Panels C and D show results for real GDP using the ACCRA price index $P_{s,t}^{ACCRA}$ and a home-price-based index $P_{s,t}^{HPI}$. The real series show smaller impacts, especially three and four years after the tax changes for the bottom 90%. In terms of estimates from tax changes for the top 10%, estimates for both measures of income in nominal and real terms provide no evidence that tax changes for high-income earners materially impact economic activity over a business cycle frequency.[25]

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[24] I discuss the magnitudes and relate them to existing literature in section 3.3.

[25] While it is possible that the effects show up further into the future, detecting such effects is inherently difficult. See Romer and Romer (2014) for some historical evidence on longer-term effects.

Table 1 presents the main regression estimates of state employment and income. Panel A shows estimates of the distributed lag specification using equation 1 as well as the sum of effects $\sum_{m=0}^{2} \beta^{g,m}$ of tax changes for each group $g \in \{\text{Bottom 90}, \text{Top 10}\}$. Panel B shows estimates from the more parsimonious two-year change specification using 3. For each panel, the baseline specification is a rich set of controls: mechanical policy changes in spending as a share of state GDP on social insurance programs (AFDC, TANF, SNAP, SSI, and Medicaid) as well as state and cyclicality-quintile by year fixed effects. Employment declines roughly 3.5% in both specifications following a tax change of 1% of state GDP for the bottom 90%, and top tax changes have no impact in either specification. Panel B also reports the p-value for the test that $b^{B90} = b^{B90}$, i.e., that the impacts on two-year employment growth from tax changes for both groups are equal. This test is rejected with 94% confidence in column 1. The employment-to-population ratio also shows similar patterns but is less precise over a two-year window relative to three and four years after the tax change as shown in Figure 3. The next three columns show estimates for nominal and real state GDP. The impacts are very large for the bottom 90% and not for the top 10%. Although the point estimates for state GDP are less stable and range from 5.3% to 9.2%, the qualitative pattern of nearly all responsiveness from lower-income groups and small impacts from top groups is very robust.[26] Each specification rejects the null hypothesis of equal impacts from tax changes for the bottom 90% and top 10% with more than 99% confidence.

### 3.2 Mechanisms

The results in section 3.1 show large employment and income declines after tax changes affecting lower-income taxpayers. These employment and income results are reduced-form estimates that reflect changes in both the supply and demand for labor following a tax change. This section discusses impacts on labor market outcomes and on consumption, the relative importance of supply and demand changes at the state level, and effects on aggregate investment.

Figure 5 shows the impacts of tax changes for different groups on extensive and intensive labor market responses, real wages, and consumption. On the extensive margin, Panel A shows that labor force participation rates decline roughly 3 percentage points three and four years

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[26] Appendix Tables A8 and A9 show robustness tests for nominal state GDP. Appendix Tables A10 and A11 show robustness tests for real state GDP.

after a tax change for the bottom 90%. On the intensive margin, hours of workers who work at least 48 weeks decline by roughly 2 percent soon after the tax change but return to the levels before the tax change.[27] Panel C shows that real wages increase following tax changes for the bottom 90%.[28] These real wage results, though imprecise, reveal the relative importance of supply and demand changes in the labor market. The increase in real wages suggests that supply-side responses are important and may exceed demand-side responses to tax changes for the bottom 90%.

In terms of aggregate mechanisms, Table 4 shows national results for real GDP and its components. Real GDP decreases 3.8% following tax changes for the bottom 90% and decreases 1.1% following tax changes for the top 10%. These point estimates are noisy – the standard error for the top 10% estimate is 4.6% at the national level – but could be consistent with impacts of tax changes from the top 10% that spillover to other states. That said, the impacts on the top 10% are statistically indistinguishable from zero and 2.7 percentage points lower than the aggregate estimate for the bottom 90%. The components of GDP are also noisy.[29] Other than the impacts on investment, which are much more responsive to tax changes for the bottom 90% and are weakly significant statistically, there is not enough variation in the time series to pin down heterogeneous effects on macro aggregates.[30] The investment responses and the overall real GDP point estimates, however, suggest that the effects of additional economic growth from tax changes for the bottom 90% tend to exceed the effects from income changes among those who are more likely to save.

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[27] Results are similar for hours of workers who work on average at least 35 hours per week and at least 48 weeks per year.

[28] Nominal wages tend to be roughly flat but then increase following tax changes for the bottom 90%. Panel C uses the ACCRA price index $P_{s,t}^{ACCRA}$ as a deflator and adjusts wages holding constant the composition of workers, which indicates that the real wage increases are reflecting actual increases rather than compositional shifts in labor supply. Results using other deflators and raw average wages are similar and presented in appendix Figure A14.

[29] Given the limited number of tax changes events in the postwar period, the possibility of coincidental trends in income inequality, for example, suggests caution when interpreting the national results and provides another reason why evidence from the state-level analysis, especially when the analysis accounts for regional trends, may be more informative.

[30] The consumption results are somewhat mixed. Although durable good consumption is much more responsive to bottom 90% tax changes, the non-durable consumption estimates work in the opposite direction, leading to similar overall consumption impacts. The similarity in consumption impacts is inconsistent with the literature on MPCs and the state-level results in Figure 4 which show much larger responses from the bottom 90% on consumption.

### 3.3 Discussion of Results

Quantitatively, the main reduced-form results in this paper are large, but within a range that is consistent with existing cross-sectional evidence. In particular, the 3.4% estimate for the increase in state employment from a 1% of GDP tax cut for the bottom 90% translates to roughly $31,500 per job.[31] These cost-per-job estimates are consistent with those reported in Ramey (2011): $25,000 in Wilson (2012), roughly $28, 600 in Chodorow-Reich et al. (2012), $30,000 in Suárez Serrato and Wingender (2011), and $35,000 in Shoag (2010).[32] My estimates for the impact of tax cuts for the top 10% on employment are statistically and economically indistinguishable from zero, so the corresponding cost-per-job estimate is much higher. Therefore, given my estimates by income group, the overall impact of a tax cut of 1% of GDP that goes half to the bottom 90% and half to the top 10% will have roughly a $63,000 cost-per-job.

The estimates for impacts on real income, however, are larger than most papers in this literature.[33] First, the variation that I am exploiting could potentially yield stronger effects than prior studies. Second, the confidence intervals are large, so one cannot rule out smaller effects. Third, in terms of point estimates, the average output multiplier in a recent survey by Chodorow-Reich (2017) is 2.1, though some studies estimate sizable cumulative output multipliers (e.g., Leduc and Wilson (2015) estimate a cumulative multiplier of 6.6). The estimated impact on real income from the bottom 90% depends on the specification, but is roughly 7.[34] The impact from the top 10% is roughly zero, so the overall multiplier on real income, computed as the average of the group-specific multipliers, is roughly 3.5. It is important to emphasize that these estimates are regional multipliers, which can differ from national multipliers to the extent that time fixed effects absorb general equilibrium forces (e.g., countercyclical monetary policy).[35] Since state

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[31] Using 2011 numbers, the cost of a 1% of GDP tax cut is roughly $150 billion and a 3.4% increase in employment on a base of 140 million is 4.76 million. Therefore, the cost-per-job is $\frac{\$150,000M}{4.76M} = \$31,513$.

[32] Note that Wilson (2012) and Chodorow-Reich et al. (2012) focus on effects during a recession, which likely results in lower cost-per-job estimates. There are also estimates of smaller multipliers (e.g., Clemens and Miran (2012)). See Chodorow-Reich (2017) for a recent survey.

[33] Nakamura and Steinsson (2014), for example, find output multipliers from government spending of 1.32 to 4.79 in their Table 3 and roughly similar estimates for output multipliers in real terms.

[34] See, for example, Figure 4 panels C and D or the real income estimates in Table 1 or appendix Tables A6 and A7. Other measures of income, e.g., total personal income from CPS, increase by roughly 5% as shown in appendix Figure A21, but these estimates are noisy.

[35] Although regional multipliers are generally believed to be larger than national multipliers, the relative size of regional and national multipliers is an active area of research (Chodorow-Reich, 2017). It is also worth noting that common national shocks like countercyclical monetary policy are not likely to be fully absorbed by time fixed effects given regional heterogeneity and the possibility of heterogeneous impacts of monetary policy changes.

GDP, particularly in real terms, is measured with error,[36] my preferred interpretation of these results is that the point estimates for real income are more variable and thus less reliable than the employment estimates, but impacts on both outcomes provide robust evidence that economic activity is substantially more responsive to tax changes for the bottom 90% than to those for the top 10%. Okun's law suggests that employment and GDP are closely related, so putting emphasis on the better measured of the two seems advantageous.

In terms of mechanisms and the relative importance of consumption and labor supply responses, rationalizing the large responses in economic activity through consumption responses alone is not persuasive. First, the traditional multiplier of $\frac{MPC}{1-MPC}$ would require marginal propensities to consume that are larger than most MPCs estimated in the literature, e.g., Johnson et al. (2006) and Parker et al. (2013). Second, in terms of heterogeneous MPCs by income group, the initial impact on consumption could be sizable,[37] but the subsequent rounds do not feed back exclusively to lower-income groups, so the MPCs in subsequent rounds are not the MPCs of lower-income consumers, but economy-wide average MPCs. Third, to the extent some of the initial spending is on durable goods, which are often traded, the impacts from increased consumption may not be especially concentrated in the states where tax change recipients live (other than through spillovers to the consumption of complementary non-tradables). Substantial labor supply responses, therefore, are likely an important mechanism, which is consistent with the evidence presented on labor force participation, hours, and real wages.

One may find these results surprising from the perspective of the theoretical literature. Although the employment estimates are comparable to those in the empirical literature on regional multipliers, it may be somewhat surprising from the perspective of the theoretical literature that tax cuts for lower-income earners are more effective than government spending.[38] Farhi and Werning (2016), however, show that externally-financed regional multipliers with

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[36] BEA relies on measures from a range of sources when computing state GDP, many of which are from the economic census. The economic census is compiled every five years and in non-benchmark years, state GDP estimates involve "interpolation and extrapolation techniques using indicator series that mirror the movement in the GDP by state component being estimated." See `https://www.bea.gov/regional/pdf/gsp/GDPState.pdf`.

[37] Aaronson et al. (2012) show that household spending increases by roughly $700 per quarter following a $250 per quarter income increase due to minimum wage increases. This $\frac{700}{250} \approx 3X$ impact on spending among low-income earners comes from a small number of households that make large durable purchases following the income shock. Similar spending behavior following tax shocks for lower-income earners could generate sizable impacts on economic activity.

[38] MPC estimates are typically smaller than 1 and the traditional government spending multiplier is $\frac{1}{1-MPC}$, so the traditional tax multiplier is smaller than the traditional government spending multiplier, i.e., $MPC < 1$ implies that $\frac{MPC}{1-MPC} < \frac{1}{1-MPC}$.

redistribution and non-Ricardian agents can be larger than traditional multipliers. Additionally, other channels, such as extensive margin labor supply responses with heterogeneous agents, are often not incorporated and can impact conclusions about multipliers.

The results may also be surprising in terms of Ricardian equivalence. Ricardian agents will increase expenditures based on the annuity value of the tax change, which may be zero if they expect to finance the tax change in the future.[39] However, there are a few reasons why Ricardian equivalence may fail, especially when considering tax changes for lower-income groups in a spatial setting. First, agents may consider tax changes a transfer if the tax change is (i) financed contemporaneously by other agents (from other locations or from other income groups) or (ii) if they expect others to pay for it in the future. Second, agents may be liquidity constrained. Third, agents may be myopic. These considerations may also help explain why there are different impacts for different income groups.

## 3.4 Threats to Validity and Robustness

There are three key threats to the validity of the estimates: endogenous tax changes, prior economic conditions and differential trends, and concomitant progressive government spending changes. First, I assess the concern that the composition of tax shocks may be endogenous by appealing to an orthogonality test used by Favero and Giavazzi (2012). This test compares the federal tax change series before and after partialling out macro aggregates. Appendix Figure A8 shows that the raw tax shock series and the orthogonalized tax shock series are very similar for each income group, supporting the compositional exogeneity assumption.[40]

Tables 2 and 3 present distributed lag estimates for a wide range of robustness tests to address the second and third concerns, respectively. Table 2 shows impacts of tax changes on state employment growth.[41] The first five columns present different ways to account for state-specific cyclicality; (1) presents the baseline specification with cyclicality-quintile by year fixed effects, (2) presents year effects, (3) presents cyclicality-quintile by year fixed effects where the

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[39] This discussion of Ricardian equivalence draws from the discussion of Ricardian equivalence and regional multipliers in Chodorow-Reich (2017).

[40] More generally, tax changes could be endogenous by income group, year, and state. I address concerns with respect to the timing and location of tax changes by using only tax changes Romer and Romer (2010) classify as exogenous and by exploiting regional variation in the income distribution.

[41] Appendix Tables A8 and A9 show results for nominal state GDP. Appendix Tables A10 and A11 show results for real state GDP.

quintiles are defined based on the standard deviation in state GDP per capita, (4) cyclicality-decile by year fixed effects, and (5) cyclicality-quintile by year fixed effects that group states only using the years before the sample (i.e., before 1980). The next five columns show controls for state-specific sensitivity to other shocks and trends; (6) controls for oil price interacted with state dummies, (7) controls for real interest rate interacted with state dummies, (8) and (9) add region fixed effects to (6) and (7), and (10) includes state-specific trends. The specific point estimates for the impact on employment growth from tax changes for the bottom 90% depend on the specification, are almost always significant statistically, and tend to be within a one percentage point range of the baseline estimates. Similar patterns emerge in Table 3, which shows results for a wide range of policy parameters and controls for government spending. Panel B of both tables show the same controls using the two-year change specification for additional measures of economic activity and show similar patterns. For example, Table 3 shows that two-year employment growth following a tax change for the bottom 90% ranges between 3.2 percent to 3.6 percent across 11 different policy controls. Overall, the general patterns are quite robust. Almost all the impact on economic activity from tax changes comes from tax changes from the bottom 90%.

## 4 Conclusion

This paper quantifies the importance of the distribution of tax changes for their overall impact on economic activity. I construct a new data series of tax changes by income group from tax return data. I use this series and variation from the income distribution across states and federal tax shocks to estimate the effects of tax changes for different groups. I find that the stimulative effects of income tax cuts are largely driven by tax cuts for the bottom 90% and that the empirical link between employment growth and tax changes for the top 10% is weak to negligible over a business cycle frequency. These effects are not confounded by changes in progressive spending, state trends, or prior economic conditions. The effects seem to come from labor supply responses as well as increased consumption and investment.

These results are important for characterizing central equity-efficiency tradeoffs in tax policy. If policy makers aim to increase economic activity in the short to medium run, this paper strongly suggests that tax cuts for top-income earners will be less effective than tax cuts for lower-income earners. While it is possible that tax cuts for top-income earners have sizable long-run impacts through different channels such as human capital investment, firm creation, or innovation,[42] much more compelling evidence on these channels is needed to support top-income tax cuts on efficiency grounds, especially given the magnitude of resources devoted to these tax policy changes. Overall, the results not only suggest some skepticism for "trickle down" economics, but they also provide evidence that supply-side tax policies should do more to consider the relative efficacy of tax cuts targeted lower in the income distribution. Finally, as a note of caution, the estimates in this paper come from modest changes in tax rates that have been executed in the post-war period; using these estimates to evaluate the likely impacts of large tax changes on high-income earners requires extrapolation beyond the observed variation in the data.

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[42] Extending the analysis to study medium- and longer-term effects of tax changes, such as new firm creation or patent activity, is a good topic for future research.

Mr. LEVIN. Okay. Now I want to talk about manufacturing. The chairman used a few examples. And no one cares more, I think, about resurgence of manufacturing than I do; but the examples that you used of steel, that happened because China rigged its currency, because of their State-owned enterprises. It was not related in any real way to our tax system or theirs.

The same is true of your reference to the automotive industry and the movement of auto parts and vehicle assembly to Mexico. It wasn't because of our tax systems; it was because of the huge differential in the cost of labor. And in both case, the Republican majority, both as to steel and as to auto parts, refused to address trade-related issues that impacted on the loss of manufacturing jobs.

Now, let me just try to get to one of the nubs. I want to ask Professor Clausing this: In Mr. Lindsey's testimony, he reiterates an argument made by proponents of a BAT, namely, that U.S. companies are now disadvantaged when other countries operate under VATs with rebates for their exports.

Two conservative analysts from Cato and George Mason have suggested this claim is false, saying the real issue is whether the playing field is level in a given market. They point out that if a U.S. company and a German company sell a product in Germany, both firms pay a VAT and corporate tax. If they sell in the U.S., both pay just a corporate tax. In other words, companies selling in the same market are treated the same.

What is your view of this issue?

Ms. CLAUSING. I absolutely agree with that characterization. And the designers of this tax, who are economists, also agree with that characterization. The VAT doesn't create on unlevel playing field across countries. And so the Made in America tax concept is little bit misleading. Put simply, imagine an American firm selling a good in France. If the American firm sells it in France, they pay the French value added tax, but so the does the French firm. They pay the U.S. corporate tax, and the French firm pays the French corporate tax. So they are treated the same. If the two firms instead sell in America, neither of them pay a value added tax, but they both pay their corporate taxes at home. So we already have a level playing field with respect to those taxes. And that is why the Cato person that you cite agrees with that, but also Alan Auerbach and Mike Devereux, and others who designed this tax, would similarly agree with that.

Mr. LEVIN. Okay. This is one of the gists of the argument. And I think as we talk about substance, both on manufacturing but also on the BAT, we need to really look at the realities. There may be a difference in the corporate tax structure in Europe and the United States, and, therefore, there may be some differential. It may not be entirely level. But in terms of each paying the same kind of taxes, it is the same. I yield back.

Chairman BRADY. Thank you.

Mr. Reichert, you are recognized.

Mr. REICHERT. Thank you, Mr. Chairman. Welcome, and thank you for your testimony today.

Like our witnesses last week, you have all made it very clear that we are behind in global competition, that the Tax Code is holding our businesses, farmers, and workers back. And we all know that given half a chance, our American workers will always exceed and win, from the apple grower in Eastern Washington, to the manufacturer on the west side of the mountains south of Seattle.

We all agree that we need tax reform. The devil is in the details. And your testimony today has been very educational and helpful to me, I know for sure. But this is our chance to build a competitive Tax Code that leads to increased growth, higher paychecks, and greater opportunity, and I know Mr. Neal said ease the financial burden of the middle class. But we are more interested in not just easing the financial burden, but providing job opportunities and economic growth. I mean, we want to think big and move forward, look to the future.

So I want, Mr. Luciano, please, if you could discuss further how the international tax system impacts your company's domestic/international operations, and with the modernized code, would you invest more in the United States?

Mr. LUCIANO. Thank you for the question, Congressman.

So a healthy agricultural industry is important for us to be able to feed the world. We will have to feed 9 billion people in 2050, and that is a challenge in itself. But it is also important because of the connection with the middle class and middle America. We are a company that have 32,000 people, but we have only in our headquarter—global headquarter in Chicago, we are less than 70 people. The rest of the people are in small communities, whether it is Decatur, Illinois; Cedar Rapids, Iowa; Alpharetta, Georgia, those are where the people are. And we see those communities. And in those communities inside the country, in small, rural America, there are very little competitive advantages left. And that is why it is so difficult to get jobs, and to get industries. One of the competitive advantages is agriculture.

But the way we are operating today, when we compete in a global market, if I need to sell to Egypt, and I have the choice to bring the product from Kansas City, wheat, Kansas City, or from Ukraine, Ukraine has the opportunity to get the refund of the BAT. So the Ukraine does not have—they get the credit for that 20 percent, where the U.S. does not.

So, to me, if you think about one thing to have a competitive playing field for the farmers in the U.S.—and you heard my oral testimony, we have lost market share. We used to be the breadbasket of the world. We have lost it in wheat to Russia. We have lost it in soybeans to Brazil. We are hanging to corn, but not for long. So what happened in this period is that acreage in the United States has been reduced 12 percent over the last 20 years. While in Russia, production of corn has improved 61 percent. The planted area of soybeans has increased by three times.

So all these countries where they have the same competitive advantage that we have, whether it is, you know, a very good weather, good soil, and land available, have countered with policies that actually have been helping those farmers to take market share from the U.S. So we are not leading any more into that, and we are slowly declining. As you decline, those communities that are boosted by agriculture, continue to decline as well. Because when we go there, we just don't have an elevator or storage. We buy from the farmers, and the farmers—and we also have an ecosystem of other companies that basically supply security to us. They supply, you know, safety equipment, that they supply——

Mr. REICHERT. Would you invest more money into the United States?

Mr. LUCIANO. I am sorry?

Mr. REICHERT. Would your company invest more money back into the United States?

Mr. LUCIANO. Of course. If the farmer would be growing in the United States. At this point in time, again, we have lost 50 million acres. So we are going to invest if there is going to be more production. So I think that with the plan like the blueprint we are considering today, we can see us leveling the playing field for the U.S. farmer to be competitive in the world. And that could become, as you guys said before, a magnet for investment in the U.S. and jobs. And I think that this blueprint achieves that.

Mr. REICHERT. Thank you.

Chairman BRADY. Thank you. Time has expired. Mr. Lewis, you are recognized.

Mr. LEWIS. Thank you, very much, Mr. Chairman. Let me thank all of the witnesses for being here today.

Dr. Clausing, you are the Democratic witness, right?

Ms. CLAUSING. That is correct.

Mr. LEWIS. And you are the only woman on this panel?

Ms. CLAUSING. That is also correct.

Mr. LEWIS. You see a lot of men here dressed in blue suits.

[VOICE]. Not everybody.

Mr. LEWIS. Well, one in gray.

Don't you think it is sort of strange when we are talking about tax reform, and when women make up more than 50 percent of the population of America, and you see all of these men here?

Ms. CLAUSING. Well, there is a lot of strange things about tax reform.

Chairman BRADY. Thank you.

Mr. LEWIS. Don't you think we should move into the 21st century as a Nation and as a people?

Ms. CLAUSING. Absolutely.

Mr. LEWIS. Comprehensive tax reform should help the middle class and working families. Do you think this proposal will help the middle class and working families.

Ms. CLAUSING. I have several doubts about that. And mostly, if you rely on the nonpartisan Tax Policy Center estimates, my biggest concern is that the top one percent get a tax cut that is about $200,000, and the bottom four-fifths of the population get a tax cut that is about $200. Now, this $200 tax cut is nice, but it is not going to go very far if your imported goods are more expensive, or if you have lost your job because you are in the retail industry and the exchange rate didn't adjust as quickly as we thought. Waiting around for an exchange rate to adjust can take some time, and as Keynes once said, "In the long run, we are all dead." So I worry a lot about the middle class given the way that this tax cut is structured.

Mr. LEWIS. You stated in your testimony that business tax reform should be revenue neutral. Can you explain why this is so important?

Ms. CLAUSING. Yes. The deficit is an important issue for several reasons. We have a lot of obligations to our senior citizens, many of whom are retiring now and will be older in the coming years. And this means that even on a normal trajectory, our deficits are going to be increasing due to our Social Security and Medicare obligations.

So tax cuts, at this point, will make those deficits even larger, and those deficits can crowd out investment or increase the size of our trade deficit, both things that this committee might worry about.

So I think it is important to raise adequate revenue, because we are going to need that revenue for priorities that also affect our competitiveness, like infrastructure, education, healthcare, and the like.

Mr. LEWIS. Thank you.

Mr. Chairman, I would like to yield the balance of my time to Mr. Doggett.

Mr. DOGGETT. Thank you very much.

So many of our colleagues believe that there is a giant tax cut rainbow, and at the end of that rainbow is a huge pot of tax cut gold, that if we can just find the right good tax cut fairy, everything will be blissful in our country. And because they believe that, there is no obstruction of justice, there is no breach of our national security, there is no tweet that is too outrageous to be ignored, because Donald Trump is viewed as the key way to find that good tax cut fairy.

We find ourselves here today with more of the mythology and fantasy that has characterized this debate from the outset.

Now, I agree 100 percent with the chairman that we should be supporting a pro-growth tax policy to grow jobs in this country.

The problem is the so-called better way, as self-styled, does not do that, and it does not even come close. It is a better way to get more national debt. It is a better way to widen the income gap and disparities that are already out there. And without the border adjustment tax, which is already on life support, the remainder of the territorial system here will only grow jobs overseas as it advantages multinationals over small territories.

And how amazing to hear that the policy we need to follow from the Tax Foundation is to achieve the type of system Estonia and Latvia have. Who knew that that was the approach to success here? Well, Estonia and Latvia, in the time that they have had that, over in the last 3 years, have never grown more than three percent. And we are told that under this magical tax fairy approach, we will achieve over 5 percent growth. It is mythology in action.

Chairman BRADY. All time has expired. Mr. Roskam, you are recognized.

Mr. ROSKAM. Thank you, Mr. Chairman.

Three observations, and a question for you, Mr. Simon.

Observation number one: Mr. Neal observed that there is no small business here, and yet on Thursday, it is no myth, there was a small business here; Mr. Mottl, from the Chicago area, who testified two or three times in a competitiveness hearing how in favor he was of border adjustment. It was very powerful testimony. You can look at the record. Point number two: It is interesting, we are an hour and 20 minutes into this hearing and no witness, no member of this body, has mentioned the myth of $1700 negative impact on average, middle Americans that has been running on television ads, criticizing the border adjustment tax. Really interesting. And I commend the critics of border adjustment today not using what factcheck.org called baloney.

Third point: Professor Clausing was pretty dismissive—I mean, listen, we are all in the advocacy business—but was pretty dismissive of this WTO question. And I just think we have got to be sort of measured and sobered, because she made a claim that this will inevitably lose before the WTO, and then quickly, in the testimony, was, like, tripping us down into the valley of retaliation. And I thought it is important to recognize that the Director General, Alberto Acevedo, of the WTO, has noted that there is lots of gray areas in the WTO rules. And he has declined to speculate. And we are working through these details. And we are mindful of the criticism. But, surely, we don't need to be just coming to the conclusion that this is not compliant.

Mr. Simon, I think you are the most interesting person here today. You are the most interesting person here today because you have got the value of actual perspective. And you have made some very strong claims. You said this in the best interest of our country, if properly implemented. That is an incredibly strong claim.

You said: If we do the work, it is worth it. The change in American sourcing becomes increasingly viable. I mean, there is an aspiration there.

Look, one point—and then I am really interested in your viewpoint as somebody who has run, arguably, one of the biggest retail operations on the globe, why doesn't this create fear and loathing in you in the way that it does Mr. Cornell and others? Why do you say, no, no, no, this is a good thing. I know this system. This is a good thing.

Here is one point: We haven't discussed the nature of the companies that are leaving today. So in Chicago, for example, when Aon left, where did they go? They went to the U.K. They are going to our best friends. When Burger King left, they went to Canada. They are not going to some tax haven.

Walgreens tried to make a jail break not long ago. They weren't successful based on the politics.

But it seems to me, like our Tax Code is an island that is dissolving underneath us. Dissolving underneath us. And we have got an opportunity for a transformational moment. What is the transformational moment, Mr. Simon, that we should seize? Why is your insight so helpful? And what assurance do you have for people who have no interest in having an adverse impact on middle class families? Why is this a boon?

Mr. SIMON. My view is not too dramatically different from what Mr. Cornell just described, or the retail industry. The concerns that they have are real. And if we can address those with an implementation mechanism or a safety net of sorts or a——

Mr. ROSKAM. A transition.

Mr. SIMON [continuing]. A transitional plan for them, on the other side of this, it will be very, very good for the country. That is the point I came here to say today. I don't want to ignore, nor bulldoze their concerns. Because improperly implemented, it will be very, very hurtful for the industry and the consumer.

But if we take the time and do the work, and sit down in a group and iron out, lay out, what it will look like, I think it will be very, very successful for U.S. manufacturing. Once the middle class jobs start to return to the country, and the wage increases that would come with that, retail will start to see a new sort of resurgence and a period of growth.

Right now, the wind is coming out of retail sales because the wind is coming out of the middle class. And the points about the bifurcation of income have been well-documented. There just aren't enough people on the high-end to keep all the retail locations that we have going, and that is why they are struggling.

But if we can rebuild a middle class through a manufacturing base, retail, in the long run—and I know everybody is dead—but in the long run will be better.

The question is, how do we get to the long run? And that is what I would like to get to discuss.

Mr. ROSKAM. And I think a smooth transition is key. Thank you, Mr. Simon.

Mr. CHAIRMAN. Thank you. Time has expired. Mr. Doggett, you are recognized.

Mr. DOGGETT. Well, thank you, very much.

I guess we do just have a basic disagreement. In referring to America as a prison break, America is not a prison for American business. We have some of the most competitive businesses in the entire world.

And to refer to it as a prison break, is also wrong in that the reason these companies have suddenly renounced their American citizenship and gone abroad, in many cases is because of the consistent refusal of our Republican colleagues to support measures to put a stop to it. They won't close the door to those who want to do their business here in America and head off to Ireland, or the Bahamas, or the Cayman Islands. And Dr. Clausing has some impressive data about that that I would like to explore.

Additionally, we have already seen the path, the rainbow, to the pot of gold followed once in this committee already, with the results that will be achieved if we do it a second time. And that is on the so-called ObamaCare repeal, which was really nothing but a $1 trillion tax cut that rewarded certain special interests like pharmaceutical manufacturers, and dramatically, again, widened the income gap by giving the benefits to those at the top rather than to the middle class.

Of course, we don't know exactly how much it did that, because it was rushed through this committee almost overnight. And we still don't have a score from the Congressional Budget Office for that ill-advised proposal. Even though they rushed it through, it is still sitting on the Speaker's desk. They weren't in such a rush they sent it over to the Senate for action.

Let's focus on the propaganda and mythology associated with today's proposal, the so-called Better Way.

And one of the big aspects of the pot of gold that is out there waiting for us is $2.6 trillion that is just dying to come back to America if we will treat it right.

Dr. Clausing, I would like to ask you about this $2.6 trillion in so-called stranded offshore earnings that could allegedly do so much good in creating jobs here in America. Is it true that much of that money can already be invested in the U.S. economy without those multinationals paying a dime of tax on it unless they earn money from their investments here? Indeed, aren't a substantial portion of that $2.6 trillion, isn't it already being held in Wall Street institutions right here, onshore, within the United States?

Ms. CLAUSING. Agreed. Yes. Much of that money is booked offshore for tax purposes, but it is still invested in U.S. assets through U.S. financial institutions.

There are limits on what firms can do with that money. They can't give it back to their shareholders as dividends or as share repurchases. And this is why they are very anxious to get that money back. But they can still borrow against those funds, and the firms that have those funds abroad are some of the most creditworthy firms, you know, on the planet, and they have no trouble financing new investments.

Mr. DOGGETT. And your paper shows that they, in fact, earn millions, if not billions, of dollars in interest and dividends right here in the United States on their offshore earnings today.

Ms. CLAUSING. That is correct.

Mr. DOGGETT. Now, you mentioned the fact that they would like to have this money back not to create jobs but to give higher earning executives even more high earnings and to give their shareholders dividends and stock buybacks. We have had a little experience with that before. And it is just really appropriate that former Chairman Thomas was here. Because he was the author pushing through this committee what was called the American Jobs Creation Act of 2004.

How many jobs did that bill that this committee heard much of the same rhetoric that we are hearing in support of this measure, how many jobs did that bill create?

Ms. CLAUSING. My understanding is that all economists who have looked at that bill found that it didn't create a single job or cause a single investment, and this includes some people who advised George W. Bush, who also looked into this. That money was used for dividends and share repurchases and some of the firms that repatriated the most money actually laid off workers. It is possible it did have a small job creation affect for lawyers and accountants because there was a lot of complexity in the bill as well.

Mr. DOGGETT. We were told by the chairman, follow the example of the Tax Foundation, follow Estonia and Latvia and their tax policies. Do you think our companies will be more competitive if we adopt the Estonian and Latvian approach to international taxation? Are they competitive today in the international market?

Ms. CLAUSING. As the slides I showed earlier indicate, they are quite competitive. We have profits these days that are 50 percent higher than they were in prior decades.

Mr. DOGGETT. Thank you.

Mr. CHAIRMAN. Thank you. Time has expired. Mr. Buchanan, you are recognized.

Mr. BUCHANAN. Thank you, Mr. Chairman. I also want to thank all of our witnesses for being here today.

Dr. Lindsey, let me ask you: I think you have had as much to do with the blueprint as anybody. The economy is growing an anemic 1 percent, on average 1½ percent the last 10 years. I guess you have got to go back in the 1950s where it is only grown at that percentage. But what is your thoughts, when you talk about growing the economy and this plan from 3, 3½, 4 percent, I don't want your number, but I heard 3½. On what basis, and what are the drivers that is going to drive it up from 1, 1½ percent, to 3½?

Mr. LINDSEY. Sure.

There are two steps here. The first is what I would call long-run capacity. Auerbach and Kotlikoff, for example, have the same long-run number that I do, which is 2.7, 2¾ percent.

However, to get to that capacity, we are likely to have a short-term increase in business-fixed investment. That is actually the demand side of the proposal. That is going to stimulate the economy in the short run. I think this is a very high multiplier tax cut in that regard. And that is how I got to the numbers that I got to. There is both a long run and a short run component.

Mr. BUCHANAN. Let me ask you another question. One of my concerns—and I have heard other people express it—is the idea of budget deficits. When we came here almost 10 years ago, it was $8 trillion and change; today it is $20 trillion. At some point, it ends badly. That is why I am a believer, like 49 out of 50 Governors, have a constitutional balanced budget amendment. But what does this do to our deficit long-term? I mean, ideally, with the growth, it should be somewhat revenue neutrality, ideally. What are your thoughts on that?

Mr. LINDSEY. Yeah. Though I scored out the long-term debt situation, I think on an annual basis, the blueprint breaks even about in year 6, and I think that by year 12, the total cost of the deficit—excuse me, deficit cost of the bill will be covered.

So long run, very long run, I think it is a positive. And I think that it is essentially a revenue-neutral bill over 12 years.

Mr. BUCHANAN. And my last question is on inversions. We do have a lot of great companies leaving America. I would like to think that as a part of our tax planning, this could be the best place on the planet to do business in terms of a pro-growth tax policy where they are not moving their tax havens; they are moving to our friends in Canada and Great Britain where they have cut their rates. In fact, I read—someone said The New York Times—that the inversions in Great Britain have come down dramatically, or pretty much quit. What is your thoughts in terms of that?

Mr. LINDSEY. I think it is important that we differentiate between the inversion piece and the offshore money piece.

I listened to Mr. Doggett's comments carefully, and there is actually one component in which I think he is correct, and that is, that the money so-called kept overseas is in international markets. And I know a lot of people have said, Oh, let's use that for infrastructure, things like that. I think it is in international markets already.

However, the tax revenue associated with that has not come to the U.S. Treasury.

My colleague here estimates that the annual cost of that is $100 billion that is being lost to the U.S. Treasury. This bill fixes that. In addition, if you have a one-time deemed repatriation, depending on the rates you select, you are liable to get perhaps as much as $200 billion. I don't know what the actual number is, depends on your rate. So, yes, the money is in international markets. But the taxes on that money is not in the U.S. Treasury. It should be, and the bill under consideration will do that.

Mr. BUCHANAN. The other thing I have watched—I have been in business for 30 years before I got here—is that people will move to different States; Florida, no State income tax; Texas; Nevada. You can name the States. They will move and move their businesses to other States, and it is the same thing in terms of moving—in terms of inversions and other things. Not everybody, but some. It is a major consideration and major driver. Don't you agree?

Mr. LINDSEY. Absolutely. The best thing we can do, long run, for workers, for everyone, is to make America the best place in the world in which to invest, and start a business, and hire people. And I think this bill does that.

Mr. BUCHANAN. Thank you.

Mr. CHAIRMAN. Thank you.

Mr. Thompson, you are recognized.

Mr. THOMPSON. Thank you, Mr. Chairman. And thanks to all the witnesses for being here.

Mr. Chairman, I have two articles that I would like unanimous consent to place into the record. One is out of The New York Times that points out that after eight years of steady growth, the main economic concern in Utah, and a growing number of other States, is no longer the lack of jobs, but a lack of workers. And it goes on to explain this shortage. I would like to have that——

Mr. CHAIRMAN. Without objection.

[The information follows:]

Thompson SFR#2

The New York Times | https://nyti.ms/2qJarwU

POLITICS

# Lack of Workers, Not Work, Weighs on the Nation's Economy

By **BINYAMIN APPELBAUM** MAY 21, 2017

SALT LAKE CITY — Stephanie Pappas and her brothers built their roofing supply company in this fast-growing region by promising next-day delivery, but lately they've been forced to tell some customers that tomorrow is impossible.

Their company, Roofers Supply, employs 28 drivers across Utah, and Ms. Pappas said she would need at least 15 more to meet the exploding demand for shingles and tiles. The company has raised its starting wage by 10 percent since the beginning of the year to $17.50 an hour, but it's not enough.

"We never want to have to say, 'We can't do it,' but we need people," Ms. Pappas said.

After eight years of steady growth, the main economic concern in Utah and a growing number of other states is no longer a lack of jobs, but a lack of workers. The unemployment rate here fell to 3.1 percent in March, among the lowest figures in the nation. Nearly a third of the 388 metropolitan areas tracked by the **Bureau of Labor Statistics** have an **unemployment rate** below 4 percent, well below the level that economists consider "full employment," the normal churn of people quitting to find new jobs. The rate in some cities, like Ames, Iowa, and Boulder, Colo., is even lower, at 2 percent.

That's good news for workers, who are reaping wage increases and moving to better jobs after years of stagnating pay that, for many, was stuck at a low level. Daniel Edlund, a 21-year-old call center worker in Provo, Utah, learned Monday that his hours were changing. On Wednesday, he had his first interview for a new job.

"I'm trying to find a company that treats you well," he said.

But labor shortages are weighing on overall economic growth, slowing the pace of expansion in northern Utah and other fast-growing regions even as unemployment remains stubbornly high in Rust Belt cities like Cleveland and in regions still recovering from the 2008 recession, like inland California.

To Todd Bingham, the president of the Utah Manufacturers Association, "3.1 percent unemployment is fabulous unless you're looking to hire people."

"Our companies are saying, 'We could grow faster, we could produce more product, if we had the workers,'" he said. "Is it holding the economy back? I think it definitely is."

President Trump continues to promise that he will accelerate job growth by cutting taxes and regulations. But the accumulating evidence that workers are getting harder to find, and that wages are rising more quickly, has convinced many economists that significantly faster growth is unlikely. The Federal Reserve has cited the trend as its reason for moving to wind down its own economic stimulus campaign. The Fed may raise interest rates again at its next meeting in June.

Qualtrics, which conducts online market research, is a prime example of the rapid growth of the Utah economy — and the sense that Utah is straining at the limits of its growth potential. Scott Smith started the company with his son, Ryan, and a college classmate in his Provo home in 2002. Qualtrics now employs 1,300 people, including about 800 in a new headquarters building opened in August at the mouth of Provo Canyon. And it is bringing workers to Utah as fast as it can.

Each Monday, the company ties red balloons to the desks of that week's batch of new employees. Last week, there were several dozen of those balloons. The parking lot outside the new headquarters building is already overstuffed, including many cars that still have out-of-state plates.

Ryan Smith, now the chief executive, said Qualtrics had hired about three dozen graduates from the University of Michigan alone last year. The company estimates that new arrivals bought 100 homes in Provo last year.

Utah's tech scene is growing alongside the company. More local university students are studying engineering; more start-ups are popping up in the region, which boosters would very much like everyone to call "Silicon Slopes." But by the end of the year, Mr. Smith said, he expects the company will have more employees outside Utah than in its home state. It is growing where it finds workers.

Companies in Utah, as in the rest of the country, were slow to raise wages in recent years. At first there were plenty of available workers. But by the end of 2015, a report by Utah's Department of Workforce Services concluded that inadequate wages had become a key reason companies were struggling to find employees.

"It was as if employers hadn't adjusted their approach to the labor market" as the economy recovered, said Carrie Mayne, the department's chief economist.

Now there are signs the logjam is breaking. Adam Himoff, the president of Xemplar Skilled Workforce Solutions, a recruiting firm hired by Roofers Supply to find drivers, said he had seen an increase this year in the willingness of clients to raise wages.

"Labor has become the constraint on their growth goals, and they're recognizing that they're going to have to increase wages to achieve what they want to achieve," he said.

Ms. Mayne said the state also saw signs of what she described as a broad-based acceleration in wages in the most recent data, through the end of last year.

But the share of Utah adults who have withdrawn from the labor force remains higher than before the recession. Last year, 31.7 percent of adults in Utah were neither working nor looking for work, up from 28.2 percent in 2006. That is part of a broad national trend.

And a 3.1 percent unemployment rate still means that about 50,000 people in Utah were trying to find jobs in March.

Some, like Monica Von Strahl, expect to find work quickly. Ms. Von Strahl, 44, moved to Utah from Oregon in April for family reasons. She left a job as a caregiver for adults with disabilities that paid $16 an hour; so far, the most she has been offered in Utah is $10 an hour. She plans to keep looking a little longer. (Scholars at M.I.T. estimate that a living wage in Utah for a single person is $10.71 an hour.)

But even in a red-hot market, some of the people who are looking for work struggle to find the right fit. Noel Nampijja, 42, left her job as a nurse's aide two months ago because the work of moving patients was hurting her back. She just completed training as a phlebotomist, a medical assistant who draws blood.

"I'm hoping to find a job that won't hurt as much," she said.

In less lucrative industries, labor shortages may remain an intractable problem.

Ron Gibson, a fifth-generation dairy farmer, tends 1,500 cows on family land outside Ogden. Last month, he placed an ad in local papers seeking three workers at wages starting around $12 an hour. It did not draw any responses.

Mr. Gibson cannot afford to chase workers by raising wages. The price of milk, adjusted for inflation, is lower now than in the 1980s. Instead, he is producing less milk. Each cow is milked three times a day; only 15 percent get a fourth milking.

He also laughed at the idea that Americans might move from other states to milk cows in Utah. He relies primarily on immigrant labor, communicating with his two dozen workers in the Spanish he learned as a young Mormon missionary in Argentina. And since Mr. Trump's election, he said, workers are harder to find.

"We are either going to import workers or we are going to import milk," Mr. Gibson said.

The work "is dirty, stinky and hard," he added. "It's not what we teach our young people to do."

But there is another solution on the horizon: automation. Last year, Mr. Gibson and his son visited a farm in upstate New York where robots milk cows. The cows learn to approach the machines when their udders are full.

Mr. Gibson is not yet ready to make the jump. Each machine costs half a million dollars, and the New York farmer spends about as much on mechanics as he spent on farmhands. But Mr. Gibson said he expected his children would use robots to milk cows.

A version of this article appears in print on May 22, 2017, on Page A1 of the New York edition with the headline: Labor Shortages Slowing Growth Of U.S. Economy.

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Mr. THOMPSON. And then the second one is a Wall Street Journal article that explains, I think beautifully, the point that Mr. Doggett was making as to what companies who repatriated moneys from overseas spent that money on. And I think it hits those points exactly. And I think Mr. Doggett was correct. I would like to have that put into the record.

Mr. CHAIRMAN. Without objection.

[The information follows:]

Thompson SFR #3

THE WALL STREET JOURNAL

## Report: Repatriation Tax Holiday a 'Failed' Policy

By Kristina Peterson | Wall Street Journal
Oct. 10, 2011 9:41 p.m. ET

WASHINGTON -- The 15 companies that benefited the most from a 2004 tax break for the return of their overseas profits cut more than 20,000 net jobs and decreased the pace of their research spending, according to report from the Democratic staff of the Senate Permanent Subcommittee on Investigations released Monday night.

The report warned against repeating the tax break, calling the 2004 effort "a failed tax policy" that cost the U.S. Treasury $3.3 billion in estimated lost revenues over 10 years and led to U.S. companies directing more funds offshore. U.S.-based multinationals often defer bringing back profits earned abroad to avoid paying U.S. taxes on them.

The 15 companies that repatriated the most after the 2004 tax break on the return of overseas profits later cut a net 20,931 jobs between 2004 and 2007 and slightly decreased the pace of their spending on research and development, found the report surveying 19 companies' activity.

When Congress passed the repatriation tax holiday in 2004, the legislation specified that the funds should be earmarked for activities like hiring workers or conducting research and prohibited using the money for executive compensation or buying back stock. Companies that brought back profits earned abroad saw them taxed at roughly 5%, instead of the top 35% corporate tax rate.

"There is no evidence that the previous repatriation tax giveaway put Americans to work, and substantial evidence that it instead grew executive paychecks, propped up stock prices, and drew more money and jobs offshore," Sen. Carl Levin (D., Mich.), chairman of the subcommittee, said in a statement Monday night. "Those who want a new corporate tax break claim it will help rebuild our economy, but the facts are lined up against them."

companies surveyed by the committee, seven repatriated between 90% and 100% of their funds from tax havens.

The 2004 repatriation tax holiday further motivated companies to keep even more of their earnings overseas, the report found. With the exception of Pfizer, the 10 companies that repatriated the most money after the 2004 tax break have stashed increasing funds offshore every year since the 2004 tax break, the survey noted.

For example, Coca-Cola Co. KO 0.64% brought back "nearly all" of its qualified earnings from a unit in the Cayman Islands that had no Cayman employees and functioned to provide "legal insulation" for its U.S. assets, the company answered in the survey.

The "negative effects" of the tax break "create unfair tax advantages for a narrow sector of corporations with damaging economic impacts on the U.S. economy as a whole," the report concluded.

Supporters of another repatriation tax holiday Monday night said the report was one-sided and didn't reflect the stimulating effect an influx of funds could have on the struggling U.S. economy.

"Unfortunately, Senator Levin believes that Europe and Asia can do better things with the money than America," said Win America, a coalition backing the tax break, in a statement. "The real question is, should we allow American companies the freedom to deploy this money here or risk it being spent overseas?"

Mr. Levin and Sen. Kent Conrad (D., N.D.), chairman of the Senate Budget Committee also sent a letter to the Joint Select Committee on Deficit Reduction urging the 12-lawmaker panel not to support a repatriation tax break in its proposal to reduce the federal budget deficit.

Mr. THOMPSON. Thank you.

Ms. Clausing, you mentioned in your written testimony that the border adjustment tax would raise revenue, but that that revenue was ultimately borrowed from future taxpayers. I want to make sure that people at home fully understand what this means, and how it is going to impact their pocketbook. Can you elaborate on that a little bit, please?

Ms. CLAUSING. Sure. At present, we run a trade deficit. And because of the size of that deficit, that means that when you tax imports and exempt exports from taxation, on net, the border tax will raise revenue, and the Tax Policy Center estimates it is about $1 trillion over 10 years. But no country can run a trade deficit forever. Trade deficits entail a flip side, which is borrowing from foreigners. It is equal and opposite to the size of the trade deficit.

So, eventually, when we repay that money, we will also be running a trade surplus. In those years, the import tax will raise less revenue than the export exemption costs the Treasury. So in the future, our taxpayers will actually lose money from the border adjustment. So that means that, basically, what we are getting from that is revenue that we are borrowing from future generations.

Mr. THOMPSON. I had someone come in and talk to me the other day about the effect that the border adjustment tax would have on their business. They are a company located in Washington.

They make $30 million a year, employ 4,000 employees. What they sell, they buy from 31 other countries. They are items that wouldn't be made in this country no matter what we do. There is a very low markup on this stuff.

And they told me if the BAT comes about, that they will go from making $30 million a year to losing $130 million a year. In other words, this Washington State company would close the doors, five-generations-long company, would close the doors. And I think that is something that we need to be concerned about. But the other side of that—and it has really become—made clear today is our constituents, those consumers that buy those products—and there is a couple of companies represented on the dais today that represent companies that those consumers that buy those products, they are going to be hurt. And that is exactly, I think, what it is that Ms. Clausing is talking about. So your consumers, our constituents, are going to see their prices go up.

There was also—Ms. Clausing made the point about the WTO impact.

How would this play out? When would we see this happen? I represent a district that imports a lot of products overseas. I represent wine country in California. And whenever there is a discussion about anybody retaliating, it doesn't take long before that conversation comes back to U.S.-exported wine.

So can you tell me what our constituent companies are going to experience if retaliation becomes a reality?

Ms. CLAUSING. Yeah. So our trading partners are already preparing suits to be filed with the disputes settlement mechanism of the WTO. This dispute settlement mechanism, by the way, is something the U.S. helped negotiate, and it is something that serves our interests very well because often the WTO will rule in our favor about disputes that we have too. The WTO has over 160 member countries, and it supervises a well-functioning trading system. But once they authorize that our tax is a direct tax, which it is, and thus it violates the WTO obligations, that then gives the green light to trading partners to retaliate in an equal and opposite fashion. And because of the size of this, that will entail large tariff burdens.

Mr. THOMPSON. Thank you very much.

Chairman BRADY. Thank you.

And without objection, I would seek to place in the record the Goldman Sachs report that estimates that with no appreciation of the dollar, 85 percent of industries have actually cut their prices, still maintain their current profit margins, and with the dollar even partially adjusted, likely no industry would need to raise prices. Without objection.

[The information follows:]

Brady SFR

Goldman Sachs | Economics Research

8 December 2016

# US Daily: What Would the Transition to Destination-Based Taxation Look Like? (Mericle/Phillips/Struyven)

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■ A key feature of the House Republican blueprint for corporate tax reform is a proposed switch to destination-based taxation. In today's note, we discuss how the transition to destination-based taxation would work and the bumps that might be felt along the way.

■ Under an idealized version of the transition, the dollar would appreciate enough to offset the impact of the tax change, resulting in no impact on prices, margins, or trade flows. Even in this case, a large and abrupt change in exchange rates would deliver a sizeable hit to US residents' foreign wealth and could create risks of dollar-denominated debt problems abroad.

■ An alternative transition scenario featuring partial dollar appreciation, higher inflation, a hit to the profit margins of US net importers, and higher net exports appears more likely. Industries with low margins and high import shares such as apparel would be particularly vulnerable to the change. A gradual phase-in of the new system could help, but creates its own risks.

■ While destination-based taxation offers meaningful benefits, the transition to the new system could have unintended consequences, regardless of how adjustment takes place. In light of the uncertainty regarding the potential effects of such a policy, and the opposition it has already provoked, we think that Congress is more likely to move away from the destination-basis tax proposal.

A key feature of the House Republican blueprint for corporate tax reform is a proposal to switch to destination-based taxation. Last week, we discussed the details of the proposed change, which is currently being debated in the House. In today's note, we discuss how the transition to destination-based taxation would work and the bumps that might be felt along the way.

The practical effect of switching to destination-based taxation would be that US firms would exclude export revenues but would no longer deduct import costs when calculating their tax base. The economy would adjust to the new system during a transition period through some combination of changes in nominal exchange rates, price levels, corporate profit margins, and trade flows.

We begin by describing an idealized version of the transition as it has been presented to Congress. Proponents of destination-based taxation cite economic research showing that symmetric border adjustments should not affect trade flows. For example, Auerbach and Holtz-Eakin argue that "Border adjustments do not distort trade, as exchange rates should react immediately to offset the initial impact of these adjustments. As a corollary, border adjustments do not distort the pattern of domestic sales and purchases." In theory, the border adjustments would initially make imports less competitive and US exports more competitive, reducing demand for imports and increasing demand for exports. This would cause dollar appreciation, reversing the initial effect on competitiveness and trade flows.

If financial markets anticipate this new equilibrium, proponents argue, nominal exchange rates should react immediately to offset the impact of the border adjustment. For example, assuming a 20% statutory tax rate, a US company selling an imported product for $100 with no profit would need to increase prices by $20 to continue operating without running an after-tax loss. For a $20 decline in import costs to offset the impact of the $20 increase in taxes, the dollar would need to appreciate by 1/(1-tax rate), or 25% in this example.

If dollar appreciation were immediate and perfectly calibrated, there would be no effect on consumer prices, profit margins, or trade flows.[1] Moreover, there would be no differential impact on firms with low vs. high import cost shares or low vs. high profit margins. To illustrate this, Exhibit 1 provides examples of income statements for various types of firms under each tax regime. Under current law, taxes are assessed on total sales minus total costs. Under a destination-based border-adjusted tax, taxes would instead be assessed only on domestic sales minus domestic costs. For net importers, this results in a much larger tax burden, as shown in the first column of Exhibit 1. However, because the dollar appreciates, the firm's import costs—when measured in dollars—decline, offsetting the larger tax burden. As a result, after-tax profits are identical in the two tax regimes. In the case of net exporters, shown in the second column of Exhibit 1, lower revenues measured in dollars are offset by a smaller tax burden, again resulting in no change to after-tax profits after the switch to destination-based taxation.

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[1] The examples assume that the world prices of both imported and exported goods are set in foreign currency units and are unchanged after the switch to destination-based taxation.

**Exhibit 1: The Transition to Destination-Based Taxation under Full Nominal Exchange Rate Adjustment**

| | | Type of Firm | | | | | |
|---|---|---|---|---|---|---|---|
| | | Net Importer | Net Exporter | High Import Share | Low Import Share | High Profit Margin | Low Profit Margin |
| Current Law | Exchange rate (foreign currency per $) | 1 | 1 | 1 | 1 | 1 | 1 |
| | Domestic sales in $ | 100 | 0 | 100 | 100 | 100 | 100 |
| | Foreign sales in foreign currency | 0 | 100 | 0 | 0 | 0 | 0 |
| | Total sales in $ | 100 | 100 | 100 | 100 | 100 | 100 |
| | Domestic costs in $ | 45 | 45 | 0 | 90 | 25 | 49 |
| | Foreign costs in foreign currency | 45 | 45 | 90 | 0 | 25 | 49 |
| | Total costs in $ | 90 | 90 | 90 | 90 | 50 | 98 |
| | Tax burden at 20% | 2 | 2 | 2 | 2 | 10 | 0.4 |
| | After-tax profit | 8 | 8 | 8 | 8 | 40 | 1.6 |
| Destination-Based Taxation | Exchange rate (foreign currency per $) | 1.25 | 1.25 | 1.25 | 1.25 | 1.25 | 1.25 |
| | Domestic sales in $ | 100 | 0 | 100 | 100 | 100 | 100 |
| | Foreign sales in foreign currency | 0 | 100 | 0 | 0 | 0 | 0 |
| | Total sales in $ | 100 | 80 | 100 | 100 | 100 | 100 |
| | Domestic costs in $ | 45 | 45 | 0 | 90 | 25 | 49 |
| | Foreign costs in foreign currency | 45 | 45 | 90 | 0 | 25 | 49 |
| | Total costs in $ | 81 | 81 | 72 | 90 | 45 | 88.2 |
| | Tax burden at 20% | 11 | -9 | 20 | 2 | 15 | 10.2 |
| | After-tax profit | 8 | 8 | 8 | 8 | 40 | 1.6 |

Source: Goldman Sachs Global Investment Research

We see two reasons to be skeptical about this smooth picture of the transition process. The first reason is that even an adjustment that did occur entirely through nominal exchange rates would create large risks. As noted above, the required dollar appreciation would be very large: 25% if the statutory corporate tax rate were reduced to 20%, and even higher if the statutory rate were reduced by less. Such an abrupt change would result in large negative wealth effects for US residents and the risk of potentially serious dollar-denominated debt problems abroad.[2]

The second reason is that we think it is unlikely that nominal or even real exchange rates would in fact adjust so quickly and perfectly. Our FX strategists have shown that many Asian central banks have intervened to stabilize exchange rates. The combination of pegged exchange rates in many trading partners with price stickiness implies that real exchange rates would not adjust as smoothly as implied by current policy proposals. While Desai and Hines have found that floating exchange rates respond to news about changes in US tax-based export incentives, the past moves were of a vastly smaller magnitude.

Instead, we think it is more likely that the transition to destination-based taxation in the US would result in meaningful but imperfect dollar appreciation and price adjustment. In the near term, such an incomplete change in real exchange rates

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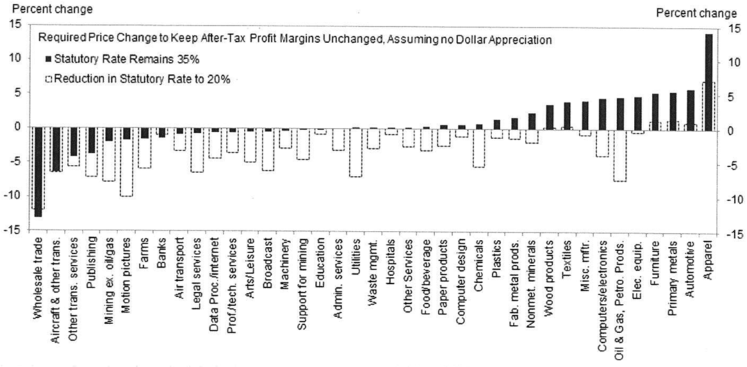
[2] There are two offsets to concerns about dollar denominated debt problems abroad. First, some firms have offsetting dollar revenue exposure. Second, the net impact on total foreign wealth would be positive, possibly allowing some governments to tax beneficiaries and subsidize threatened firms. Even so, we think such a large and abrupt change would create meaningful risks in places with large dollar liabilities.

could result in lower profit margins for US importers and a decline in the US trade deficit. This scenario would have a number of economic consequences. Higher consumer price inflation could lead to tighter monetary policy, though Fed officials might downplay the impact as a transitory influence. Pressure on margins from the policy shift could be substantial, challenging the solvency of some net importer firms that were in good financial condition prior to the sudden policy change. Finally, reduced import demand and increased export demand would initially boost US output, but could invite retaliation, especially since the new US rules are unlikely to be judged to be WTO compliant, in our view.[3]

It is very difficult to know in advance how adjustment during the transition period would be split among the various margins. We can, however, assess which industries would be most vulnerable to a less elegant transition than described in Exhibit 1. We measure an industry's vulnerability as the consumer price change that would be required to keep after-tax profit margins unchanged, assuming no change in exchange rates (the magnitudes would be smaller under partial dollar appreciation). We also repeat the calculation under the assumption that statutory corporate tax rates simultaneously fall to 20%. These vulnerability measures, shown in Exhibit 2, are increasing in the net import share and decreasing in margins, both of which we measure using data from the input-output tables. We caution that these are industry averages, and in every industry there will be firms whose vulnerability is much greater.

**Exhibit 2: Industries with High Net Import Shares and Low Margins Would Be Most Vulnerable**



Source: Department of Commerce, Goldman Sachs Global Investment Research

We draw three conclusions from Exhibit 2. First, the required price increases would be fairly large for some net importing industries and probably very large for some

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[3] Of course, the strongest complaints would presumably come from countries with pegs, who would have the option of relaxing their pegs.

firms in those industries, meaning that some compression of profit margins for the biggest net importers seems likely. Second, a simultaneous reduction in the statutory tax rate to the 20% level proposed by House Republicans would substantially cushion the blow, allowing after-tax profits to hold steady while prices adjusted over a more realistic time horizon.[4] Third, apparel stands out as a uniquely vulnerable industry.

To summarize, we see such a large and abrupt change in corporate tax policy as likely to be somewhat disruptive, however it occurs. Even adjustment entirely via nominal exchange rates would create meaningful risks, especially risks abroad that US policymakers would have limited power to mitigate. The more likely scenario of partial dollar adjustment could lead to some combination of higher US inflation, sizeable hits to the profit margins of net importers, and a shrinking trade deficit that could prompt retaliatory trade policies. Could a gradual transition to destination-based taxation alleviate these risks? For example, what if one-third of import costs and export revenues were ignored the first year, then two-thirds the second year, before full implementation in the third year?

A gradual phase-in would probably do little to reduce the side-effects of sudden dollar appreciation because most of the dollar response to even a staggered policy should occur upon announcement, not implementation, assuming it is credible. It could, however, reduce short-run pressure on the profit margins of US net importers, reducing the risk of making currently viable firms insolvent. But staggering implementation creates risks of its own: if the dollar appreciated more quickly than policymakers anticipated, gradual phase-in would actually benefit net importers and harm net exporters because importers' costs would fall more quickly than their tax bills would rise and exporters' costs would rise more quickly than their tax bills would fall, the scenario shown in the top-right box of Exhibit 3.

**Exhibit 3: A Gradual Phase-in of Destination-Based Taxation Does Not Eliminate Transition Risks**

**Phase-in of New Destination-Based Corporate Tax Regime**

| **Exchange Rate Adjustment** | Immediate | Gradual |
|---|---|---|
| Immediate | **Importers:** Neutral<br>**Exporters:** Neutral | **Importers:** Higher margins<br>**Exporters:** Lower margins |
| Gradual | **Importers:** Lower margins<br>**Exporters:** Higher margins | **Importers:** Roughly neutral<br>**Exporters:** Roughly neutral |

Note: We assume price adjustment provides an incomplete offset.

Source: Goldman Sachs Global Investment Research

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[4] If combined with other proposed measures that would make the overall tax revenue impact more neutral, such as the elimination of net interest deductibility in favor of full capex expensing, the required price changes would rise.

Proponents of a switch to destination-based taxation note that it would allow the US to reduce its relatively high statutory rate and reduce the incentive for firms to report profits in countries with lower tax rates. These are meaningful benefits with strong bipartisan appeal. But the transition to the new system would invite a range of risks, regardless of how adjustment takes place. These costs might be worth bearing, but they have already provoked opposition from those who fear incomplete adjustment of real exchange rates, including both concerned net importers and free-traders who worry that partial adjustment will amount to protectionism. Largely for these reasons, we think that Congress is more likely to ultimately move away from the current destination-basis tax proposal.

David Mericle

Alec Phillips

Daan Struyven

# Disclosure Appendix

## Reg AC

We, Jan Hatzius, Zach Pandl, Alec Phillips, David Mericle, Daan Struyven, Karen Reichgott and Avisha Thakkar, hereby certify that all of the views expressed in this report accurately reflect our personal views, which have not been influenced by considerations of the firm's business or client relationships.

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Chairman BRADY. Mr. Smith, you are recognized.

Mr. SMITH OF NEBRASKA. Thank you, Mr. Chairman. And thank you to our witnesses here today for sharing your perspective and insights. I think this is an overdue conversation that we need to have, and I think a constructive moment here as we do sift through the facts. And I just think that the status quo with our Tax Code shows that we have great opportunity to change it, to be bold, and to truly pursue growth-oriented policies.

Representing agriculture, the number one agriculture district in the Nation, certainly we are pretty good at exporting things already. I don't want to jeopardize that. But I also am concerned that there actually are still significant barriers.

And, Mr. Luciano, you stated that there are some barriers that are still out there that you feel that the tax proposals that are being made would be helpful in overcoming some of those obstacles.

I am also concerned when I hear Professor Clausing say that U.S. multinationals are not paying very much tax, and that the tax rates proposed in the tax reform plan are too low, and that a better reform would be to expand the U.S. worldwide tax system by eliminating deferral. And now imposing immediate taxes on U.S. companies' worldwide income, I believe, would move our country in the exact opposite direction as our trading partners, and I think a lot of the facts would point to that.

But, Mr. Luciano, can you talk about your perspective?

Obviously, it is a pretty broad perspective. I know you depend on ag producers, one at a time, being successful, hopefully, on their productivity, their efficiency. Can you, perhaps, expound on how you think that this plan might help and that also perhaps some of the notions that imposing immediate taxes on U.S. companies' worldwide income moving our country in a negative direction?

Mr. LUCIANO. Yeah. Thank you for the question.

This is all about balancing the playing field. When we compete with the other companies, other global grain companies that are as well capitalized, or they have the same technology as we have, and experience that we have, as I said before, we pay about 30 percent. I have two of them that pay in the low 20s, the rest in the mid teens. So that is the kind of difference. And in agriculture and the business we are in, business models are very similar. So it is very similar to compare these. So there are no major differences in our margins because the trade of commodities are very thin. So these differences in income tax are astronomical in putting ADM, at this point, at a disadvantage to other competitors around the world. And then they have the flexibility to move their earnings and invest wherever they want, which, you know, we are partially restricted to.

And the third point is that a lot of their exports are coming from countries that they refund the BAT. If you look at Ukraine provides 20 percent refund of BAT. Argentina, 10 percent. Germany, 19 percent. And then you have places that compete with us, whether it is Australia, Canada, or Brazil, that basically have internal consumption taxes that they are not assessed for exports. So there is no wonder that our market share of global commodities from the U.S., exported to the world, is declining, and it is going to continue to do so because we are at a disadvantage.

So, to me, this proposal addresses those three issues, where they are going to get jobs back to middle America, and to the middle class of America, through agriculture, which is, I think, one of the true competitive advantages of the U.S., inside the U.S., the middle of the U.S., still have.

Mr. SMITH OF NEBRASKA. Thank you. I know that there are many challenges facing agriculture, and I would hope that we would not complicate matters and that hopefully a growing economy will also help agriculture.

Ms. Clausing, I think you suggested—but correct me if I am wrong—that perhaps the corporate Tax Code that we currently have is really not that bad.

Now, I thought that perhaps some lower hanging fruit in terms of agreement on changing our Tax Code would fall in that corporate category. But am I wrong in——

Ms. CLAUSING. You are wrong. I mean, I think that most economists across the political spectrum think that there is ample room for a fair improvement to the corporate tax system, and I suggested some alternates in my testimony.

Mr. SMITH OF NEBRASKA. What would that look like?

Ms. CLAUSING. But I believe it would include, potentially, a lower rate, but combine that with closing the loopholes that we have presently. Right now, some of the domestic firms pay, you know, much higher rates than these mobile multinationals.

Mr. SMITH OF NEBRASKA. Thank you.

Chairman BRADY. Thank you.

Mr. Larson, you are recognized.

Mr. LARSON. Thank you, Mr. Chairman. And I want to thank all the panelists. We always like to think that Congress is about the vitality of ideas openly exchanged. And today, Mr. Chairman, you are to be commended, because I think we are witnessing that here. I also want to thank my colleague, Mr. Roskam, for pointing out, and I share his sentiments about Mr. Simon, and I must confess a prejudice because of representing the city of Hartford, and also would note the strong feeling we share, I know on this side of the aisle, and I daresay my colleagues on the other side, as well, with the key to manufacturing.

You mentioned, too, in Hartford, both Colt Manufacturing, and, of course, Pratt & Whitney, which is a part of United Technologies. United Technologies does exemplary in terms of what they do for their employees. And I would hope all manufacturers would take heed in terms of offering free education to further their training in any field, paying for that, and giving them time off. That is a little plug for United Technologies and for the city of Hartford. And thank you for being here. Thank all the panelists.

To get back to your point about manufacturing. If we are going to revive the middle class, and I think the disparities, as everyone on this committee has pointed out, are pretty well-known to everybody. The concern, on this side, is that what we see is this shift that is going to take place again.

Mr. Doggett pointed out that we saw that in healthcare, and now it seems in the tax proposal that we are going to see this again.

Ms. Clausing, you pointed out that that shift is very dramatic, and what would result in this would be almost 1,000 percent difference in terms of what would be the share for the middle class versus the Nation's top one percent.

Could you explain that?

Ms. CLAUSING. Those come from the Tax Policy Center estimates of the bill. And that is a nonpartisan center. And those are their estimates, that the top 1 percent would get a $200,000 tax cut, and the bottom 80 percent would get a $200 tax cut. So that is a thousand fold difference.

What Mr. Lindsey's testimony suggests is that if you had enough growth, that could maybe counter some of those effects. If you had enough investment, that could raise wages. But I have some concerns about that as well. In particular, it seems odd to suggest that what we need is more after-tax corporate profits to generate investment and wages when we are at a period of historically very high corporate profits.

And sometimes, these growth forecasts can be a little too optimistic. When they surveyed economists very recently about whether the Trump growth forecast that went with his tax plan were, you know, accurate, 35 of 37 economists concluded that those growth forecasts were way too optimistic. And when they asked the other two, well, why do you think it is going to grow so quickly, it turns out they misread the question. So all 37 really disagreed with those optimistic growth estimates.

So I think it is important that our budgets and our tax plans raise the revenue that is needed now without making valiant assumptions about growth and——

Mr. LARSON. I think a number of our manufacturers and exporters—and Mr. Simon pointed out how this could work. And I appreciate a lot of the optimism and concern that have been stressed. He mentioned caution as we go forward to make sure that we get this right.

Being from a strong manufacturing State, what would be some of the risks for major manufacturers? And is it clear that this is a clear winner or do we have to exhibit that caution? And what would be your concerns, Ms. Clausing?

Ms. CLAUSING. I think the exchange rate risk is a serious one. I went back and looked at all of the countries that have adopted VATs, which should see a similar exchange rate adjustment under a floating exchange rate. And there are only a handful of rich countries that have adopted VATs under floating exchange rates to look at. But if you look at that set of countries, in three quarters of the cases, the exchange rate actually moved in the wrong direction. So I guess my point is exchange rates are very volatile. It is a very large market. We can't be sure it is going to move in the right direction or by the right amount, and that gives us a big risk for the import-intensive industries. If you look at the data, it appears that countries with VATs also trade somewhat less than other countries. And I think trade is an important part of a healthy manufacturing sector, and many of our products are made with global supply chains throughout the world.

Mr. LARSON. Thank you. And, again, I thank the panelists.

And in many cases, many people who have commented on this bill oftentimes feel like they are trapped between this proposal, and the White House, and the Senate. But I want to assure people and thank them for being here today. And the exchange of these ideas has been beneficial to the committee.

Chairman BRADY. Thank you. Ms. Jenkins, you are recognized.

Ms. JENKINS. Thank you, Mr. Chairman, for holding the hearing. And we thank the panel for your time this morning.

Mr. Luciano, I have a question for you, coming from Kansas, just to follow up on the ag inquiry of my seatmate, Mr. Smith. In your testimony, you talk about growing global demand for food. If we can get this international tax reform right, how does that pair with increased global demand to put more money in the pockets of Kansas farmers? And how does the border adjustment help U.S. farmers see a bigger and better market for their goods?

Mr. LUCIANO. Thank you for the question.

So the world is growing the population, and the population, as I said before, will reach 9 billion people in 2050. But the production is in only three parts of the world. The production is concentrated in North America, South America, and Eastern Europe. So you have—China has 22 percent of the world population, only 6 percent of the water, 8 percent of the land. So they are always going to be importing.

So you have this global middle class that needs the product that we produce. The issue is this race between Eastern Europe, South America, and the U.S. And both places, Brazil, or Argentina, or Ukraine, or Romania, or Russia, they have BATs that basically they discount what we export. So the U.S. farmer in Kansas is actually at a disadvantage. Because when you form the price, everybody else discount that tax, and we add it to the tax.

So we are all just waiting for a level playing field. There is no technological difference between the farmer in Kansas and the farmer in Russia. There is actually a competitive advantage we have in logistics. Even if our infrastructure is deteriorating, we still have a competitive advantage. We still can ship something 1,500 miles cheaper than what Argentina can ship it 300 kilometers.

But the issue is of all the things that the farmer and companies like us can control, we are more competitive than the other countries. Only tax that makes the difference.

So I don't think it is the only factor. But I think that the proposal, the blueprint, addresses a lot of that——

Ms. JENKINS. Thank you. Mr. Chairman, I yield back.

Chairman BRADY. Thank you.

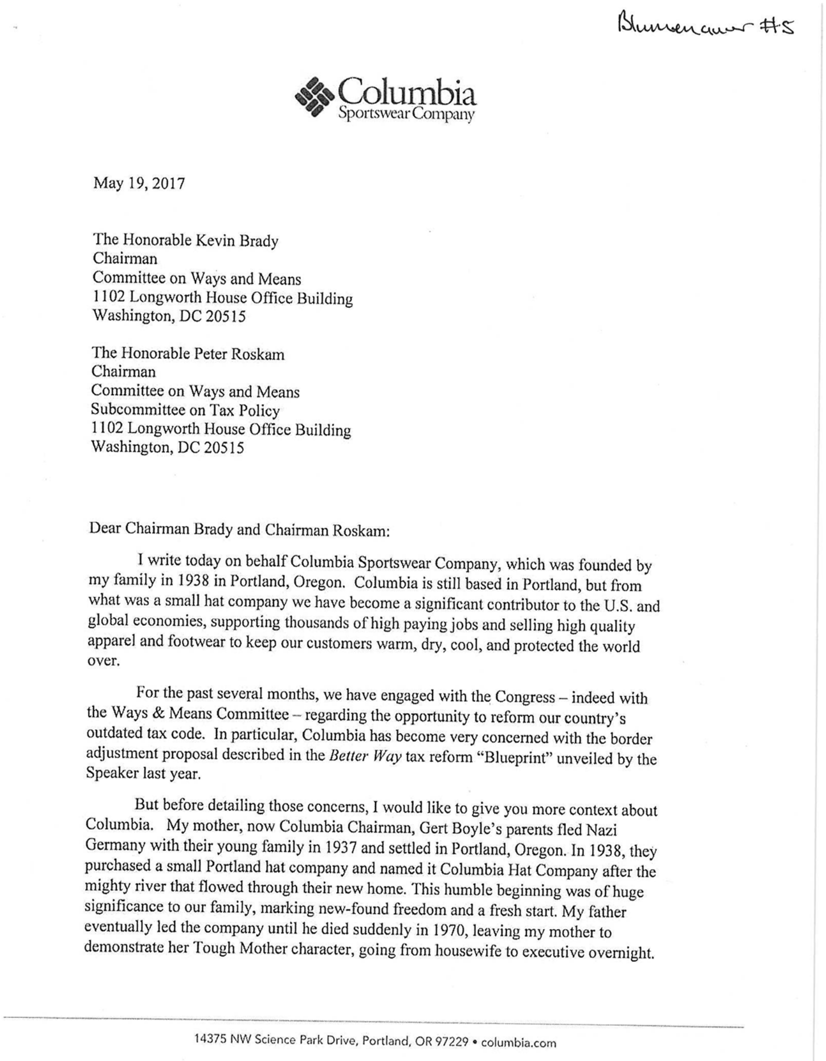
Mr. Blumenauer, you are recognized.

Mr. BLUMENAUER. Thank you, Mr. Chairman. I would like to welcome Dr. Clausing, a constituent from Reed College, really appreciate your joining us.

But first, Mr. Chairman, I would like to enter into the record a letter to you and Mr. Roskam from Tim Boyle, the chairman and CEO of Columbia Manufacturing in Portland, where he outlines the deep concerns his company has with the approach to a Border Adjustment Tax. He also points out that they transact with their foreign partners and contractors exclusively in U.S. dollars, and so the adjustment in terms of the currency——

Chairman BRADY. Without objection.

[The information follows:]



Blumenauer #5

Columbia
Sportswear Company

May 19, 2017

The Honorable Kevin Brady
Chairman
Committee on Ways and Means
1102 Longworth House Office Building
Washington, DC 20515

The Honorable Peter Roskam
Chairman
Committee on Ways and Means
Subcommittee on Tax Policy
1102 Longworth House Office Building
Washington, DC 20515

Dear Chairman Brady and Chairman Roskam:

I write today on behalf Columbia Sportswear Company, which was founded by my family in 1938 in Portland, Oregon. Columbia is still based in Portland, but from what was a small hat company we have become a significant contributor to the U.S. and global economies, supporting thousands of high paying jobs and selling high quality apparel and footwear to keep our customers warm, dry, cool, and protected the world over.

For the past several months, we have engaged with the Congress – indeed with the Ways & Means Committee – regarding the opportunity to reform our country's outdated tax code. In particular, Columbia has become very concerned with the border adjustment proposal described in the *Better Way* tax reform "Blueprint" unveiled by the Speaker last year.

But before detailing those concerns, I would like to give you more context about Columbia. My mother, now Columbia Chairman, Gert Boyle's parents fled Nazi Germany with their young family in 1937 and settled in Portland, Oregon. In 1938, they purchased a small Portland hat company and named it Columbia Hat Company after the mighty river that flowed through their new home. This humble beginning was of huge significance to our family, marking new-found freedom and a fresh start. My father eventually led the company until he died suddenly in 1970, leaving my mother to demonstrate her Tough Mother character, going from housewife to executive overnight.

Today, I preside over a $2.4 billion global business that ranks among the FORTUNE 1000. The company has over 4,300 U.S. employees in more than 40 states, as well as more than 1,700 employees across Asia, Europe and Canada. The company's products are sold in nearly 100 countries, manufactured in 17 countries, and connect people everywhere with their passion to live active, healthy, outdoor lifestyles.

Those jobs in the U.S. depend upon a supply chain the near entirety of which left this country long ago and has continued to move around globe, seeking manufacturing costs to produce quality goods for which Americans are willing to pay. Some have made well intentioned claims about moving parts of the supply chain back to our shores, but those claims depend upon near total automation that is likely not possible for decades at any useful scale.

Even if only coincidental, it is notable that Columbia was started as the U.S. was still digging out of the Great Depression given that remnants of the Great Depression-exacerbating Smoot-Hawley Tariff Act still apply to apparel and footwear imports. Columbia pays double digit tariffs on imports into the U.S., making it the 49th highest duty payer out of 375,000 importers. I assure you that Columbia is not nearly the 49th highest importer by dollar value. One need look no further for proof that such manufacturing will not move back to our shores.

Given these dynamics, we believe that the border adjustment proposal, as we understand it, would be devastating to the apparel business and the domestic jobs it supports, American consumers, or both. Based on our modeling, we believe it would significantly raise our effective tax rate, even if the corporate rate were reduced to 20 percent. We believe this would lead to significantly higher consumer prices, and that is on top of the current import taxes.

Again, unlike other industries that may have an opportunity to move their supply chains into the U.S. and avoid the significant blow of border adjustment, Columbia and other retailers must settle for another economic reality that trades overseas manufacturing for thousands of very good paying technical and creative jobs in the U.S.

In addition, our team of tax, trade, and currency professionals have worked through the putative benefits to importers that would come as the result of a strengthened dollar. In sum, we do not believe to any requisite certainty that such an adjustment would occur, but even if it did, there are several problems with our business model that are likely similar to other retailers and perhaps businesses in other sectors. First, we transact with our foreign partners and contractors exclusively in U.S. dollars, essentially eliminating any relative advantage that would come from such a strengthening of the currency. Second, we now derive a significant portion of total revenue from overseas sales. A strengthened dollar would do nothing but limit those customers from purchasing our products.

Columbia
Sportswear Company

It is difficult to think of how a border adjustment tax, when applied to the apparel and footwear business, could result in anything other than significantly increased prices for consumers. As I understand it, this is true of retail as a whole. We do appreciate your work on tax reform as a general matter. Simplification, fairness, and efficacious administration are sorely missing from our current code and regulations. Columbia is very appreciative of the time we have been able to spend with Committee staff and we will endeavor to remain engaged and collaborative as this process moves forward. Thank you again for your service and that of your colleagues.

Sincerely,

Tim Boyle

Chief Executive Officer

cc: The Honorable Richard Neal
Ranking Member
Committee on Ways and Means
1102 Longworth House Office Building
Washington, DC 20515

The Honorable Lloyd Doggett
Ranking Member
Committee on Ways and Means
Subcommittee on Tax Policy
1102 Longworth House Office Building

Mr. BLUMENAUER [continuing]. Have problems for them, and that most of the products that they are involved with are no longer manufactured in the United States and haven't been for some time, leaving them without choice. So I appreciate your courtesy on that.

I do appreciate the notion, Mr. Simon, about doing it right, trying to get the balance, your concern about having hollowed out the middle class, and not being available to purchase, and collapsing retail. Would it not be possible to stimulate demand here at home by putting people to work on infrastructure projects that can't be outsourced? If we were to do something radical like raise the gas tax, like dozens of Republican States have done to improve infrastructure? Wouldn't we be able to strengthen the middle class in purchasing power by taking a step like that?

Mr. SIMON. Well, you are clearly out of my area of expertise when you start talking about infrastructure. But anything that would provide——

Mr. BLUMENAUER. Haven't your enterprises relied heavily on well-functioning American infrastructure——

Mr. SIMON. Absolutely.

Mr. BLUMENAUER [continuing]. Problems with congestion or lack of reliability——

Mr. SIMON. Anything that builds good, solid, strong, long-term middle class jobs would be good for the industry.

Mr. BLUMENAUER. But, Mr. Cornell, doesn't your business rely upon a well-functioning American infrastructure?

Mr. CORNELL. We certainly do. And we would certainly love to see infrastructure improvements.

Mr. BLUMENAUER. I would like to turn back to Dr. Clausing, a point that you made that I think is important, in your testimony I really appreciate that you are making a distinction that is not often made before this committee. Yes, there are some companies that are wildly disadvantaged and pay close to the statutory rate because they don't have as many opportunities to engineer the Tax Code. But you make a point that American international corporations have been very successful. They have higher profit rates than their competitors. That they have an effective tax rate that is very similar to what their competitors are because they take advantage of this stupid jerry-rigged Tax Code, and they spend time and energy engineering it. But, at the end, aren't they basically at status quo ante? You say it better than I in your testimony.

Ms. CLAUSING. Yes. There is a big difference between label and reality in our tax system. So our label is a statutory tax rate of 35 percent. But our reality treats different firms very differently from each other. Some domestics pay an amount that is close to the statutory rate. But many multinational firms, including some of the more aggressive profit shifters, can get their rate down into the single digits. And so you have a big discrepancy there.

There is another label mismatch with the worldwide and territorial. Our worldwide system, some describe as just a stupid territorial system. And I think that is pretty accurate. Many multinational firms, most of them, don't pay a single cent on their foreign profits. They leave them offshore, and they wait for the hopes that one of you guys will give them a holiday. You know?

So where some of our trading partners who have purportedly territorial systems, they tax immediately some of the foreign income that is earned because of their base erosion protections through things that look a lot like a minimum tax. So we have to be careful about how we characterize the system.

Mr. BLUMENAUER. I think it is important to look at the big picture the way that you do. There are opportunities for us to move forward. Investing in infrastructure is one of them. But to have a broad brush, so-called reform that puts us at risk for companies like Columbia Sportswear, and sets us up in the future because we are not going to run huge trade deficits in perpetuity, for significant revenue loss. And your point about tax changes like this could incent people to have unnatural mergers simply because of the Tax Code, like the aforementioned Archer Daniels Midland and Wal-Mart. We can do better than that, and I think the committee can do better with that if we listen carefully to the information like you presented.

Thank you.

Chairman BRADY. All time has expired. Mr. Paulsen, you are recognized.

Mr. PAULSEN. Thank you, Mr. Chairman. And, first of all, thank you all for providing very constructive testimony here today. I especially appreciate the opportunity to have a great Minnesota company be a part of this tax reform conversation, which I think provides a good component to this discussion.

You know, the primary justification for the advocates of border adjustability is end the special tax breaks for foreign products over American products, and to keep American businesses and jobs from moving overseas. Certainly, given that the pace of American companies moving their headquarters to other countries, inversions, which we talked about earlier in recent years, it has happened both in Minnesota and across the country. You don't need to convince Minnesotans that something needs to be done.

We need to make sure that America is a destination to not only invest, but to build or be able to create a business. But this has to be done in a very thoughtful way, a way that addresses the very real and valid concerns that, Mr. Cornell, you raised today, and I heard from others, certainly, that have been raised. I cannot support the border adjustability provisions as introduced last year in the blueprint. I really want to urge this committee to listen, to be educated, and then to address these concerns that we heard as we move forward with reform.

Now, last week we had a really good hearing, a hearing that talked about the need for the comprehensive reform efforts, for fundamental reform. It is very important. We heard a lot about the positive effects it would have in the form of more jobs, higher wages, and greater economic growth. We also heard about the effects it would have on companies, both large and small, up and down the supply chain at every level. So we know the tax policy impacts different businesses in different ways. And we know the reform proposals will affect different businesses in different ways. But we got to focus on making sure that we are lifting everyone up. And economic growth is a key component. Because I think of the four key principles as focusing on growth, on simplicity, dealing with base erosion, and then dealing with permanency so you can count—as you are budgeting, count on, with predictability and certainty, as you are budgeting, allocating capital for 5 years, investing in your people and your companies, we are giving you that certainty, that confidence.

So, Mr. Cornell, you shared your views about border adjustability. And you also mention we can't keep the status quo. You said we should have every tax provision out there, tax benefits, should be on the table. I agree.

So keeping that in mind, what might be some—knowing that we are working on fiscally responsible tax reform in revenue neutrality, et cetera, what might be some policy recommendations that you would offer that should be key components of this reform effort as part of a comprehensive effort? Because that is really—it is not just about cutting rates. It is about the comprehensive effort that——

Mr. CORNELL. Well, again, I am certainly not a tax expert. I run a retail business and deal with real consumers, and real families, and real employees every day.

To your point, we certainly would like to see tax reform. As a company that pays one of the highest effective rates anywhere in America, at 35 percent, we would certainly like to see that rate lowered so that we can continue to invest in our business and see our business grow. We would certainly like to see simplification.

But as I listen this morning to the discussion, there is one word I continue to hear repeated again and again. And that is "if." If currency depreciates, and if the GDP grows, and if manufacturing comes back, and if we can avoid trade wars. We certainly need to be sitting here working on something that is going to provide greater certainty to certainly the families we serve at Target, my 320,000 employees, those small businesses in the back of the room. It is really hard for me to sit here today and craft a business plan, one that is focused on investing in America, and strengthening my company, and creating more jobs, when I keep hearing these provisions that say if this happens and if these triggers are in place.

I think we have to be focused on a plan that creates growth in America but simplifies the Tax Code, gives us greater certainty, so that we have greater certainty as I talk to families across America or interface with my team each and every day. I can't ask American families to sit back and say, if these things happen, you will be okay. I can't sit with 320,000 employees, Mr. Paulsen, and let them know if all these things come to pass, our company will still be here. And I know for small business in America, they can't sit here today saying, If all of these different factors come together, they will be okay.

So I would be happy to work with you. I think we have shown and demonstrated that to the chairman. We are willing to roll up our sleeves. But I think we need greater simplicity, much greater clarity, and much more certainty going forward.

Mr. PAULSEN. And I would just urge you to keep your seat at the table for that discussion. Because that is what, really, we are counting on as a part of that education effort.

So I yield back, Mr. Chairman.

Chairman BRADY. Thank you. Mr. Pascrell, you are recognized.

Mr. PASCRELL. Thank you, Mr. Chairman. Great, great committee before us today, the panel, and thank you for all of your testimony.

Mr. Simon, there is a reason, you say, in your testimony that the middle class in the United States has struggled recently. It is the same reason the middle class in the other global markets has emerged. The manufacturing base has moved and jobs followed, unquote.

Look, the manufacturing base, that is an inanimate object. You, your companies, and before even this panel, in the past 25 years, you moved manufacturing. You moved it. You moved it offshore, because it was cheaper labor and very few regulations. You are entitled to your opinions. As some would say, you are not entitled to your own set of facts.

Now, I look at this hearing today as part of act two, scene two. Act one was what happened in 2001 and 2003, with promises attached as to what it would do to not only increase and help the economy to grow its domestic product, but also have it sustained, question number one. And question number two is, it was obviously not sustained.

Act two began last week in our hearing. We had a search for anything in tax reform that even referred to the people in the other cars and the caboose, everything about the top 1 percent. Everyone else was left offstage.

Now, we have heard a lot today that businesses in this country cannot compete globally because our taxes are too high. I would like to see real bipartisan revenue-neutral tax reform that would benefit all Americans, while bringing down the top corporate rate to be more in line with our competitors around the world. I have no problem doing that. The number we can debate.

I introduced legislation a few years back, the Bring Jobs Home Act. I tried to get bipartisan support, like I do all my legislation.

My Republican colleagues are clinging to a debunked idea, a debunked theory that a bill would end the tax break companies get for shipping jobs offshore. No, they believe in the idea that if they cut taxes at the top, all that will trickle down and serve everyone. But firms in the United States already have checked this out. The highest, higher after-tax profits than at any time since the 1960s, that is a fact of life. But they are not investing those profits towards increased productivity; they are just paying it out to wealthy shareholders.

Corporations that are sitting on record profits today do not need to be showered with deficit-financed tax cuts at a time when middle class wages are stagnant, as some of you brought up in your own presentations, and broad gross domestic product is sluggish. It is, quite simply, a misallocation of our resources.

Further, U.S. firms are extremely competitive, Mr. Chairman, by any metric. The Forbes Global 2000 list of the largest public companies in the United States is disproportionately represented. The World Economic Forum ranks the United States third in global competitiveness out of 138 countries. And lastly, with all the deductions and loopholes corporations employ, effective tax rates paid by profitable organizations and companies are closer to 25 percent, similar to or lower than the averages around the world.

Manufacturing jobs aren't moving abroad because, really, primarily the Tax Code, but because they seek low labor costs. So as long as factory workers in Vietnam make 20 cents an hour, textile factories will continue to move there, regardless of what tax we employ on what is coming across the border. We know what boosts productivity. We can invest in infrastructure and developing our workforce and raising wages for middle class families and the working poor.

And, Mr. Chairman, is my time up?

Chairman BRADY. Yes, sir, all time has expired.

Mr. PASCRELL. I have a lot more to say about it.

Chairman BRADY. I know, Mr. Pascrell. So we will begin two-to-one questioning so we can balance out the questions here.

Mr. Marchant, you are recognized.

Mr. MARCHANT. Thank you, Mr. Chairman.

We all have the same goals here today. We want a simpler, fairer Tax Code that significantly lowers personal pass-through corporate rates and makes our companies competitive on the world stage. I think we can all agree on that.

Mr. Cornell, what percentage of product that you sell in your store is brought in from overseas?

Mr. CORNELL. Half of all the products we sell today are made right here in the United States. The other half, obviously, would be brought in from other countries. So you take a look at the composition of our business today, eight of our top ten vendors are companies right here in the United States. They are companies like Procter & Gamble in Ohio or Frito-Lay in Plano, Texas, companies like KitchenAid in Ohio, Johnson & Johnson in New York. So it is a balance. So many of the products——

Mr. MARCHANT. But the answer is about 50 percent?

Mr. CORNELL. About 50/50.

Mr. MARCHANT. Mr. Simon, when you were affiliated with another major retailer, what figure did you use? What was the common——

Mr. SIMON. Because of the heavy concentration of food at Walmart, about two-thirds of what they sell in the U.S. is either grown or made in the U.S.

Mr. MARCHANT. So about a third?

Mr. SIMON. Two-thirds.

Mr. MARCHANT. Two-thirds, okay.

One of the big objections that I have heard today about the border adjustability tax is the uncertainty of how the currency would adjust and whether the currency would adjust, and how would you deal with a currency that adjusted?

Chairman BRADY. So, Mr. Marchant, while we are adjusting the microphones, you might want to speak a little closer to the microphone.

Mr. MARCHANT. I would like to ask Mr. Lindsey, how has retail across the world adjusted in the last 3 months? While we have seen the dollar-euro, the dollar has lost about 8 percent against the euro in the last 3 or 4 weeks, 3 months, while we have been talking about this discussion, and the pound has gained about 8 cents, from 122 to 130. And then when we had the Brexit, we had a drop in one day from 160 down to 120.

So after all that has happened, what have the companies that are adjusting the currency—Mr. Simon and Mr. Cornell, how has your company dealt with those currency swings?

Mr. CORNELL. We have currency experts that look at this all the time. There are a number of other factors that you have to consider as we think about changes in costs. Currency is one of them. Commodity prices tend to change; and those are impacted by a number of different variables, starting with weather, extreme freezes, extreme heat, floods and droughts.

Transportation costs can be impacted by——

Mr. MARCHANT. But in this case, we are talking about currency. So, Mr. Lindsey, how are companies dealing with these kind of currency swings?

Mr. LINDSEY. Well, first of all, let's just take an example of border adjustability. All the countries, the 160 countries that have border adjustability, amazingly still have retail sectors that haven't been wiped out by the imposition of border adjustability.

So I think the claims of the damage that will be done to those companies is exaggerated. What companies do, first of all, is there are currency hedgers. They take up positions in various currencies.

The other thing that happens is one of the reasons the currencies adjust is these folks have market power. To imagine that Walmart or Target doesn't have market power with regards to Chinese sweatshops I find kind of silly. And, in fact, what will happen, the Chinese politburo understands that perfectly well and they will adjust their currency. There is no doubt in my mind that they will do it, and then that is why there is not really an issue here.

Mr. CORNELL. If I could, I think one of the other important factors we all need to recognize is, for a company like Target—and I can speak for many others in the retail industry today—our contracts are dollar-denominated. They are today; they will be tomorrow. And the vendors that we work with, their raw materials are largely dollar-denominated. So I think we have to recognize as we go forward, the U.S. dollar is the global currency.

Mr. MARCHANT. Thank you.

Chairman BRADY. Thank you. Mr. Kelly, you are recognized.

Mr. KELLY. Thank you, Chairman.

Thank you all for being here. Please don't take this as disrespect. Mr. Lindsey, Ms. Clausing, I appreciate your being here, but I wanted to talk to the people that are actually in the retail business. I am an automobile dealer. I am not somebody that grew up on a laptop; I grew up on blacktop.

Who I talk to are moms and dads who are trying to make sure that their budgets are workable. And whenever I sit down with people to see if we can get to some type of solution for their transportation problem, it is always the wife who makes the final determination of whether they can afford or not afford to buy a new car or new truck. And sometimes, the difference is $5 a month. Now, in Washington, DC, people say, oh, that can't be possible. Please come home with me and see what blue-collar people go through every single day of their life.

So that is why I wanted to ask you, because you are in the retail business. My concern is the final price on the shelf for those folks that pick up the tab on every single thing this wonderful government does in their name.

So if you could just tell me, now, Mr. Luciano, you talked about things that were happening in ag. Mr. Cornell, you talked about what was happening at Target, which my wife is addicted to being in every Sunday right after mass. And Walmart I go to quite a bit, because they are all in my town.

The effect, the actual effect on everyday Americans, because the global supply chain has changed. I also have in my pocket, by the way, Monroney labels, which I would love to share with people, that show parts content, because that is truly the complication of how do you tax different pieces.

So if you can tell us—and there is not enough time to do it, 5 minutes is not nearly enough time to talk about this huge proposal—how does this affect the price on the shelf and how will it affect consumers as we go down this road, both plus and minus? I know we have to pay for these tax cuts, but I don't want it to be on the back of everyday hardworking American taxpayers.

Mr. CORNELL. I would be happy to start.

Mr. Chairman, for the record, I think I will stay with Mr. Cornell for today.

But we talk to consumers all the time. I have 30 million shoppers in our stores every single week. I spend time with them in our stores and in their omes. And, to your point, these are families, middle class families on a budget. And for those families, as we look at the implications, I think the unintended implications of the new border adjustability tax, we know that their prices will go up on essential items.

They will pay 20 percent more for apparel—I am going to spend a few minutes explaining why—on back-to-school items. They are also going to spend more on essential items, like produce, that in the winter we don't grow in the United States. They come from Mexico and Chile. We are not going to be growing bananas anytime soon in Ohio or coffee beans in Michigan. So that basic American family, they are going to pay higher prices.

We have talked about manufacturing coming back to the U.S., and I would certainly love to see that happen, but I also know—and Mr. Simon has talked about this—for many of the supply chains, they don't exist here in the U.S. right now.

Ninety-seven percent, 97 percent of all the apparel we buy in the U.S. is made outside the U.S. Those supply chains don't exist here.

So I know under the new border adjustability tax, the prices we pay, that those moms pay to buy apparel and clothing for their kids, they go up. And right now, I can tell you when I sit with them, they are on a budget. At the start of the month, when they get a paycheck in their family, they are loading up their pantry, they are buying a few unique things for their family.

By the end of the month, they are counting their final dollars. So we have got to make sure we understand the impact on American consumers. All of the electronic devices we all love, all of our phones and tablets, those supply chains are not here in the U.S.

Mr. KELLY. I am just going to stop you for one second, because I am running out of time.

How many employees do you have?

Mr. CORNELL. I have 320,000 employees, 99 percent of which are right here in the U.S.

Mr. KELLY. Mr. Simon.

Mr. SIMON. Well, I am retired now. I have one.

Mr. KELLY. But when you weren't retired?

Mr. SIMON. One point three million.

Mr. KELLY. One point three million. Mr. Luciano?

Mr. LUCIANO. Thirty-two thousand globally, 20,000 in the U.S.

Mr. KELLY. Okay. But I want to get really clear as I hear this thing, we go into political talking points rather than good policy here. How can we attack the other side? I would just like to remind everybody that is sitting in this panel, in addition to paying taxes on your profits, there is a huge item there called wage taxes, there are business privilege taxes, there are real estate taxes that actually propel all the wonderful programs this Nation supplies for its people. And I think sometimes we miss the bigger part of this.

It is you that is responsible or makes up all the revenue for social security, for Medicare. All these wonderful programs that we have come out of wage taxes. And I think that we better take a look at are we going to eliminate people who are working. They are the ones that pick up the tab on all these wonderful things.

I thank you so much for being here, we share your concerns, and we are on board. We are going to do this the right way.

Thank you, and I yield back.

Chairman BRADY. Thank you.

And, without objection, I will submit for the record research by J.P. Morgan that shows that if the dollar didn't adjust at all, which no one believes, retailers would need to raise prices by only 5 percent, on average, to offset it, and it would be just 2 percent final parts retailers. Without objection.

[The information follows:]

Brady SFR

Disseminated 03 Feb 2017 12:15 AM EST

J.P.Morgan

North America Equity Research

03 February 2017

# Hardlines / Broadlines Retailing

## Tax-Math Update: Price Increases Needed to Offset BAT - Who Has Pricing Power?

Following up on our detailed December analysis looking at the impacts of proposed tax policy changes on our coverage universe (including the Border Adjustment Tax, lower headline corporate tax rate, and interest/capex deductibility changes; see our note "Tax-Math Olympics"), the big question is how retailers make up for the lost tax deduction of imported goods. JPM US Chief Economist Michael Feroli indicates that the impact of BAT will be fully offset if the USD appreciates 25%, thus making imports cheaper (though we could run into issues with dollar-denominated contracts). The other path is price increases.

- **Retailers, on average, would need to raise prices by 5% to offset the negative impact of BAT, with some retailers as high as 14% (BBY) and some at only 1% (GNC/VSI).** As shown in Figure 1, we estimate the highest price hikes need to be done by BBY (14%), PRTY (11%), WMT (9%), and WSM/TCS (8%), while some of the lowest hikes need to be done by the auto-parts retailers (2%). This range follows the overall impact of the BAT, with high gross margin businesses with primarily domestic sourcing (e.g., TSCO) seeing a lift while low GM sectors with higher imports (e.g., BBY, WMT) needing bigger price increases. *See Figure 1 below.*

- **The question we often get asked is who has pricing power in our universe.** Clearly, we believe home improvement, TSCO, ULTA, and autoparts have pricing power. We also believe that DKS might, so long as the key brands enforce minimum pricing and manage the channels. Also retailers with small tickets like MIK and PRTY seem to have a clear path for a large portion of the assortment. However, we question if the world of electronics (brands and the online competition) will have the discipline, and home furnishings seems similarly challenged. The grocery world seems precarious. First, you have companies like COST who live on price disparities. Second, we recall the impact of the hard discounters in the UK during the inflationary period around the financial crisis where mainline grocers raised prices but the hard discounters kept it low. This seemed to open the floodgates of share loss and WMT has first-hand experience of that with its Asda banner.

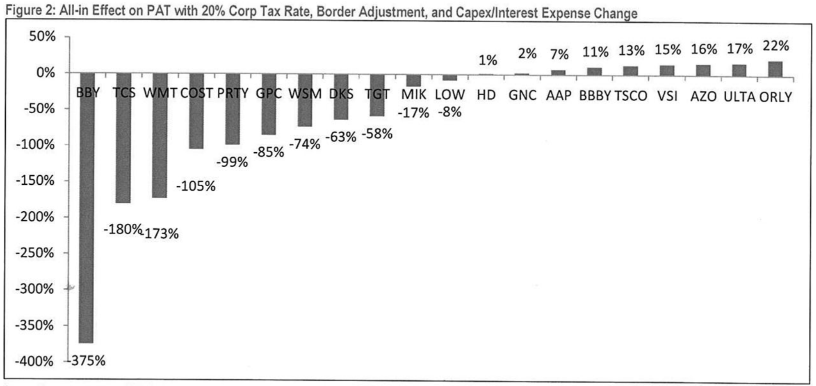
- **See Figure 2-4 for a recap of results from our previous note detailing the impact of proposed tax changes and email us if you would like a copy of our working file containing the calculations.**

Figure 1: Price Hike Needed to Offset Border Adjustment Tax Impact on PAT

| | Price Hike Needed to Offset BAT Impact on PAT |
|---|---|
| BBY | 14% |
| PRTY | 11% |
| WMT | 9% |
| WSM | 8% |
| TCS | 8% |
| DKS | 7% |
| GPC | 7% |
| COST | 5% |
| TGT | 5% |
| MIK | 4% |
| ULTA | 3% |
| HD | 3% |
| LOW | 3% |
| AAP | 2% |
| TSCO | 2% |
| AZO | 2% |
| ORLY | 2% |
| BBBY | 2% |
| VSI | 1% |
| GNC | 1% |

Source: J.P. Morgan estimates.

Figure 2: All-in Effect on PAT with 20% Corp Tax Rate, Border Adjustment, and Capex/Interest Expense Change



Source: Company reports and J.P. Morgan estimates.

Figure 3: Impact to PAT by Layering on the Capex Inclusion and Interest Expense Exclusion at 20% Tax Rate

| | Effective Tax Rate 2017E | Reduction In Effective Tax Rate @20% Corp Tax | % Increase PAT (adjusted for geographic mix) | Incremental Tax (on 20%) from Border Adjustment | % Increase PAT (adjusted for geographic mix) | Incremental Tax (on 20%) from Interest/Capex | % Increase PAT (adjusted for geographic mix) | New Effective Tax Rate as % of EBT | % Increase PAT (adjusted for geographic mix) |
|---|---|---|---|---|---|---|---|---|---|
| Ticker | | | | | | | | | |
| AAP | 37.8% | -17.8% | 28.6% | 17.9% | -22.4% | -4.7% | 5.9% | 33.2% | 7.3% |
| AZO | 34.9% | -14.9% | 21.3% | 7.6% | -8.9% | -3.9% | 4.5% | 23.7% | 16.0% |
| GPC | 36.5% | -16.5% | 21.2% | 79.6% | -81.2% | 3.1% | -3.2% | 102.7% | -85.0% |
| ORLY | 36.7% | -16.7% | 26.4% | 7.3% | -9.1% | -4.5% | 5.6% | 22.8% | 22.0% |
| BBY | 35.8% | -15.8% | 22.9% | 282.7% | -328.6% | -8.0% | 9.3% | 294.7% | -374.9% |
| COST | 35.2% | -15.2% | 13.9% | 143.4% | -106.2% | -13.5% | 10.0% | 149.9% | -104.8% |
| TGT | 35.5% | -15.5% | 24.0% | 60.3% | -75.3% | -7.0% | 8.8% | 73.2% | -58.5% |
| WMT | 32.3% | -12.3% | 13.3% | 180.5% | -165.6% | -8.4% | 7.7% | 192.1% | -173.2% |
| BBBY | 37.0% | -17.0% | 25.4% | 14.4% | -16.9% | -4.9% | 5.7% | 29.5% | 11.2% |
| MIK | 35.0% | -15.0% | 20.4% | 27.1% | -29.9% | 0.1% | -0.1% | 47.2% | -16.6% |
| TCS | 39.0% | -19.0% | 25.9% | 159.2% | -165.2% | -7.8% | 8.1% | 171.4% | -180.2% |
| WSM | 37.5% | -17.5% | 28.0% | 72.4% | -90.5% | -8.9% | 11.1% | 83.5% | -73.7% |
| HD | 37.0% | -17.0% | 23.8% | 17.0% | -18.8% | -0.9% | 1.0% | 36.1% | 1.2% |
| LOW | 37.7% | -17.7% | 26.1% | 25.4% | -29.2% | -2.2% | 2.5% | 43.2% | -8.2% |
| GNC | 35.0% | -15.0% | 14.6% | 12.5% | -9.9% | 0.2% | -0.1% | 32.7% | 2.2% |
| VSI | 39.0% | -19.0% | 31.1% | 16.9% | -21.1% | -7.1% | 8.8% | 29.8% | 15.1% |
| DKS | 38.0% | -18.0% | 29.0% | 67.7% | -84.6% | -10.5% | 13.1% | 77.2% | -63.2% |
| TSCO | 36.7% | -16.7% | 26.4% | 15.5% | -19.3% | -7.2% | 9.0% | 28.3% | 13.3% |
| ULTA | 38.0% | -18.0% | 29.0% | 17.4% | -21.8% | -10.0% | 12.5% | 27.4% | 17.1% |
| PRTY | 37.0% | -17.0% | 23.1% | 89.3% | -95.5% | 0.7% | -0.8% | 110.0% | -99.2% |

Source: Source: Company reports and J.P. Morgan estimates. Note that we iterate the impact of lower corporate tax of 20% on each scenario. So, the Border Adjustment and capex/interest expense adjustment are layered on top of a lower corporate tax separately, before finally aggregating the impacts of all three in the final two columns.

Figure 4: Estimated Overseas Direct Sourcing

| | % of COGS Sourced Overseas |
|---|---|
| TCS | 76.0% |
| BBY | 75.0% |
| PRTY | 75.0% |
| WSM | 67.0% |
| WMT | 50.0% |
| DKS | 45.0% |
| GPC | 40.0% |
| MIK | 30.0% |
| TGT | 27.5% |
| COST | 25.0% |
| ULTA | 20.0% |
| HD | 17.5% |
| LOW | 17.5% |
| AAP | 15.0% |
| AZO | 15.0% |
| ORLY | 15.0% |
| TSCO | 12.0% |
| BBBY | 10.0% |
| GNC | 10.0% |
| VSI | 10.0% |

Source: Company reports and J.P. Morgan estimates.

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Chairman BRADY. Dr. Davis, you are recognized.

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

And I too want to thank our witnesses. It is a very interesting hearing, and I think in order to understand how these tax proposals will affect our constituents, we must examine them in light of the cruel Republican budget priorities released to date: This budget, which cuts hundreds of billions of dollars from the most vulnerable Americans; this budget, which makes draconian cuts in food stamps, Meals on Wheels, heating assistance, and support for the extremely poor, elderly and disabled people, particularly targeting families with disabled children; it eliminates the Social Services Block Grant that funds critical child welfare and youth services, and eviscerates our health education and job training supports.

The Trump Republican tax plan amplifies the harm from these mean-spirited policies by taking even more from these families to give an average tax cut of at least $15 million a year to the wealthiest 400 families and the most profitable corporations, in sharp contrast to the minimal $250 relief for middle class families.

In addition, these untested tax policies promises to shock our vulnerable economic system. In a time of stagnant wages, heightened economic insecurity, appalling wealth gaps, and shocks to the workforce from trade agreements and technological advances, the Republican plan could send prices at stores skyrocketing by 20 percent and force huge job losses in the retail sector, which would certainly undermine my city, my State, and our Nation.

Professor Clausing, given the Republican policies to dramatically cut Federal support to middle and working class families on the spending side, I am deeply concerned about the possible harm to these same families from these tax policies.

Could you expand on your concerns about the potential shock to our economic system and how it could affect jobs, income, and cost to families?

Ms. CLAUSING. Sure. This tax system, while border adjustment is similar in some respects to a VAT, really has no precedent. There isn't another country that does a border-adjusted corporate tax. And so that makes it fundamentally different. I think the biggest risk to households really do come from the possible absence of adequate exchange rate appreciation, but this is an untested plan, and there are other types of risk too.

Let's say the dollar does appreciate by the amount they said it would, to 25 percent immediately. That could create an emerging market crisis. There are $9 trillion worth of dollar-denominated debt in the world economy. And Mr. Cornell is exactly right, the dollar is a unique currency in the world system. And so when the dollar appreciates, that can harm the entire world economy, which, again, can hurt the middle class, because the middle class is dependent on international trade, whether they have export jobs or whether they have jobs that are import industries.

So between the fears of higher costs and the fears of job loss in trade-intensive sectors, those would be my big concerns.

Chairman BRADY. Thank you. All time is expired. Mr. Renacci, you are recognized.

Mr. RENACCI. Thank you, Mr. Chairman.

I want to thank the witnesses for being here.

Look, I believe getting tax legislation signed into law is absolutely critical to getting our economy growing. I must admit, though, I have been skeptical of the border adjustment as a central element of the blueprint, but I am trying not to be. It is not because I oppose border adjustment in all contexts. As many of you know, I am a strong supporter of a more conventional border adjustment consumption tax.

My concern is really rooted in three questions: Does border adjustment, adjustability in the blueprint pick winners and losers; who will the tax burden ultimately shift to; and is it compliant with our international treaty obligations? There are just three simple questions.

From what I have heard today, the answer to the first two questions hinges on economic theory, that currency will adjust to offset the tax. Market analysts and currency experts have been skeptical. Wall Street firms believe there is a large potential for disruption and could cause volatility in the market.

With respect to question three, it really seems, at best, border adjustment is in a case of first impression, or at worst, it is a flagrant violation of our international obligations.

I am also hearing very real concerns from Main Street Ohio, where I represent. One major employer in my district sells coffee. But coffee beans generally come from high-altitude mountains in Africa and Latin America. You just can't buy much U.S.-grown coffee here in America. Border adjustment would increase the price of coffee.

I am very concerned for the low-margin companies in my district that rely on imported goods not primarily produced in the United States, whether that be coffee or any other good that can only be imported.

So, look, I am a business guy like Mr. Kelly, a CPA, a tax practitioner. I understand taxes and I understand business. I have been in the business world for 30 years. I have made all of my decisions on factual background, normally not on economic theory. In fact, economic theory in many cases in the business world can be troubling if you do it the wrong way, as you all know.

So, to each witnesses, can any of you assure me that the currency will adjust so that there will be no effect to the cost to our consumers, yes or no, to each one of you?

Mr. CORNELL. No, I can't.

Chairman BRADY. Anybody?

Mr. LINDSEY. No.

Mr. RENACCI. There is going to be an effect to our consumer. Currency will adjust——

Mr. LINDSEY. Nothing has no effect. I think it will be extremely minimal.

Mr. RENACCI. Okay, but there is an effect.

Mr. Lindsey, you gave an answer on my third concern, which is WTO. To each of the other witnesses, do you have any experience to know whether this will pass WTO, yes or no?

Mr. LINDSEY. No one will know whether it can pass WTO until it is brought there. No one could possibly know the answer to that question.

Mr. RENACCI. Anybody else? Do you think, yes or no, will it pass WTO?

Ms. CLAUSING. I don't think it will, based on discussions with lots of trade lawyers.

Mr. RENACCI. Any other individuals, yes or no, will it pass WTO?

Mr. LUCIANO. Difficult to know. It is pretty similar to VAT that is being enforced today.

Mr. RENACCI. Mr. Lindsey, I am going to come back to you, because I was listening to you. You said WTO is a European-based organization. Okay for Europeans to do it, but not Americans. Isn't it true that European-based border adjustments do not allow for deduction of labor; and if it did, the same thing with our BAT, if we eliminated labor in our BAT concept, it would become a VAT and, therefore, it would be WTO-compliant, yes or no?

Mr. LINDSEY. No. Let me describe exactly what the Europeans did. What they did was they put on a VAT, and then they cut other taxes with the revenue they got.

Mr. RENACCI. I understand.

Mr. LINDSEY. So essentially, essentially what they did was exactly what the BAT do, exactly.

Mr. RENACCI. I know. But if labor was eliminated, we would have the same thing.

Mr. LINDSEY. If they eliminated. What they did was to reduce other taxes on labor with it.

Mr. RENACCI. I understand.

Mr. LINDSEY. So that is why I think it will pass WTO muster, because essentially the Europeans did exactly what this tax——

Mr. RENACCI. I have got a couple other questions. I appreciate.

Mr. Simon, you indicate in your testimony, a long implementation period for this to work. In the 1950s, 90 American companies made TVs. Today, there is not a single American company making TVs, and there hasn't been in over 20 years an American company has made a TV. How long, on average, do you think it would take to get American companies back in the business of making TVs? Because you said a long implementation period; I would like to know what that means?

Mr. SIMON. TVs are being assembled in the U.S. for the first time since the seventies today, with a progression towards making them in the U.S. I can tell you the same thing about bicycles. They started in South Carolina in assembly, and they are moving into paint and powder and rolled steel. It takes time, and the process for bicycle has taken 4 years.

Mr. RENACCI. Mr. Lindsey, I am going to come back to you. You said this bill is the best way to make America the most competitive place in the business world. Is this the only way to get this accomplished, this bill? Is it the only way?

Mr. LINDSEY. This is the best way that I have seen to get it done.

Mr. RENACCI. So far?

Mr. LINDSEY. That is correct. And I am, by the way, very supportive of what was called for here, which is careful implementation, phasing in and things like that. I am a big supporter of it.

And what I hear from the chairman and others is that they are too. So I think that will happen.

Mr. RENACCI. I thank you all. My time has expired.

Chairman BRADY. Thank you, Ms. Noem, you are recognized.

Mrs. NOEM. Thank you, Mr. Chairman.

My name is Kristi Noem. I represent the entire State of South Dakota. And I go to Walmart to get a lot of things that I need, but I go to Target for fun. So I don't know. Our family appreciates both of you being in towns in South Dakota, because a lot of times we don't have a lot of options.

I am very concerned about small retailers. I am very concerned about small businesses. That is the lifeblood of South Dakota. But our number one industry is agriculture, which supports all of the small businesses in our State and our families.

Mr. Luciano, I wanted to talk to you about that, because we read over and over again about large companies being bought out by companies not from the United States, especially in the agriculture industry. We are seeing concentration happening, in Chinese companies specifically, coming in and purchasing large chemical companies and other within the agriculture industry.

Do you believe that our Tax Code and policies have perpetuated this problem that we see, this consolidation happening in the industry? But also we see it, the ownership changing to other countries, and how that is impacting the United States. And what in this proposal could be beneficial in stopping that type of change that we don't believe is necessarily—I don't believe necessarily is in the Nation's best interests? And I have a follow up question when you are done with that one too.

Mr. LUCIANO. First of all, Congresswoman Noem, let me thank you on behalf of ADM and the biodiesel industry for your personal leadership for both biofuels overall and for biodiesel in particular. That was very helpful to the industry.

I think this proposal, as we are analyzing it today and it is presented to us, helps improve the competitiveness of the industry. The fight for grabbing sources of food, as you describe, is very important, very strategic, whether you are in the Middle East, whether you are in China, whether you are in all those places where you have multiple nations in production, actually. And we have that and South America has that, as I said before, and the Black Sea has that.

So whether we can stop that, I mean, I am not sure any proposal can stop if China determines that strategically they need to own resources, but I think it can make us more competitive. I think it can allow us, for the U.S. farmer to continue to invest and for us to have the ability to help the farmer to become more competitive, by investing in infrastructure, by investing in support for the farmer.

And I think that that is what it limits. I worry very much about losing competitiveness and losing share, what I said in my oral testimony. Because once you lose a customer, once you present to that customer that you are not a reliable supplier, because you are retrenching, things change.

And when somebody in Egypt that has been using our wheat for years to make bread starts to use some wheat from Romania, things change, and they adapt recipes and all that and then you become a secondary supplier, a supplier of last resort instead of the primary supplier.

And we are slowly going into that direction. So, to me, this blueprint address helps to restore the profitability and the competitiveness of the farmer in the U.S.

Mrs. NOEM. I am a lifelong farmer and rancher, and when I talk about the BAT at home to other farmers and ranchers, I talk about it how when our beef leaves the United States, it is taxed. Then it hits the border of Japan, they add another tariff to it, which makes it virtually unaffordable to be purchased in that country. And the BAT could potentially shift that to making it more affordable if we didn't do that.

But a lot of the farmers and the ranchers are worried. They are concerned that with the BAT that potentially they sell their commodity to ADM, ADM then sells to another country, keeps more of a profit margin and doesn't necessarily let it flow down to those guys producing the actual crops, the actual commodities.

How would you answer that concern? Because I face that quite often, that yeah, sure, maybe the big companies that actually market the grain overseas get a bigger profit, but how is that going to help my pocketbook?

Mr. LUCIANO. It is a very good question. In the U.S., the product is commingled. We have the system. But you have to understand ADM does not thrive unless there is a thriving farmer. We don't own land. We don't farm.

So we cannot export, I mean, individually. The farmer cannot export, we cannot export the production that doesn't exist. So we work with the farmer. Our farmers are our partners for 115 years, and we spend a lot of time in this community supporting the farmer.

If you go and see what we do every day in an elevator, you go into an elevator, it might have six commercial people from our side—I mean a storage unit or origination unit—and then you are going to have six or seven farmers sitting out there, you know, reading the newspaper, but they are also evaluating what they should do and getting from ADM what they should plan, when they should sell.

So it is a very symbiotic relationship. ADM does not exist without the farmer.

Mrs. NOEM. Thank you, appreciate that. I yield back.

Chairman BRADY. Thank you.

Ms. Sánchez, you are recognized.

Ms. SÁNCHEZ. Thank you, Mr. Chairman, and to our witnesses for here being here today. Mr. Chairman, I would like to ask unanimous consent to enter into the record a Bloomberg news article in which Treasury Secretary Mnuchin states that one of the problems with the border adjustment tax is that it doesn't create a level playing field, it has very different impacts on different companies, it has the potential to pass on significant cost to the consumer, and it has the potential of moving those currencies.

Chairman BRADY. Without objection.

[The information follows:]

Sanchez SFR#

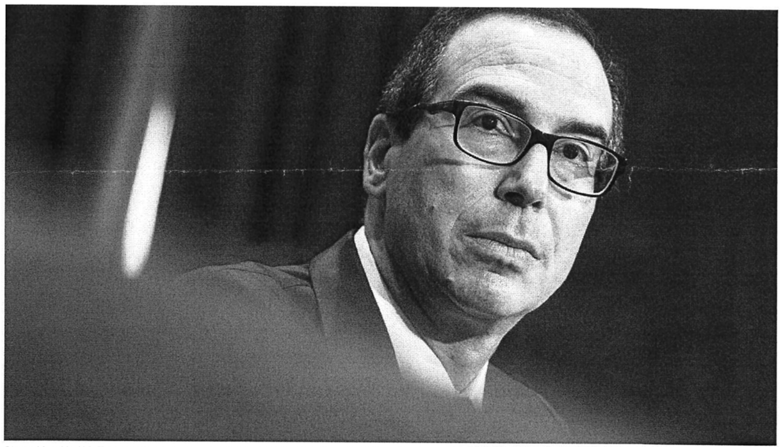
# Mnuchin Cites Problems in Border Tax as House Panel Seeks Tweaks

by **Alexis Leondis**

May 23, 2017, 10:30 AM EDT
*Updated on* May 23, 2017, 11:15 AM EDT

→ Treasury secretary says it won't create 'level playing field'

→ Ryan has said there should be a phase-in period for BAT



Steven Mnuchin, U.S. Treasury secretary, testifies during a Senate Committee on Banking, Housing, and Urban Affairs hearing in Washington on May 18, 2017. *Photographer: T.J. Kirkpatrick/Bloomberg*

House Ways and Means Chairman Kevin Brady said he's open to tweaking parts of the House Republican tax blueprint as Congress looks for a path forward on trying to make U.S. businesses more competitive globally -- even as Treasury Secretary Steven Mnuchin offered his most direct criticism of the plan yet.

"We know there are legitimate concerns -- including from some of our witnesses here today and our colleagues on the other side of the aisle -- about how it will affect American workers, businesses, and consumers," Brady said Tuesday during a hearing to discuss a controversial proposal for a border-adjusted tax on imports. "We are committed to working with all of you to address these concerns."

Meanwhile, Mnuchin sounded a clear warning about the BAT proposal during an appearance in Washington.

the problems with the border-adjusted tax is that it doesn't create a level playing field," said Mnuchin, who is playing a key role in ping legislation with the House and Senate. "It has very different impacts on different companies, it has the potential to pass on significant osts to the consumer, it has the potential of moving the currencies."

The House Republican leaders' tax plan depends in part on taxing U.S. companies' domestic sales and imported goods while exempting exports. The concept has faced resistance from President Donald Trump's top economic advisers as well as criticism among Senate Republicans. Retailers and other importers have been trying to kill the idea and Target Corp. Chief Executive Officer Brian Cornell is scheduled to testify on their behalf. Opposing him will be Bill Simon, a former top executive for Wal-Mart Stores Inc., who recently called the retail industry "hysterical" on the issue.

House Speaker Paul Ryan said May 18 that a border-adjusted tax "should have some kind of an adjustment and phase-in period." The retail lobby, however, has said it opposes BAT in any form.

Ms. SÁNCHEZ. Thank you.

Today's hearing has definitely provided an interesting mix of perspectives on what most consider to be the centerpiece of the Republican tax reform plan, and I think it is high time that we began to dig into this brand new proposal that sort of blind-sided everybody last year.

I happen to believe that a proposal of this size deserves some thoughtful consideration, and I am pleased that we are finally starting that process today. But I can't help but note that I wish we were here discussing a bipartisan idea that came together through substantive committee process rather than a few pages of talking points.

I want to share some of the concerns that my colleagues have highlighted. Number one is an ill-advised gamble on the value of the U.S. dollar to not tank world economic markets, should the rate not adjust immediately to the very optimistically projected level.

Second, the fear that adopting the Republican plan would set the United States up for a huge loss at the WTO, which could have lasting implications on domestic producers and consumers for many years to come.

And thirdly, a system that could incentivize some of the largest corporate exporters to merge with large importers, creating even bigger behemoth multinational corporations to game the new tax system.

Those are just three of my concerns.

Ms. Clausing, I would like to spend my time focusing on the issue of distribution that you raised in the slides that you provided. I find those numbers to be truly staggering. So can you provide a little more insight into how the proposed Republican plan not only exacerbates the divide between the rich and the poor in this country, but how the middle class households specifically will be squeezed by this policy?

Ms. CLAUSING. Sure. You are exactly right to focus on income distribution. It has been a big issue for the last 35 years. If you look at the last 35 years of data, you will see that the middle class wages have been growing very slowly and that the vast majority of GDP growth has gone to those at the top of the income distribution. So this is an important thing to consider.

The problem with this tax plan is that the tax cut is much higher for those at the very top of the distribution who have already been benefitting a lot from the global economy and from technological change and from other forces that have been hitting our economy. So it seems in a way the opposite of what you would want to do.

When you have shocks to an economy, like trade disruption, technological change and other things, you want the tax system to sort of insulate people from shock so that everybody's after-tax income can go up. You know, a rising tide should lift all boats. But if your response to those shocks is to give a huge tax cut to the top, at the top 1 percent, and then give $200 to the bottom 80 percent, then that is going to be the opposite of what would be helpful in the current context.

Ms. SÁNCHEZ. Following up on that, right now middle class families in my district are forced to make what I call unwinnable choices, such as using the majority of one-parent salary to pay for childcare or having a parent leave the workforce entirely because the cost of childcare means that what they effectively take home at the end of the year is not going to—is not worth it.

And I think we should be highlighting those issues that we force our constituents to try to figure out, you know, for themselves when we have a Tax Code that can help blunt those effects and hopefully make those working families not have to make those difficult choices.

So with the time I have left, I would like you to address alternative ways that we could address international tax reform in a way that would actually help working families?

Ms. CLAUSING. Absolutely. There are a lot of good ways that we could do better to protect our corporate tax base from erosion. One option is to simply end deferral and combine that with a lower rate, but a minimum tax, done on a per-country basis, could also be very effective. Ninety-eight percent of all the profit-shifting is done with countries that have effective tax rates below 15 percent, and 80 percent of it is done with just a few havens.

So expanding the corporate tax base would help buttress revenues, and that is important because a lot of our priorities, including infrastructure, education, healthcare, require government revenue. So having an adequate revenue base is very important.

Ms. SÁNCHEZ. Great. Thank you so much for your testimony. And I yield back.

Chairman BRADY. Thank you.

Mr. Holding, you are recognized.

Mr. HOLDING. Thank you, Mr. Chairman.

I think we all agree we have got a Tax Code that is 30 years old, despite having an economy that is vastly different than it was 30 years ago. And I think we can all probably agree that we need to undertake a permanent comprehensive tax reform.

My concern, like I know the concern of a lot of us here, for 8 years we have had ballooning debt, well over $20 trillion. We need to ensure that we put in place a Tax Code that spurs the economy in a fiscally responsible way, promotes growth, and puts us in a position to be able to reduce the debt.

So I am worried when I hear from Ms. Clausing's testimony, when she states that when trade deficits turn into surpluses, the border adjustment will lose revenue. So, Mr. Lindsey, do you agree with this statement, and could you walk us through the impact that the border adjustment will have, perhaps, on the deficit long and short term?

Mr. LINDSEY. Certainly, Mr. Holding. I would also take just 30 seconds to say, to comment on something Congresswoman Sanchez just said, that this was a new idea that was just sprung out of some talking points.

This was a tax system, a tax structure that was discussed when I was in graduate school and was considered one of the best systems we could have. And I assure you I was not in graduate school yesterday.

As to your particular question, I am sorry.

Mr. HOLDING. The particular question has to do with the border adjustment.

Mr. LINDSEY. Right, being permanent. Thank you. See, I wasn't in school yesterday; I can forget things.

First of all, we have had a trade deficit now for 50 years. So saying that trade deficits will turn into surpluses gives new meaning to the word "theoretical." However, I think that the right thing to focus on is how we finance that trade deficit. And what we do now is we basically put it on our credit card. We sell our debt overseas. That is the main way we finance it. This is called the capital account.

What this bill will do instead is it will finance it by encouraging foreign direct investment into America. And I think that is a much better way of financing a trade deficit than simply selling Treasury bonds.

Mr. HOLDING. Another function that we are trying to get, a goal we are trying to reach is protecting our national tax base from base erosion, whether it be from the erosion of the corporate tax base, and I also think we need to be worried about the erosion of our human capital base here. It is a stunning fact that the number of expatriations from the United States has been rising just at a tremendous rate.

In 2016, we had 5,400 people expatriate from the United States; compared to 2008, when you had 231 people expatriate.

Mr. Chairman, I would like to introduce into the record a recent article from the international tax blog regarding expatriation rates.

Chairman BRADY. Without objection.

[The information follows:]

# International Tax Blog (http://intltax.typepad.com/intltax_blog/)

New and Interesting International Tax Issues

May 09, 2017

## 2017 First Quarter Published Expatriates – A Total of 1,313

Today the Treasury Department published the names of individuals (https://s3.amazonaws.com/public-inspection.federalregister.gov/2017-09475.pdf) who renounced their U.S. citizenship or terminated their long-term U.S. residency ("expatriated") during the first quarter of 2017.

The number of published expatriates for the quarter was 1,313.

The data released today follows four consecutive years where new records were set for the number of expatriates. In 2013, there were 2,999 published expatriates (http://intltax.typepad.com/intltax_blog/2014/02/2013-expatriations-increase-by-____.html), and last year there were 5,411 published expatriates (http://intltax.typepad.com/intltax_blog/2017/02/2016-fourth-quarter-published-expatriates-new-annual-record.html). For a discussion of how the IRS compiles the data, see these posts: missing names (http://intltax.typepad.com/intltax_blog/2015/09/is-the-irs-missing-names-from-its-quarterly-publication-of-expatriates.html), source of data (http://intltax.typepad.com/intltax_blog/2014/02/quarterly-list-of-expatriates-source-of-data.html).

The escalation of offshore penalties over the last 20 years (http://intltax.typepad.com/intltax_blog/2015/11/the-escalation-of-offshore-penalties-over-the-last-20-years.html) is likely contributing to the increased incidence of expatriation.

We continue to believe that the IRS is likely missing a significant number of names from its quarterly publication of expatriates (http://intltax.typepad.com/intltax_blog/2015/09/is-the-irs-missing-names-from-its-quarterly-publication-of-expatriates.html). During the first quarter of 2017, the FBI added 1,484 individuals who renounced their U.S. citizenship to the NICS index. The IRS list is supposed to include U.S. citizens who have lost their U.S. citizenship as well as long-term green card holders who have terminated their green cards. The IRS number is lower than the FBI number, when we would expect it to be significantly higher than the FBI number.

Below is a graph of the quarterly number of published expatriates since 2008 through the first quarter of 2017.

For our prior coverage of expatriation, see all posts tagged Expatriation (http://intltax.typepad.com/intltax_blog/number-of-expatriates/).

(http://intltax.typepad.com/.a/6a00e54fb13f51883401bb09998a1c970d-pi)

Posted on May 09, 2017 in 877A Individual Expatriation (http://intltax.typepad.com/intltax_blog/number-of-expatriates/) | Permalink (http://intltax.typepad.com/intltax_blog/2017/05/2017-first-quarter-published-expatriates-a-total-of-1313.html) (http://twitter.com/share?url=http%3A%2F%2Fintltax.typepad.com%2Fintltax_blog%2F2017%2F05%2F2017-first-quarter-published-expatriates-a-total-of-1313.html&text=2017%20First%20Quarter%20Publishe...) (https://plus.google.com/share?url=http://intltax.typepad.com/intltax_blog/2017/05/2017-first-quarter-published-expatriates-a-total-of-1313.html) (http://www.facebook.com/sharer.php?u=http%3A%2F%2Fintltax.typepad.com%2Fintltax_blog%2F2017%2F05%2F2017-first-quarter-published-expatriates-a-total-of-1313.html)

Mr. HOLDING. Back to the tax base on a corporate level. So is there any other plan that achieves, other than the border adjustment, what we are trying to achieve with protecting the national tax base?

Mr. LINDSEY. Yes, there is. A lot has been discussed, and some of the comments have come out today. And this committee considered a number of options a few years ago to try and crack down on the ability of firms to go overseas. You know, there is an old saying that the beatings will stop once morale improves, which I think kind of has it backward.

And what I think we need to focus on is that all of those other plans punish American companies by putting more rules on American companies, but do not touch foreign companies. And I just think that is simply the wrong way to go about it. We need to start thinking about why it should be attractive to be headquartered in America, and why it should be attractive to move our production facilities here.

Mr. HOLDING. Thank you. Mr. Chairman, I yield back. Chairman BRADY. Thank you.

Mr. Higgins, you are recognized.

Mr. HIGGINS. Thank you, Mr. Chairman.

The border assessment adjustment tax is a poorly-conceived tax, because it will be adjusted a second time domestically, internally, in higher consumer prices for every American.

Target and Walmart don't make things; they sell to Americans what other countries make, particularly China.

America is 5 percent of the world's population and 23 percent of the world's economy. The United States is the world's largest economy and 70 percent consumption. We consume much more than we make. China is 20 percent of the world's population and 90 percent of the world's economy.

America's largest goods trading partner is China. Last year, we sold to China $115 billion worth of goods, and they sold to us $462 billion. We had a good trade deficit with China last year of $347 billion. So the border adjustment tax will hit China mostly, which I would be okay with, but we know that the border adjustment tax will really result in higher consumer prices and hurt American retailers.

There is lots of tough talk in Washington about challenging China's ambitions to become the world's economic leader, but that tough talk lacks guts or backbone. What do I mean by this?

Washington whines about China's currency manipulation, about China's poor quality of their air and their water and their land, about how poorly they treat their own people, but you know what China just did?

China announced a $1 trillion investment to open up China, to connect to 47 other Asian countries, to sell the stuff that they make to 47 brand new markets much more efficiently.

The United States, under this administration, is looking inward. The United States wants to build a $38 billion wall along its southern border; and the United States has responded to $2 trillion in infrastructure needs with a pathetically weak $200 billion investment in American infrastructure, maybe.

Look, I think you get the point. China is making an aggressive challenge to the United States' leadership in the world. China knows that infrastructure is how you dominate. China's peaceful rise is driven by economic growth rather than military force. The United States, under this administration, wants to spend another $50 billion on war. It wants to take healthcare from those who need it most, and it has a tax scheme to take away money from those who need it to give it to people who don't.

I am not quite sure what I am missing here, but a tax policy that doesn't put money into the hands of people that will spend it in the world's largest economy that is 70 percent consumption is a policy that can't work.

I often hear here that these tax cuts will pay for themselves. There is not a tax cut in human history that has paid for itself. The most conservative economic estimates are that maybe a third of tax cuts would be paid for by ensuing economic growth.

What you have to do to grow your economy is to invest in it. People to bring them to and beyond the current technology. Your infrastructure, which, based on any objective analysis, puts the quality of our infrastructure at a very, very poor rate as it relates to the rest of the world.

So you can talk about tax policy all we want here, but unless we are going to back it up with serious investments to compete on a global scale with places like China, the platitudes about where we want our tax policy to take us will never take us there. I have pretty much used all the time, and I apologize for that, but I think it is a statement that needed to be made and I think it is very important relative to this debate.

And I yield back.

Chairman BRADY. Thank you.

Mr. Schweikert, you are recognized.

Mr. SCHWEIKERT. Thank you, Mr. Chairman.

This is going to be one of those hearings when we all go back and actually read the transcript. It is going to be absolutely fascinating trying to follow some of the intellectual consistency on the lines. But at least we now have heard that many of our brothers on the left, our brothers and sisters on the left now are supporting much more trade and a lot of these other things. I cannot wait to grab my highlighter and go over this.

Mr. Simon, you actually have one of the most unique work experiences in history, and that was a massive company trying to restructure parts of your supply chain. Can you put a little more detail on that experience, because I just a moment ago—which your company I absolutely love, it is in my neighborhood. But we actually grow vegetables in Arizona in the winter. We supply the Nation's lettuce crop, and we can do a lot more except right now the rest of the world has a financial arbitrage on us south of the border.

Tell us about rebuilding supply chains that became domestic from products that were foreign before?

Mr. SIMON. Well, Mr. Cornell is right, 97 percent of apparel is made outside of the U.S. today. A good percentage of it is made with American cotton. So imagine the irony: Cotton grown in the U.S., 12 million bales a year exported, much of it to Asia, where it is made into apparel, then reimported into the U.S. It makes no sense. The labor component isn't the driver of that. You have transportation in two directions and all the other things that go with it.

But my mother-in-law in North Carolina used to make blue jeans at a factory there. And that product migrated. It migrated because initially labor, but eventually tax and infrastructure eroded. In order for it to come back, we need to rejigger the puzzle pieces. We need incentives like some of the things that have been discussed today that will allow that to happen. It won't happen on its own. We can't survive as a service economy.

The gentleman mentioned 70 percent of our economy is consumption. It is. But I can't go to the movies and you can't go to a restaurant every day and have the economy be buoyant. We have to make things.

Mr. SCHWEIKERT. But did you have that experience where a product that, as Walmart had been an international supply chain, and the skepticism, and then a couple years later you had found a way to domestically source?

Mr. SIMON. Every product that Walmart has been able to repatriate—and the list is quite long now—has taken an incredible amount of effort from both the supplier and the company. They sit down and they analyze the cost components of every single leg along the way. And we are overcoming 30 years of muscle memory, where the way that we have done things, the way that we have accounted for costs that are in the system, costs like currency.

And we had that discussion earlier. Currency in most companies is a footnote on their earnings statement, and they say, our earnings were $3 a share, that is up or down versus last year because of currency. And then Wall Street usually doesn't reward or penalize a currency adjustment. So our whole thinking isn't around currency adjustments. Our whole thinking is about how much earnings per share can you deliver.

We found out that the transportation costs and the time value of money from paying FOB in Shanghai versus delivery at your dock in Delaware is 3 months, and that 3 months on, you know, a billion dollars of imports is a significant amount of money. So as you restructure your supply chains, you also have to restructure your practices and the way that you look at your business.

Mr. SCHWEIKERT. And look, it has everything from currency exposures to environmental costs to moving things of those dimensions.

Look, hopefully we have a universal agreement of all the Members on the right and the left here. We actually have a wealth gap issue. We actually have an income-worker mobility issue. And yet I keep hearing, because we are, you know, taking little shots at each other, almost defense of the status quo, which is absurd. And as we sort of walk through this, look, I am fixated on some of the technologies.

We have been talking about apparel. And the articles that are now coming out that last year we finally now know how to laser-cut cloth, where before that was always the excuse of why it had to be done with labor. Now we actually have a technology that can change that predictive capacity. There are technological solutions that actually will make repatriation of some of these supply chains possible. And I know there are so many things.

Ms. Clausing, can you help me, just because you have actually said a couple of things that I found absolutely fascinating. And I must give you a compliment. I have been actually reading some of the things you have done. Thank you for being a person of the left, but also caring about what is happening debt-wise and the destruction that does for our next generation and why we must actually step up and deal with it.

With that, I yield back.

Chairman BRADY. Thank you.

Ms. DelBene, you are recognized.

Ms. DELBENE. Thank you, Mr. Chair.

And thanks to all of you for being here today and, Professor Clausing, for being here from my alma mater.

Actually, I want to start with a question for you. I have heard from small brewers in my district. They are very concerned about the border adjustment proposal, because they rely on imported ingredients in barrels to produce specialty beers, and often they only sell domestically.

So, despite the fact that they are supporting jobs and economic activity right here at home, they would be hit by border adjustment with no offset. And so I wondered, do you agree with that and how would you respond to their concerns?

Ms. CLAUSING. Yes, I agree that there are substantial risks here to import-intensive industries, because of the possibility that the exchange rate won't adjust perfectly.

And one thing that this testimony has reminded me of is the fact that we can't really do everything in one country. Like we have international and trade for a reason. We don't want absolutely everything to be done in the United States. It might make more sense to do the apparel abroad.

But that doesn't mean, you know, that we can't be sensitive in terms of thinking about how trade has affected American workers. And one way that you can help the workers who have been hurt by the downsides of international trade is by a tax system that favors, for instance, the earned income tax credit at the low end, or middle incomes as well.

But there are many industries, including brewing and the wine makers of Oregon and others, that are worried about this, because of the possible lack of an exchange rate offset.

Ms. DELBENE. Our tax system, when we talk about things, we generally talk about physical goods, the movement of something or nexus where something is located. But I wonder if you can comment on digital goods and intangible goods, how they would be treated right now under this proposal, or do we even have enough information to have a sense of how they would be treated?

Ms. CLAUSING. One of the difficult things with digital goods is that they are more difficult to observe. And so this has actually raised a huge issue with countries that have VATs, for instance, because they need to observe the passage of a good across a border; and with a digital good, that is often difficult to observe, and so that generates possible avoidance opportunities.

In general, the economic literature in taxation suggests that the more physical or real something is, the less responsive it is to taxes. So if you look, for instance, at U.S. multinational firms, where they have jobs abroad is often other countries that have high tax rates and high regulations, but where they have their profits are in these low-tax havens. And so you get this big difference in how responsive things are to tax, based on how easy they are to move. And digital goods are one example of things that are very, very easy to move.

Ms. DELBENE. Do we have enough information right now in terms of how border adjustment in particular might impact digital goods, specifically this plan?

Ms. CLAUSING. I think it would raise enforcement concerns, but this is one of several things that haven't been fully worked out in the plan. Another big issue is finance, because the financial sector would have to be treated differently under this plan, and this creates huge headaches in terms of thinking about how to administer this tax with respect to the financial sector.

Ms. DELBENE. One other issue that was alluded to earlier is that manufacturing is moving to more automation, using technology, artificial intelligence, robots, and so may not use as many people for that work. And if we look going forward, do economists look at this as we estimate kind of future impact and impacts on families and workers? Is that part of the modeling, because I haven't heard people talking about that as much.

Ms. CLAUSING. I think technological change is a huge issue. And one thing to think about, when we think about what it means to bring something back to the United States, if we bring it back and use robots to make it, it is not clear that that is generating any more American jobs than if we had left it somewhere else.

Adapting to technological change requires both tax policy that is sensitive to the needs of the middle class, but also spending policy. We want workers who can use technology to their advantage, not be replaced by it. So if you have an engineering degree or you write software, technology is your friend; but if you are a low-skilled worker, technology hurts you.

So the answer to that seems to be upgrading the skill levels of our population, and that is going to require investments in education, investments in infrastructure, not just hard infrastructure like roads, but other types of infrastructure, like internet access and computing access and the like. So I think our spending priorities need to reflect that.

Ms. DELBENE. Thank you very much. And, Mr. Chair, I yield back.

Chairman BRADY. Thank you. Mr. Rice, you are recognized.

Mr. RICE. Mr. Lindsey, I have a question for you. If you have an American company and an Irish company, and they both make the exact same product, and they both compete worldwide for the materials to make that product, and they both compete worldwide for customers to sell that product to, and the American company pays a 35 percent income tax, and the Irish company pays a 13 percent income tax, at a VAT, can you tell me the outcome of that story?

Mr. LINDSEY. It is very simple. Obviously, the Irish company is well advantaged.

Mr. RICE. So either the American company is going to end up bankrupt, right, or bought by the Irish company, correct?

Mr. LINDSEY. Well, it is certainly going to be less competitive. There is no question.

Mr. RICE. Do you disagree with that, Ms. Clausing?

Ms. CLAUSING. I think that some of the competitiveness issues here are misunderstood. In particular, any company that is serving a particular market——

Mr. RICE. You disagree with that is what you are saying?

You disagree with that?

Ms. CLAUSING. Yeah. I disagree.

Mr. RICE. You know, I ask that theoretical question all the time. You are the first person I have actually heard disagree with that. But you know, that point, I ask it as a theoretical question. But we have a real live instance of it right here. Mr. Luciano has made a much better case for that point than I ever could when he says that our American manufacturers are facing competition from Ukraine and from Brazil on grain exports, correct?

Mr. LUCIANO. Right.

Mr. RICE. And they have for what period of time, Mr. Luciano?

Mr. LUCIANO. Sir?

Mr. RICE. What period of time have we faced this competition?

Mr. LUCIANO. Well, we have faced it for the last 50 years, but I would say in the last five years it has accelerated.

Mr. RICE. And Brazil and Ukraine have these consumption taxes that we are talking about here, the border adjustment. Is that correct?

Mr. LUCIANO. That is correct.

Mr. RICE. So the effect of that, as you said earlier, is that to sell to worldwide markets, the price they charge for their product is less.

Mr. LUCIANO. [Nonverbal response.]

Mr. RICE. By how much?

Mr. LUCIANO. Enough to make the U.S. uncompetitive for long periods of time.

Mr. RICE. So if China is one of the big markets for our agricultural exports, the question is, I suppose, if our tax system, our income tax system, creates a 15 percent higher cost on American farmers, are the Chinese going to pay 15 percent more for American corn than they are for Ukrainian corn or for Brazilian corn? Is that right?

Mr. LUCIANO. I think what end up happening is that the actual price that the U.S. farmer will get for the product, in order to compete with those markets, will be lower than the price that the Brazilian farmer or the Ukrainian farmer——

Mr. RICE. But we have seen the effects of it already over the last decade, right? And what has been the effect? I mean, what has happened to our market share?

Mr. LUCIANO. We have been declining. We lost it by half.

Mr. RICE. Mr. Lindsey, does that line of reasoning just apply to agricultural products or any other products made in America with this higher tax bracket?

Mr. LINDSEY. All right. Obviously, it applies to all products. I would also point out the number of companies, how many companies have switched and moved intellectual property from here to Ireland versus the number of Irish companies that have moved back. I think I would point out to the ranking member how smart the Irish are in this regard.

Mr. RICE. Well, you know, and they are. And they have designed a tax system that has a low income tax and a higher VAT. Correct? Why would they do such a thing?

Mr. LINDSEY. Why would the Irish do such a thing?

Mr. RICE. Yeah. Yeah.

Mr. LINDSEY. Because they are very clever people.

Mr. RICE. Because they want to be competitive, correct?

Mr. LINDSEY. They want to be competitive.

Mr. RICE. And it has worked, hasn't it?

Mr. LINDSEY. It has worked beautifully. Ireland 30 years ago was not a particularly prosperous place, and now it is. And they have done a very good job.

Mr. RICE. I think that if the playing field is leveled, the American worker can compete with anybody. But since 1986 Washington has stood by and let the rest of the world tilt the playing field against the American worker.

My friends on the left spend their time arguing about the distribution of the tax reductions. And I sure want to work and make that fair. But, in my opinion, that is small potatoes.

Median household income in the United States is just about equal today to what it was in 1990. The American middle class has not had a raise in 27 years. The American middle class was 50 percent of the population in 1990. Today, it is 43 percent. So our middle class is shrinking, and its income is stagnant.

We have to do better. We can't stay where we are. In my opinion, the growth and GDP from this plan will dwarf any reduction in taxes. In my opinion, we will see a resurgence in American manufacturing. In my opinion, we will see a resurgence in the American middle class. In my opinion, we will see a reduction in income disparity.

I yield back, Mr. Chairman.

Chairman BRADY. Thank you.

Mr. Curbelo, you are recognized.

Mr. CURBELO. Mr. Chairman, thank you for hosting yet another important hearing on a comprehensive tax reform. And I thank the witnesses for their participation today.

I want to build on my comments from last week and reiterate my support for permanent, revenue-neutral and comprehensive tax reform. That is the surest way to bring the U.S. economy into the 21st Century.

And, again, I am pleased to hear that there is so much bipartisan consensus in favor of permanent, revenue-neutral tax reform. I think that is absolutely critical, as it is important that individuals, and families, as well as business of all sizes, have confidence in knowing their tax system is permanent, fair, and that it strives to achieve the lowest rates and the most simplicity for all taxpayers.

I want to ask Mr. Simon, I would like you to take into account the region I represent, Miami, oftentimes mentioned the gateway to the Americas, many export opportunities in South Florida. We have access to many markets all over the world. But, also, the Port of Miami sees a lot of imports.

So looking at our blueprint more broadly and then honing in specifically on today's topic, border adjustability, how do you think an area like Miami, like South Florida, where there is this great entrepreneurial spirit, where we have immigrants who are thirsty to contribute to our country, to start new businesses, who bring new ideas, how does an area like ours fair under the house blueprint? And specifically with regards to the policy that we are considering today?

Mr. SIMON. Well, I mean, by all accounts, American exporters will be more competitive because they will have a substantially different tax situation than they do today.

So the port and all the activity around the Port of Miami and all of our ports will remain vital.

By most accounts, at least in the short and medium term, we will still be very, very heavily importing because the supply chain, supply lines, won't be there.

I think the risk—and we have talked about it quite a bit—is that if we can't figure out a transition plan and prices go up, consumer prices go up, which I think everybody in the room doesn't want to have happen, if we can't figure that out, we could see a slowdown in some of the imports.

But, fundamentally, what will happen in most of the economy in the U.S. is that because of the revitalization of our export base and our manufacturing base, we will start to see rising consumer household incomes, and increased participation of consumers in the market, and retail industry will begin to become more vital, both large and small retailers, because of the spending power of the middle class, which, as we heard eloquently just a moment ago, has been eroded over the last 20 years. And once that is rebuilt, a lot of really, really exciting things happen.

Mr. CURBELO. And, Mr. Simon, what is your message for businesses who rely on textile imports? Of course, South Florida has been a great beneficiary of many wonderful trade deals like DR–CAFTA and other bilateral deals throughout the region.

And we do receive a lot of imports through our South Florida ports. And, of course, there are American businesses that rely on these imports who employ many people in my community. They have very serious concerns that they have conveyed to me. How would you address those concerns?

Mr. SIMON. I really commend my friend, Mr. Cornell here, for being here and being at the table. Because that is the way we are going to get this done, particularly in some of these more challenging industries. We need to sit down together, and understand the impact, and then try to find ways, the best ways, to mitigate them, and not with theory, and not with hope, and not with plan. And build in bridges and safety nets so these industries that may be impacted—and, to be quite honest with you, we are all, you know, have our own opinions.

But let's not have our opinions determine the outcome of his company or his industry. Let's figure out ways to bridge the gap, and build a transition so that we can get to the other side of this, and get rid of that 30 years of muscle memory that is having us doing things this way and has no other option besides offshore for apparel and many other industries. Once we do that, we will be able to move forward.

Mr. CURBELO. Mr. Cornell, briefly, I will give you the balance of my time.

Mr. CORNELL. I think Mr. Simon has talked about some of the issues. But I think you have hit a really important topic. Short-term, all the products that are imported into your district today will be impacted in a very negative way. And knowing your district pretty well, you have hundreds and hundreds of small businesses. And I know that they depend on import products.

So the short-term implications are significant. They could be devastating.

Mr. CURBELO. Thank you, Mr. Cornell. Thank you, Mr. Chairman.

Chairman BRADY. Thank you. Ms. Chu, you are recognized.

Ms. CHU. Ms. Clausing, I represent a district in Los Angeles county that relies on its cars. In fact, our survival in that area depends on owning a vehicle and navigating the freeways. For many middle class and working families, purchasing a vehicle is often one of the largest household expenditures of their lives, and I am concerned about the effect of a border adjustment tax on vehicle prices for these families.

Now, the automakers that have come in to see me tell me that automakers in the U.S. are part of a highly globally integrated industry, and because of the integrated supply chain, no vehicle made in the U.S. contains exclusively domestic content. Also, there are studies such as from the Center for Auto motive Research which estimates that the average auto price will increase by $2,000, and the Roland Berger study estimates that the average price increase would be about $3,300. That sounds to me pretty prohibitive.

So I would like to know how you think this plan will effect the American consumers of automobiles and the auto industry as a whole. And there are others on this panel who are saying that the rise in wages will mitigate price increases. Is that true?

Ms. CLAUSING. Yes. Thank you for your question.

I think the auto industry is one that is highly globally integrated as you point out. Whether you buy a Ford or whether you buy a Toyota, if you look at that sticker, you will see that both of those cars come from many, many different countries. And so any globally integrated industry like the auto industry is going to have some risk associated with it.

On the import side, if the exchange rate doesn't appreciate, that is going to drive up the auto prices of imported cars, which will, of course, increase the price of domestic cars as well, because they compete with each other in the economy as a whole. And so that would be one risk for the auto consumer.

For exporters of cars, there are also risks associated with the potential for WTO problems and trade and tariff retaliation. The auto sector would be an obvious one to target in retaliatory tariffs. So that would be one worry that I would have there.

And I would also point out that our auto exporters in general are competing on a level playing field with other countries with respect to a sales tax. If a country like Ukraine has a sales tax, or a VAT, you know, that is, of course, rebated when they export to another country. We could add a sales tax here and rebate it, but that is not going to make our companies more competitive. We already have a level playing field with respect to sales tax.

Ms. CHU. Well, I was shocked to see that this proposal could have very different effects for the top 1 percent versus the bottom 80 percent. In fact, you point out that the top 1 percent would get a tax cut averaging $213,000, the bottom 80 percent will get a tax cut averaging $210. That means that the upper 1 percent benefit by a thousand times more than the bottom 80 percent.

And we see also that the cost of everyday products that average consumers purchase would rise, like food. And the USDA says that certain food products are very import heavy, like fish, fruit and nuts, and that almost all bananas, mangoes, coffee, cocoa, tea, spices, tomatoes, melons, and grapes are imported.

So I have families in my district that live on a limited income, seniors that live on a fixed income. Thinking about all these families and seniors, does this tax plan and the BAT result in a regressive tax on consumers and especially those on a fixed income?

Ms. CLAUSING. Yes. And there are three ways in which I would worry about this. One, as you point out, if the exchange rate doesn't adjust, people would pay more for all of their imported products. And we know that the poorer you are, the higher the share in your consumption bundle is imported goods. And so that is my first concern.

Second, if you just look at the estimates, even ignoring the exchange rate effects, the tax cuts are just much larger at the top, as you point out, a thousand times larger than they are for the bottom 80 percent.

And, third, returning to this wage issue that you mentioned in your last question, we really have to ask, what is going to drive American wages higher? I think this plan is premised on the idea that it will unleash a new wave of investments and increase the supply side of the economy to drive up wages. But if you look again at corporate profits after tax, they are higher than they have ever been in all of our lifetimes.

So if they really need more after-tax profits in order to generate more investments, you kind of wonder, well, where is the investment paradise over the last 15 years? Because we have had really high profits, but without big investments. So I think a strong middle class is the answer to big investments.

Chairman BRADY. Thank you. Time has expired. Mr. Reed, you are recognized.

Mr. REED. Well, thank you, Mr. Chairman. And I know I went down to three minutes, so I will be quick. That is the penalty of coming late, you have to go a little shorter, which I appreciate.

To the panel, I want to just—one, I think there is broad agreement. We cannot maintain the status quo. The status quo of the American Tax Code is just fundamentally flawed and puts us at such a competitive disadvantage that we have to do something. Would everybody agree with that at least?

Okay. So we got common agreement there, heads shaking. I want to focus on repatriation, because it is important to a lot of folks back in my district and some interests that we have in the district.

The holiday of 2004 was just that, a holiday. And when that occurred, there was a lot of concern about that going to corporate shareholders and others. Obviously, I believe, there is a reason for that. Don't you have a fiduciary obligation to your shareholders in America? And if you got a holiday, and you get a one-time injection of cash, is there the fiduciary obligation that has to be satisfied to give that to your shareholders?

So is that a concern if we do another holiday going forward, Mr. Lindsey?

Mr. LINDSEY. I would not do another holiday. That is one reason I like this bill. Not only is it not a holiday, it takes care of the problem permanently. And I——

Mr. REED. And Ms. Clausing——

Mr. LINDSEY [continuing]. Estimate was a hundred billion a year by ending profit sharing.

Mr. REED. Reclaiming my time.

So for the democratic witness, you would agree with that too correct?

Ms. CLAUSING. Correct.

Mr. REED. So doing it permanent is the way to go? That is the general consensus of the panel?

Ms. CLAUSING. I am sure we disagree on the rate, but I agree that it should be permanent, and the holidays are a bad idea.

Mr. REED. I totally appreciate that.

The other source of agreement that I want to get to is when you look at the overseas trapped earnings. My understanding of it is you got, essentially, two types of overseas trapped earnings that are there. You have cash or cash equivalents, and you have investment oversea earnings that are sitting in brick and mortar and other type of investments overseas. Does that not encourage us to make sure that we have a bifurcated rate as opposed to one rate?

And, Mr. Lindsey, could you offer some comment?

Mr. LINDSEY. My instinct—and, obviously, it just my instinct—is no, because the way that money was repatriated over there, retained over there, was due to the combination of the foreign tax credit and the delay in repatriation.

What they chose to do with that money, given that it was over there, that issue should be irrelevant to how we have deemed repatriation.

Mr. REED. So you are advocating for a single rate, as opposed——

Mr. LINDSEY. Single rate.

Mr. REED [continuing]. To bifurcated?

Anyone disagree with that assessment? Any of you have overseas trapped earnings? I know you are retail. ADM, doesn't matter either way?

Okay. Well, I am very concerned because I do know Uncle Sam, and Uncle Sam does not take payments in regards to brick and mortar. He wants cash. And if you don't have the cash on your books to pay, I am very concerned that an impact of a single rate could have on those companies is that they would be significantly hit from a cash flow perspective and a cash balance sheet.

So, with that, I yield back.

Chairman BRADY. Thank you. Mr. Bishop, you are recognized.

Mr. BISHOP. Thank you, Mr. Chairman.

Sitting here, I know that I have a thousand questions for all of you. Thank you for the time you have taken. And I am sorry I only have three minutes to ask the question.

I am from the Detroit area, home of the Motor City, autos, component parts, manufacturing, big deal for us.

Mr. Simon, your comment that we have to make things is very important to me. I do believe that. We are not a service-centered economy. In my area, that is very important. And I would like to, if I could, drill down on the manufacturing issue a little bit more.

Tool and dye in our country is on the verge of extinction. We are the Arsenal of Democracy. We are the home of the Big Three, home of Henry Ford, home of the greatest auto industry in the world. Yet, in the blink of an eye, we have lost 70 percent of the tool and dye industry and a full 80 percent of its skilled workforce.

In a magazine article that I have here dated May 15, Mark Schmidt, who is the president of Atlas Tool in Roseville, Michigan, made some alarming statements and a very dire prediction. And in his article he said that China is under a deliberate and predatory economic attack right now. He talks about how they are undercutting all the prices in the United States and making it impossible for American folks to compete. And he also says that soon we will not have the sufficient capacity because we will be pushed out of the industry entirely. China will completely take over, and, as a result, will become the dominant automotive manufacturer and supplier in the world.

This represents a huge threat to the United States, not just in the area of the economy and jobs, but also all the way into the realm of national security. What are we doing? This is the craziest thing I have ever heard. If we are not doing something today, or in this process, that will address this concern, I would like to know from all of you what we can do to try to address this. But this is insanity to me if we can't do something about this. And I don't know if border adjustment is the solution.

But, Mr. Lindsey, can you comment on that? I am sorry to have taken so much time.

Mr. LINDSEY. I think that there are a number of things. Again, it comes back to, How do you make America the best place in the world to invest and produce things? And I think we are targeting that in this bill, particularly with the expensing component. Because we are going to be accelerating the incentives to, you know, have a new plant and new equipment here. I think that that is number one.

I also think the general reduction in rates is probably helpful. But I would go back to the most important answer I think is the expensing component.

Mr. BISHOP. Thank you. And one quick question for all of you. How important is it for us to get this done before 2018.

Mr. LINDSEY. Oh, vital, vital, vital, vital.

Mr. BISHOP. Mr. Simon.

Mr. SIMON. Every day is important. We are eroding. We are running out of energy.

Mr. BISHOP. I would ask you all, but I——

Chairman BRADY. Thank you. All time has expired. Mrs. Walorski for the last question.

Mrs. WALORSKI. The last question. Thanks again for being here. I represent Northern Indiana, and I come from the medical device and pharmaceutical industries. So inversions have been extremely detrimental to our State and could potentially be as well.

Another issue, Zimmer Biomet is a global leader in orthopedic medical devices, is headquartered in Indiana. I met with their head of global tax a few months ago, and he put this in stark terms. This is why I bring this up.

He said: Indiana is a consistent leader in quality infrastructure, high skilled labor, reliable and low energy costs. A few years ago, they were considering expanding their manufacturing footprint, and excluding the Tax Code, Indiana was the clear leader. But when you factored in the U.S. Tax Code, Indiana dropped to dead last. And that is jarring.

Mr. Luciano, is there a solution to make the U.S. competitive and attract investment other than tax reform? Is my one question. I got to do this quick.

How important for ADM, and others in your industry, is moving away from a worldwide tax system and ending the lockout effect? And then, what ripple effects do you see when companies are acquired by foreign competitors or inverters?

Mr. LUCIANO. Yeah, I think I said this before. I think that what we see in this proposal, to us, addresses that competitive issue that you are describing, and I think allows us to move freely investments to whatever we need to make those investments that makes sense.

And our intention is always to make it here, to improve the competitiveness of the U.S. It is a very competitive market out there, and if we are not allowed to help, in my case a farmer, or any other manufacturers, we are going to be falling behind to other countries that are challenging the U.S. supremacy in all of this.

Mrs. WALORSKI. I appreciate it.

Mr. Chairman, I yield back just one minute.

Chairman BRADY. So noted.

So, a couple of things. One, I would, for the record, like to introduce the Freund and Gagnon study for the Peterson Institute that shows in review of 34 countries that adopted or adjusted their border adjusted taxes since 1970, all but one, a full depreciation of the currency to balance trade effects.

[The information follows:]

Brady SFR #4

PIIE PETERSON INSTITUTE FOR
INTERNATIONAL ECONOMICS

WORKING PAPER

# 17-5 Effects of Consumption Taxes on Real Exchange Rates and Trade Balances

Caroline Freund and Joseph E. Gagnon

April 2017

**Abstract**

This paper examines the effects of border-adjusted consumption taxes (mainly value added taxes or VATs) in a sample of 34 advanced economies from 1970 through 2015. We find that the real exchange rate tends to rise by the full amount of any consumption tax increase, with little effect on the current account balance and modest offsetting effects on the trade and income balances. Case studies suggest that adjustment comes initially through prices. We note that the border-adjusted cash flow tax of the House Republicans differs in important ways from consumption taxes used in our study, which raises the possibility of a slower adjustment process with temporarily larger trade effects.

**JEL codes:** F31, F32, H20
**Keywords:** VAT, border tax adjustment, exchange rate adjustment, current account adjustment

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## INTRODUCTION

As the United States considers moving to a destination-based cash flow tax, there is growing concern about the impact of the proposed border adjustment on trade.[1] Border adjustment on sales taxes, which tax imports and exempt exports, is a common way of taxing only goods consumed in a country. Most countries perform such border adjustments on value added taxes (VATs). US states effectively border-adjust sales taxes, which apply to all goods consumed in a state, irrespective of where they are produced.

Economic models imply that border adjustment does not affect trade patterns or the trade balance because the real exchange rate (RER) adjusts. But many producers and market participants fear that border adjustment will be protectionist, raising costs and disrupting supply chains. A critical question thus is: Does border adjustment generate an offsetting movement in the real exchange rate or does it work like a tax and export subsidy and raise the trade balance?

We attempt to answer this question by examining the experiences of countries that have implemented VATs and other border-adjusted consumption taxes.[2] We do it in three ways. First, we examine movements in the RER, the trade balance, and other variables around the dates that countries first implemented a VAT. Second, we use cross-country time-series regressions to examine long-run correlations between consumption tax rates, the RER, and various measures of external balance, while controlling for other variables that would be expected to move the exchange rate and trade. Finally, we consider a handful of case studies.

Overall, our results support the basic theoretical conclusion that RER movements fully offset border-adjusted consumption taxes, including the VAT. Our results also suggest that a large share of the movement in the RER comes via consumer prices. In particular, increases in VAT rates temporarily increase inflation, which permanently changes the RER. There is little evidence of any significant effect of border-adjusted consumption taxes on the current account balance, although there may be different effects on the components of the current account. Most of the adjustment occurs within three years.

The destination-based cash flow tax proposed by the House Republicans[3] differs in important ways from border-adjusted consumption taxes used in other countries. In particular, under the border-adjusted cash flow tax (CFT), tax rates vary depending on the firms' labor cost share and international exposure. This key difference implies that the channel of RER adjustment is likely to be different. As Auerbach et al. (2017) note, a VAT requires an increase in consumer prices relative to wages, which may explain the adjustment pattern seen in the data. In contrast, because labor costs can be deducted, a CFT does not

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[1] "Destination-based" refers to the tax being levied based on the location of the consumer. By taxing imports and exempting exports, border adjustment enables a tax to focus on consumers within a country.

[2] The paper focuses on VATs in the event study and on consumption taxes, nearly all of which are border adjusted, more broadly in the regression analysis.

[3] *A Better Way: Our Vision for a Confident America—Tax*, June 24, 2016, https://abetterway.speaker.gov/_assets/pdf/ABetterWay-Tax-PolicyPaper.pdf.

require a change in consumer prices relative to wages, so any adjustment may be more likely to come through the nominal exchange rate. The House proposal would tax gross cash flow at 20 percent, which implies a 25 percent tax rate on cash flow net of the tax, and would require a 25 percent RER appreciation in equilibrium.

Although appreciation of the nominal exchange rate would facilitate domestic economic adjustment, it might disrupt the global financial system given the dollar's dominant role in finance. Alternatively, the special role of the dollar could mean that the nominal exchange rate responds only partially to trade pressures, especially if other countries resist the corresponding depreciation of their currencies. Limits on dollar appreciation force adjustment to come through US prices and wages. It would take time for prices and wages to reach a new equilibrium, because wages are set in advance through contracts and the Federal Reserve may not accommodate the full shift. Whether adjustment eventually comes through a 25 percent appreciation or a 25 percent increase in wages and prices or some combination of the two, these adjustments are large, and much larger than the events studied in this paper.

When a VAT is increased, domestic prices often go up almost one for one. As a result, exporters and importers remain indifferent between domestic and foreign markets because the increase in the tax is offset by the increase in the domestic price. In contrast, when a CFT is implemented, the price pressures will vary across industries and even across firms within industries unless the nominal exchange rate adjusts quickly. In the absence of nominal exchange rate adjustment, the result is likely to be a temporary stimulus to domestic production and an improvement in the trade balance.

## WHY SHOULD THE REAL EXCHANGE RATE ADJUST TO VALUE ADDED TAXES?

Consider a country implementing a VAT or final sales tax on goods sold domestically. Imports face the tax but exports do not. The process of adjustment depends on the extent to which the tax leads to higher consumer prices. We consider two extreme cases, one in which consumer prices rise by the full amount of the tax, and the other in which consumer prices do not rise at all.

When consumer prices rise by the full amount of the tax, the nominal exchange rate does not need to adjust. The price of exports, which are not taxed, does not rise, and they continue to be sold in foreign markets at the same local price as before. The price of imports, which are taxed, rises by the same amount as domestically produced goods. Assuming that the tax revenue is transferred back to consumers, perhaps through a reduction in other taxes, consumers maintain their total consumption spending.[4] Moreover, consumers don't have to switch between imports and domestic products because their prices have risen

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[4] As our focus is on the border adjustment, the relevant comparison is the same tax system, with or without border adjustment. Shifting from a corporate tax to a consumer tax, as proposed in the House blueprint, would likely affect saving and investment. A tax increase designed to reduce the fiscal deficit would also have real effects because consumers would have lower after-tax real incomes.

equally. The trade balance is thus not affected. The RER, which is the exchange rate–adjusted ratio of consumer prices at home to consumer prices abroad, rises by the full amount of the tax.

When consumer prices do not change—because of monetary policy aimed at maintaining stable prices and/or reductions in other business taxes that lower the local cost of production—the nominal exchange rate must appreciate. If it did not, firms would have a strong incentive to increase exports because they would be able to sell them abroad at the same price as at home and avoid paying the tax. Imports, on the other hand, would face the tax but would not cost any less than before. The increased supply of exports and reduced demand for imports would create an imbalance in the foreign exchange market, which would push up the value of the domestic currency. An appreciation exactly equal to the tax rate rebalances the foreign exchange market and keeps exports and imports, and thus the trade balance, unchanged.

A country's trade balance is equal to the gap between domestic saving and domestic investment. If the government returns consumption tax revenues to households, its saving does not rise and households have the same after-tax real income as before. Consumption taxes do not affect the after-tax return on saving or the cost of capital, so there is no reason to expect any change to private saving or investment. Thus, with full RER offset and a constant fiscal balance, border-adjusted consumption taxes should not affect saving, investment, or the trade balance (Feldstein and Krugman 1990).

A uniform VAT rate on consumption is important because it prevents distortions. If the tax is levied more heavily on some products, then there will be an incentive to shift away from those goods. In practice, most countries exclude some services, such as education, government, and health, as well as basic foodstuffs. Doing so is problematic because it encourages a shift toward these generally nontraded goods.[5] Another distortion arises because tourists should pay the tax rate of their home country but in practice pay the tax rate of the country they are visiting. When these tax rates differ, demand shifts toward the country with the lower tax rate.

Exempt sectors and tourism tend to represent a sizable share of consumption. The VAT revenue ratio measures the extent to which the tax covers all goods and services. It is defined as actual VAT revenue divided by revenue that would be collected if all consumption were taxed at the VAT rate. It equals 1 if the VAT is broad based and properly administered. It is less than 1 if some sectors are untaxed or if collection is uneven. It can exceed 1 if some export rebates are absent or if a country has a tourism surplus.

As shown in table 1, even among OECD countries, VAT revenue ratios are well below 1, averaging just 0.55, and have remained roughly unchanged over the last decade.

The difference between a VAT and a border-adjusted CFT is that price adjustment is more complex under a CFT. To the extent that the nominal exchange rate does not appreciate quickly and fully, prices of imports and goods with imported content are likely to rise substantially. It is less clear what happens to

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[5] The exceptions also generate incentives for tax fraud by mis-invoicing some taxable goods as nontaxable. They may also push some transactions into the informal economy.

other goods. To fully adjust to the tax, both prices and wages have to rise. Given labor contracts, adjustment could take longer than with a VAT.

In contrast, if adjustment comes through the nominal exchange rate appreciation it could neutralize the border-adjusted CFT more rapidly. Given the dollar's status as the world's premier reserve currency and a major target of pegged exchange rates, it is not clear how far or fast adjustment would proceed through this channel.

## PREVIOUS STUDIES ON THE ECONOMIC EFFECTS OF CONSUMER TAXES

A few studies examine the effect of VATs on trade flows, employment, and prices. Desai and Hines (2005) use data from 168 countries for 1950–2000 and find that countries with a VAT export 10 percent less and have lower overall openness than countries without a VAT. They also find that subsidiaries of US multinationals in VAT countries tend to export less. They argue that exports are lower because VATs tend to be higher on traded goods than nontraded goods (as shown by the relatively low VAT revenue ratios reported above), which pushes production and consumption into nontradables. Incomplete VAT rebates to exporters compounds the shift of resources toward nontradables.

Nicholson (2010) uses panel data from 12 years, 29 industries, and 146 countries to examine the effect of VAT and US corporate income tax on US competitiveness. Like Desai and Hines, he finds that VATs tend to reduce trade, both imports and exports, and that the effects differ across sectors. He also finds that VATs in developing countries tend to affect US exports but not imports and interprets this finding as evidence that VAT may be disproportionately applied to goods entering a country, acting as a barrier to trade. He also explores the relationship between the US corporate income tax and foreign VATs in a cross section gravity model. The results show reduced US exports and expanded US imports in country-industries where corporate taxes are highest and VATs are present, offering some evidence that border adjustments in other countries coupled with existing US corporate income tax hurt US competitiveness.

The study most closely related to the proposed border adjustment on a cash flow tax is by De Mooij and Keen (2012), who examine the economic effects of shifting taxation away from labor and toward consumption. They show that such fiscal devaluations have large short-term positive effects on employment and trade balances, especially in eurozone countries. Because each euro member's currency is determined by the group, no single member can appreciate to offset these events. Effects on noneuro countries are slightly smaller and not as statistically significant, although positive short-run effects remain.

A larger body of literature focuses on the price effects of implementing a VAT.[6] The studies find that in countries where a VAT replaces sales taxes there are no price effects; in contrast, in countries where the share of revenues from consumption taxes increases, there tends to be a one-time increase in prices. Studies

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[6] See Zodrow et al. (2010) for a summary. Benedek et al. (2015) find similar results.

that examine rises in VAT rates find that prices tend to rise almost one for one with VAT rates. Overall, the results are consistent with a full one-time offset of VAT in the price level.

## Methodology and Data

We take two approaches. First we look at the effects of a new VAT on prices, real exchange rates, and trade balances, both on average across countries and on a few specific cases. The advantage of this approach is that these are big events, often with large increases in the tax and the associated border adjustment. The disadvantage is that other taxes are being phased out, some of which may be border adjusted. The VAT is often part of a larger reform package, which may confound exchange rates and trade balances. In addition, in many cases a VAT is implemented in response to a fiscal crisis.

The second approach is a more comprehensive econometric analysis, which focuses on fluctuations in consumer taxes over time and across countries. The advantage of this approach is that it allows us to control for other factors that affect exchange rates and trade balances. The disadvantage is that factors besides policy changes, such as changes in consumption of taxable goods, may cause fluctuations in the goods and services tax share of consumption. To minimize the effect of cyclical changes in consumption, which may fall more heavily on highly taxed goods, we focus on long-run relationships in the data.

Most of the data are from 34 OECD countries.[7] Data on current account balances and net international investment positions are from the External Wealth of Nations dataset.[8] Missing data are filled in from the International Monetary Fund's (IMF) *World Economic Outlook* database where available. We exclude a few observations from transition economies in Eastern Europe before 1995 out of concern about the reliability of the initial posttransition data. We also exclude Luxembourg because its role as a financial center and electronic commerce hub distorts its measured consumption tax rate.[9]

The data are annual from 1970 through 2015. Data for many countries are missing in the first half of this sample; 2015 data are missing for a few countries.

In principle, the RER depends on relative consumption tax rates at home and abroad. For the regression analysis, we use bilateral RERs based on consumption deflators between each country and a fixed partner country and measure the relative consumption tax rates as the ratio (1 + home tax rate) / (1 + partner tax rate). Control variables are also expressed relative to partner country values. The partner countries are either the United States or Germany. For the external balance regressions, we use only the home tax rate, but the results are not affected much if we compare external balances against a partner country and use the ratio of

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[7] OECD Annual National Accounts and Revenue Statistics databases.

[8] The dataset is available at www.imf.org/external/pubs/ft/wp/2006/data/update/wp0669.zip.

[9] Despite no tax increase, upward trends in the effective consumption tax rate and the goods and services trade balance have been strong in Luxembourg since 1992. Financial services provided to other EU countries pay VAT on inputs but do not receive a rebate. In addition, exports of electronic services, telecommunications, and broadcasting services are subject to VAT in Luxembourg (OECD 2014a).

tax rates. For the case studies, we focus on behavior in the country implementing a pronounced change and measure the exchange rate as the trade-weighted RER.[10] The primary measure of the trade balance (BAL) is the current account balance (CAB). However, we also examine the goods and services trade balance (GSB) and the difference between the CAB and the GSB, which is the balance on income and transfers (INC). All balance measures are expressed as percents of nominal GDP.

Goods and services tax revenue (GSREV) are taxes on goods and services transactions, including VAT, sales taxes, excise taxes, and tariffs.[11] All of these taxes are border adjusted, so that imports incur the tax and exports do not.[12] Household consumption (CONS) is in nominal terms.

## WHAT HAPPENS AFTER A VAT IS ADOPTED?

Analyzing the effect of introducing a VAT with border adjustment depends on what taxes are being replaced and whether the total tax burden is rising or falling. If other types of sales taxes that are also border adjusted are replaced, the effect on the RER will be minimal. In contrast, if corporate or income taxes are replaced, one would expect the effects to show up in the exchange rate.

Table 2 lists the OECD countries and the year VAT was adopted, the VAT rate, and the taxes that were replaced. In most cases, VATs were introduced to replace other more distortionary turnover taxes. The problem with a sales tax that applies to all goods is that it taxes intermediates twice—once when they are sold and again when the final good in which they are an input is sold. Like VATs, they are largely border adjusted, because imports face the tax but exports do not. However, the border adjustment is incomplete, because rebates are not provided on sales taxes paid on intermediates of exported goods.

After VATs were introduced, most countries recorded an increase in the share of tax revenue from goods and services taxes—in part because VATs require fewer exceptions and can be charged more broadly and at a higher rate, without the distortions a sales tax creates.

Figure 1 shows the movement of exchange rates, prices, and trade balances in countries around the time VATs were imposed. Panel A shows results for the maximum number of countries that have data for four years before and after implementation in each series. Panel B shows results for 10 countries that have data in all series. The upper left charts in panels A and B show the change in the tax rate—measured using OECD data on goods and services taxes as a share of consumption. On average, the share of goods and services taxes in consumption increased by 1.5 percentage points when the VAT was implemented. In New Zealand, Poland, Portugal, and Spain, which also reduced income taxes, the increase was above 3 percentage points. To the extent that some of the taxes in the measure may not have been border adjusted—for example, turn-

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[10] Data on trade-weighted exchange rates are from the World Bank's *World Development Indicators*.

[11] In these countries tariff rates are low and stable, and taxes on exports are uniformly zero.

[12] It is possible that some of the non-VAT taxes are not rebated on exports, but we believe such nonadjusted taxes are a tiny share of revenues.

over taxes charged on intermediates to exports—one would still expect to see some evidence of exchange rate appreciation around the time the VAT was implemented if the border adjustment works.

The remaining charts in panels A and B show average movements in the inflation rate, the trade-weighted real exchange rate, the dollar real exchange rate, the current account relative to GDP, and the goods and services trade balance relative to GDP, for a balanced sample of countries.[13] There is strong evidence that inflation increased and the RER appreciated following VAT implementation.

While the current account generally improved throughout the period, it does not appear to have been associated with VAT implementation, as the upward trend precedes the introduction of VAT. Importantly, the goods and services trade balance to GDP stabilized at the time of VAT implementation.

## REGRESSION ANALYSIS

We next use the full panel dataset to estimate the effect of changes in the effective consumption tax rate (GSREV/CONS) on RERs and external balances. We ran panel unit root tests on all measures of RER, BAL/GDP, and GSREV/CONS. We reject that these series are nonstationary in every country. However, we also reject that these series are stationary in every country. Plots of these data display trending behavior of GSREV/CONS in some countries and RER and BAL/GDP in a few countries.

Given the apparent mixture of stationary and nonstationary data, we analyze the data using both cointegration and conventional frameworks. The results are rarely sensitive to the choice of framework. The estimated equations are shown below, where Y denotes either the real exchange rate (RER) or the external balance (BAL/GDP).

Cointegration framework:

$$\Delta Y_{it} = \beta\{Y_{it\text{-}1} - \alpha\ (\text{GSREV/CONS})_{it-1} - \Lambda\ \text{Controls}_{it-1}\} + \text{country effects} + \text{year effects} \tag{1}$$
$$+\ \Gamma\ (\Delta Y_{it-1}, \Delta(\text{GSREV/CONS})_{it+1}, \Delta(\text{GSREV/CONS})_{it}, \Delta(\text{GSREV/CONS})_{it-1}, \Delta\text{Controls}_{it})$$

Conventional framework:

$$Y_{it} = \alpha\ (\text{GSREV/CONS})_{it} + \Lambda\ \text{Controls}_{it} + \beta Y_{it-1} + \Gamma\ (\Delta Y_{it-1}, \Delta(\text{GSREV/CONS})_{it}, \tag{2}$$
$$\Delta\text{Controls}_{it}) + \text{country effects} + \text{year effects}$$

Equation (1) is estimated by a dynamic fixed effects algorithm. The coefficient α represents the long-run effect of the consumption tax rate and β represents the speed of adjustment to the long-run relationship. Equation (2) is estimated by ordinary least squares (OLS). The long-run effect is given by $\alpha/(1-\beta)$.

A notable difference between the two frameworks is the inclusion of additional dynamic terms on the tax rate variable in equation (1). In particular, the lead difference term controls for possible short-run endo-

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[13] Countries with average inflation rates above 10 percent in the four years before the VAT was implemented were excluded from the inflation graph.

geneity of the consumption tax rate to either the real exchange rate or the external balance. For example, a cyclical boom may push up RER and push down BAL/GDP at the same time that it increases GSREV/CONS because tax rates may be higher on cyclically sensitive goods. We want to exclude such a transitory correlation and focus on the long-run changes in GSREV/CONS, which we assume are driven by policy choices and not economic shocks.

We view the cointegration results as more conservative than the conventional results because the conventional framework may find spuriously significant results when the data are truly nonstationary. There are strong economic grounds for arguing that these data should be stationary, but if a series is not long enough, it may behave like a nonstationary series.

In the simple theoretical model discussed above, the RER should rise in proportion to any increase in the border-adjusted tax rate on consumption (GSREV/CONS), implying that $\alpha = 1$ in equation (1) and $\alpha/(1-\beta) = 1$ in equation (2). The same model implies that GSREV/CONS should have no effect on the external balance, so that $\alpha = 0$ in equation (1) and $\alpha/(1-\beta) = 0$ in equation (2).

Control variables include general government revenues (percent of GDP); general government fiscal balance (percent of GDP); purchasing power parity (PPP)–adjusted per capita income (log ratio to US per capita income); and net international investment position (percent of GDP).

### Real Exchange Rates

Table 3 presents our basic results for the effect of consumption taxes on RERs using the cointegration framework. The top half displays results using the RER against the United States and the bottom half displays results using the RER against Germany. Because the RER responds to factors both at home and abroad, the explanatory variables are expressed as differences between the home country value of the variable and the partner country value.[14] The partner country, either the United States or Germany, is excluded from the regressions. All regressions include a full set of country fixed effects to control for differences across countries that are stable over time.[15]

The table displays long-run coefficients on all variables that were included in the cointegrating vector. We do not display the short-run coefficients or the estimated country and year fixed effects. The bottom row displays the error correction coefficients, which capture the speed of adjustment to long-run equilibrium, about 20 percent per year. These coefficients are always highly significant, suggesting that the data are either cointegrated or stationary.

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[14] In principle, we could have specified the regressions using each country's trade-weighted real exchange rate, but doing so would have required us to construct country-specific trade-weighted measures of the foreign explanatory variables.

[15] Country fixed effects are required in these regressions because the real exchange rates are indexes set to 100 in 2010 and thus contain no information on absolute price differences across countries.

Column 1 displays results with a full set of control variables and year effects. Column 2 shows results with all control variables but no year effects. Columns 3 and 4 show results dropping the fiscal balance, the variable with the largest number of missing observations. The change in the estimated consumption tax effect (the first row) reflects the additional observations and not the omission of the fiscal variable.[16] Finally, columns 5 and 6 display results using only the consumption tax rate and country and year effects.

The first row of each half of the table displays the estimated effect of the consumption tax rate on the real exchange rate. With the United States as partner country, the average value is 1.7. With Germany as partner country, the average value is 0.7. The overall average is 1.2.

The large differences in the estimates across specifications probably reflect the fact that real exchange rates are far more volatile than consumption tax rates. For the typical country and year, the real exchange rate against the United States appreciates or depreciates by 11 percent, whereas the consumption tax rate (relative to the United States) rises or falls only 1 percent.[17] We have a slight preference for the results shown in column 3 because this specification uses a large number of control variables while retaining most of the available observations. However, the other specifications also provide a useful sense of the considerable uncertainty surrounding any one estimate.

Statistical significance is conventionally measured as a two-tailed test of deviations from 0 in either direction. The asterisks next to the coefficient estimates denote this conventional measure of significance at the traditional 1, 5, and 10 percent levels. However, we are particularly concerned about the hypothesis of full exchange rate offset of consumption taxes, $\alpha = 1$. Thus, two rows at the end each half of the table display one-tailed tests of the hypotheses that $\alpha = 0$ and $\alpha = 1$. We reject $\alpha = 0$ in favor of $\alpha > 0$ in four of six regressions against the United States and one of six regressions against Germany. We never reject $\alpha = 1$ in favor of $\alpha < 1$. In other words, the results are consistent with a one-for-one real exchange rate adjustment in response to changes in the VAT in the long run.

One measure of the short-run response of RER to GSREV/CONS is the sum of the estimated coefficients on the lead, contemporaneous, and lagged changes in GSREV/CONS. The average value of this sum for the regressions in table 3 is 0.44, implying that the real exchange rate moves by 44 percent of any change in relative consumption tax rates by the year after the tax rate changes.

Table 4 displays results based on the conventional framework. The results are broadly similar to those of table 3. The average long-run effect of the consumption tax rate on the real exchange rate is 1.3 and the average short-run effect (the sum of the coefficients on the contemporaneous level and change in GSREV/

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[16] The coefficient on the consumption tax rate is virtually unchanged by dropping the fiscal variable in column 1 and restricting the regression to the same 892 observations. This is also true in the bottom half of the table.

[17] We define "typical" as one standard deviation in the annual change of a variable. Typical RER movements against Germany are smaller (7 percent) because many countries in the sample are either in a currency union with Germany or target their exchange rates with Germany.

CONS) is 0.40. The one-tailed tests of $\alpha/(1-\beta) = 0$ are significant (in favor of $\alpha/(1-\beta) > 0$) at the 10 percent level in 10 of 12 regressions and the tests of $\alpha/(1-\beta) = 1$ are never significant.

The results broadly support the hypothesis of full exchange rate offset of changes in consumption tax rates. However, the results depend greatly on which country (the United States or Germany) is the partner country. The existence of fixed exchange rates between some countries may imply a different pattern of dynamic adjustment relative to floating exchange rates. For this reason, we also ran equation (2) separately on (a) euro area countries plus Denmark starting in 1999 and (b) non-euro-area countries excluding Denmark.[18] For the former countries (about one-quarter of the full sample), we use Germany as the partner country and for the latter countries (about one-half of the full sample) we use the United States. About one-quarter of the sample is lost owing to pre-1999 years for euro members and late joiners to the euro area.

For the non-euro-area countries, the results are similar to the full sample results, with average long-run tax rate coefficients that are never significantly different from those of the top half of table 4 and that have an average value of 1.3. For the euro area countries, the coefficients vary considerably across specifications with large standard errors, raising the likelihood of too small of a sample for the number of parameters being estimated. The coefficients are never significantly different from those of the bottom half of table 4 but the average value of the coefficients is somewhat lower, at 0.5.

### Trade Balances

Table 5 displays our basic results for external balances in the cointegration framework. The top displays results for the current account balance; the middle displays results for the goods and services trade balance; and the bottom displays results for the difference between the first two: the balance on income and transfers. In each case, a country's external balance refers to its trade with the rest of the world and we therefore do not need to specify the explanatory variables as differences between values in the home and partner countries.

The estimated effects of the consumption tax rate on the current account are all close to 0 and only one is significantly different from 0. The goods and services trade balance coefficients are uniformly higher and three out of six are significantly positive. The income and transfers coefficients are all negative and four out of six are statistically significant. The short-run effects, measured as the sum of coefficients on the changes in consumption tax rates, are about two-thirds of the long-run effects for goods and services trade and half of the long-run effects for income and transfers. Thus, most of any long-run change in the external balance happens by the year after the tax rate changes. The error correction coefficients are a bit larger than the

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[18] Denmark has maintained a tightly fixed exchange rate against the euro since 1999. We include Greece, which joined at the beginning of 2001 but exclude countries that joined the euro area after 2001.

coefficients for the RER, with a long-run adjustment speed of about 20 to 25 percent per year; they are always highly significant.

Table 6 displays analogous results using the conventional framework. Although the overall pattern is similar to that of table 5, the coefficient values are uniformly lower for the current account and the goods and services trade balance. None of the current account coefficients is significantly different from zero. Two of the goods and services coefficients are significantly positive. The results for income and transfers are nearly identical to those of table 5, with four of six significantly negative. Put simply, the results are consistent with changes in the VAT having no significant effect on the current account in the long run.

Overall, the results in tables 5 and 6 suggest that consumption taxes have little effect on the current account balance, but they tend to lower net income and transfer payments and to raise net goods and services exports. We conjecture that by raising the real exchange rate, consumption taxes reduce the value of income received from foreign investments and transfers relative to the value of payments to foreigners on their investments and to outgoing transfers from domestic residents. The higher RER also reduces the net international investment position of domestic residents and thus reduces their real wealth. This reduced wealth may increase saving and thus spur an increase in net exports. Based on a typical coefficient of 0.2 for the trade balance and –0.2 for the income and transfers balance, a 10 percentage point increase in the consumption tax rate—which is an order of magnitude larger than the typical yearly movement and larger than any yearly change in our sample—would be expected to raise the trade balance by 2 percent of GDP and reduce the income and transfers balance by an equal amount, leaving the current account unchanged.

## FOUR CASE STUDIES

The results presented above are broadly consistent with full exchange rate offset, but there are potential concerns with both methodologies. The event study suffers from confounding effects from the type of tax reform. The regression analysis allows us to control for other factors, but the coefficients are not precisely estimated. As a final attempt to understand the effect of border adjustment, we examine the consequences of a VAT introduction or increases in four countries where one would most expect to see adjustment and that are relevant for the United States.

### New Zealand

New Zealand is the cleanest example in our sample. It implemented a 10 percent value added tax in October 1986, which was raised to 12.5 percent in 1989 and 15 percent in 2010 (Benge, Pallot, and Slack 2013). The tax is uniquely broad-based: It applies to government transactions and excludes only residential rents and financial services, reflected in the VAT revenue ratio of nearly 1 (table 1). As the VAT largely replaced corporate and income taxes, there was a notable adjustment in the share of goods and services taxes in consumption. The border adjustment, therefore, was new.

Much of the initial adjustment happened via inflation. Inflation (measured relative to the same quarter the previous year) averaged 11 percent during the first three quarters of 1986, then jumped to 18 percent in the four quarters after the tax was introduced (table 7). Put differently, the 10 percent tax was accomodated by a one-time increase in the rate of inflation of 7 percent. The jump in prices mirrors the expansion in the share of goods and services taxes in consumption, which rose from 12 percent in 1985 (the year before the VAT was implemented) to 20 percent in 1987 (the first full year of the tax). These results are consistent with evidence reported in Zodrow et al. (2010) that rising VAT rates contribute to a one-time increase in prices. The price increase fed into the RER, which appreciated by 15 percent between 1986 and 1987 (figure 2).

The case of New Zealand offers evidence that the broad-based VAT was associated with a one-time real appreciation that offset the tax. The evidence suggests that the initial mechanism for the adjustment was via prices. Indeed, the real exchange rate jumped by more than the consumption tax rate, although the effect likely reflected the financial market's positive assessment of the entire package of reforms, which improved the fiscal outlook and relaxed many domestic regulations.

Figure 2 also shows the current account balance in New Zealand around the time of implementing the VAT. Overall, there was some increase in the current account balance over the period, but it started doing so before the change occurred. The shift from income to consumption taxes would be expected to increase saving, which would improve the current account over time.

### Australia

In July 2000 Australia introduced a 10 percent VAT, which largely replaced other indirect sales taxes. Despite flat or decreasing total revenue in GDP, the share of goods and services taxes in consumption increased by nearly 2 percent.

The overall impact should have been lower than in New Zealand, since the shift to border-adjusted taxes was smaller. The period was associated with rising inflation in the short run. The jump in the inflation rate of 3 percentage points (table 7) closely matched the increase in the consumption tax rate. The real exchange rate, however, did not appreciate at the time VAT was adopted. In addition, the current account to GDP ratio temporarily increased, suggesting that the border adjustment may have temporarily fed into the trade balance. Over the next two years it reversed, with no medium run change in the current account (figure 2).

### Canada

Canada introduced a 7 percent VAT in 1991, which was later reduced to 5 percent in the mid-2000s. The tax largely replaced a sales tax on manufacturers that had been in place since 1924. The manufacturer's tax cascaded through the value chain and was regressive, subjecting it to complaints and a series of reports suggesting reform from as early as the 1930s (Bird and Gendron 2009).

The new VAT was combined with provincial sales taxes, which were turned into VATs, some immediately. The share of goods and services taxes in consumption was flat, but including provincial taxes, which were added on top, the overall increase was larger. In addition, the tax was applied to a much broader base than the previous manufacturer's tax and was border adjusted to a greater extent than the manufacturer's tax. Still, given the conversion of sales taxes, we expect only a small change in prices and the exchange rate.

The tax had a small and immediate effect on prices and the real exchange rate (figure 2). The current account balance as a share of GDP remained unchanged.

The price change is apparent immediately in quarterly data (table 7). Although the increase was relatively modest, the conservative government that enacted the tax lost the next election. Sullivan (2011) writes, "The Canadian experience confirms every politician's instinct that supporting a VAT is career suicide." But, he also calls the case for the VAT "compelling," as it solved Canada's budget problems without increasing the size of government. Despite the next government campaigning to remove the tax and sweeping the election, the VAT remains in place to this day.

### China

In 1994, China implemented a 17 percent VAT on goods, with a reduced rate of 13 percent on staples. The VAT applied only to goods, with a separate business tax covering services. It deviated from a broad-based VAT in several other respects as well: For example, some capital expenditures were not deductible, and input rebates for exports varied by sector (Yan 2011).

The tax replaced a cascading turnover tax and allowed for lower corporate income taxes. The turnover tax did not allow deduction of taxes paid on intermediates, which meant that taxes cascaded up the value chain. The VAT raised significant revenue, accounting for over 40 percent of total tax revenue when it was implemented.

China also began pegging the yuan to the dollar in 1994. As a result, the nominal exchange rate could not adjust to the VAT. The VAT was implemented during a period of high inflation. Nevertheless, a sharp one-time increase in prices after VAT implementation is visible. The rate of inflation jumped from 17 to 22 percent in the first quarter VAT was applied (table 7). The price change facilitated a real exchange rate appreciation. In contrast, the current account remained relatively stable in the years after the VAT was implemented. The experience of China is also consistent with the real exchange rate adjusting to offset the border adjustment in the tax.

## CONCLUSIONS

This paper largely supports the theoretical assertion that a country's real exchange rate rises in proportion to any increase in its border-adjusted consumption taxes, with little effect on the current account balance. However, the border-adjusted cash flow tax being considered in the United States differs in important ways from the consumption taxes we examine, raising the possibility of a slower and more complicated adjustment.

### Real Exchange Rates

The event study and case studies generally find evidence of a positive effect of border-adjusted consumption taxes on the real exchange rate. Much of the adjustment comes through consumer prices. In some cases, the nominal exchange rate also appreciated and the RER appreciated by even more than the increased tax rate. This excess adjustment probably reflects other reforms that accompanied VAT increases that financial markets viewed positively.

The regressions support the hypothesis of full exchange rate offset ($\alpha = 1$) significantly more than the hypothesis of no exchange rate offset ($\alpha = 0$). One-tailed tests that the offset is greater than 0 are significant in five of 12 cases at the 10 percent level in the cointegration framework and 10 of 12 cases in the conventional framework. One-tailed tests that the offset is less than 1 are never significant.

The degree of offset is not precisely estimated. Point estimates range from 0.5 to 3.1. This imprecision almost certainly reflects the dominant role of factors other than consumption taxes, including factors not readily observable, in exchange rate behavior. Exchange rates are highly volatile, and economists have had scant success in explaining them.

### External Balances

The event study and case studies find no evidence of any strong effect of border-adjusted consumption taxes on the current account balance. In some cases, the current account increased moderately around the time of a VAT increase, but many VAT increases were associated with increases in the fiscal balance, which would restrain demand for imports.

The regressions find some evidence for a moderate effect of consumption tax rates on the components of the current account balance: the goods and services trade balance and the income and transfers balance. Median point estimates are around 0.2 for trade and –0.2 for income and transfers. One possible explanation is that the consumption tax has a small positive effect on the goods and services balance that is offset by a small negative effect on the investment income balance, reflecting the decline in profits on foreign investment caused by the real exchange rate appreciation. Goods and services and investment income are typically the two largest components of the current account.

### Implications for the Destination-Based Cash Flow Tax

In the long run, changes in policy are accommodated by changes in the real exchange rate, exactly as theory predicts. The event study and the case study analysis reveal that adjustment to the new equilibrium is complete within about two years, with much of the adjustment happening immediately through prices. The regression analysis finds somewhat slower adjustment, although more than half of adjustment seems to occur within three years. To the extent that bold tax reform is a rare event that takes place every 30 years or so, a three-year adjustment is not too worrisome.

Three important caveats are worth noting. First, the United States is a large country that controls the world's reserve currency. While movement in the nominal exchange rate could immediately offset the border adjustment of the cash flow tax, the extent to which dollar movements reflect trade relative to financial flows may be quite small in practice. In addition, the dollar's special role in global trade and finance, and the fact that a number of countries' exchange rates are tied to the dollar, could mute this channel.

Second, the proposed border-adjusted CFT is different from a VAT or sales tax, for which prices do most of the adjustment. In the absence of rapid exchange rate appreciation, adjustment requires increases in both prices and wages, which would likely take longer and be more complex. If wages are slow to adjust, there would likely be real effects on employment and trade in the short run. There is also a question of the extent to which the Federal Reserve would accommodate the change.

Third, the size of the proposed CFT is larger than other taxes. Most other countries have raised border-adjusted consumption taxes in small steps, requiring only small price increases or exchange rate appreciations. The shift to the destination-based CFT, as proposed in the House blueprint, would require a 25 percent appreciation or a 25 percent increase in wages and prices. The magnitude of the change is far outside our sample and could create additional concerns for the global financial system and for consumer price and wage inflation.

If the exchange rate does not immediately adjust, or adjusts only partially, real trade effects are likely. During the adjustment period, exporting and import-competing firms would benefit, while retailers and firms using imported inputs would suffer.

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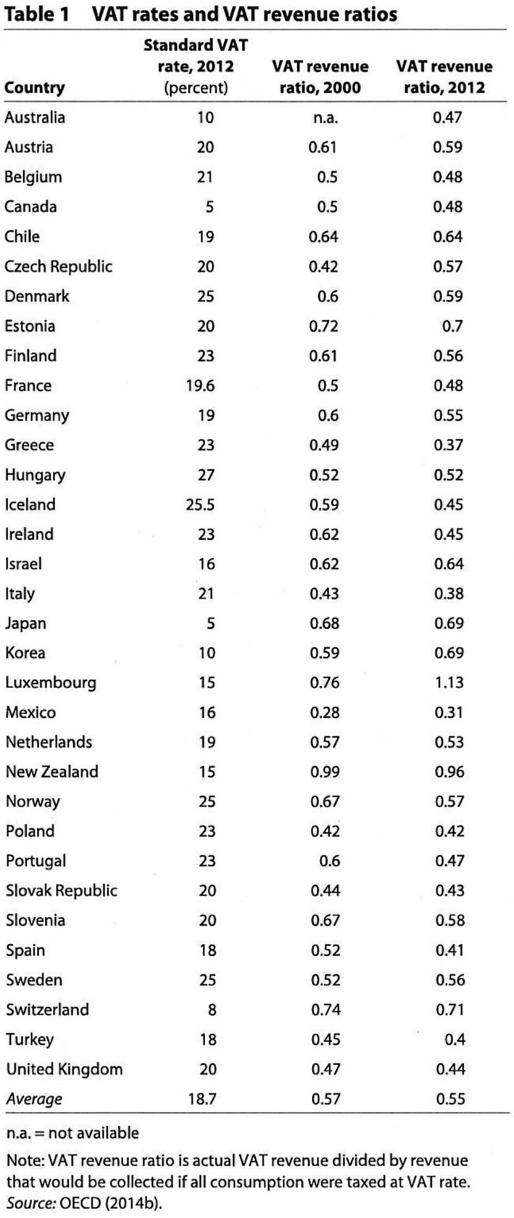


**Table 1 VAT rates and VAT revenue ratios**

| Country | Standard VAT rate, 2012 (percent) | VAT revenue ratio, 2000 | VAT revenue ratio, 2012 |
|---|---|---|---|
| Australia | 10 | n.a. | 0.47 |
| Austria | 20 | 0.61 | 0.59 |
| Belgium | 21 | 0.5 | 0.48 |
| Canada | 5 | 0.5 | 0.48 |
| Chile | 19 | 0.64 | 0.64 |
| Czech Republic | 20 | 0.42 | 0.57 |
| Denmark | 25 | 0.6 | 0.59 |
| Estonia | 20 | 0.72 | 0.7 |
| Finland | 23 | 0.61 | 0.56 |
| France | 19.6 | 0.5 | 0.48 |
| Germany | 19 | 0.6 | 0.55 |
| Greece | 23 | 0.49 | 0.37 |
| Hungary | 27 | 0.52 | 0.52 |
| Iceland | 25.5 | 0.59 | 0.45 |
| Ireland | 23 | 0.62 | 0.45 |
| Israel | 16 | 0.62 | 0.64 |
| Italy | 21 | 0.43 | 0.38 |
| Japan | 5 | 0.68 | 0.69 |
| Korea | 10 | 0.59 | 0.69 |
| Luxembourg | 15 | 0.76 | 1.13 |
| Mexico | 16 | 0.28 | 0.31 |
| Netherlands | 19 | 0.57 | 0.53 |
| New Zealand | 15 | 0.99 | 0.96 |
| Norway | 25 | 0.67 | 0.57 |
| Poland | 23 | 0.42 | 0.42 |
| Portugal | 23 | 0.6 | 0.47 |
| Slovak Republic | 20 | 0.44 | 0.43 |
| Slovenia | 20 | 0.67 | 0.58 |
| Spain | 18 | 0.52 | 0.41 |
| Sweden | 25 | 0.52 | 0.56 |
| Switzerland | 8 | 0.74 | 0.71 |
| Turkey | 18 | 0.45 | 0.4 |
| United Kingdom | 20 | 0.47 | 0.44 |
| *Average* | 18.7 | 0.57 | 0.55 |

n.a. = not available

Note: VAT revenue ratio is actual VAT revenue divided by revenue that would be collected if all consumption were taxed at VAT rate.
*Source:* OECD (2014b).

### Table 2 VAT implementation dates and rates

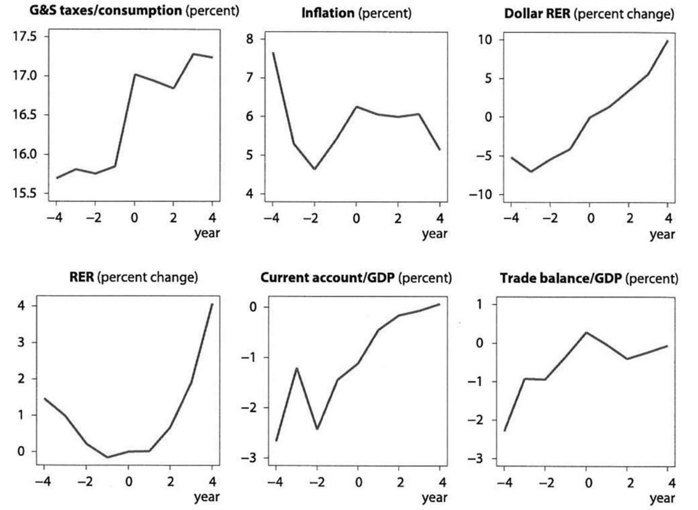
| Country | Year implemented | VAT rate | Taxes replaced |
|---|---|---|---|
| Australia | 2000 | 10% goods and services tax (VAT) | State indirect taxes and income taxes |
| Austria | 1973 | 16% VAT, reduced rate 8% | Cascade turnover tax |
| Belgium | 1971 | Four-rate VAT: standard 18%, 6%, 14%, 25% | Cascade turnover tax |
| Canada | 1991 | 7% goods and services tax (VAT) | Manufacturers' sales tax (MST) |
| Switzerland | 1995 | 6.5% VAT | Sales tax on goods |
| Chile | 1975 | 20% VAT | Cascade sales tax, other indirect taxes |
| Czech Republic | 1993 | 23% VAT, reduced rate 5% | Turnover tax |
| Germany | 1968 | 10% VAT, reduced rate 5% | Cascade turnover tax |
| Denmark | 1967 | 10% VAT | Wholesale tax |
| Spain | 1986 | Three-rate VAT: standard 12%, 6%, 33% | Cascade sales tax, other indirect taxes |
| Estonia | 1992 | 10% VAT | Turnover tax |
| Finland | 1994 | 22% VAT | Turnover tax |
| France | 1968 | 16.66% VAT | Earlier VAT |
| United Kingdom | 1974 | 10% VAT | Purchase tax and selective employment tax |
| Greece | 1987 | Four-rate VAT: standard 16%, 3%, 6%, 36% | Stamp duties, business turnover tax |
| Hungary | 1988 | Multiple-rate VAT: top rate 25% | Turnover tax |
| Ireland | 1972 | Four-rate VAT: 5.26%, 11.11%, 16.37%, 30.26% | Wholesale and turnover tax |
| Iceland | 1990 | 24.5% VAT | — |
| Israel | 1976 | 8% VAT | None |
| Italy | 1973 | 12% VAT | — |
| Japan | 1989 | 3% Consumption tax (VAT) | Other indirect and excise taxes |
| Korea | 1977 | 10% VAT | Cascade turnover tax, other indirect taxes |
| Latvia | 1995 | 18% VAT | Turnover tax |
| Luxembourg | 1971 | 8% VAT, reduced rate 4% | — |
| Mexico | 1980 | 10% VAT | — |
| Netherlands | 1969 | 12% VAT, reduced rate 4% | Cascade turnover tax |
| Norway | 1969 | 20% VAT | General sales tax |
| New Zealand | 1986 | 10% VAT | Income tax |
| Poland | 1993 | 22% VAT, reduced rate 7% | Turnover tax |
| Portugal | 1986 | Three-rate VAT: standard 16%, 8%, 30% | Tax on transactions and other indirect taxes |
| Slovak Republic | 1993 | 23% VAT, reduced rate 5% | Turnover taxes |
| Slovenia | 1999 | 20% VAT, reduced rate 8.5% | — |
| Sweden | 1969 | 10% VAT | Retail sales tax |
| Turkey | 1985 | 10% VAT | Other indirect taxes |

— = no information available

*Sources:* National sources and OECD reports.

**Figure 1** **Changes in exchange rates, prices, and trade balances following implementation of VAT**

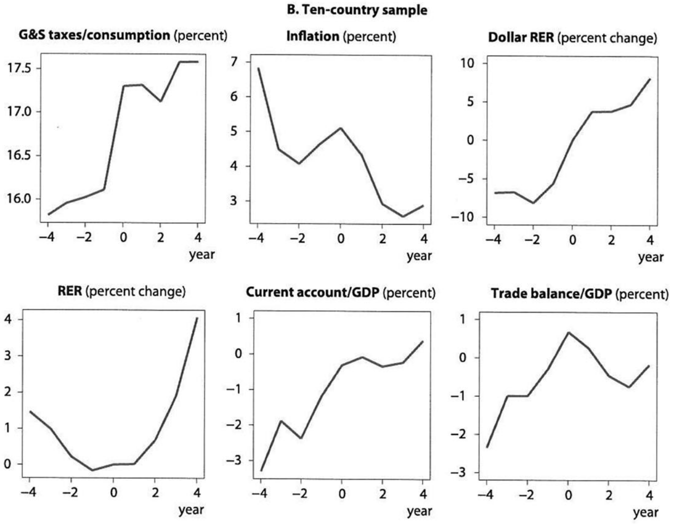
**A. All countries for which data were available**



Notes: Graphs are based on all countries for which data were available: 12 for goods and services (G&S) tax revenue as a share of consumption, 14 for inflation, 14 for the real dollar exchange rate, 10 for the trade-weighted real exchange rate (RER), 14 for the current account as a share of GDP, and 12 for the trade balance as a share of GDP.

*(figure continues)*

**Figure 1** **Changes in exchange rates, prices, and trade balances following implementation of VAT** *(continued)*



Note: The sample consists of Australia, Canada, Finland, Greece, Iceland, Japan, New Zealand, Portugal, Switzerland, and Spain. The inflation graph excludes countries with average inflation above 10 percent during the four years before tax reform.

*Source:* Authors' calculations using data described in text.

**Table 3** **Cointegrating regression of real exchange rate on consumption tax rate, 1970–2015 annual, equation (1), long-run cointegration coefficients**

| **Partner: United States** | **1** | **2** | **3** | **4** | **5** | **6** |
|---|---|---|---|---|---|---|
| Goods & services tax rate | 3.11*** | 2.17* | 1.16 | 0.70 | 0.75 | 2.04** |
| | (1.07) | (1.26) | (0.79) | (0.90) | (0.74) | (0.81) |
| Fiscal balance | 1.10** | 2.58*** | | | | |
| | (0.50) | (0.51) | | | | |
| Government revenue | −1.05 | 0.58 | 0.11 | 1.76*** | | |
| | (0.69) | (0.82) | (0.55) | (0.62) | | |
| Relative per capita income | 0.41*** | 0.51*** | 0.30*** | 0.57*** | | |
| | (0.10) | (0.12) | (0.09) | (0.11) | | |
| Net investment position | −0.06* | −0.08** | −0.03 | −0.03 | | |
| | (0.03) | (0.04) | (0.03) | (0.04) | | |
| Error correction | −0.19*** | −0.22*** | −0.17*** | −0.20*** | −0.17*** | −0.17*** |
| | (0.02) | (0.02) | (0.02) | (0.02) | (0.02) | (0.01) |
| Year effects | Yes | No | Yes | No | Yes | No |
| R-squared | 0.69 | 0.28 | 0.67 | 0.24 | 0.61 | 0.16 |
| Observations | 892 | 892 | 1120 | 1120 | 1164 | 1164 |
| α > 0 | *** | ** | * | | | *** |
| α < 1 | | | | | | |
| **Partner: Germany** | **1** | **2** | **3** | **4** | **5** | **6** |
| Goods & services tax rate | 0.83 | 0.73 | 1.04 | 0.48 | 0.61 | 0.61 |
| | (1.15) | (1.00) | (0.64) | (0.57) | (0.61) | (0.61) |
| Fiscal balance | 0.94** | 0.15 | | | | |
| | (0.43) | (0.32) | | | | |
| Government revenue | −1.76*** | −1.72*** | −0.02 | −0.09 | | |
| | (0.67) | (0.55) | (0.42) | (0.33) | | |
| Relative per capita income | 0.54*** | 0.57*** | 0.22*** | 0.32*** | | |
| | (0.11) | (0.06) | (0.07) | (0.04) | | |
| Net investment position | −0.03 | −0.02 | −0.01 | −0.05** | | |
| | (0.02) | (0.02) | (0.02) | (0.02) | | |
| Error correction | −0.21*** | −0.24*** | −0.18*** | −0.21*** | −0.17*** | −0.18*** |
| | (0.02) | (0.02) | (0.02) | (0.02) | (0.02) | (0.02) |
| Year effects | Yes | No | Yes | No | Yes | No |
| R-squared | 0.45 | 0.33 | 0.45 | 0.25 | 0.37 | 0.13 |
| Observations | 689 | 689 | 1120 | 1120 | 1164 | 1164 |
| α > 0 | | | * | | | |
| α < 1 | | | | | | |

* p<.10, ** p<.05, *** p<.01

*Source:* Authors' calculations using data described in text.

**Table 4 Ordinary least squares (OLS) regression of real exchange rate on consumption tax rate, 1970-2015 annual, equation (2), estimated long-run effects**

| **Partner: United States** | **1** | **2** | **3** | **4** | **5** | **6** |
|---|---|---|---|---|---|---|
| Goods & services tax rate | 3.14*** | 2.29* | 1.59** | 1.15 | 0.87 | 1.37* |
| | (1.08) | (1.25) | (0.74) | (0.81) | (0.66) | (0.76) |
| Fiscal balance | 1.19* | 2.75*** | | | | |
| | (0.71) | (0.73) | | | | |
| Government revenue | −1.19 | 0.40 | 0.15 | 1.59*** | | |
| | (1.18) | (1.12) | (0.72) | (0.50) | | |
| Relative per capita income | 0.44*** | 0.48** | 0.33** | 0.57*** | | |
| | (0.12) | (0.21) | (0.14) | (0.21) | | |
| Net investment position | −0.06 | −0.09 | −0.02 | −0.04 | | |
| | (0.06) | (0.07) | (0.05) | (0.05) | | |
| Year effects | Yes | No | Yes | No | Yes | No |
| R-squared | 0.92 | 0.82 | 0.92 | 0.82 | 0.90 | 0.77 |
| Observations | 905 | 905 | 1134 | 1134 | 1208 | 1208 |
| $\alpha/(1-\beta) > 0$ | *** | ** | ** | * | * | ** |
| $\alpha/(1-\beta) < 1$ | | | | | | |
| **Partner: Germany** | **1** | **2** | **3** | **4** | **5** | **6** |
| Goods & services tax rate | 0.94 | 0.70 | 1.47** | 0.87 | 0.80 | 0.84 |
| | (1.39) | (1.09) | (0.65) | (0.54) | (0.62) | (0.59) |
| Fiscal balance | 1.07 | 0.23 | | | | |
| | (0.68) | (0.48) | | | | |
| Government revenue | −1.88* | −1.72* | −0.01 | −0.15 | | |
| | (1.11) | (1.00) | (0.54) | (0.50) | | |
| Relative per capita income | 0.52*** | 0.57*** | 0.24** | 0.33*** | | |
| | (0.12) | (0.08) | (0.10) | (0.07) | | |
| Net investment position | −0.02 | −0.02 | −0.01 | −0.04 | | |
| | (0.04) | (0.03) | (0.04) | (0.04) | | |
| Year effects | Yes | No | Yes | No | Yes | No |
| R-squared | 0.87 | 0.85 | 0.85 | 0.8 | 0.82 | 0.76 |
| Observations | 700 | 700 | 1134 | 1134 | 1208 | 1208 |
| $\alpha/(1-\beta) > 0$ | | | ** | * | * | * |
| $\alpha/(1-\beta) < 1$ | | | | | | |

* $p<.10$, ** $p<.05$, *** $p<.01$

*Source:* Authors' calculations using data described in text.

**Table 5 Cointegrating regression of external balances on consumption tax rate, 1970–2015 annual, equation (1), long-run cointegration coefficients**

| **Current account** | **1** | **2** | **3** | **4** | **5** | **6** |
|---|---|---|---|---|---|---|
| Goods & services tax rate | 0.19 | 0.2 | 0.21 | 0.33** | –0.10 | 0.19 |
| | (0.22) | (0.23) | (0.16) | (0.16) | (0.14) | (0.13) |
| Fiscal balance | 0.00 | –0.07 | | | | |
| | (0.11) | (0.11) | | | | |
| Government revenue | –0.35** | –0.22 | –0.25** | –0.07 | | |
| | (0.15) | (0.15) | (0.12) | (0.10) | | |
| Relative per capita income | 0.06*** | 0.08*** | 0.05** | 0.07*** | | |
| | (0.02) | (0.02) | (0.02) | (0.02) | | |
| Net investment position | –0.01 | –0.02** | –0.01* | –0.02** | | |
| | (0.01) | (0.01) | (0.01) | (0.01) | | |
| Error correction | –0.26*** | –0.25*** | –0.25*** | –0.24*** | –0.23*** | –0.23*** |
| | (0.03) | (0.02) | (0.02) | (0.02) | (0.02) | (0.02) |
| Year effects | Yes | No | Yes | No | Yes | No |
| R-squared | 0.30 | 0.22 | 0.29 | 0.23 | 0.23 | 0.13 |
| Observations | 944 | 944 | 1162 | 1162 | 1205 | 1205 |
| **Goods & services trade balance** | **1** | **2** | **3** | **4** | **5** | **6** |
| Goods & services tax rate | 0.31 | 0.26 | 0.54*** | 0.63*** | 0.15 | 0.46*** |
| | (0.19) | (0.19) | (0.17) | (0.18) | (0.16) | (0.16) |
| Fiscal balance | –0.02 | –0.07 | | | | |
| | (0.10) | (0.09) | | | | |
| Government revenue | –0.17 | –0.11 | –0.32** | –0.09 | | |
| | (0.13) | (0.12) | (0.13) | (0.11) | | |
| Relative per capita income | 0.07*** | 0.09*** | 0.10*** | 0.13*** | | |
| | (0.02) | (0.02) | (0.02) | (0.02) | | |
| Net investment position | –0.02*** | –0.03*** | –0.04*** | –0.04*** | | |
| | (0.01) | (0.01) | (0.01) | (0.01) | | |
| Error correction | –0.25*** | –0.25*** | –0.20*** | –0.19*** | –0.18*** | –0.17*** |
| | (0.02) | (0.02) | (0.02) | (0.02) | (0.02) | (0.02) |
| Year effects | Yes | No | Yes | No | Yes | No |
| R-squared | 0.31 | 0.25 | 0.29 | 0.23 | 0.21 | 0.11 |
| Observations | 946 | 946 | 1179 | 1179 | 1242 | 1242 |

*(table continues)*

**Table 5 Cointegrating regression of external balances on consumption tax rate, 1970–2015 annual, equation (1), long-run cointegration coefficients** *(continued)*

| **Income and transfers** | **1** | **2** | **3** | **4** | **5** | **6** |
|---|---|---|---|---|---|---|
| Goods & services tax rate | –0.12<br>(0.11) | –0.06<br>(0.11) | –0.35**<br>(0.14) | –0.29**<br>(0.13) | –0.27*<br>(0.14) | –0.23*<br>(0.12) |
| Fiscal balance | 0.03<br>(0.05) | 0.01<br>(0.05) | | | | |
| Government revenue | –0.15**<br>(0.07) | –0.09<br>(0.07) | 0.06<br>(0.11) | 0.01<br>(0.09) | | |
| Relative per capita income | –0.02<br>(0.01) | –0.01<br>(0.01) | –0.05***<br>(0.02) | –0.04***<br>(0.02) | | |
| Net investment position | 0.02***<br>0.00 | 0.02***<br>0.00 | 0.01<br>(0.01) | 0.01<br>(0.01) | | |
| Error correction | –0.29*** | –0.29*** | –0.15*** | –0.16*** | –0.13*** | –0.14*** |
| | (0.03) | (0.03) | (0.02) | (0.02) | (0.02) | (0.02) |
| Year effects | Yes | No | Yes | No | Yes | No |
| R-squared | 0.35 | 0.30 | 0.28 | 0.23 | 0.12 | 0.08 |
| Observations | 944 | 944 | 1162 | 1162 | 1205 | 1205 |

* p<.10, ** p<.05, *** p<.01

*Source:* Authors' calculations using data described in text.

**Table 6 Ordinary least squares regression of external balances on consumption tax rate, 1970-2015 annual, equation (2), estimated long-run effects**

| **Current account** | **1** | **2** | **3** | **4** | **5** | **6** |
|---|---|---|---|---|---|---|
| Goods & services tax rate | –0.01 | –0.16 | 0.06 | 0.08 | –0.20 | 0.04 |
| | (0.26) | (0.28) | (0.16) | (0.17) | (0.19) | (0.18) |
| Fiscal balance | 0.00 | –0.07 | | | | |
| | (0.10) | (0.13) | | | | |
| Government revenue | –0.44** | –0.32* | –0.30** | –0.07 | | |
| | (0.17) | (0.17) | (0.13) | (0.13) | | |
| Relative per capita income | 0.06*** | 0.09*** | 0.04* | 0.08*** | | |
| | (0.02) | (0.02) | (0.02) | (0.02) | | |
| Net investment position | –0.01 | –0.02 | –0.01* | –0.02** | | |
| | (0.01) | (0.01) | (0.01) | (0.01) | | |
| Year effects | Yes | No | Yes | No | Yes | No |
| R-squared | 0.68 | 0.65 | 0.7 | 0.66 | 0.67 | 0.62 |
| Observations | 958 | 958 | 1177 | 1177 | 1251 | 1251 |
| **Goods & services trade balance** | **1** | **2** | **3** | **4** | **5** | **6** |
| Goods & services tax rate | 0.01 | –0.11 | 0.31* | 0.32* | –0.04 | 0.24 |
| | (0.24) | (0.25) | (0.16) | (0.18) | (0.23) | (0.21) |
| Fiscal balance | –0.02 | –0.06 | | | | |
| | (0.12) | (0.12) | | | | |
| Government revenue | –0.29 | –0.22 | –0.40** | –0.10 | | |
| | (0.18) | (0.17) | (0.16) | (0.13) | | |
| Relative per capita income | 0.08*** | 0.10*** | 0.10** | 0.13*** | | |
| | (0.02) | (0.02) | (0.04) | (0.02) | | |
| Net investment position | –0.03*** | –0.03*** | –0.04*** | –0.05*** | | |
| | (0.01) | (0.01) | (0.01) | (0.01) | | |
| Year effects | Yes | No | Yes | No | Yes | No |
| R-squared | 0.72 | 0.69 | 0.79 | 0.77 | 0.77 | 0.73 |
| Observations | 959 | 959 | 1193 | 1193 | 1291 | 1291 |

*(table continues)*

**Table 6 Ordinary least squares regression of external balances on consumption tax rate, 1970-2015 annual, equation (2), estimated long-run effects** *(continued)*

| Income and transfers | 1 | 2 | 3 | 4 | 5 | 6 |
|---|---|---|---|---|---|---|
| Goods & services tax rate | −0.02 | −0.05 | −0.27** | −0.23** | −0.23** | −0.23* |
| | (0.10) | (0.12) | (0.12) | (0.10) | (0.10) | (0.11) |
| Fiscal balance | 0.04 | 0.01 | | | | |
| | (0.06) | (0.06) | | | | |
| Government revenue | −0.13 | −0.07 | 0.06 | 0.01 | | |
| | (0.09) | (0.07) | (0.12) | (0.07) | | |
| Relative per capita income | −0.02 | −0.01 | −0.05 | −0.04 | | |
| | (0.01) | (0.01) | (0.03) | (0.03) | | |
| Net investment position | 0.02*** | 0.02*** | 0.01 | 0.01 | | |
| | 0.00 | (0.01) | (0.01) | (0.01) | | |
| Year effects | Yes | No | Yes | No | Yes | No |
| R-squared | 0.71 | 0.69 | 0.81 | 0.8 | 0.77 | 0.76 |
| Observations | 957 | 957 | 1176 | 1176 | 1250 | 1250 |

* p<.10, ** p<.05, *** p<.01

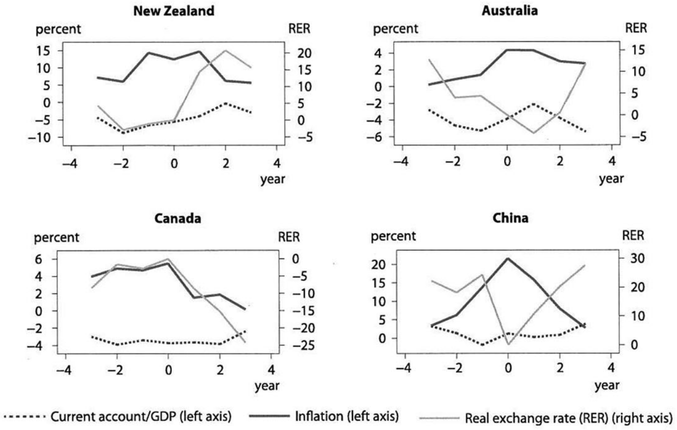
*Source:* Authors' calculations using data described in text.

**Table 7 Inflation around VAT change, four-quarter price change** (percent)

| Quarter | New Zealand | Australia | China | Canada | Average |
|---|---|---|---|---|---|
| Q3 | 12.96 | 1.92 | 13.90 | 4.61 | 8.35 |
| Q2 | 10.42 | 2.80 | 16.10 | 4.15 | 8.37 |
| Q1 | 11.03 | 3.08 | 17.13 | 4.95 | 9.05 |
| Q0 | 18.24 | 6.11 | 22.23 | 6.44 | 13.26 |
| Q1 | 18.29 | 5.79 | 21.87 | 6.21 | 13.04 |
| Q2 | 18.94 | 6.03 | 25.70 | 5.81 | 14.12 |
| Q3 | 16.95 | 6.13 | 26.90 | 4.09 | 13.52 |
| Q4 | 9.59 | 2.47 | 22.60 | 1.58 | 9.06 |
| Q5 | 8.98 | 3.15 | 19.97 | 1.37 | 8.37 |
| Q6 | 6.35 | 2.98 | 14.80 | 1.20 | 6.33 |

*Sources:* Data for Australia, New Zealand, and China are from OECD. Data for Canada are from Statistics Canada via Haver Analytics.

**Figure 2 Implementation of VAT, by country**



*Source:* Authors' calculations using data described in text.

Chairman BRADY. Another research paper by Alan Auerbach and Larry Kotlikoff remarks to show destination-based consumption tax more progressive than corporate taxes.

[The information follows:]

Brady SFR

# Assessing the House Republicans' "A Better Way" Tax Reform

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## Overview of the House Republican Tax Plan

The House Republican "A Better Way" tax reform[1] plan includes a significant redesign of our business tax system. It effectively would replace the corporate income tax with a 20 percent destination-based business cash-flow tax. Proprietorships, partnerships, S corporations and other pass-through entities would face a distinct schedule with a top rate of 25 percent on pass-through income, leading to a need for provisions to limit the ability of high-income households to move income from the new top 33 percent personal rate to the 25 percent rate.

The reform would also streamline and significantly simplify personal income taxation by eliminating the Alternative Minimum Tax, unifying the tax treatment of personal asset income (taxing half of personal asset income), eliminating exemptions, eliminating the deductibility of state income and property taxes, raising the standard deduction and modifying the child-tax credit. In addition, the plan moves from seven to three income-tax brackets, with the top rate lowered from 39.6 percent to 33 percent.

This paper examines the reform's potential impact on revenues, inequality, and fiscal progressivity.[2] The plan's proposed reform of business taxation is particularly significant for potential U.S. investment. Current net domestic investment is quite low -- just 5 percent of net national income. In 1950s it was roughly three times higher.[3] Although it is formally a "worldwide" tax system, today's U.S. corporation income tax primarily taxes U.S. and foreign corporations on income earned from investing in the United States.

There is a significant debate about the size of the marginal U.S. effective corporate tax rate both in absolute terms and relative to rates in other countries. Mintz and Chen (2014) suggest that the United States has one of the world's highest marginal effective corporate tax rates. (See figure 1). Gravelle (2014, 2016) suggests otherwise. Mintz estimates that the comprehensive (federal, state, and local) marginal effective corporate tax (METR) on investing in the U.S. would fall from 34.6 percent to 16.1 percent as a result of the tax plan.[4] The Tax Policy Center estimates the tax plan would lower the federal part of the METR from 24.0 percent to 8.8 percent.[5]

Gravelle sees a much smaller decline. Mintz's estimate of the METR includes state corporate income, property, and other taxes. Gravelle measures only the federal METR. Gravelle estimates the current federal METR at 5.7 percent, falling to – 4.7 percent under the House tax plan.[6]

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[1] https://abetterway.speaker.gov/_assets/pdf/ABetterWay-Tax-PolicyPaper.pdf

[2] We do not consider the plan's proposed elimination of the estate and gift tax.

[3] Our net national saving rate is also roughly one third of its average value in the 1950s. But domestic investment, while correlated with national saving, is not determined by national saving. This is clear from the historical record on current account deficits. In 2003, for example, foreign investment in the U.S. exceeded investment by Americans in the U.S. (i.e., it exceeded total net national saving). Recently, the current account deficit has shrunk.

[4] See https://taxfoundation.org/competitiveness-impact-of-tax-reform-for-the-united-states/

[5] See table 8 in https://taxlawjournal.columbia.edu/article/an-analysis-of-the-house-gop-tax-plan/#_Toc476651282.

[6] This is Gravelle's (2017) estimate.

Although the absolute values of their METRs differ dramatically, the implied percentage decline in the cost of capital are somewhat closer.[7] Mintz foresees a 28.3 percent decline in the overall cost of capital. The TPC expects a 20 percent decline in the federal METR. And Gravelle estimates a 9.54 percent decline in the federal METR.[8]

If the highest of these estimates is on the mark, the tax plan could significantly increase U.S. investment and wages, with an eventual real wage increase possibly as high as 8 percent, according to dynamic simulation analysis based on the Global Gaidar Model.[9] In our analysis we consider no dynamic feedback on U.S. wages as well as this optimistic 8 percent wage-increase dynamic feedback scenario, in order to explore the range of possible outcomes.[10]

The tax plan permits businesses to expense (immediately write off) the cost of their new investment. The proposed new corporate income tax also features border tax adjustments to ensure that companies no longer have an incentive to either move their operations or to shelter their profits abroad. The resulting tax is a *cash flow tax* because it taxes all revenues earned from

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[7] The percentage change in the cost of capital is calculated at the change in the METR divided by 1 minus the initial METR.

[8] If inclusion of non-federal corporate components to the METR raised Gravelle's METR under the current system from 5.7 percent to 20.7 percent, her percentage fall in the cost of capital would be 11.35 percent, which is still far lower than the 28.3 percent decline estimated by Mintz.

[9] An 8 percent increase is generated in the Global Gaidar Model by reducing the U.S. corporate tax by 53.5 ((34.6-16.1)/34.6) percent holding marginal taxes of other regions of the world constant and maintaining fixed U.S. debt to GDP during the transition. GDP also rises by close to 8 percent. Development of the Global Gaidar Model represents joint work of Laurence Kotlikoff and a team of American and Russian economists. It is a 17-region, 90-period version of the original Auerbach-Kotlikoff dynamic life-cycle CGE model. The model covers all regions of the world, incorporates the latest United Nations demographic projections, and is calibrated to the most recent IMF data. Benzell, Kotlikoff, and Lagarda (forthcoming 2017) uses the Global Gaidar Model to study the dynamic impacts on the U.S. and other regions of the House tax plan. Unlike other studies of dynamic feedback arising under the House tax plan, the Gaidar Model captures the size of the U.S. economy relative to the global economy. This matters for properly assessing the magnitude of capital inflows to the U.S. in response to corporate tax reform.

[10] We say "optimistic" for five reasons. First, other regions could respond to the U.S. move to a cash-flow tax by reducing their corporate tax rates or adopting the new U.S. business tax system. Second, Mintz's calculation of the reduction in the effective marginal corporate tax rate under the House tax plan may be overstating the change. While there is a standard method of calculating marginal effective corporate tax rates, researchers differ on their assumptions about weighting different types of capital goods as well as the degree of marginal debt finance. Third, the various modeling assumptions in the Global Gaidar Model might produce more sensitive capital flows than would result from alternative assumptions. Fourth, our estimate of an 8 percent rise in wages in the Gaidar model is predicated on the maintenance of the current U.S. debt to GDP ratio through time. If the Gaidar Model's assumption of a very quick transition to higher U.S. investment and, therefore, higher wages, with its associated addition to revenues, is inappropriate, U.S. debt to GDP could rise. If not reversed, this would produce a smaller than 8 percent increase in real wages in the Gaidar Model. We should add, though, that in at least one respect the model's assumptions might understate the growth of US domestic investment and hence real wages. The model excludes discrete location decisions regarding investments that yield rates of return in excess of the required returns. Empirical evidence (e.g., Devereux and Griffith, 1998) suggests that such decisions are responsive to international tax rate differentials, which would increase substantially in favor of the United States, which would impose a tax rate of zero on domestic-source income under the proposal. Fifth, if more investment entails more automation it could, as in Sachs and Kotlikoff (2012), lower, not raise wages.

sales within the U.S. less all costs.[11] Costs include outlays on goods, including investment goods, whether imported or produced locally, as well as all wages. Mathematically, this business cash flow tax is equivalent to imposing a subtraction-method, destination-based Value Added Tax (VAT) with an equal-rate subsidy to wages.[12]

Since a household's current and future consumption is financed by its current and future wages plus its current net worth, the combination of a VAT and a wage subsidy is effectively equivalent to taxing initial wealth as well as the future returns to capital in excess of the required market rate of return. This makes the business tax reform a significant progressive element of the overall tax plan, which offsets some regressive features of the tax plan's personal income tax reform, notably the reduction in the top rate from 39.6 percent to 33.0 percent.

This paper assesses the revenue effects, progressivity and work incentive effects of the Better Way tax plan. We also consider a modification of the tax plan, namely one that also eliminates the ceiling on Social Security's FICA payroll tax. We distinguish below between *the tax plan* (the House Republican tax plan) and *the modified plan*, which includes lifting the FICA ceiling.

Lifting the FICA ceiling would generate more revenues and raise progressivity relative to both the current system and the tax plan. It would help shore up Social Security's finances and, potentially, enhance political support. But it represents just one of many ways to modify the tax plan, and is in no way linked to the House Republican plan.

## Methodology

To measure the effects of the tax plan as well our modified tax plan on revenue, inequality, progressivity, and work incentives we ran all households sampled in the Federal Reserve's 2013 Survey of Consumer Finances (SCF) through *The Fiscal Analyzer* (TFA). TFA is a detailed life-cycle consumption-smoothing program that incorporates both borrowing constraints and lifespan uncertainty as well as all major federal and state tax and transfer programs.[13]

In the course of doing its consumption smoothing, TFA determines each household's expected present value of remaining lifetime spending, where the term *expected* references averaging over different longevity outcomes and spending encompasses all expenditures, including terminal bequests net of estate taxes. The impetus for focusing on remaining lifetimes, rather than just the current year, comes from standard life cycle economic theory, which postulates that people care about the future, not just the present.

The lifetime budget constraint facing each household is given by

(1) $S = R - T,$

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[11] The House business cash flow tax is similar in many respects to that proposed by Auerbach (2010) as well as The Growth and Investment Tax Plan proposed in 2005 by The President's Advisory Panel on Tax Reform (see https://www.treasury.gov/resource-center/tax-policy/Documents/Report-Fix-Tax-System-2005.pdf)

[12] The border adjustment can be implemented by having firms simply exclude revenues earned from exports and costs incurred from imports.

[13] See Auerbach, Kotlikoff, and Koehler (2016).

where $S$ references the present expected value of a household's remaining lifetime spending, $R$ stands for remaining lifetime resources (the present expected value of remaining lifetime labor earnings plus its current net worth) and $T$ stands for the present expected value of remaining lifetime taxes net of transfer payments received. The average net tax rate, $t$, is defined by

(2) $t = T/R$,

and the marginal net tax rate, $m$, is given by

(3) $m = \Delta T/\Delta R$,

where $\Delta T$ references the change in the present expected value of net taxes associated with an increase of $\Delta R$ in the present expected value of resources. Thus, if the expected present value of a household's spending is, for example, 65 percent of remaining lifetime resources, its average net tax rate, $t$, equals 35 percent. And if earning, say, another $10,000 this year changes $T$ by $3,000, the marginal net tax rate is 30 percent.

Average remaining lifetime net tax rates tell us not only the net share of their resources that households surrender to the government. They also tell us about the progressivity of the fiscal system. If average net tax rates rise with the level of resources, the fiscal system is progressive. If they fall, the system is regressive. If they are independent of the level of resources, the system is proportional.

This paper, like our prior studies using TFA (Auerbach et. al., 2016, Auerbach et. al., 2017), calculates inequality and the progressivity of the fiscal system on a cohort-specific basis. Specifically, we consider inequality by looking within 10-year age cohorts at the share of total remaining lifetime spending attributable to households falling within different within-cohort percentiles of remaining lifetime resources, $R$. To measure progressivity, we again look within cohorts, but at average remaining lifetime net tax rates rather than at shares of the cohort's total remaining lifetime spending.

We use cohort-specific analysis to consider inequality and progressivity because failing to do so amounts to comparing apples with oranges. Ranked by remaining lifetime spending, older cohorts would look poorer than younger cohorts simply because they had shorter remaining lifespans. And remaining lifetime net tax rates of older cohorts would appear lower than those of younger cohorts simply because the elderly would receive no credit for net taxes paid in the past and appear to be subsidized because they are collecting or will start to collect Medicare, Medicaid, and Social Security benefits sooner than younger cohorts.

## Modeling the Current Tax System

Auerbach et. al. (2016) and Auerbach et. al. (2017) discuss TFA's modeling of the current tax system. We take several steps here to match the Congressional Budget Office's 2017 revenue projections. First we inflate all dollar amounts reported in the 2013 SCF data by nominal average wage growth between 2013 and 2017.[14] Second, we inflate all wage and self-employment income by 9 percent to match the CBO's 2017 projected FICA tax receipts.

Third, we assume a corporate tax rate to match CBO's 2017 corporate revenue projections as closely as possible. We levy this corporate tax on the model's assumed pretax return to stock holdings. Stock values have risen faster than wages between 2013 and the present. In addition, the SCF respondents appear to underreport their stock holdings. Third, the CBO's makes various assumptions about corporate income-tax collections in reaching its 2017 projected total. Finally, not all corporate equity is held directly or indirectly by US households, but in our analysis we are assuming that there is no shifting of the corporate tax to others, either domestically (e.g., US workers) or abroad (e.g., foreign shareholders). To capture all of these factors, we simply set the corporate tax rate in the TFA to reproduce the CBO's 2017 corporate tax total.

Fourth, the SCF asks respondents what they specified as taxable capital gains, dividends, and interest income on their 2012 individual tax returns. We used these data (adjusted for wage growth) in calculating personal[15] income taxes under both the current tax system and the House tax plan. In the case of taxable capital gains income, we formed, by cohort and resource decile, total reported (realized) capital gains divided by total stock holdings. We vary these capital-gains, income-realization rates through time as respondents move from one age cohort to another. We engage in an identical resource-specific decile procedure to determine respondents' shares, as they move from one age group to another, of stock holdings out of total financial assets.

## Modeling the Better Way Tax Plan

As mentioned, the business tax part of the House Republican tax reform effectively implements a tax on wealth. According to Burman et al. (2017), based on estimates using the Tax Policy Center model, the plan's cash flow tax is close to revenue neutral ignoring changes in revenues arising during the transition from the current to the new business tax system.[16] Since the Better Way tax plan leaves many transition details unresolved, it seemed best, to measure its long-run consequences, simply to ignore transition revenue effects and form our calculations assuming the cash flow tax generates the same revenues as the current corporate tax system.

Since the cash flow tax represents an implicit tax on consumption financed out of wealth, we capture its impact by introducing a one-time tax on wealth in TFA. This tax is assessed only on net financial wealth; i.e., its base excludes home equity since the tax plan, like the current tax system, does not treat the receipt of imputed rent on owned homes as business income. We set the rate for this net financial wealth tax at 13.6 percent. This tax rate was chosen because it

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[14] https://www.ssa.gov/oact/cola/AWI.html#Series reports Social Security's average wage index series through 2015. We assume the same growth rate for 2015 and 2016 as that reported for 2014.

[15] In both procedures, we assume that respondents in resource decile *j* will remain in resource decile *j* as they move from one ten-year age bracket to another.

[16] According to Table 2 in their paper, the corporate tax provisions would reduce revenues slightly, by a total of $192.5 billion over the decade 2027-2036.

reduces TFA's 2017 total consumption spending by roughly $315 billion, which is the amount of 2017 corporate tax revenues generated by TFA under the current tax system.

On the personal income tax side, we follow the tax plan with respect to all specified details. One detail that is not clearly specified is how the tax plan will prevent high tax-bracket households who receive pass-through self-employment and other income from declaring all their income as business income to permit its taxation at 25 percent. The Better Way tax reform document hints at the implementation of a limit on such behavior. Our guess of how this limit would be imposed is the implementation of a ceiling on the share of income that would otherwise be taxed at a rate above 25 percent that can be declared business income. We set the share of such income that cannot be claimed as business income at 25 percent. (Assuming a higher share would lower our estimated revenue loss from the proposal.)

## TFA-Generated 2017 Revenues Under the Current Tax System

The CBO projects 2017 personal income tax, FICA tax, and corporate income tax revenues of $1.651 trillion, $1.150 trillion, and $320 billion, respectively.[17] TFA's corresponding 2017 tax revenues estimates are $1.791 trillion, $1.104 trillion, and $330 billion, respectively. Thus, relative to the CBO, TFA is 8.48 percent high in estimating federal income taxes, 4.00 percent low in estimating FICA taxes, and 3.12 percent high in estimating corporate income taxes.

## Findings

### Revenues

Absent dynamic feedback (DF) effects, the House tax plan loses $212 billion in revenue on an annual basis, according to our methodology. With DF effects, which we again stress appear to represent an upper bound for wage growth under the plan, there is an annual revenue gain of $38 billion. With DF effects and the lifting of the FICA ceiling, there is a $328 billion annual rise in revenues.[18] These potential revenue changes need to be compared with our model's baseline total federal revenue (including just corporate and personal income taxes) of $3.272 trillion. Absent DF, the tax plan produces 6.5 percent less federal revenue. With the posited DF response, the revenue gain is 1.2 percent. And with the modified tax plan, which includes elimination of Social Security's FICA taxable earnings ceiling, the revenue gain is 10.0 percent.

### Spending Inequality

We present results for the 40-49 year-old cohort as the findings for other cohorts are quite similar. Figures 2 through 5 consider spending inequality under a) current law, b) the tax plan

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[17] https://www.cbo.gov/about/products/budget-economic-data#7 provides the CBO's projections as of January 2017.

[18] This last estimate is in a sense even more optimistic than the basic DF estimate and should be regarded with caution, as it assumes the same growth in wages even though individuals above the FICA ceiling face higher marginal tax rates on their labor earnings.

with no DF, c) the tax plan with DF, and d), the modified tax plan with DF. The figures also show inequality in net wealth.

As figure 2 shows, remaining lifetime spending is less unequal than is net wealth. This is due to a more equal distribution of human wealth as well as the progressivity of the fiscal system. Under the current system, the top 1 percent (measured in terms of *R*) of 40 year olds own 19.0 percent of the wealth, but account for only 11.5 percent of the spending. In contrast, the poorest 20 percent account for only 2.5 percent of total cohort wealth, but 6.3 percent of cohort spending.

As figure 3 indicates, the House tax plan, absent any DF increases in labor income, increases the spending share of the richest 20 percent from 51.0 percent to 51.6 percent. It raises the spending share of the top 1 percent from 11.5 percent to 11.7 percent. The poorest 20 percent experience a fall in their spending share from 6.3 percent to 6.2 percent. These are relatively small changes in the distribution of spending, although they do represent a small shift toward greater inequality.

An increase in wages by 8 percent, considered in figure 4, makes no difference to the spending share of the top quintile, which remains at 51.6 percent. But it reduces the spending share of the top 1 percent from 11.7 percent to 11.6 percent. The fact that higher labor income does so little to alter spending inequality may be surprising. But there is considerable inequality in labor income, especially when one considers the different labor income trajectories of labor income for those with different resource levels.

Figure 5 shows that our modified tax plan in the presence of DF reduces the spending share of the top 1 percent to 11.0 percent, a small decrease from its 11.5 percent value under the current system. The top 20 percent now get to spend 50.8 percent of total cohort spending, a bit less than the 51.0 percent share under the current system. The spending share of the bottom quintile falls slightly from 6.3 percent under current tax provisions to 6.2 percent.

### Average Remaining Lifetime and Current-Year Net Tax Rates

Table 1 shows average remaining lifetime net tax rates under current law and the three tax reform cases.[19] The fact that all rates are negative for the lowest quintile and rise sharply with the percentile levels of remaining lifetime resources indicates that the U.S. fiscal system is highly progressive. It remains highly progressive in each of the three reform cases. But the tax plan without DF lowers the average remaining lifetime net tax rate for the lowest quintile by .5 percentage points while lowering it by 3.0 percentage points for the top 1 percent. The second, third, and fourth quintiles experience cuts in their average remaining lifetime net tax rate, but these cuts are smaller than the 2.7 percentage-point cut experienced by the top quintile. Adding DF effects to the mix raises the average net tax rate dramatically for the lowest quintile – by 5.9 percentage points relative to the current system. At the same time, average net tax rates for other quintiles rise as well. For the top 1 percent, the reduction in the average net tax rate of the top 1 percent relative to the current system falls to 1.4 percentage points.

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[19] As discussed in Auerbach, et. al. (2016), traditional current-year tax rates are unreliable guides to either average or marginal net tax rates because they omit future net tax payments and resources.

The last row of table 1 presents average tax rates under the modified tax plan with DF. There is, as expected, no change to average tax rates at the bottom end of the resource distribution. But lifting the FICA tax ceiling raises average tax rates of the rich. Indeed, those in the top 20, top 5, and top 1 percent of the resource distribution end up with higher average remaining lifetime net tax rates than under the current tax system. For the top 1 percent, the increase in the average remaining lifetime net tax rate is 3.1 percentage points relative to the current system.

### Remaining Lifetime Median Marginal Net Tax Rates

Table 2 considers median remaining lifetime marginal net tax rates for our four cases. The marginal net tax experiment we consider involves one-year increase in earnings of the household head by $1,000. Recall, if the present value of remaining lifetime spending rises by, for example, $700, we measure the marginal remaining lifetime net tax rate as 30 percent.

The House tax plan without DF significantly reduces median remaining lifetime marginal net tax rates for all five quintiles. For the poorest quintile, the median marginal tax falls by 3.4 percentage points. For the top 1 percent, the median rate falls by 9.6 percent points. Adding DF to the mix makes little difference to the median marginal net tax rates in the bottom two quintiles. But moving to the modified tax plan raises median marginal rates above their initial level for the third quintile and roughly back to their current values for the fourth quintile, top quintile, top 5 percent, and top 1 percent.

### Impact on Spending

Table 3 shows the impact on percentile-specific average remaining lifetime spending of the tax plan. With no dynamic feedback, all percentile groups are better off, but the average spending increase is highest at the top – 4.56 percent for the top 1 percent compared with 0.33 percent for the bottom 20 percent. Adding DF effects produces more significant spending gains for all percentile groups, particularly for the highest resource groups. Now the bottom quintile experiences a 2.05 percent average spending increase. The top 1 percent see their average spending rise by 9.49 percent. These spending changes are more equitably distributed under the modified tax plan. The poorest 20 percent still experience, on average, a 2.05 percent spending increase. But for the top 1 percent average spending now rises by only 2.71 percent.

### Why the House Tax Plan May Be More Progressive Than Our Calculations Suggest

In this analysis we've made a traditional assumption that owners of U.S. corporations bear 100 percent of the burden of the current corporate income tax. But given the mobility of capital, some of the burden of the corporate tax may fall on workers. Indeed, the Congressional Budget Office estimates this share at 25 percent in its own distributional calculations. And other studies (e.g., Fehr, et. al., 2013) suggest this share could be substantially higher, even potentially greater than 100 percent.[20] Were we to model the current corporate tax as falling in part or in full on workers, the tax plan would be more progressive than we've portrayed. Consequently, our results on the

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[20] This possibility arises because the impact of the corporate tax on U.S. investment and, thus, real wages, depends on the marginal rate of corporate income taxation. In contrast, corporate revenues depend on the lower average rate of corporate income taxation.

tax plan's progressivity should be viewed as having at least one bias against our finding that the plan is somewhat less progressive than the current tax system.

## Conclusion

The House tax plan represents a significant reform of our tax system and its business tax provisions have the potential to increase wages by encouraging domestic investment. The business tax reform effectively replaces a tax on asset income with a tax on wealth. On balance this is a progressive move that offsets certain regressive elements of the personal tax reform.

With no dynamic feedback effects, the House tax plan will, we estimate, reduce federal revenues by $212 billion on an annual basis, ignoring the additional revenue costs of transition provisions. With a strong feedback to wages (an 8 percent wage increase), the reform will raise $38 billion annually. One way to help ensure revenues don't fall is to couple the House tax plan with the lifting of the ceiling on Social Security's FICA tax.[21] Ignoring any adverse behavioral response to higher tax rates on labor income, doing so will raise annual revenues by $328 billion assuming wages rise by 8 percent. Eliminating the FICA ceiling would help shore up Social Security's finances. As things now stand, the system is 32 percent underfinanced and faces a $32.1 trillion unfunded liability.[22]

The House tax plan would slightly worsen U.S. inequality as measured by the share of cohort-spending done by the rich. Were the modified tax plan chosen, inequality in spending would remain close to where it is under current tax provisions.

Work incentives would improve for all resource groups under the House plan, with the biggest improvement for the rich. However, given that the plan, absent sizable dynamic feedback, produces a revenue loss, one would want to take into account any incentive effects of whatever provisions are eventually adopted to offset a potential revenue loss. For example, the adoption of the modified tax plan would leave the rich facing roughly the same marginal net tax rates as under the current tax system.

The House tax plan represents a revenue gamble. If the economy responds as one might optimistically hope, revenues will be close to if not exceed their current values. Moreover, wages as well as GDP will be significantly higher. If the economy does not respond, the House tax plan will materially increase the federal deficit. One alternative, considered here, which greatly reduces the risk of lost revenues but retains the potential for significant economic growth, is to couple the House tax plan with the elimination of the ceiling on Social Security's FICA tax. In addition to raising revenues, this modification of the House tax plan would make the proposed tax reform more progressive.

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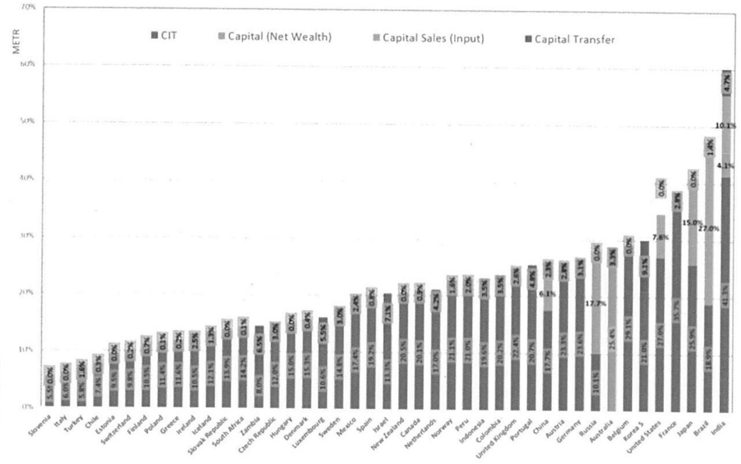
[21] An important caveat with respect to lifting the FICA tax ceiling is that doing so may reduce the labor supply and, thus, taxable labor income, of high earning workers.

[22] https://www.ssa.gov/oact/tr/2016/VI_F_infinite.html

Figure 1

Marginal Effective Corporate Tax Rates Across Countries, 2017*



*Source: Jack Mintz, School of Public Policy, University of Calgary,
http://www.minerals.org.au/file_upload/files/publications/With_global_company_tax_reform_in_the_air%2C_will_Australia_finally_respond_FINAL.pdf

**Figure 2 Current Law, Net Wealth and Lifetime Spending by Resource Percentile Range, Ages 40 - 49**

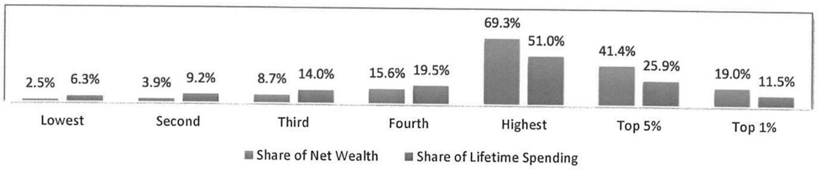


**Figure 3, House Tax Plan, No Dynamic Feedback, Net Wealth and Lifetime Spending by Resource Percentile Range, Ages 40 - 49**

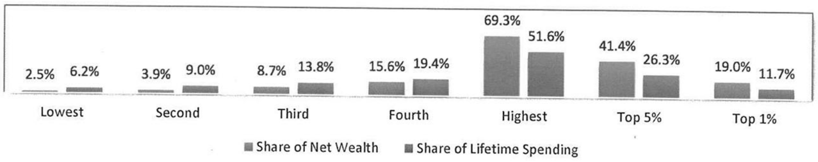


**Figure 4 House Tax Plan with Dynamic Feedback, Net Wealth and Lifetime Spending by Resource Percentile Range, Ages 40 - 49**

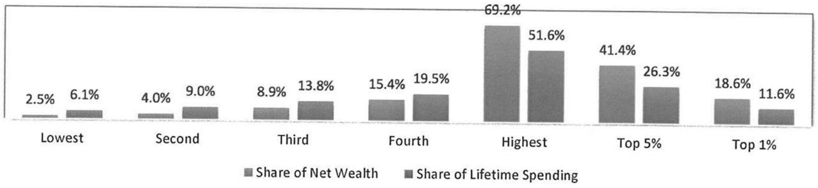
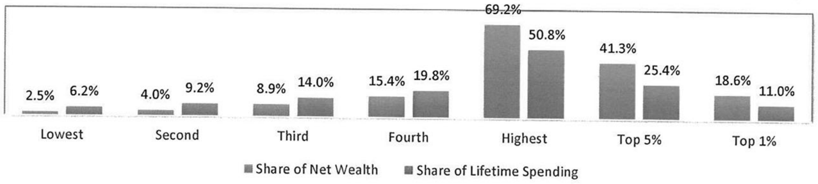


**Figure 5 House Tax Plan with Dynamic Feedback and Elimination of FICA Tax Ceiling Net Wealth and Lifetime Spending by Resource Percentile Range, Ages 40 - 49**



## Table 1

### Average Remaining Lifetime Net Tax Rates

| | Bottom Quintile | Second Quintile | Third Quintile | Fourth Quintile | Top Quintile | Top 5% | Top 1% |
|---|---|---|---|---|---|---|---|
| Current Law | -52.7% | 4.3% | 12.1% | 18.8% | 28.2% | 30.7% | 33.9% |
| Tax Plan | -53.2% | 3.2% | 10.7% | 17.1% | 25.5% | 27.8% | 30.9% |
| Tax Plan with 8% Wage Increase | -47.3% | 5.0% | 12.1% | 18.6% | 26.3% | 28.5% | 31.5% |
| Modified Tax Plan* with 8% Wage Increase | -47.3% | 5.0% | 12.1% | 18.7% | 29.4% | 32.9% | 37.0% |

*House Republican tax plan with no ceiling on Social Security's FICA tax.

## Table 2

### Median Marginal Remaining Lifetime Net Tax Rates

| | Bottom Quintile | Second Quintile | Third Quintile | Fourth Quintile | Top Quintile | Top 5% | Top 1% |
|---|---|---|---|---|---|---|---|
| Current Law | 37.4% | 34.8% | 36.7% | 42.9% | 44.8% | 47.2% | 50.7% |
| Tax Plan | 34.0% | 31.7% | 33.9% | 41.5% | 40.9% | 40.9% | 41.1% |
| Tax Plan with 8% Wage Increase | 33.2% | 31.7% | 37.7% | 41.1% | 40.4% | 41.1% | 41.3% |
| Modified Tax Plan* with 10% Wage Increase | 33.2% | 31.8% | 38.9% | 42.0% | 44.6% | 47.9% | 49.8% |

*House Republican tax plan with no ceiling on Social Security's FICA tax.

Percent Increase in Average Present Value of Remaining Lifetime Spending Relative to the Current Tax System

| | Bottom Quintile | Second Quintile | Third Quintile | Fourth Quintile | Top Quintile | Top 5% | Top 1% |
|---|---|---|---|---|---|---|---|
| Tax Plan | 0.33% | 1.14% | 1.58% | 2.12% | 3.76% | 4.22% | 4.56% |
| Tax Plan with 8% Wage Increase | 2.05% | 5.50% | 5.35% | 6.61% | 8.28% | 8.48% | 9.49% |
| Modified Tax Plan* with 10% Wage Increase | 2.05% | 5.50% | 5.31% | 6.52% | 4.92% | 3.53% | 2.71% |

*House Republican tax plan with no ceiling on Social Security's FICA tax.

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Chairman BRADY. I would like to thank our witnesses today.

You have brought incredible insight to this well-watched hearing. You can tell, some have already given up on U.S. manufacturing in agriculture. You have heard it: We don't make that anymore, it is not coming back.

I am heartened, though, by discussions we have heard here today, that that is not necessarily the case. And I know with Mr. Simon, you have told me before about when you bring back manufacturing capability for lawn furniture, you bring it back to manufacturing hair dryers—not that I use those anymore—and on, and on, and on down that supply chain.

I am heartened by Rich Noll, who is the Chairman of Hanes company. They have got the Hanes, Champion, Playtex, apparel, you know, very import sensitive, who makes the case that if we had this Tax Code in place today, these supply chains would be back here in America.

And I also am heartened by the fact that we all recognize that moving forward with this type of bold change requires thoughtful transition, deliberate transitions, addressing successfully the valid concerns we have heard today.

So we are going to continue on that track. And please be advised that Members of Congress on the committee have two weeks to submit written questions to you, to be answered later in writing, so those questions and your answers will be made part of the formal hearing record.

Again, on behalf of Mr. Neal and myself, thank you for being here today. The meeting stands adjourned.

[Whereupon, at 1:24 p.m., the committee was adjourned.]

[Member Questions for the Record follows:]

# HEARING ON INCREASING U.S. COMPETITIVENESS AND PREVENTING AMERICAN JOBS FROM MOVING OVERSEAS

## Questions for the Record

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**Questions from Rep. Johnson**
*Questions for Mr. Cornell*

**Question 1:**
In your testimony you say that "under the new border adjustment tax, our rate would more than double, from 35 percent to 75 percent." Could you explain exactly how Target's tax rate would double?

**Answer:**
As I stated in my testimony, Target has had an average effective tax rate of 35 percent for the past decade. Lowering this high tax rate would help Target hire and grow, and motivates our strong support for tax reform.

While the House Republican Blueprint lowers the corporate tax rate, it does not allow importers to deduct the cost of goods sold. This dramatically increases our taxable income. This inability to deduct the costs of our direct imports, as well as the loss of interest deductibility under the plan, would by our estimates increase our effective tax rate from 35 percent to 75 percent.

We have been conservative in our estimates, even including the highly uncertain prospect of currency appreciation. Some of my retail peers have modeled even higher effective tax rate numbers under this new border adjustment tax.

**Question 2:**
Furthermore in your testimony you say that "instead of investing and creating American jobs, we'd be pushed in the other direction." Could you elaborate on this concern? Could you share with the committee to the best extent possible what the impact would be on Target's ability to invest? Further, what would be the impact on jobs?

**Answer:**
Target is investing and hiring in America. We recently announced we are investing $7 billion in communities across the country to build new stores, renovate hundreds of existing locations, and transform our distribution network. These investments will create thousands of new jobs at Target, and thousands more for engineers, electricians, plumbers, and painters all across the country. These are in addition to the 320,000 people Target employs today.

If the border adjustment tax goes forward and saddles Target with a 75 percent effective tax rate, we would be forced to reconsider not just our growth plans but also our existing stores business model. I would be left with only bad options under this new tax burden.

*Question for Dr. Lindsey*

**Lead in:**
In an op-ed published earlier this year by former Texas Senator Phil Gramm entitled "How 'Border Adjustment' Poisons Tax Reform; the House's 20% import fee is political industrial policy that will convulse the economy. Better to follow the 1986 model," the Senator states the following:
*By assuming that the plan would not change international capital transactions, and therefore trade balances, the House assumes it would ultimately push up the value of the dollar by 25%. This would offset the cost that the proposal imposes on consumers, who would be buying imports with a more valuable dollar. In the same way, the tax preference for exporters would also disappear as the cost of buying U.S. exports abroad rises with the dollar. Thus all exchange-rate-adjusted prices would return to where they were before border adjustment—except that with imports accounting for $600 billion more than exports, the 20% tax would produce a $120 billion annual revenue windfall.*

**Question:**
Do you agree with this statement and the conclusion that the border adjustment tax would lead to a $120 billion "windfall"?

**Answer:**
I hesitate to use the word "windfall" but the math is correct and for the reasons given. It is a "windfall" to the United States in a sense though because the after-tax dollar price paid by the American importer is unchanged and therefore so is the price to the consumer. The cost of the tax is placed on the exporter who now gets *fewer* dollars for his export. The exporter does, however, receive the same amount in his local currency however. That is actually one of the reasons why I think this is a very attractive tax by which to gather revenue to offset some of the pro-growth tax provisions in the rest of the bill. The combined effect will be to make America far more productive.

*Question for all witnesses*

**Question:**
In an op-ed by the former Senator Gramm entitled "How 'Border Adjustment' Poisons Tax Reform," the Senator claims that "border adjustment will be challenged under international trade agreements." Do you agree? And if not, why not?

**Answer- Mr. Cornell:**
Respectfully, Target's expertise is in the business of retail. While we have not taken a position whether border adjustment will be challenged under international trade agreements, I do understand that trade litigation can bring businesses uncertainty and undermine growth.

**Answer- Dr. Lindsey:**
I have no doubt that border adjustment will be challenged. Given what I have said above, any exporter to America has it in his interest to do so. But that doesn't mean they will prevail. The WTO, which will ultimately be the arbiter, would find it very hard to rule against the United States in this matter even though it is dominated politically by countries that export to us. First,

the United States has a very strong case. The WTO has approved this approach on indirect taxes for many other countries and to deny it to us would expose this. Second, such a ruling would be so unfair that I believe that the U.S. should consider its relationship with WTO. Given that likelihood I doubt very much that the WTO would rule against us.

**Answer- Mr. Luciano:**
ADM is a global company and as such compliance with America's international obligations is important to ADM. To this end, it is critical that tax reform legislation be compliant with international trade agreements. We are not WTO experts but observe that many countries around the world rely on value added or similar indirect taxes which are adjusted at the border. A Value Added Tax (VAT) is a requirement for membership in the EU, for example, and we face rigorous competition from EU-based companies. VATs are border adjustable and the WTO has not objected to this structure. We are confident that with the assistance of trade experts, including the significant expertise on Committee staffs, Congress can design a border adjustable tax that, like a VAT, is trade agreement compliant.

**Answer- Mr. Simon:**
I am not an international trade expert and cannot answer this question.

**Answer- Dr. Clausing:**
[Please note portions of the following text are excerpted from a previously prepared fact sheet on the same issue, jointly authored with Reuven Avi-Yonah at University of Michigan Law School. Professor Avi-Yonah has more legal expertise on these matters.]

Yes, the border adjustment is incompatible with World Trade Organization rules and risks undermining the world trading system.

The tax is a direct tax and would violate the WTO Subsidies and Countervailing Measures Agreement. Under this agreement, a tax may be border adjustable only if it is an indirect tax. Indirect taxes are defined as consumption-based taxes such as sales, excise, or value-added taxes. Direct taxes, in contrast, are income-based, including taxes on wages, profits, or rents. Because the Ryan blueprint allows businesses a deduction for wages, it is a tax imposed on an income base.

The proposal would damage U.S. international and trade relations. The proposal argues that the deduction for wages effectively subsidizes exports and taxes imports, and increases the incentive for businesses to be based in the United States. The proposal also would reduce our trading partners' tax revenues because foreign companies' profit shifting to the United States will not affect U.S. tax liabilities but will reduce foreign liabilities. Trading partners are likely to legally challenge these measures, increasing the likelihood of retaliatory tariffs and causing an uncertain investment environment in the United States.

Many economists argue that the trade effects of the plan will be blunted if not eliminated by subsequent appreciation of the U.S. dollar. Yet lags in the exchange-rate change or incomplete exchange rate adjustment could cause substantial disruption to importing industries. And, even if the exchange rate adjusts fully eventually, dollar appreciation will have large effects on U.S. holders of foreign assets, and dollar appreciation would expose the world economy to additional risk. Further, retaliation by trading partners could have effects that outlast these disruptions.

If the U.S. government eventually makes the tax law change WTO compatible by dropping the wage deduction then it would convert the corporate tax into a consumption tax, turning one of our most progressive tax instruments into a regressive sales tax. If the United States eventually complies with WTO rules by dropping the border adjustment, then the tax plan will lose even more revenue and there will be massive opportunities for tax avoidance.

**Questions from Rep. Curbelo**

*Questions for Mr. Simon*

**Lead in:**

Mr. Simon, I appreciated your unique insights with bringing manufacturing back to the United States. After reading your written testimony, I couldn't agree with you more, that the global market has seen a rise in middle class jobs at the expense of our own workers here in the United States.

**Question 1:**

I represent South Florida, an area of the country that is no stranger to the struggles of congested traffic and the delay in getting goods to market. Can you elaborate further on the notion that being closer to the point of consumption actual lowers transportation costs and increases manufacturing flexibility?

**Answer:**

Clearly, from a transportation perspective, costs are lower if the product is produced close to the point of consumption. However, there are substantial benefits in addition to transportation. Lead times can be as much as 6 months shorter freeing up cash for longer periods. Additionally, with shorter lead times, a company has the flexibility to change quantities, colors and sizes in response to changing trends.

**Question 2:**

Can you talk about how comprehensive tax reform, as outlined in the Blueprint, can strengthen manufacturing jobs here at home, while increasing ease of market access for U.S. goods and ultimately lowering transportation costs?

**Answer:**

Our current tax code is exactly backwards when it comes to manufacturing. Companies who earn money outside of the US cannot return the cash in order to invest. They say the money is 'trapped' overseas, but it isn't. The money is invested in foreign markets. Ironically, companies can use their money to buy goods from foreign markets and bring those goods into the country without any tax. So, they invest in offshore manufacturing to avoid the repatriation penalties, and buy goods offshore and bring them back tax free. We let them bring in goods to take advantage of our markets but tax them if they bring back cash to invest. Exactly backwards.

*Question for Mr. Simon and Mr. Luciano*

**Question:**

We have heard of the importance of building and growing strong supply chains for companies, both in the United States and abroad. Businesses thrive when supply-chains are strong, and that is the ultimate goal of our Blueprint, to strengthen production for firms and grow opportunities for workers. Can you elaborate on the importance for strong-supply chains, and share thoughts on how the border adjustment might benefit or affect U.S. companies with supply-chains in Puerto Rico?

**Answer- Mr. Luciano:**
ADM believes that lower tax rates, combined with a territorial tax system and border adjustments will benefit market participants throughout the supply chain. That will help U.S. farmers, vendors, suppliers, and working families. The agricultural commodity markets are quite efficient and transparent, and savings quickly become a component of market price. Moreover, the Blueprint's comprehensive tax proposal should free up capital, which would encourage domestic investment in areas such as infrastructure. This could, for example, reduce transportation and storage costs and have a favorable impact on the supply chain and benefit farmers, suppliers and consumers. ADM does not have an extensive supply chain originating in Puerto Rico, so we are not in a position to comment on the specific impact there.

**Answer- Mr. Simon:**
Supply chain is everything. The manufacture and transportation of goods to market are the difference between a developed country and one that is underdeveloped. Markets benefit when they are in close proximity to their supply chain. As stated above, the efficiencies and cost advantage of locating production close to the point of consumption are a competitive advantage. Unfortunately, the current tax code actually compromises that advantage. The markets are located in the US. We should have an advantage versus global competitors but we don't. A border adjustment would return the equation to equilibrium. With respect to Puerto Rico, the inherent benefits of having access to US markets should make them a preferred location to base manufacturing. However, they are faced with all of the disadvantages of the current tax code requires of them and as such, have seen their manufacturing base decay without direct subsidies. A border adjustment would reverse that.

*Question for Dr. Lindsey*

**Lead in:**
In your testimony you indicate one of the best ways to measure economic productivity is the movement of workers and being able to take new jobs, as well as the rate of growth in new businesses. Your testimony indicates in the past few years, both of these benchmarks have reported some of their worst numbers in decades.

Last month, it was reported by the Kauffman Foundation that the Miami-Fort Lauderdale area ranked Number 1 among the 40 largest metro areas in the U.S. for startup activity and business creation. I am very proud to represent a community that thrives on a great entrepreneurial spirit that has contributed to the increase in Miami-area jobs.

**Question 1:**
What role do you see the tax code playing in encouraging or discouraging new business formation today? Is today's tax code - not just in terms of rate, but also its complexity and design

- encouraging entrepreneurship and economic dynamism? What can be done to encourage even more job creation?

**Answer:**
The current tax code, along with many excessive and cost-ineffective regulations is hampering the development of small business in America. Its complexity is one of the main reasons. Any complex regulation places a greater compliance burden on a small business than a large one as it has fewer sales over which to amortize the burden. That is especially true of taxes.

In addition, one of the hallmarks of small business creation is capital formation – the equipment and structures needed to get the business up and running. One of the biggest advantages the tax proposal under consideration provides is expensing for tax purposes of such investments. Not only is this much simpler than the current depreciation system, it also lowers the effective tax rate on such capital, thereby encouraging its acquisition.

The “churn” in the economy created by small business is the main driver of productivity in our economy. And, those small businesses provide the vast bulk of new jobs. So, the tax proposal under consideration would be a major incentive for entrepreneurship, economic dynamism, and job creation.

**Question 2:**
Some claim that the BAT would lose in a WTO compliance challenge because the Blueprint allows for businesses to deduct wagers and labor. Some studies have indicated that Japan has a subtraction method VAT similar to what the Blueprint/BAT proposes. While subtraction method is unique and not a credit invoice method like most VATs, how can Japan still be compliant with WTO?

**Answer:**
The Blueprint/BAT proposal is very similar to the subtraction method that Japan uses. Japan is compliant. The WTO would find the U.S. in compliance as well. Fundamentally the economics of both the subtraction method and the credit/invoice method is the same. The WTO would find it difficult both legally and in terms of the risk to its image of impartiality to find against an American BAT.

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[Public Submissions for the Record follows:]

accurate
signs & engraving, inc.

May 22, 2017

The Honorable Kevin Brady
Chairman
Committee on Ways and Means
1102 Longworth House Office Building
Washington, DC 20515

The Honorable Peter Roskam
Chairman
Committee on Ways and Means
Subcommittee on Tax Policy
1102 Longworth House Office Building
Washington, DC 20515

Dear Chairman Brady and Chairman Roskam:

Serving with numerous business and economic groups here in Arizona, including Board member of the AZ Small Business Association and Board Chair of Local First Arizona, has given me a great perspective on the value that small businesses, especially those in retail, are for our communities. Furthermore, being a small business owner of over 35 years myself, I know the burden that comes with protecting ones bottom line.

Today, I own a company that is the largest provider of laser engraved tags to solar panel installers. The unnecessary higher costs to my and all small businesses, which is the economic backbone of American job creation, for equipment, food stuffs, timber and higher costs on petroleum products would adversely affect every small business owner and consumer in America!

Already in Arizona, we collect an 8.6% sales tax on products sold. Adding the Border Adjustment Tax on top of an existing high tax rate, prices us out of our market, thereby driving consumers to online retailers many of whom enjoy the luxury of not paying any sales tax because Congress hasn't yet enacted a national sales tax for online retailers, further damaging existing brick and mortar sales and jobs!

Small business owners simply don't have the cash flow necessary to absorb this onerous tax, as we have less flexibility in our margins for goods sold, and don't have the luxury of spreading this tax among a broader array of product offerings.

Sincerely,

[redacted]
Owner of Accurate Signs & Engraving
Phoenix, AZ

accurate
signs & engraving, inc.

cc: The Honorable Richard Neal
Ranking Member
Committee on Ways and Means
1102 Longworth House Office Building
Washington, DC 20515

The Honorable Lloyd Doggett
Ranking Member
Committee on Ways and Means
Subcommittee on Tax Policy
1102 Longworth House Office Building
Washington, DC 20515

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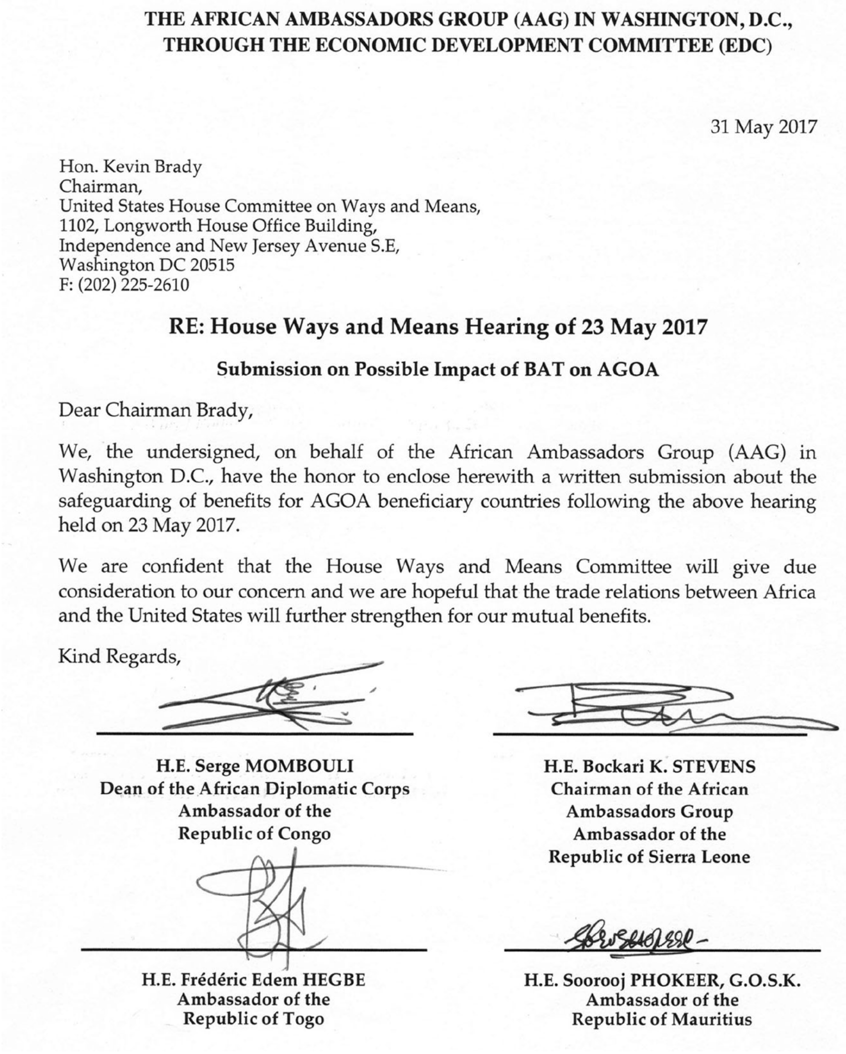

**THE AFRICAN AMBASSADORS GROUP (AAG) IN WASHINGTON, D.C.,**
**THROUGH THE ECONOMIC DEVELOPMENT COMMITTEE (EDC)**

31 May 2017

Hon. Kevin Brady
Chairman,
United States House Committee on Ways and Means,
1102, Longworth House Office Building,
Independence and New Jersey Avenue S.E,
Washington DC 20515
F: (202) 225-2610

**RE: House Ways and Means Hearing of 23 May 2017**

**Submission on Possible Impact of BAT on AGOA**

Dear Chairman Brady,

We, the undersigned, on behalf of the African Ambassadors Group (AAG) in Washington D.C., have the honor to enclose herewith a written submission about the safeguarding of benefits for AGOA beneficiary countries following the above hearing held on 23 May 2017.

We are confident that the House Ways and Means Committee will give due consideration to our concern and we are hopeful that the trade relations between Africa and the United States will further strengthen for our mutual benefits.

Kind Regards,

**H.E. Serge MOMBOULI**
**Dean of the African Diplomatic Corps**
**Ambassador of the**
**Republic of Congo**

**H.E. Bockari K. STEVENS**
**Chairman of the African**
**Ambassadors Group**
**Ambassador of the**
**Republic of Sierra Leone**

**H.E. Frédéric Edem HEGBE**
**Ambassador of the**
**Republic of Togo**

**H.E. Soorooj PHOKEER, G.O.S.K.**
**Ambassador of the**
**Republic of Mauritius**

# Submission by the African Ambassadors Group (AAG) in Washington, D.C., through the Economic Development Committee (EDC)

**for consideration by**
**the House Ways and Means Committee**
**in reference to the hearing of 23 May 2017,**

## "Increasing US Competitiveness and Preventing American Jobs from Moving Overseas"

**05 June 2017**

# THE AFRICAN AMBASSADORS GROUP (AAG) IN WASHINGTON, D.C., THROUGH THE ECONOMIC DEVELOPMENT COMMITTEE (EDC)

## Background

The central theme of the Africa Growth and Opportunity Act (AGOA) is to spur economic development in Africa by incentivizing private sector investment in export-oriented industries by means of a duty preference program. Thus, in order for AGOA to succeed, US companies should invest in Africa and export to the United States.

The core purpose of the proposed border adjustment tax (BAT) is exactly the opposite: to discourage private sector companies from investing overseas for the purpose of exporting to the United States. By eliminating imports from "cost of goods sold" for purposes of determining taxable income, BAT creates a powerful incentive for keeping your money in the United States and investing here.

## Risk to AGOA if BAT is enacted

There is a serious risk, therefore, that BAT, if enacted, would undermine AGOA. The burden of the BAT would fall on those sectors, which rely heavily on imports, like the apparel sector where US retailers import some 97% of the apparel sold.

In a BAT environment, competitive Asian producers will be able to cut their prices to retain their buyers. This will result in US buyers shifting orders from Africa to Asia. ***Hence, it is likely to undermine AGOA exports to the US***.

In the event that some kind of a BAT is introduced, AGOA countries should be exempted from it. Alternatively, non-extractive product imports under AGOA could be exempted from BAT, which would further reduce the impact on BAT.

## THE AFRICAN AMBASSADORS GROUP (AAG) IN WASHINGTON, D.C., THROUGH THE ECONOMIC DEVELOPMENT COMMITTEE (EDC)

### AGOA countries are minor exporters to the US market

AGOA has had and continues to have a very positive impact on the socio-economic development in Africa.

It is important to point out that ***AGOA countries are minor exporters compared to other major exporters*** and therefore exempting AGOA countries from BAT coverage would not have major implications to the US economy.

In 2016, the US imported a total of $2.2 trillion from all countries. From the AGOA countries, the US imported $20.1 billion or 0.9% of total imports. Excluding extractive products (mostly oil and minerals), the US imported $8.0 billion from the AGOA countries or just 0.4% total imports. In 2016, the US imported $12.1 billion in petroleum and other extractive products from the AGOA countries.

In 2016, the US ran a trade deficit with the AGOA countries of $7.1 billion. However, excluding extractive products, ***the US had a $5.0 billion trade surplus with the AGOA countries***.

Although the exports from AGOA beneficiaries stand at a mere 0.9% of total US imports (0.4% of non-extractive imports), nonetheless they have a substantial positive impact on Africa's development and provide employment to the most valuable segments of society, in particular women.

## THE AFRICAN AMBASSADORS GROUP (AAG) IN WASHINGTON, D.C., THROUGH THE ECONOMIC DEVELOPMENT COMMITTEE (EDC)

### AGOA: The "Win-Win" option

It is widely believed that AGOA has created hundreds of thousands of new direct jobs and millions of indirect jobs in Africa. **Similarly, it is estimated that AGOA-related trade has created more than 300,000 jobs in the United States.**

In short, AGOA has definitely succeeded in creating economic development in Africa through trade. At the same time, the United States has also benefited. Hopefully the 10-year extension of AGOA in 2015 will provide further impetus for even more growth on both sides, provided BAT does not undercut this growth.

### Recommendation: AGOA to be exempted from BAT, if and when enacted

We respectfully urge, therefore, that Congress takes into account that AGOA could be potentially undermined by BAT. If a decision is made to go forward with BAT, we urge that products imported under AGOA should be exempted from BAT.

**Economic Development Committee (EDC)**

**African Ambassadors Group (AAG)**

**Washington D.C.**

**05 June 2017**

## THE AFRICAN AMBASSADORS GROUP (AAG) IN WASHINGTON, D.C., THROUGH THE ECONOMIC DEVELOPMENT COMMITTEE (EDC)

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www.acttrade.org

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May 29, 2017

Hon. Kevin Brady
Chairman
Committee on Ways and Means
U.S. House of Representatives
Washington, D.C. 20515

Re: May 23, 2017 Border Adjustment Tax Hearing

Dear Chairman Brady:

We are writing to submit comments for the record of the Ways and Means Committee's May 23, 2017 hearing on the proposed border adjustment tax (BAT). The African Coalition for Trade (ACT) is an association of African private sector entities trading with the United States under the African Growth and Opportunity Act (AGOA). Our members are concerned that the proposed BAT would undermine the mutually beneficial trade under AGOA.

Enacted in 2000 and renewed for another ten years in 2015, AGOA extends generous duty-free preferences to most products imported from Africa. The central goal of AGOA has been to eliminate poverty in Africa through private sector funded economic growth and job creation in export-oriented sectors. AGOA has been successful, as U.S. non-petroleum imports from Africa have almost doubled from $6.9 billion in 2000 to $12.2 billion in 2016. The United States has also benefited directly as its exports to Africa have almost tripled from $5.6 billion in 2000 to $13.0 billion in 2016. The U.S. non-petroleum trade balance with Africa has improved from a $1.3 billion deficit in 2000 to a surplus of $831 million in 2016. AGOA has led to the creation of hundreds of thousands of jobs in both the United States and in Africa.

While AGOA's policy goal is the elimination of poverty through private sector investment and trade, BAT's goals are to discourage imports, to discourage U.S. private sector investment overseas and to encourage manufacturing in the United States. The policy goals of the two programs are undeniably at odds. Although the impact of BAT on AGOA was not directly addressed at the May 23 hearing, Mr. Brian Cornell, CEO of Target responded to a question from Congressman Curbelo (R-FL) that BAT would have a negative impact on companies that trade under DR-CAFTA. The same conclusion is inescapable for AGOA as well.

One of the sectors that has succeeded under AGOA has been the apparel sector. A new apparel manufacturing sector has been created in Africa in response to AGOA's duty preference. U.S. apparel imports from Africa under AGOA have increased to $1.0 billion in 2016. An estimated 300,000 direct jobs have been created in the AGOA apparel sector in Africa, along with more than one million indirect jobs in support sectors. But Mr. Cornell testified at the May 23 hearing that the apparel sector would be among the hardest hit by the proposed BAT, putting these new African jobs in jeopardy.

AGOA has been a successful program for the past seventeen years. It has the potential to achieve much more in continuing to foster economic development and reducing poverty in Africa during the next eight years if it is not undermined by BAT. If Congress concludes that BAT must be enacted, we respectfully ask that imports from Africa under AGOA should be exempted so that AGOA can continue to serve as the cornerstone of U.S.-African economic relations.

We would be happy to answer any questions you may have. Thank you for considering our views on this important issue.

Respectfully submitted,

Paul Ryberg
President

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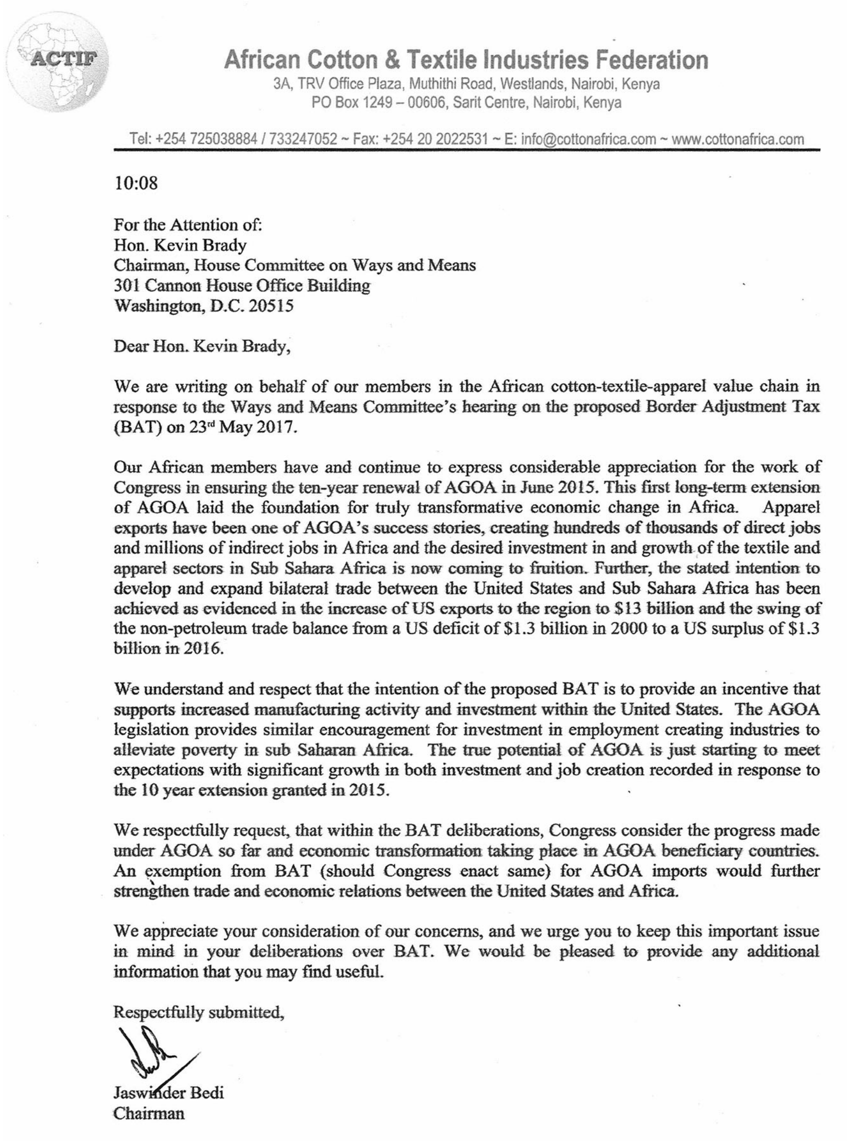

ACTIF

**African Cotton & Textile Industries Federation**
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10:08

For the Attention of:
Hon. Kevin Brady
Chairman, House Committee on Ways and Means
301 Cannon House Office Building
Washington, D.C. 20515

Dear Hon. Kevin Brady,

We are writing on behalf of our members in the African cotton-textile-apparel value chain in response to the Ways and Means Committee's hearing on the proposed Border Adjustment Tax (BAT) on 23rd May 2017.

Our African members have and continue to express considerable appreciation for the work of Congress in ensuring the ten-year renewal of AGOA in June 2015. This first long-term extension of AGOA laid the foundation for truly transformative economic change in Africa. Apparel exports have been one of AGOA's success stories, creating hundreds of thousands of direct jobs and millions of indirect jobs in Africa and the desired investment in and growth of the textile and apparel sectors in Sub Sahara Africa is now coming to fruition. Further, the stated intention to develop and expand bilateral trade between the United States and Sub Sahara Africa has been achieved as evidenced in the increase of US exports to the region to $13 billion and the swing of the non-petroleum trade balance from a US deficit of $1.3 billion in 2000 to a US surplus of $1.3 billion in 2016.

We understand and respect that the intention of the proposed BAT is to provide an incentive that supports increased manufacturing activity and investment within the United States. The AGOA legislation provides similar encouragement for investment in employment creating industries to alleviate poverty in sub Saharan Africa. The true potential of AGOA is just starting to meet expectations with significant growth in both investment and job creation recorded in response to the 10 year extension granted in 2015.

We respectfully request, that within the BAT deliberations, Congress consider the progress made under AGOA so far and economic transformation taking place in AGOA beneficiary countries. An exemption from BAT (should Congress enact same) for AGOA imports would further strengthen trade and economic relations between the United States and Africa.

We appreciate your consideration of our concerns, and we urge you to keep this important issue in mind in your deliberations over BAT. We would be pleased to provide any additional information that you may find useful.

Respectfully submitted,

Jaswinder Bedi
Chairman

U.S. House of Representatives

Committee on Ways and Means

Tax Reform Hearing on Increasing U.S. Competitiveness and Preventing American Jobs from Moving Overseas

May 19, 2017

Submission by Alan J. Auerbach
Robert D. Burch Professor of Economics and Law
Director, Burch Center for Tax Policy and Public Finance
University of California, Berkeley

I am pleased to provide this statement, on my own behalf, for the Committee on Ways and Means in connection with its hearing on border adjustability and tax reform. The United States needs tax reform to help the nation improve its economic performance and provide the funding necessary for its operations. Nowhere in the federal tax system is reform more necessary than in the area of business taxation, where antiquated provisions enacted long ago are no longer adequate for dealing with multinational companies that operate in the modern global economy.

The economy has changed and our tax system needs to change, too. In the fifty years between 1965 and 2015, the share of intellectual property in nonresidential US assets doubled.[1] Over that same period, the share of profits from US companies' overseas operations quadrupled.[2] These changes have made it much more difficult to determine where income is earned; they have made the meaning of being a "US company" less clear; and they have given companies more flexibility regarding the location of their operations.

For many years, the US tax system has remained static as other countries reacted to the changing economic landscape in pursuit of their own national interests. In response, many solutions have been proposed for the United States, but traditional solutions have proved unsatisfactory, because they failed to address the problems at the root of our current tax system.

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[1] Bureau of Economic Analysis, Fixed Assets Accounts Table 2.1. "Current-Cost Net Stock of Private Fixed Assets, Equipment, Structures, and Intellectual Property Products by Type."

[2] Bureau of Economic Analysis, NIPA Table 6.17, "Corporate Profits Before Tax by Industry."

Our tax system, which attempts to tax companies based on where they produce and report profits, and to tax US resident companies on the profits they earn offshore, all subject to a corporate tax rate that is essentially the highest in the world, has led to a host of serious problems. These problems include manipulation of transfer pricing to shift profits to other countries, moving production activities abroad to benefit from lower tax rates, keeping profits offshore to avoid paying tax on their repatriation to the United States, and undergoing corporate inversions to escape the US worldwide tax system. It has been tempting to blame companies for doing what the tax system allows them to do, but such criticism is no substitute for having a good tax system that removes incentives for undesirable behavior.

While different traditional approaches to tax reform may address specific problems, they typically exacerbate others. Strengthening worldwide taxation might reduce profit shifting by US corporations, but it would also worsen their competitive position and spur inversions. Moving toward a standard territorial tax system might improve the competitiveness of US corporations and limit inversions, while at the same time exacerbating incentives for moving operations and shifting profits to countries with lower tax rates. And a sharp reduction in the tax rates on business income, while lessening all of the problems already noted, would leave a revenue shortfall that the United States cannot afford, particularly in light of our imposing long-term fiscal imbalance.[3]

Yet, a much more effective solution exists, and may be found by looking at the tax systems of other countries. Nearly all developed countries have moved in the direction of destination-based taxation, choosing to impose tax based on where products are sold rather than on where they are produced. They have done so by introducing value added taxes (VATs) – which are transformed from territorial taxes on domestic production into destination-based taxes on domestic consumption through the mechanism of border adjustment – as they have reduced their corporate tax rates. But moving to destination-based taxation does not require a new tax like the VAT – it can be accomplished much faster and more directly through adoption of a destination-based cash flow tax (DBCFT), as has been proposed in the House Blueprint (*A Better Way*, https://waysandmeans.house.gov/taxreform/). The result will be a simpler, fairer system of business taxation that will reverse the bad incentives of the current system, eliminating the tax on US production, the incentive to shift profits abroad, and the urge to undertake inversions. Regarding each of these important conclusions, there has been little dispute, because the structure of the tax system speaks for itself. What, then, can stand in the way of adopting this reform? Unfortunately, opposition to the reform has arisen because of a range of

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[3] Alan J. Auerbach and William G. Gale, "The Fiscal Outlook at the Beginning of the Trump Administration," Tax Policy Center, January, 2017, estimate that a combination of tax increases and non-interest spending reductions of between 5 and 9 percent of GDP, on a permanent basis, are needed to address the fiscal gap in the federal budget under current policy.

objections, largely to perceived – rather than actual – features or effects of the proposed tax system. I wish to take this opportunity to address some of these misperceptions.

1. **The DBCFT, including border adjustment, is not protectionist or targeted at imports.**

   Taxing based on destination rather than production is a standard element of consumption-based taxation. The fact that the DBCFT permits a deduction for wages and salaries has no impact on this conclusion, any more than coupling a VAT with a reduction in payroll taxes would. Unlike a tariff, which hits only imports and discourages trade, the symmetric border adjustment of exports and imports does not disturb trade incentives.[4] Moreover, evidence based on experience with the VAT[5] indicates that adoption of border adjustments does not disturb trade or the relative costs of imports and exports; and evidence based on "fiscal devaluations" that mimic the effects of border adjustment (through replacement of employment-based taxes with consumption-based taxes) finds that such policies do not affect a country's trade balance of exports and imports, for countries that, like the United States, have floating exchange rates.[6] Predictions of a small or nonexistent response of the US dollar to the adoption of border adjustment are difficult to reconcile with this evidence.[7] And predictions that import-intensive sectors will wither is inconsistent with evidence from around the world for countries that already impose border adjustments, in some cases at rates as high or higher than 20 percent, through their tax systems.

   The DBCFT would encourage investment and production in the United States. But these would result from elimination of the tax on the income from US production as a consequence of the move to cash-flow taxation and the adoption of the destination principle.

2. **Revenue gains from border adjustment will continue beyond the short term.**

   A well-known proposition in international economics is that countries cannot run trade deficits forever. This has led to the conclusion that countries that, like the United States,

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[4] For further discussion of this point, see Alan Auerbach and Douglas Holtz-Eakin, "The Role of Border Adjustments in International Taxation," American Action Forum, December 2, 2016.

[5] Caroline Freund and Joseph E. Gagnon, "Do Border Adjusted Taxes Affect Trade or the Exchange Rate?" Peterson Institute for International Economics, April 5, 2017.

[6] Ruud de Mooij, Michael Keen, "'Fiscal Devaluation' and Fiscal Consolidation: The VAT in Troubled Times," in Alberto Alesina and Francesco Giavazzi, editors, *Fiscal Policy after the Financial Crisis*, University of Chicago Press, 2013.

[7] Alan J. Auerbach, "Border Adjustment and the Dollar," American Enterprise Institute Economic Perspectives, February, 2017.

currently run trade deficits will at some future point have to run trade surpluses. Indeed, I have cited this view myself in the past when discussing the revenue consequences of border adjustments.[8] But this analysis fails to account for the fact that much of the current US trade deficit may simply be the result of profit-shifting between US companies and foreign related parties in low-tax jurisdictions. When a US company overstates the profits of a foreign subsidiary and understates its US profits, this reduces the US tax base, but it has no impact on our need to run trade surpluses in the future, because the US international investment position – our net obligations to foreigners that must eventually be addressed with trade surpluses – is unaffected by this profit-shifting part of the trade deficit – the larger trade deficit is offset in the current account by the US company's higher offshore earnings. In simple terms, we are not borrowing from abroad to finance these overstated imports, because these "imports" are from ourselves and the profits they generate are ours as well. Thus, removing the tax deduction for these imports, as border adjustment does, provides an enduring revenue gain.[9]

This component of the trade deficit, and hence the associated long-run revenue gain, may be important. Its existence, and the associated overstatement of earnings on overseas investments, helps explain the puzzling fact that, even as, according to data from the US Bureau of Economic Analysis (BEA), the US had accumulated a large negative international investment position of -$8.1 trillion as of 2016, it still had positive net investment income of $192 billion in the same year.[10] And recent estimates based on BEA data suggest that, relative to what would be predicted based on the location of their payroll and sales, US companies shifted $280 billion in profits overseas in 2012 through trade with related foreign parties – accounting for more than half of that year's trade deficit.[11]

3. **The DBCFT would greatly simplify the business tax system.**

   The DBCFT would reduce taxpayers' compliance costs and the costs to the government of tax administration. Because the DBCFT is a tax on domestic cash flows, its adoption would

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[8] Alan J. Auerbach, "The Future of Fundamental Tax Reform," *American Economic Review*, May, 1997.

[9] The fact that these "imports" may evaporate once border adjustment is in place does not change the conclusion, because the revenue gain is computed relative to the current tax system. Thus, claims that the tax revenues from border adjustment would fall if the trade deficit falls are incorrect.

[10] The figures come from BEA International Transactions (ITA) Table 1.1 and International Investment Position (IIP) Table 1.1.

[11] Fatih Guvenen, Raymond J. Mataloni, Jr., Dylan G. Rassier, Kim J. Ruhl, "Offshore Profit Shifting and Domestic Productivity Measurement," NBER Working Paper No. 23324, April, 2017.

- Eliminate the need to measure business income or keep track of asset bases; a cash-flow tax is based, as its name indicates, solely on business cash flows.
- Eliminate the need to draw a line between a company's debt and it equity; a business's payments to the holders of its debt and equity would no longer be treated differently.
- Eliminate the need to keep track of US companies' offshore earnings; such earnings would no longer be subject to tax.
- Eliminate the need to keep track of business exports or imports; such transactions would be excluded from the tax base.
- Eliminate the need for provisions aimed at limiting corporate inversions; because a company's residence would not affect its US tax liability, being a US company would no longer be a disadvantage.
- Eliminate the need for transfer-pricing enforcement provisions aimed at limiting the shifting income out of the United States; companies would no longer have any mechanism for engaging in such profit shifting.

In particular, tax planning by multinational companies would no longer have any impact on their US tax liabilities. Claims that multinationals would continue to benefit from profit-shifting activities are based on faulty reasoning, a misunderstanding of how the DBCFT would be implemented, or a consideration of the taxes that multinationals pay to other countries. Countries that continue to attempt to tax business income based on the location of production would still, of course, be susceptible to the profit-shifting that now plagues the United States as well. But that is a defect of existing tax systems, not the DBCFT.

Adoption of any major tax reform involves the complexity of transition; this feature is not unique to the DBCFT. Once the DBCFT is fully in place, tax compliance and administration will be far simpler than under our current system.

### 4. The DBCFT is not a regressive tax.

Some analyses have purported to show that the DBCFT would impose heavy tax burdens on low- and moderate-income working families. But this conclusion is strongly at odds with the nature of the tax. The DBCFT is a consumption-based tax that, because it permits a deduction for wages, protects those who rely on wage and salary income to finance their consumption.[12] Unlike the existing corporate income tax, which is also assessed on business income but may fall to a large extent on the workers whose wages suffer from

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[12] Alan J. Auerbach and Michael P. Devereux," Cash Flow Taxes in an International Setting," February, 2017.

capital flight, [13] the DBCFT would encourage the inflow of productive capital to the United States, enhancing the growth of wages and productivity. Adopting a tax policy that promotes investment, production and employment is a direct, effective way to address the recent weak growth of wages and productivity in the United States.

## Conclusions

The United States taxes business income as it did several decades ago, but the nature of business production has changed and the tax systems of other countries have changed with it, worsening the US competitive position. The question is not whether we will enact major tax reform for corporate and non-corporate business, but when. Taking a cautious approach now when major changes are needed is no solution at all, and will simply defer the necessary changes as the effectiveness of our tax system further erodes.

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[13] For example, the Congressional Budget Office currently assigns 25 percent of the burden of corporate income taxes to labor income. See CBO, *The Distribution of Household Income and Federal Taxes, 2013*, June, 2016, p. 26. Others have estimated an even larger share to fall on labor.

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AAFA
american apparel &
footwear association

## Statement of the American Apparel & Footwear Association

## Hearing on Increasing U.S. Competitiveness and Preventing American Jobs from Moving Overseas

**May 23, 2017**

Thank you for providing us this opportunity to submit testimony in connection with the Committee's hearing on increasing U.S. competitiveness and preventing American jobs from moving overseas.

AAFA is the national trade association representing apparel, footwear, and other sewn products companies, and their suppliers, which compete in the global market. AAFA represents about 350 companies accounting for more than 1,000 brands. AAFA is the trusted public policy and political voice of the apparel and footwear industry, its management and shareholders, its nearly four million U.S. workers, and its contribution of more than $380 billion in annual U.S. retail sales.

Our members design, make, market, and sell clothes, shoes, and fashion accessories in the United States and in nearly every country around the world. Realizing that our industry literally touches every human being on the planet, it is easy to see how our industry stands on the "frontlines" of globalization.

We strongly support tax reform and welcome the Committee's active efforts to see a comprehensive reform effort become law this year. We strongly endorse the Committee's stated goals of reducing tax burdens, expanding the base to close loopholes, simplifying the tax code, and reconfiguring the U.S. tax regime so that it helps U.S. tax payers compete more effectively – both in the United States and abroad. We also agree that delaying tax reform delays the ability of companies in our industry to create U.S. jobs and invest in the U.S. economy.

At the same time, we strongly oppose the border adjustment tax (BAT) concept that is currently proposed in the Committee's 35-page "A Better Way" blueprint. The principle purpose of the BAT is to raise revenues – estimated at $1.2 trillion – to offset provisions in the tax reform package. The practical effect of this is to concentrate the revenue raising-burden of tax reform primarily on one part of the economy – the part dependent upon imports – with consequent negative implications for their workers, consumers, and other stakeholders. While ensuring that tax reform is revenue neutral is a laudable goal, the focus of the BAT approach on one sector of the economy is unacceptable.

**As currently proposed, the BAT would completely offset the value of the rest of the beneficial tax reform proposals – such as immediate expensing and lower tax rates – in the "A Better Way" blueprint, causing many companies to face a tax bill several times larger than their profit.**

**The BAT would trigger massive job losses; significantly raise consumer prices on clothes, shoes, accessories, and other everyday goods; and force companies in our industry – who are not able to raise prices and/or slash expenses – out of business**.

As a simple example, suppose a company had $100 million in revenues with overhead of $30 million and a cost of imported goods sold (COGS) of $60 million. At the current 35 percent tax rate, the $10 million profit would yield $3.5 million in taxes and an after-tax profit of $6.5 million. Under the "A Better Way" plan with a BAT, the lower tax rate of 20 percent would be charged on both the $10 million profit and the $60 million in imported COGS. Although the tax rate drops substantially, the tax bill now rises to $14 million – four times its previous amount. The new tax bill now exceeds the profit, which means the company must significantly raise prices to generate more revenue and/or drop costs if it is to sustain operations and avoid bankruptcy.

We understand the Committee may be working on modifications to address the many concerns that have been articulated by our industry and by many like-minded groups, and we look forward to seeing and responding to those new details once they are published. In the meantime, we discuss our concerns in more detail below.

First, the BAT will have a **massive inflationary impact in our industry**. With approximately 98 percent of all clothes and shoes imported, a border adjustment that eliminates the ability to deduct the cost of imported goods sold from income tax calculations would translate to an additional 20 percent (or 25 percent in the case of pass through corporations) tax on clothing and shoes. With an industry that faces low margins, especially on lower priced products, this tax would pass through to the consumer – raising prices by as much as 20-25 percent. Such a price increase would be especially regressive, hitting lower income Americans hardest since a greater percentage of their disposable income is spent on basic everyday goods, such as clothing and shoes.

Second, the BAT will **trigger devastating job losses** in our industry as companies attempt to reduce payroll to save costs so they can pay the higher tax bill. Such job losses would hit companies of all sizes and affect jobs throughout the supply chain, including high-paying jobs in design, compliance, logistics, and retail. A second round of layoffs would hit as companies lose revenue because consumers are not able to buy as many clothes and shoes due to the aforementioned price increases. Companies not able to manage this transition would, sadly, be forced to shut their doors leading to a third wave of layoffs. Of course, our industry is already weathering a high level of store closings, which reduce customers and trigger retail job losses. The BAT would only exacerbate this difficult environment.

Third, such a tax increase would **tax products that are already among the mostly highly taxed in the world**. Currently, the United States assesses high duty rates on clothes, shoes, and other fashion accessories like backpacks. Although some tariffs are in the lower single digits, most are much higher with apparel and footwear rates topping out at 32 and 67 percent, respectively. The U.S. government collects approximately $15 billion annually in tariffs on these articles. The current border tax bill accounts for about 47 percent of all tariffs collected by the U.S. government, even though the underlying products account for only about 5 percent (by value) of all U.S. imports (see attached chart). Assessing a border adjustment on the value of these imports, which have already been assessed a tariff, amounts to double taxation. More troubling is that, under the “A Better Way” plan, the tariff paid would also be taxed as part of the border adjustment calculation, raising the prospect that an imported article is in fact taxed three times. Of course, state and local income taxes are calculated on top of these other charges, magnifying the burden further.

Fourth, some claim changes in the exchange rate would offset the price increases so companies in our industry, or their consumers, would be unharmed. Such a view does not reflect reality. Not only is there considerable disagreement among the economics profession and currency traders that the BAT would trigger exchange rate changes of the magnitude necessary to offset import inflation but **our industry is largely insulated from such exchange rate changes in any circumstance**. Our member companies buy most of their goods in U.S. dollars. Their products are in turn made from materials – such as cotton – which are traded primarily in U.S. dollars. Other costs are paid in currencies pegged to the U.S. dollar. In fact, data from the last two years, when the dollar appreciated significantly, shows no corresponding drop in acquisition costs of imported articles in our industry (see attached chart).

Fifth, **implementation of a BAT on income tax by the United States would lead to a host of reactions by our trading partners** – many of whom have already threatened to retaliate in some form – especially since no other country implements a BAT on income tax. The BAT appears to violate at least two tenets of international trade law – national treatment and prohibition of export subsidies – that may lead to authorized retaliation in the World Trade Organization (WTO) and in free trade agreements (FTA). With U.S. exports of textiles and clothing being among the top targets routinely identified in retaliation lists, many exporters in our industry are concerned the BAT could trigger a trade war that would make their products less competitive abroad. Even if these trade bodies find the BAT does not contradict U.S. trade obligations, this merely opens the door to those partners imposing their own BAT – creating more economic turmoil.

Sixth, we are concerned that so much of the revenue generating aspects of the “A Better Way” proposal, as manifested by the BAT, is centered on transactions related to trade. Further, from a philosophical perspective, we find it hard to understand why the Committee would want to use the tax code to impose an extra cost on articles because they are imported. While such an approach plays a role in trade policy through the imposition of tariffs – and as noted our industry pays a disproportionate share of tariffs collected by the U.S. government – it makes no sense to use tax policy for this purpose. In fact, it puts tax policy at cross purposes with trade policy in numerous ways. The **value of FTAs and trade preference programs are eroded by the BAT**, which imposes an income tax charge on goods that are duty-free (including goods that contain U.S. content). Programs, such as the miscellaneous tariff bill (MTB), which reduce duties for U.S. manufacturers that import products and raw materials not domestically available, are more than offset by a BAT that re-imposes those costs (and then some). These outcomes seem to reverse the longstanding goals of U.S. trade policy to create jobs and consumer benefits by linking U.S. companies to U.S. and global supply chains and global markets.

Seventh, further to the previous two points, the **BAT would put U.S. manufacturers in our industry at a disadvantage**. Many companies manufacture products in the United States using imported inputs, be they textiles, leather, or energy. With BAT imposing an extra charge on those inputs, these manufacturers will see their cost to produce in the United States increase. Since most of their products are consumed in the United States, rather than exported, these manufacturers will not see any benefit from the provisions in BAT that exempt export income from tax calculations.

Eighth, **U.S. exporters in industry could be hurt as well**. Although the BAT does contain provisions that exempt their export income from taxation, the incentives to use those exported materials in products re-exported to the United States are diminished by the current BAT proposal. A garment or pair of shoes that contain U.S. content – such as leather, cotton, yarn, fabric, snaps, buttons, or zippers – would be taxed the same as an article that contains no U.S. content. Companies looking to lower their import costs may opt to use less expensive foreign-sourced inputs instead of more expensive U.S.-made materials. Of course, foreign retaliation on U.S. exports – as noted earlier – would be a source of additional cost and concern as well.

Finally, **the BAT makes no accounting of the non-tangible U.S. value that is contained in many imported articles.** For example, even though 100 percent of the value of a good entering the U.S. market is presumed to be foreign for customs purposes, much of the design, quality control, intellectual property, and logistics involved in the production and transport of those articles occurs in the U.S. A recent study by noted economist Dr. Susan Hester of Moongate Associates quantifies this impact further. Taking proprietary data from several major brands and retailers, she estimates that the U.S. value-added in any given imported apparel article equals about 70 percent of the retail value of the final garment. Dr. Hester notes that the U.S. jobs that comprise this 70 percent value share are a combination of blue and white collar jobs and, judging from Bureau of Labor Statistics (BLS) data, are well-paying. Anecdotal information and other studies, including one examining the IPod, suggest that 70 percent is comparable for other consumer goods, including footwear.

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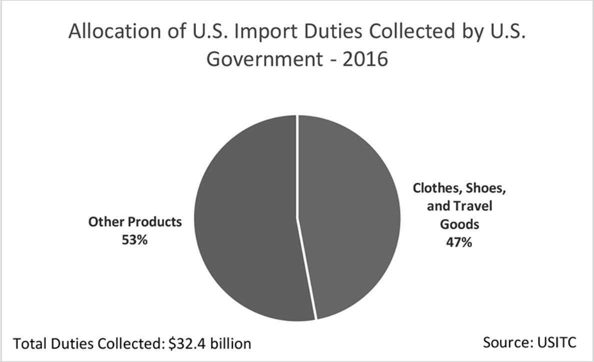
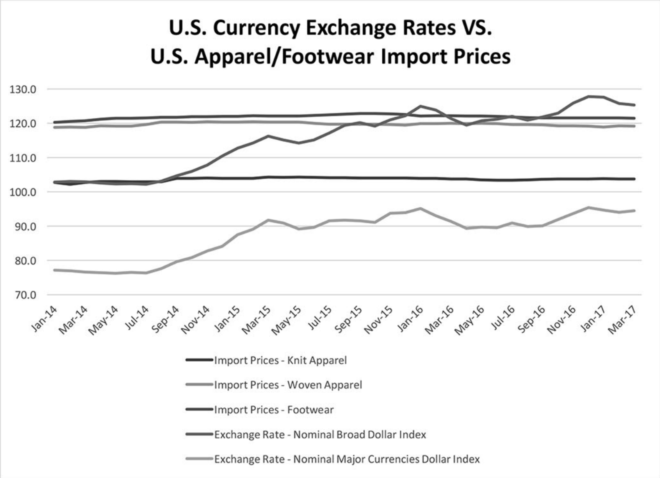
The American apparel and footwear industry plays a significant role in the U.S. economy, supporting nearly 4 million jobs and more than $380 billion in retail sales. Tax reform done the right way would allow us to reinvest in our companies and create new jobs in such high-paying fields as marketing, design, innovation, technology, retail and more. Tax reform done the right way would also further our ability to offer affordable fashion that meets U.S. consumer needs. But tax reform that appears to single out our industry – because we compete using global supply chains – would harm our companies, our workers, and our consumers.

We need tax policy that supports our industry, our innovation, our entrepreneurship, and the positive impact we have on the economy.

# Who Already Gets Taxed at the Border?



**Clothes, Shoes, and Travel Goods Account for 5% of All U.S. Imports Yet Generate 47% of All U.S. Duties Collected**



U.S. Currency Exchange Rates VS.
U.S. Apparel/Footwear Import Prices

AIADA
American International Automobile Dealers Association

SUBMITTED TESTIMONY OF
AMERICAN INTERNATIONAL AUTOMOBILE DEALERS ASSOCIATION

# Hearing on Increasing U.S Competitiveness and Preventing American Jobs from Moving Overseas: How Border Adjustment and Other Policies Will Boost Jobs, Investment, and Growth in the U.S.

Tuesday, May 23, 2017
1100 Longworth House Office Building
10 a.m.

HOUSE OF REPRESENTATIVES

COMMITTEE ON WAYS AND MEANS

# Hearing on Increasing U.S Competitiveness and Preventing American Jobs from Moving Overseas: How Border Adjustment and Other Policies Will Boost Jobs, Investment, and Growth in the U.S.

## SUBMITTED TESTIMONY OF
## AMERICAN INTERNATIONAL AUTOMOBILE DEALERS ASSOCIATION

This statement is submitted by the American International Automobile Dealers Association[1] (AIADA) in response to the hearing held on May 23, 2017 in the Committee on Ways and Means regarding the proposed border adjustment tax (BAT). Established in 1970, AIADA is and continues to be the only association whose sole purpose is to represent America's international nameplate automobile franchises that sell and service vehicles in the U.S. Our mission is to increase awareness in Washington, D.C., and around the country of our members' contributions to their communities and the American economy, and to preserve and promote a free market for international brand automobiles in the United States.

In cities and towns across our country, dealers of international brands operate 9,600 franchises and employ 577,000 Americans with a payroll of 32 billion dollars. Together they account for an additional 527,000 indirect jobs. In 2016, those same franchises sold 8.4 million vehicles, or 59 percent of total U.S. market share. Moreover, international nameplate auto dealers did not stop there; in 2016 they spent an overwhelming $4.8 billion on advertising and sold $54 billion in parts and services. International nameplate auto dealers are a large, visible, and vital cog in our nation's economy, and they rely on the competitive pricing of their products to maintain and grow their businesses.

AIADA's dealer members represent the retail side of the international auto manufacturing industry, which has also invested heavily in the United States. In fact, these brands have more than doubled their production in the U.S. over the past 15 years, making them responsible for 47 percent of all vehicles built here in America. In 2016 alone, 5.5 million vehicles were built by international nameplate manufacturers in the U.S., creating 1.29 million direct and indirect U.S. jobs. These same companies invest $75 billion in U.S. operations. Additionally, in 2016 international automakers contributed to the 265,000 jobs that were needed to produce and

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[1] AIADA represents America's international nameplate automobile franchises that sell and service the following brands: Acura, Aston Martin, Audi, Bentley, BMW, Ferrari, Genesis, Honda, Hyundai, Infiniti, Jaguar, Kia, Land Rover, Lexus, Maserati, Mazda, Mercedes, MINI, Mitsubishi, Nissan, Porsche, Rolls Royce, Scion, Smart, Subaru, Toyota, Volkswagen, and Volvo. These retailers have a positive economic impact both nationally and in the local communities they serve, providing more than 500,000 American jobs. Visit AIADA online at www.aiada.org.

export the vehicles they built in the U.S. These exports totaled 925,000 vehicles, which were exported to over 140 countries.

AIADA highlights all this information to ensure that the committee members are aware of the economic impact of international auto dealers and automakers in the United States. As an industry we are very concerned with the proposed border adjustment tax provision currently being discussed by House Republicans in their "Better Way" tax reform proposal. If passed into law, the 20 percent tax on all goods and services crossing the border into our country would have a number of detrimental effects on American workers, consumers, dealers, and manufacturers.

Made in America

Contrary to what border adjustment tax proponents might say, there is no "Made in America" tax. Under the current tax system, both imported and domestically produced products are treated equally. When an American and foreign firm sell in another country, they both pay a corporate tax and a value added tax (VAT). American and foreign firms selling a product in the U.S. both pay just a corporate tax – the difference is that the American firm pays a 35 percent rate, while a foreign manufacturer might only pay a 17 or 20 percent rate. If American firms are at a disadvantage, it is due to the exorbitant American corporate tax rate, not a need to border adjust taxes.

Misconceptions also persist about what actually constitutes an American product. For example, the automobile industry is so globally integrated, that many automobiles traditionally thought of as "foreign" are actually built right here in the U.S. and with more U.S. parts than the traditional American brands. Not one car sold in America contains 100 percent domestically produced content. Therefore, the 20 percent import tax will increase the price on all new vehicles, not just imported vehicles.

In fact, the 2016 Cars.com American Made Index[2] (AMI), which looks at cars on a model-by-model basis, not by manufacturer, put the Toyota Camry at the top of their chart. The AMI recognizes cars that are assembled here, using a high percentage of domestic parts, and which are bought in large numbers by American consumers. The Toyota Camry is followed by: Honda

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[2] Cars.com's American-Made Index rates vehicles built and bought in the U.S. Factors include the percentage of parts considered domestic under federal regulations, whether the car is assembled in the U.S. and U.S. sales. We disqualify models with a domestic-parts content rating below 75 percent, models built exclusively outside the U.S. or models soon to be discontinued without a U.S.-built successor.
Domestic-parts content stems from Congress' 1992 American Automobile Labeling Act, which groups the U.S. and Canada under the same "domestic" umbrella. It's one of the bill's imperfections, but the AALA is the only domestic-parts labeling system car shoppers can find on every new car sold in America. Other domestic-content ratings — namely those used for the North American Free Trade Agreement and the corporate average fuel economy programs — are unpublished, give a simple over/under indication or lump even more countries, like Mexico, into the "domestic" pool. https://www.cars.com/articles/the-2016-carscom-american-made-index-1420684865874/

Accord (2), Toyota Sienna (3), Honda Odyssey (4), Honda Pilot (5), Chevrolet Traverse (6), GMC Acadia (7), and Buick Enclave (8).

Cars.com also studied employment and production figures to see how many U.S. assembly-plant jobs each model supports. The 2016 analysis shows that the Toyota Camry still supports more assembly-plant jobs of any vehicle studied. The remaining AMI autos followed in the same order as in the initial ranking; Honda Accord (2), Toyota Sienna (3), Honda Odyssey (4), Honda Pilot (5), Chevrolet Traverse (6), GMC Acadia (7), and Buick Enclave (8).

Finally worth noting, the Cars.com AMI used production numbers instead of sales figures as a measure of assembly-line employment. If using that data, the top two autos actually switch positions with the Honda Accord coming out on top. The remaining rankings follow as originally ranked: Toyota Camry (2), Toyota Sienna (3), Honda Odyssey (4), Honda Pilot (5), Chevrolet Traverse (6), GMC Acadia (7), and Buick Enclave (8).

In an increasingly global economy, it would be ill-advised and short-sighted to attempt to classify products, particularly automobiles, into categories of imports and exports and therefore pick winners and losers. Many Americans are employed as a result of the international nameplate automobile industry, including the 577,000 employed by international nameplate automobile dealers, and many more Americans benefit from being able to purchase quality products at affordable prices that result from this integrated supply chain.

Affordability

As mentioned before, ALL vehicles sold in the U.S. have non-U.S. parts content. Therefore, the 20 percent border adjustment tax will increase the price on all new vehicles, not just imported vehicles. The proposed border adjustment tax will significantly impact new car sales through higher prices, reduced demand, restricted choice, and an increased inability by customers to qualify for higher loans.

In fact, should the proposed border adjustment tax be implemented, a recent study conducted by the Center for Automotive Research[3] pegs the average price increase at about $2,000 per vehicle. Another study by Deutsche Bank says we should expect an increase of $2,300 per vehicle, reducing U.S. demand by 1.2 million units per year in the short term and 0.5 million units in the long term. That is a striking decrease in sales and would cause a dramatic downstream impact on the entire dealership operation.

The auto industry already has an affordability issue. Today's average vehicle transaction price hovers around $35,000. Given today's average new car loan rates and terms, with 2 percent down and 66 months financed, this could increase the payment for the average car buyer by

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[3] CAR's mission is to conduct independent research and analysis to educate, inform and advise stakeholders, policy makers, and the general public on critical issues facing the automotive industry, and the industry's impact on the U.S. economy and society. http://www.aiada.org/sites/default/files/CARS%20Study.pdf

nearly $100 per month. The current average monthly payment, according to Cox Automotive,[4] is $424, and if the border adjustment tax was implemented, AIADA estimates it would increase to $509. A recent presentation by Cox Automotive states that according to Kelley Blue Book, 66 percent of car buyers are concerned with affordability, and are more concerned with the monthly payment than the overall price. A $100 per month increase in a new car payment will cause many consumers to be priced out of the car market all together. Furthermore, to arrive at that monthly payment, consumers would also need longer loan terms. Cox Automotive again finds that 75 percent of automotive loans in 2015 were longer than 5 years versus 51 percent in 2009.

The concern of affordability is not new to the auto industry. As the regulatory burden of manufacturing autos has increased with time, so has the cost of the vehicles they produce. But what has not increased for consumers is household income. Cox Automotive found that while the current average price of a new car has increased to $35,496, an increase of $2,280 since 2015, the median U.S. household income has only risen 3 percent in the last 20 years. That's a 35 percent increase for a new vehicle compared to a 3 percent income increase.

The impact of the proposed border adjustment tax would be felt throughout the entire dealership. In addition to the increase in the cost of the vehicle, servicing and repairing a car would also icrease. Analysts predict that the cost of gasoline would also rise approximately 30 cents per gallon[5]. Consumers least able to afford the added cost will be the most impacted. Customers need safe, new cars and trucks to transport their families and get to work. They don't need a new consumer tax. Nor do they need tax reform relying on untested economic models and the hope of a quick currency adjustment that would supposedly make the affordability problem disappear.

Currency Rates

The idea that currency will adjust and the dollar will appreciate by a significant amount, rendering the increase in costs of all imported goods negligible, is a central justification that has been used by border adjustment tax proponents. However, experts indicate this argument is flawed and lacking any real-world examples.

An economic report released in May 2017 by the international macroeconomics firm Capital Economics titled, *Border adjustment taxation - the implications*[6], finds the economic theory behind the border adjustment tax to be a "gross simplification" of today's currency markets.

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[4] Cox Automotive is a leading provider of products and services spanning the automotive ecosystem. No matter the stage of the auto buying or selling process, we have a solution for clients of any size.

[5] The Brattle Group, Border Adjustment Import Taxation Impact on the U.S. Crude Oil and Petroleum Product Markets, http://www.brattle.com/system/publications/pdfs/000/005/384/original/FINAL_Border_Tax_Paper_2016_12_16.pdf?1481912863

[6] *Border adjustment taxation – the implications*, https://www.rila.org/Public-Policy/Documents/Capital%20Economics%20-%20Border%20adjustment%20tax%20analysis%20Final%20-%20May%202017.pdf

The report concludes that even in the long-term, the dollar will appreciate no more than 8 percent in response to the House proposed border adjustment tax—well short of the 25 percent it has been suggested will be needed to offset higher costs on the thousands of items Americans buy every day.

Additionally, in congressional testimony in February, Federal Reserve Chair Janet Yellen herself noted that "a strong set of assumptions is needed to believe that markets would fully offset"[7] the price increases which would result from the border adjustment tax. Respected financial institutions CITI[8], Goldman Sachs[9], and J.P. Morgan Chase[10] have all also called into question the currency assumptions made in the plan.

In reality, there is just no way to tell if or how currencies will react, and it is too much of a gamble to risk real-world jobs and incomes on uncertain economic theory.

## Closing

The automotive industry in the U.S. is constantly evolving, and international nameplate automobile manufacturers and dealers are designing, building, and selling more vehicles across the U.S. than ever before. In the process, they are redefining the meaning of an "American" car. International nameplate dealers are growing their investment in the American economy and communities in a variety of ways and today provide the majority of America's auto retailing jobs and vehicles for American consumers, selling 59 percent of the new cars purchased by American consumers in 2016.

AIADA strongly supports a pro-growth comprehensive tax reform bill, but we believe the proposed border adjustment tax provision will have unintended consequences that will cause harm to our dealerships, their employees, and their customers.

AIADA and its 9,600 American auto dealers strongly oppose the proposed border adjustment tax.

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[7] Bloomberg Markets, *Currency Traders Spot Fatal Flaw in Republicans' Border Tax Plan*, https://www.bloomberg.com/news/articles/2017-04-18/currency-traders-spot-fatal-flaw-in-republicans-border-tax-plan

[8] Willem Buiter, "Exchange Rate Implications Of Border Tax Adjustment Neutrality," Citi Research, 2/22/17

[9] Brian Faler, "Border Adjustment Debate Giving Washington A Crash Course In Currency Markets," Politico Pro, 2/1/17

[10] Brian Faler, "JP Morgan: Border Adjustment Tax Plan Will Shake Wall Street," Politico Pro, 12/20/16

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# Border Adjustment Tax: Estimated Impact on U.S. Vehicle Prices

## Overview

This analysis highlights the immediate impacts of implementing a border adjustment tax on U.S. vehicle prices.

- The border adjustment mechanism is being considered as an integral part of the major corporate tax reforms that are expected to be introduced in the 115th Congress.
- Border adjustment is being considered as a way to generate sufficient tax revenues to offset the impact of lowering the overall corporate tax rate.
- The border adjustment mechanism functions by excluding cash-inflow from overseas (export revenue) and cash- outflow to foreign countries (import costs) in the taxable profit calculation.
- Automakers and suppliers that sell and manufacture in the United States are part of a highly globally-integrated industry.
- The automotive industry would see significant changes to their tax base under a border adjustment; the tax would be highly disruptive to U.S. vehicle sales and production.

## Methodology

- This analysis is based on confidential financial data received from automakers representing over 50 percent o U.S. light vehicle sales.
- This analysis holds exchange rates constant, and examines only a price response to the implementation of border adjustment.
- The estimates are based on the impact of the proposed border adjustment tax on imported vehicles as well as parts used for vehicle production in the United States.
- This analysis estimates a price increase with no change in unit sales or domestic production—both of which would be affected by a price increase of this magnitude.

## Findings

In response to the border adjustment:

- U.S. light vehicle prices would increase 5.6 percent in immediate response to border adjustment.
- Since the current U.S. average transaction price for new vehicles is $34,968 (Kelley Blue Book, 2017), average per vehicle price increases are estimated at $1,970.
- Assuming U.S. sales at 17.5 million vehicles in 2016, the light vehicle price increase represents $34.6 billion in higher costs to consumers.
- The $1,970 price increase resulting from the proposed border adjustment masks the turbulence and churn in the market which would significantly impact models, segments, and even entire companies.

http://mediaroom.kbb.com/2017-02-01-New-Car-Transaction-Prices-Remain-High-Up-More-Than-3-Percent-Year-Over-Year-In-January-2017-According-To-Kelley-Blue-Book

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This briefing was funded by a consortium including members of The Association of Global Automakers and the American International Automobile Dealers Association.

The American Made Coalition (AMC) represents a broad collection of industry leaders from every corner of America's economy, including both small and large businesses. AMC companies collectively employ millions of Americans, either directly or through their suppliers and distributors, and we are proud of our roots here in the United States. We do business all over the world, import to and export from the United States, and witness every day how a badly broken tax code has restrained our country's global competitiveness, limited the growth of our economy, and reduced the number of jobs available to American workers. Our membership continues to grow, and you can find our latest list on our website: www.americanmadecoalition.org. www.americanmadecoalition.org.

The American Made Coalition believes that 2017 presents the best opportunity to transform our outdated tax code – to create jobs, increase wages, and save taxpayers money. For three decades, the United States has failed to act while other countries have modernized their tax codes. As a result, the United States has one of the most complicated and anti-competitive tax codes in the world. This has resulted in stagnant growth, wages, and productivity all at the expense of American workers and businesses. Yet, now we are faced with an historic opportunity to deliver bold, comprehensive tax reform that would have a game-changing effect on our economy if done on a permanent basis and prioritizes American competitiveness first. The tax reform ideas laid out by the White House and House Republicans have provided momentum to finally achieve long overdue reform of a broken tax system that has undermined American growth and prosperity for far too long.

**The Need for Tax Reform**

The simple fact is the United States imposes some of the highest business tax rates in the world, and we couple those high rates with a worldwide system that forces companies based in the United States to pay these high tax rates on all their income, regardless of where it is earned. This approach to business taxation has largely remained unchanged for over 50 years, and this antiquated system actively encourages – and often requires -- companies to shift their headquarters, operations, and assets to other countries in order to remain competitive or, alternatively, leave themselves exposed to acquisition by foreign-domiciled companies. This hurts American workers. The complexity and distortions brought about by the tax code are a familiar, unpleasant reality for companies who would far prefer to reinvest in the United States while avoiding a foreign takeover. Comprehensive tax reform gives us a chance to correct those systemic flaws and bring our tax code into the 21st Century by lowering rates and adopting a competitive territorial system.

Meanwhile, the rest of the world has been busy reforming their tax codes. Other countries have lowered rates, shifted from worldwide to territorial tax systems, increased innovation incentives and moved from taxing business income to taxing consumption. According to the OECD Tax Database, the United States corporate tax rate (combined federal and state) is 38.9 percent and is largely unchanged since we last reformed the tax code back in 1986. Meanwhile, the average corporate rate for the rest of the world has declined sharply, from more than 40 percent thirty years ago to just 22.5 percent today. While the United States has stood still, the rest of the world has dramatically improved their tax codes and left the United States behind.

The result is what House Ways and Means Chairman Kevin Brady calls the "Made in America" tax, where products made in America face a higher tax burden than products produced someplace else. This inequity puts American workers and the companies that employ them at a disadvantage. It costs jobs and it hurts our communities. For this very reason, we are in full agreement with President Trump and his administration that the United States needs to move to a territorial tax system that levels the playing field for American businesses.

Tinkering around the edges of the current system will not fix the problem. Without competitive rates, the United States will continue to lose jobs and investment to other countries. Without a territorial system that treats exports and imports equally, foreign competition will continue to have the upper hand in bidding on new work and acquisition targets both here and abroad. Just as important is the need to make these changes permanent. Without certainty, businesses and investors will not respond robustly to the new incentives. We need to address these challenges in a meaningful and permanent way to succeed.

The House Blueprint released last summer is a good example of comprehensive, competitive, and permanent reform. We are also pleased that President Trump's proposed tax reform principles reflect most of the same goals as provided in the proposal. Specifically, the Blueprint offers American workers, and the companies that employ them, the most comprehensive rewrite of our tax code since its inception in 1913. The proposal's components work together and must be viewed in their entirety:

- ✓ *Dramatically lowers tax rates on businesses and workers alike;*
- ✓ *Allows businesses immediate and full write-off of capital investments, including factories, equipment, and inventories;*
- ✓ *Repeals the estate tax and the Alternative Minimum Tax;*
- ✓ *Moves us from a punishing worldwide system to a more competitive territorial system where we only tax business activity occurring here in the US; and*
- ✓ *Provides sufficient offsets and growth incentives to ensure that the changes can become a permanent part of the tax code moving forward.*

The combination of full expensing and the move to a territorial system replaces our old system of taxing business income with a new "destination based, cash flow tax." This cash flow tax is like the value added taxes (VAT) used in more than 160 countries worldwide, only better. Like a value added tax, it shifts the tax code from taxing income to taxing consumption. But unlike a VAT, the cash flow tax doesn't double tax labor. That means workers are better off because, unlike most of our trading partners, the resulting tax system would be fully integrated, only taxing workers once and at progressive rates.

The resulting tax system is a potential game-changer that will provide communities across America with a jolt of growth. According to the Tax Foundation, comprehensive reform will result in an economy that's 9 percent larger with 1.7 million additional jobs and 8 percent higher wages. The Tax Foundation estimates that the combination of higher wages and lower taxes on families will give the typical family an additional $4600 per year to spend.

In short, the American Made Coalition supports reform that transforms our tax code from one of the worst in the world to one of the best. American businesses, families and the communities in which they reside will be better off as a result.

**Restoring Business Investment**

The American Made Coalition is comprised of companies that invest in America and its workers. It is our strong commitment to domestic production and investing in American workers that drives us to support permanent, comprehensive tax reform here at home.

To succeed in the global marketplace, we need to provide American workers with the best tax system possible to create a level playing field that will allow us to compete in areas such as employee recruitment and overall productivity against foreign counterparts. These are basic economic principles- you must have capital for investment. Any tax reform plan worth enacting must reduce the tax on domestic capital, to encourage more investment and increase the quantity and quality of the tools we provide to our workers. That is the only way we can increase our ability to compete on a global scale.

One way to shift to a territorial system is through the adoption of a border adjusted cash flow tax. For example, the Tax Foundation estimates that the House Blueprint's cash flow tax would cut the marginal effective tax on new investment in half -- from 35 percent to just 16 percent -- fueling a 28 percent increase in capital investment in the United States. That means 28 percent more factories, machines, computers, and inventory than if Congress chooses to do nothing. The net result would be a larger economy, more jobs, and higher wages for American workers.

**Shifting to a Territorial System: Border Adjustment as a Path**

The American Made Coalition supports replacing our outdated corporate income tax because it presents an opportunity to remake and rebuild American industry. One way of achieving this objective is through a destination-based cash flow system that applies to businesses both large and small. By reducing business tax rates and allowing businesses to immediately write-off capital investments, a cash flow system would simplify tax compliance and enforcement even as it encourages new investment here in the United States.

Over 160 countries have already shifted to a border adjusted system. One way of moving to a territorial system – as outlined in the House Blueprint – is through a border adjustment. A border adjustment would accomplish the following four objectives:

1. **Levels the Playing Field:** A border adjustment would eliminate the unfair bias in the tax code by taxing American-made exports and foreign imports equally, thus leveling the playing field for American businesses and workers.

2. **Stops Inversions**: A border adjustment would facilitate the adoption of a competitive territorial tax system and eliminate the incentive for tax-motivated foreign takeovers of American companies. Experts from across the political spectrum agree that border adjustability would end inversions, level the playing field for U.S. companies seeking to acquire other U.S. assets and businesses, and protect the U.S. tax base from tax-motivated shifting of production and earnings.
3. **Creates Jobs**: A border adjustment would protect American jobs and encourage more businesses to investment in domestic productions. More goods and services produced here would lead to more jobs up-and-down the supply chain, from factory workers to service and retail operations.
4. **Makes Tax Reform Permanent:** A border adjustment is central to making tax reform permanent, providing certainty necessary for American businesses need to make long-term investments in the United States. Shifting to a domestic-based system also helps ensure there is enough revenue to pay for $2.4 trillion in tax relief for businesses of all sizes.

### Permanence and Competitiveness

A border adjustment helps to enforce the move to a territorial system as well, serving to protect the American tax base without complicated anti-base erosion provisions. Without a territorial system, companies doing business in the United States will retain an incentive to shift profits and operations to low tax jurisdictions. Additionally, tax reform measures that are made permanent will provide businesses with the certainty that is necessary to make long-term decisions, such as locating manufacturing facilities in the United States. Setting aside the challenges of identifying alternative offsets or passing a tax bill with a large deficit impact, nothing comes close to stimulating the economy and the workforce than shifting to a territorial system and making such reforms to the tax code permanent.

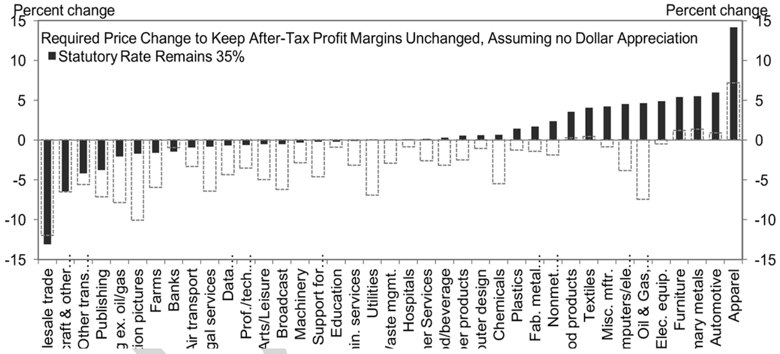
If Congress were to reject applying a border adjustment to our business taxes, it would need to scale back and make temporary any changes it enacts. Instead of historic reform that transforms the American tax system from one of the worst to one of the best, it would be reduced to temporarily tinkering around the edges, leaving in place the current advantage foreign competition has over American production and jobs. Meanwhile, other countries would respond by lowering their tax rates to ensure continued attraction of business.

### Border Adjustments and Consumers

Border adjustments have been used successfully in some of the largest economies in the world, and those countries all have robust retail sectors and active consumers. In the past several months, retailers and other interests have raised concerns about border adjustments and their potential impact on imports and on consumers, but the fact is retailers and other importers manage to operate and thrive in the more than 160 countries with border adjusted taxes.

Missing from the retailers' concerns is any analysis of the overall plan. The border adjustment is designed to be an integral part of a comprehensive, permanent tax reform plan that significantly reduces the tax burden on workers and businesses alike. The result would be to reduce the average tax applied to goods and services, putting downward pressure on real prices.

For example, an analysis by Goldman Sachs estimated the required price change necessary for different industries to keep their after-tax profit margins unchanged, assuming no dollar appreciation and not taking the other portions of the House Blueprint into account. As the accompanying chart shows, this worst case scenario analysis found that of 39 industries studied, 33 would be able to reduce their prices and still maintain their margins. Of the six remaining industries, only small price increases of 7 percent or less would be required to maintain margins. As Goldman Sachs makes clear, this analysis does not predict the real-world impact on prices and families, since it ignores dollar appreciation, wage growth, and family tax relief, all of which should act to mitigate price adjustments and protect families.



Despite this underlying reality, concerns have been raised by retailers currently profiting from the tax advantage that foreign goods and services have over domestic products. For example, the National Retail Federation (NRF) has argued that applying the same tax on imports as exports would result in higher consumer costs of $1,700 per family.

While the details of the NRF's analysis remains hidden, a brief write-up of their methodology reveals some disturbing lapses. For example, the NRF's analysis ignores the business and family tax relief that would be part of comprehensive tax reform, ignores economic growth generated from implementation of the plan, and assumes no offsetting appreciation of the dollar.

More comprehensive assessments find that, under comprehensive tax reform, American families will have more job opportunities, higher wages and more after-tax income than under the current tax system. According to an econometric analysis by the Tax Foundation referenced earlier, the House Blueprint is a $2.4 trillion tax cut for businesses and families, where a typical family making $55,000 a year will see their after-tax income rise by more than $4,600 a year. Families will be better off, with more money to spend, under permanent, comprehensive reform.

## Border Adjustments and Currency Markets

Another area of concern is the reaction of the currency markets to enactment of tax reform that includes a border adjustment. Many observers have argued that a broad, comprehensive border adjustment of domestic taxes will be offset by changes in real currency rates, leaving trade flows unaffected. In other words, the dollar would appreciate to offset the border adjustment so that consumers would be protected from price increases, even on those goods with high import content.

The idea that real currency rates will adjust in response to the border adjustment is not based on theory but rather experience. As the United States Treasury Office of Tax Policy noted earlier this year, "The experience of around the world, as predicted by economic theory, has been that border adjustment does not have trade effects." Joseph Gagnon of the Peterson Institute of International Economics looked at the experience of other countries and came to the same conclusion, "There is an adjustment of prices such that exports and imports should not be disadvantaged or changed."

Moreover, because of its structure, replacing our business income tax with a smaller cash flow tax should see any change in relative pricing enacted through the appreciation of the nominal dollar. As the Peterson Institute for International Studies observed:

> *First, under the destination-based cash flow tax, the pressure to adjust falls more strongly on nominal exchange rates than on prices. A VAT requires an increase in consumer prices relative to wages, which may explain the adjustment pattern seen in the data. Tax rates under the destination-based cash flow tax vary depending on the firms' labor cost share and international exposure. Because labor costs can be deducted, a cash flow tax does not require a change in consumer prices relative to wages, so any adjustment may be more likely to come through the nominal exchange rate.*

Meanwhile, a complete opposite concern has also been put forward that, if the dollar does appreciate sufficiently to offset the border adjustment, it will hurt foreign countries that have dollar denominated debt and those companies that are tied into multi-year contracts. These are legitimate concerns, and one reason the Chairman of the Ways and Means Committee has repeatedly suggested that tax reform should include transition provisions to give companies and other countries time to adjust their positions to mitigate any short-term challenges a stronger dollar would otherwise cause.

The AMC supports the inclusion of comprehensive provisions to smooth the transition from our business income tax to a border adjusted cash flow tax.

## Border Adjustments and the WTO

The American Made Coalition supports replacing our business income tax with a destination based cash flow tax. This is economically similar to value-added taxes, but does not tax labor, as a traditional VAT does.

As Harvard Economist Greg Mankiw points out, this approach is the equivalent of 1) repealing the corporate income tax, 2) replacing it with a traditional VAT, and 3) using some of the VAT's revenues to reduce the payroll tax. All of those steps are compliant with the WTO and our other trade agreements, and all of those steps are consistent with what other countries have done when implementing or increasing their border adjusted taxes.

The House Blueprint imposes the same tax burden on domestic and imported products. With a border adjusted cash flow tax in place, importers would no longer have a tax advantage over domestic products and services. Nor would they be penalized. The playing field would be level, which is consistent with the underlying goal of the WTO rules.

## Conclusion

As highlighted by recent comments by President Trump, including the release of his tax reform principles, our tax code is broken and outdated. For the last three decades, the United States has stood still while our competitors have modernized their tax codes by systematically cutting tax rates and moving away from corporate income taxes and towards border adjusted consumption taxes. The result is that companies based in the United States today are stuck with a "Made in America" tax, where products produced here by American workers are subject to a higher tax than those imported from other countries. Without shifting to a territorial system that levels the playing field for American businesses and workers, it means less investment, fewer jobs, and lower wages.

With the new Congress and Administration, we have the opportunity to fix this imbalance. Game-changing, comprehensive, and permanent tax reform would allow us to "leapfrog" the rest of the world and go from one of the worst tax systems to one of the best. It would dramatically reduce taxes on businesses large and small, resulting in more investment, a larger economy and improved worker status. Domestic employees would now have more job opportunities and higher wages.

The time has come for Congress to take aggressive action to increase economic growth and bring back good paying jobs and healthy, vibrant communities. Permanent, comprehensive tax reform is necessary to start that process. A temporary rate cut alone will not lead to the type of economic investment and job growth that comprehensive tax reform can deliver. Real game-changing tax reform will grow American jobs, keep American companies headquartered in the United States, inspire innovation, unleash investment and put more money in the pockets of hardworking Americans. We strongly encourage the members of the House Ways and Means

Committee to support comprehensive tax reform that will fix our tax code, encourage economic growth and improve our communities.

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**American Sugar Refining, Inc.**
One North Clematis Street
Suite 200
West Palm Beach, FL 33401

ASR
GROUP

May 22, 2017

Hon. Kevin Brady
Chairman
Hon. Richard E. Neal
Ranking Member

House Committee on Ways and Means
1102 Longworth House Office Bldg.
Independence & New Jersey Ave. S.E.
Washington, D.C. 20515

RE: Border Adjustment Taxes (BAT); Ways and Means Hearing of May 23, 2017

Dear Chairman Brady:

American Sugar Refining Inc. (ASR) is writing to advise the Committee of the material adverse impact that a Border Adjustment Tax would have on the economics of the U.S. sugar industry.

The U.S. sugar industry is composed of two roughly equivalent sectors; a sugar beet sector located in the upper Midwest and Rocky Mountain states, sourcing its refined sugar from domestically grown sugar beets, and a sugar cane sector that refines raw cane sugar into refined cane sugar. The end product of both beet and cane processes is equivalent and is sold competitively based upon price and transportation differentials. However, U.S. refined cane sugar is sourced both from domestically produced raw cane sugar and raw cane sugar imported from over 25 countries from around the world. The dual nature of this supply to U.S. cane refineries is necessitated by the fact that raw cane sugar is a tropical product and can only be grown in a very few locations in the U.S., notably in parts of Florida, Louisiana and Texas. Importation of foreign raw cane sugar for refining is critical to the U.S. food industry supply chain because the U.S. is not capable of producing sufficient domestic refined beet sugar or raw cane sugar to satisfy total domestic demand.

The structural dependence of the cane sugar refining industry on imports of raw cane sugar means that it would be uniquely disadvantaged under a system of taxation that taxes its primary imported raw agricultural input while exempting its beet sugar competitors from similar taxation. The competitive impact is heightened given that the value of the raw agricultural input exceeds 65% of the end product (refined sugar) in the cane sugar sector. The tropical nature of sugar cane limits the ability of U.S. farmers to substantially increase domestic production of raw cane sugar to supplant raw sugar imports. Thus, the U.S. cane sugar sector has historically been, and will remain, dependent upon imports of raw cane sugar for a large share of its raw material supplies.

Moreover, and most importantly, a Border Adjustment Tax will result in a significant price increase to consumers, grounded in price increases in the grocery and food service industry sectors as well as cost increases passed through by the food processing industry.

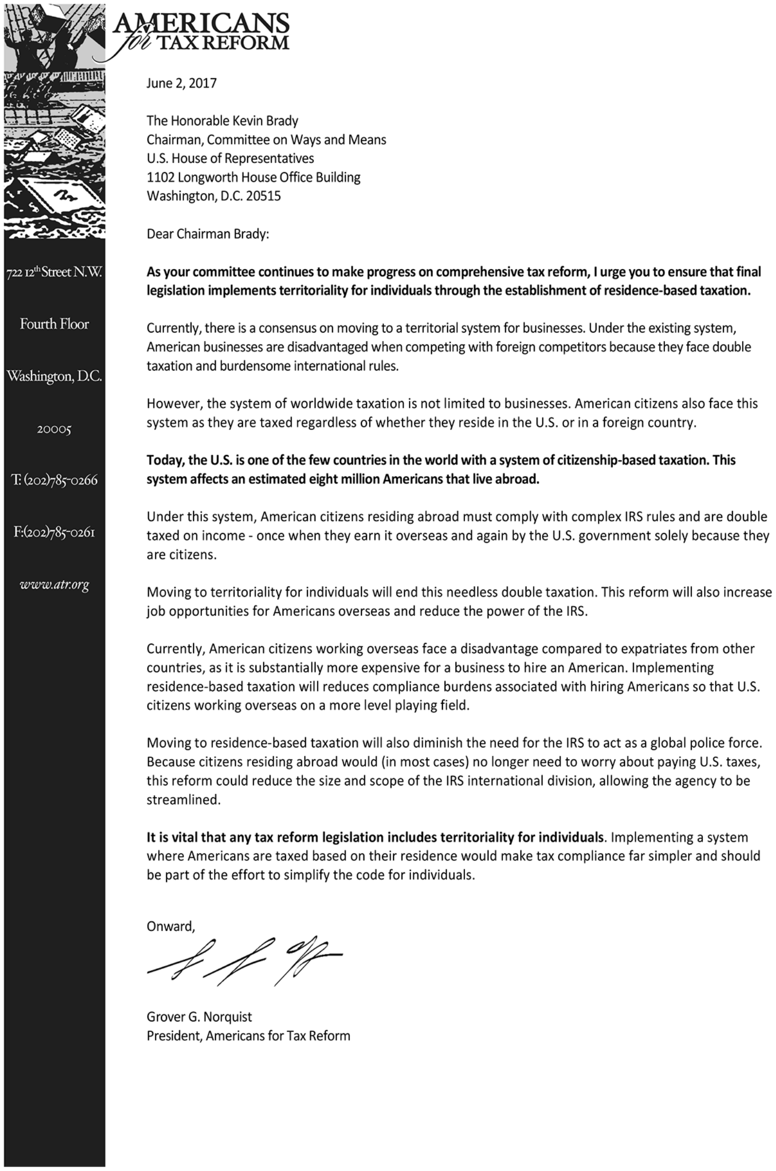
The structural nature of the U.S. sugar industry forces ASR to oppose the imposition of a Border Adjustment Tax, absent an exemption for raw agricultural inputs such as raw cane sugar that cannot be grown in sufficient quantities in the United States to supply the needs of U.S. cane refiners.

Respectfully,

Luis Fernandez
Co-President

Tony Contreras
Co-President

cc/ Florida Congressional Delegation



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June 2, 2017

The Honorable Kevin Brady
Chairman, Committee on Ways and Means
U.S. House of Representatives
1102 Longworth House Office Building
Washington, D.C. 20515

Dear Chairman Brady:

**As your committee continues to make progress on comprehensive tax reform, I urge you to ensure that final legislation implements territoriality for individuals through the establishment of residence-based taxation.**

Currently, there is a consensus on moving to a territorial system for businesses. Under the existing system, American businesses are disadvantaged when competing with foreign competitors because they face double taxation and burdensome international rules.

However, the system of worldwide taxation is not limited to businesses. American citizens also face this system as they are taxed regardless of whether they reside in the U.S. or in a foreign country.

**Today, the U.S. is one of the few countries in the world with a system of citizenship-based taxation. This system affects an estimated eight million Americans that live abroad.**

Under this system, American citizens residing abroad must comply with complex IRS rules and are double taxed on income - once when they earn it overseas and again by the U.S. government solely because they are citizens.

Moving to territoriality for individuals will end this needless double taxation. This reform will also increase job opportunities for Americans overseas and reduce the power of the IRS.

Currently, American citizens working overseas face a disadvantage compared to expatriates from other countries, as it is substantially more expensive for a business to hire an American. Implementing residence-based taxation will reduces compliance burdens associated with hiring Americans so that U.S. citizens working overseas on a more level playing field.

Moving to residence-based taxation will also diminish the need for the IRS to act as a global police force. Because citizens residing abroad would (in most cases) no longer need to worry about paying U.S. taxes, this reform could reduce the size and scope of the IRS international division, allowing the agency to be streamlined.

**It is vital that any tax reform legislation includes territoriality for individuals**. Implementing a system where Americans are taxed based on their residence would make tax compliance far simpler and should be part of the effort to simplify the code for individuals.

Onward,

Grover G. Norquist
President, Americans for Tax Reform

ABIR

**Association of Bermuda Insurers and Reinsurers**

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## Statement for the Record
## Submitted by the Association of Bermuda Insurers and Reinsurers
## To
## U.S. Committee on Ways & Means
## Hearing on
## "Increasing U.S. Competitiveness and Preventing American Jobs from Moving Overseas"
## May 23, 2017

The membership of the Association of Bermuda Insurers and Reinsurers ("ABIR"), which consists of 22 global insurers and reinsurers that have insurance underwriting legal entities domiciled in Bermuda, fully supports the efforts by the President and Congress to enact reforms to the U.S. tax system that will lower tax rates and produce a more competitive and rational international tax regime. ABIR appreciates the opportunity to submit this statement for the record in support of maintaining full deductibility of all insurance and reinsurance premiums paid by U.S. companies to foreign insurers or reinsurers; in conjunction with the U.S. Committee on Ways and Means' hearing on "Increasing U.S. Competitiveness and Preventing American Jobs from Moving Overseas."

Insurance is the backbone of the safety net that U.S. businesses and consumers depend on to help rebuild when disaster strikes. U.S. insurers, in turn, rely on an efficient and stable global reinsurance market that provides access to affordable reinsurance.

ABIR has serious concerns about the impact that any proposal to disallow deductions for reinsurance premiums that property and casualty (P&C) insurance companies pay to foreign reinsurers or to their foreign affiliates. Specifically we believe that potential application to insurance and reinsurance transactions of the Border Adjustment proposal (i.e. border adjustment tax or BAT) that is a feature of the House Republican Blueprint for Comprehensive Tax Reform would have serious negative consequences for the market for reinsurance of United States risks. Similarly, we believe other more targeted proposals aimed specifically at so-called related party reinsurance would also cause significant disruptions in reinsurance coverage and lead to dramatically higher costs for consumers. We urge the Ways & Means Committee to take the information set forth below into account if it considers any proposals that would limit the deductibility of reinsurance premiums paid to foreign affiliates or any BAT-style proposals that would treat commercial insurance and reinsurance transactions as an import of a service that would result in the denial of the deduction for premiums paid for insurance or reinsurance acquired from non-U.S. insurance and reinsurance companies.

**Proposals to limit the deductibility of P&C reinsurance premiums paid to foreign affiliates.**

The Obama Administration's FY2017 Budget, along with prior budget plans, proposed to disallow deductions for property and casualty (P&C) reinsurance premiums paid to foreign affiliates that are not subject to U.S. federal income tax. A substantially identical proposal was included in both (1) the *Tax Reform Act of 2014* introduced by former Chairman Camp of the

Ways and Means Committee and (2) former Chairman Baucus's staff discussion draft on international tax reform, published in November 2013. These are similar to the legislative proposal that has been introduced over the years by Rep. Richard Neal (D-MA) (and by Sen. Mark Warner (D-VA) in the Senate in 2016).

The Obama Administration offered the following "reasons for change" in their Budget proposal: "Reinsurance transactions with affiliates that are not subject to U.S. federal income tax on insurance income can result in substantial U.S. tax advantages over similar transactions with entities that are subject to tax in the United States.….These tax advantages create an inappropriate incentive for foreign-owned domestic insurance companies to reinsure U.S. risks with foreign affiliates.[1]" ABIR respectfully submits that the Obama Administration failed to offer credible evidence in support of these assertions; in contrast, the information, facts, and data discussed below flatly contradict the notion that U.S. subsidiaries of foreign reinsurers enjoy a substantial competitive advantage.

A group of large and profitable U.S. insurance companies have waged a decade-long campaign to obtain a competitive advantage by pushing for the enactment of the type of discriminatory rule exemplified by the Obama Administration's proposal.[2]

All insurance companies, foreign and domestic, use reinsurance as a way of spreading risk, so when they have to pay out claims, they have an adequate pool of capital to make payments. Many foreign-based insurance companies have U.S. subsidiaries that provide insurance to customers in the United States. A subsidiary that reinsures a policy with its foreign affiliate takes a deduction for the reinsurance premium payment, as an ordinary and necessary business expense—the same as if a U.S. subsidiary engaged in manufacturing were to buy raw materials from its foreign affiliate and take a deduction for that cost.

The U.S. subsidiaries of foreign-based insurance companies are U.S. taxpayers and their transactions are highly scrutinized on a regular basis by state insurance regulators and the Internal Revenue Service. Under transfer pricing rules set forth in Internal Revenue Code Sections 482 and 845 and the underlying regulations, the IRS has authority to make any allocation, re-characterization, or adjustment deemed necessary to reflect the proper amount, source or character of the taxable income, deductions, or any other item related to a reinsurance agreement. Further, Bermuda-based insurance companies are required to pay a 1% Federal Excise Tax ("FET") on gross reinsurance premiums received with respect to U.S. risks. In our economic analysis, U.S. insurance companies' income tax payments, on average, are equal to 2.3% of premiums, while FET on premiums ceded to a Bermuda affiliate (plus the income tax paid by the U.S. affiliate) equate to 2.0% of premiums. This is equivalent to the difference between an income tax rate of 35% and 30.4%. Thus any statements in support of this proposal

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[1] *General Explanations of the Administration's Fiscal Year 2017 Revenue Proposals*, Department of the Treasury (February 2016) page 15.

[2] This contingent of U.S. P&C companies call themselves "The Coalition for a Domestic Insurance Industry," but they do not speak for the majority of the U.S. P&C industry: The major insurance trade associations are neutral on the Obama Administration's proposal. The 12 members of the coalition are: W.R. Berkley Corporation, AMBAC Financial Group Inc.; American Financial Group; Berkshire Hathaway Inc.; EMC Insurance Companies; The Hartford Financial Services Group, Inc.; Liberty Mutual Group, Inc. (which recently purchased Bermuda's Ironshore Insurance Group); Markel Corporation (which recently purchased Bermuda's Alterra Capital); MBIA Inc. ; Scottsdale Insurance Company; The Travelers Companies, Inc.; and Zenith Insurance Company (now owned by Canada's Fairfax Financial).

often exaggerate the tax benefits of deductible reinsurance premiums paid to a Bermuda affiliate. Moreover, many ignore the fact that when reinsured losses occur, the ceding U.S. subsidiaries do not receive the benefit of business expense deductions for paying the relevant claims.

Furthermore, there is no evidence that foreign based insurance groups use affiliate reinsurance to any greater degree than wholly US owned insurance groups. The Brattle Group study found that "US P&C companies rely heavily on other companies in the same insurance group (i.e., affiliates) for reinsurance…half of the US-owned insurers ceded at least 60 percent of their premiums to an affiliate, and close to 40 percent of them ceded at least 90 percent." Brattle further noted:[3]

> "It is not hard to understand why affiliate reinsurance would play a central role in the insurance market. Absent reinsurance, regulators would require each company within an insurance group to have enough capital on a standalone basis to support the business it writes. With offshore affiliate reinsurance, US subsidiaries can reduce the total amount of capital needed to support their business. Reinsurance becomes an integral part of an insurer's capital structure as recognized in regulatory and accounting rules."

Foreign-based reinsurers play an important role in the U.S economy by helping U.S. property owners recover and rebuild when catastrophe strikes. Foreign insurers have provided substantial support following recent disasters: foreign reinsurers paid nearly 50 percent of the estimated $19 billion in losses incurred from Hurricane Sandy; an estimated 85 percent of privately insured crop losses resulting from the 2012 drought (approximately $1.2 billion) were paid by international reinsurers; and, in the aftermath of the 2001 terrorist attacks on New York, international insurance and reinsurance firms paid 64 percent of the estimated $27 billion in US payouts for the claims.

Proposals to deny a tax deduction for certain premium payments paid to foreign-based affiliates are widely opposed by consumer advocates, insurance regulators and other stakeholders.[4] There is no basis for singling out the global reinsurance industry by enactment of tax legislation that would penalize the U.S. operations of foreign insurance and reinsurance companies, including those based in Bermuda. Particularly in view of continuing uncertainty in the global capital markets, it seems counter-intuitive to advance a legislative proposal that would limit the availability of foreign sources of insurance capital, which would occur under any new rule disallowing deductions for reinsurance premiums in whole or in part. Increasing the taxes on international insurance carriers will result in reduced insurance capacity and increased costs for U.S. consumers.

A recent study by the Brattle Group reported "U.S. homeowners and businesses would feel the effect of the denial of a deduction in the form of reduced availability of, and higher prices for,

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[3] The Impact of Offshore Affiliate Reinsurance Tax Proposals on the U.S. Insurance Market, An Updated Economic Analysis, the Brattle Group, Jan. 23, 2017, pages 23-24

[4] For example, public opposition to reinsurance tax proposals is evidenced by letters from past or current insurance commissioners of the following states: Florida, Georgia, Louisiana, Mississippi, Nevada, North Carolina, Pennsylvania, South Carolina and Utah; copies of which are available at www.keepinsurancecompetitive.com Consumer groups which have written in opposition include: the Florida Consumer Action Network, the Consumer Federation of the Southeast, the Risk and Insurance Management Society and the American Consumer Institute.

P&C insurance….finding that the net supply of reinsurance (non-affiliate and affiliate combined) would drop by one-eighth or $18.3 billion as a result of the proposed tax increase…[and] that U.S. **consumers would have to pay $5 billion more per year to obtain the same coverage**.[5]"

"The numbers really do speak for themselves," said Lars Powell, one of the study's authors and director of the Alabama Center for Insurance Information and Research. "This study reaffirms prior Brattle studies on the issue: if the US subsidiaries of foreign-based reinsurers are subject to the tax outlined in Sen. Warner's and Rep. Neal's legislation, then there will be a marked decrease in the domestic supply of insurance. This will increase costs, and homeowners and businesses throughout the country, especially those in areas that are vulnerable to catastrophes, will end up paying the price."

Areas prone to hurricanes and other natural disasters, like earthquakes, will see the highest increases in costs to consumers. According to the Brattle report, the following chart shows the "The hardest-hit states (California, Florida, New York, Texas, New Jersey, Illinois and Pennsylvania) have large, diverse economies with huge exposure to property and liability losses." Based on the amount of premiums written, the following chart shows the states that will have the highest increase in costs from the reinsurance tax.

**Table 9. State-Level Impact—Linear Allocation ($ Millions)**

| | Direct Premiums Written (2015) | Increase in Cost in Selected Lines |
|---|---|---|
| California | 54,157 | 481 |
| Florida | 36,433 | 259 |
| New York | 35,896 | 335 |
| Texas | 35,277 | 271 |
| Illinois | 18,609 | 172 |
| Pennsylvania | 17,587 | 139 |
| New Jersey | 16,362 | 131 |
| Michigan | 13,155 | 79 |
| Georgia | 13,038 | 88 |
| Ohio | 11,132 | 79 |
| **Top 10 Total** | **251,646** | **2,033** |
| **All States Total** | **444,248** | **3,458** |

Source: Appendix B. States are ranked by its direct premiums written in 15 lines in 2015.

In identifying the importance of showing the impact by state, it is noted that the Brattle report "…comes at a critical time," said Louisiana Insurance Commissioner James Donelon. "As lawmakers begin to consider reforming the tax code, they must be mindful of the sweeping effects that the proposed Neal-Warner legislation will have on homeowners, consumers and businesses if enacted. Louisiana alone will see insurance prices skyrocket more than $30 million, and I am sure that my fellow insurance commissioners throughout the country, many of whom also oppose this measure, would strongly agree that this will hit nearly all Americans in the pocketbook. That isn't something to take lightly."

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[5] The Impact of Offshore Affiliate Reinsurance Tax Proposals on the U.S. Insurance Market: An Updated Economic Analysis. January 23, 2017. (Executive Summary)

U.S. consumers who depend on access to affordable insurance and reinsurance to protect their most valuable assets, can't afford new reinsurance taxes.

A reinsurance tax increase could negatively impact the economy.

A recent economic study by the Tax Foundation[6] found that the Obama Administration's proposal would cost the U.S. economy more than four dollars for every dollar raised. In addition, the study also projects that over the long term, the United States' GDP would experience $1.35 billion in losses. The report states, "over the long term, the tax provision reduces GDP by about twice the revenue it collects directly. As a result, about 40 percent of the intended revenue from the provision ends up being lost through lower collections of other taxes." The Tax Foundation concludes its report with the following commentary on tax reform:

> "Eliminating the deduction for foreign reinsurance premiums ultimately creates more problems than it solves. It redefines the corporate tax base to effectively ignore legitimate business transactions. It is poor for growth because it increases the cost of capital. And it doubles down on a dubious corporate tax system in need of broader reforms.
>
> "Congress should not go through the tax code industry-by-industry, legislatively redesigning the definition of corporate income on an ad-hoc basis in an attempt to find more corporate revenue from overseas firms. Instead, it should look to larger reforms that make the U.S. more attractive as a domicile for corporations."

**The House Republican Blueprint and the BAT**

The Blueprint released in June 2016 does not provide sufficient details to determine the tax treatment of cross border insurance and reinsurance under the BAT proposal that would tax imports and provide for tax-free exports. It is our understanding that the authors of the Blueprint intended that the BAT apply to services as well as goods, but we also understand that the application of the BAT to financial services is a design issue -- the final details of which are still being developed. If policy makers were to follow the design of most other border adjustable tax systems imposed globally, generally through value added taxes, they would exempt such services from the BAT as most countries that impose VAT or GST taxes do not apply those taxes to insurance or reinsurance.

However, should legislation implementing the Blueprint impose a new tax on all cross-border reinsurance transactions, the distortions to the U.S. insurance markets could be devastating to U.S. consumers—according to the Brattle report[7]:

- "At the low end, for example, a 20 percent reduction in reinsurance would lead to a $15.6 billion drop in the supply of U.S. insurance, which is 67 percent greater than the impact we calculated under the Warner/Neal Bill, and U.S. consumers would pay $8.4 billion more to obtain the same coverage.

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[6] *Incorrectly Defining Business Income: The Proposal to Eliminate the Deductibility of Foreign Reinsurance Premiums,* by Alan Cole, Economist, Tax Foundation. February 18, 2015. Report number 452.

[7] The Brattle report provides annual economic impact costs.

- "At the high end, an 80 percent reduction in reinsurance would lead to a $69.3 billion drop in the supply of U.S. insurance, which is 7.5 times the impact we calculated under the Warner/Neal Bill, and U.S. consumers would pay $37.4 billion more to obtain the same coverage.
- "If we apply our analysis of the Warner/Neal Bill and assume the 39 percent reduction in reinsurance ceded by foreign firms in long-return lines similarly applied to all firms and all lines, the impact would be a $31.2 billion drop in the supply of U.S. insurance, and U.S. consumers would pay $16.9 billion more to obtain the same coverage."

KPMG in a paper providing an analysis of a theoretical application of the BAT to various reinsurance transactions found:

> "The result of disallowing a deduction for the net ceded premium … is distortionary compared with the result under a wholly domestic reinsurance transaction … and could be seen as creating a strong disincentive for cross-border risk pooling and spreading." The report noted this would be particularly troubling for long tailed risk and infrequent but severe catastrophe risks.[8]

Further to the consumer impact potential, the R Street Institute and Florida Tax Watch scholars analyzed the impact a decrease in the supply of international reinsurance would have on the property insurance premiums paid by consumers in states prone to natural catastrophe, including Florida, Louisiana, North Carolina, and Texas. The results have been sobering.

These studies found that, a BAT set at 20 percent would increase the cost of property-casualty insurance in Texas by $3.39 billion over the next ten years. In Louisiana, it would result in an increase of $1.1 billion over the next ten years. And, in North Carolina, it would result in an increase of $800 million over the next ten years. Yet, most striking is the impact a BAT would have on Florida. Research indicates premiums would need to increase between $1.4 and $2.6 billion *annually* simply to maintain coverage as it exists today.

R Street noted: "Deep and liquid global reinsurance markets are a vital component of the nation's approach to risk transfer. Having access to international reinsurance capital keeps insurance rates affordable and allows consumers to protect themselves without burdening fellow taxpayers. Our research indicates that virtually any scenario in which a BAT set at a rate of 20 percent were levied on the import of insurance or reinsurance would have significant negative effects for policyholders. Insurance, and the financial services sector as a whole, benefit from the ready availability of international capital. Policy developments limiting the availability of such capital produce a cascade of negative effects for Americans across the country and from all walks of life."[9]

Senator Lindsey Graham (R-SC) said it best, "Simply put, any policy proposal which drives up costs of Corona, tequila, or margaritas is a big-time bad idea," Mr. Graham wrote in a post on Twitter. [10] The same can be said for the reinsurance that protects the U.S. and its consumers.

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[8] KPMG report: Questions for insurers and reinsurers raised by proposed Border Adjustment Tax. April 2017.

[9] R Street Institute. www.Rstreet.org. Impact of a border adjustment tax on the North Carolina Insurance Market, May 17, 2017; Impact of a border adjustment tax on the Louisiana Insurance Market, May 4, 2017; Impact of a border adjustment tax on the Texas insurance market, April 27, 2017; Policy studies by Dr. Lars Powell.

[10] Ibid.

## Conclusion

Reinsurance plays a vital role in spreading risk in the global marketplace. *All* insurance companies, U.S.-based and foreign-based, utilize reinsurance in order to most efficiently and safely pool catastrophic and other risks and to match capital to support those risks. Such pooling diversifies risk into a global portfolio providing substantial price and capacity benefits to insurance markets globally. A reinsurance tax proposal would unfairly penalize foreign-based insurers, raise costs for domestic insurers and consumers, and would arguably violate U.S. obligations under the World Trade Organization's (WTO) "National Treatment" principle, which ensures equal access to the U.S. market[11]. In addition, the BAT is designed to put the United States on a level footing with much of the rest of the world that imposes border adjustable consumption taxes. However, since most of the world excludes cross-border insurance and reinsurances from their VAT systems, application of the BAT to reinsurance would seem to be unnecessary and counterproductive. It would not follow the global best practices for a VAT/GST and could cause major disruptions in the U.S. reinsurance markets impacting the amount of affordable reinsurance available

Foreign-based reinsurers play an important role in the U.S. insurance marketplace— they help the U.S. recover and rebuild when catastrophe strikes. There is no reason why a policy maker would choose to compel New York policyholders and U.S. investors to shoulder the entire costs of the 9/11 terrorism attack or Gulf Coast policyholders and US investors to shoulder the entire costs of Hurricane Katrina – when the alternative of sharing these losses with global shareholders is available and affords identifiably better benefits in lower prices and more competitive insurance markets to US consumers.

We urge you to maintain the current law treatment of deductions for reinsurance premiums paid by U.S. companies to foreign insurers, reinsurers or their affiliates.

Sincerely yours,

Bradley J Kading

Bradley Kading
President and Executive Director
Association of Bermuda Insurers and Reinsurers

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[11] April 15, 2013 Letter from former U.S. Trade Representatives Mickey Kantor and Susan Schwab.

ABI

**About the ABI**

The Association of British Insurers is the voice of the UK's insurance and long term savings industry. Our 250 members include most household names and specialist providers who contribute £12bn in taxes and manage investments of £1.6trillion. The UK insurance industry is the fourth largest in the world (after the US, Japan and China) and the largest in the EU.

**Executive Summary**

**1.** The ABI welcomes the opportunity to submit a written statement for consideration by the Committee and for inclusion in the printed record of the hearing on 'Increasing U.S Competitiveness and Preventing American Jobs from Moving Overseas'. We recognise the importance of US Tax reform, but have concerns that by inadvertently impacting insurance business models the reforms may negatively impact American business and consumers. In the spirit of working constructively with the Committee, we offer information about the impact of proposed reforms on the normal conduct of insurance business.

2. In particular, we focus in this submission on the way insurers balance the risks they take on including the use of risk diversification and reinsurance. Good risk management gives consumers competitive premium pricing and the availability of cover for large or complex risks whilst strengthening the insurer's capital base.

3. Reinsurance is a global business covering significant US risks and paying out when disasters, such as the World Trade Centre Tragedy and Hurricane Sandy, strike.

**4.** Applying a Border Adjustment Tax to insurance would impact on the ability to reinsure US risks, reducing the capacity of US insurers to write business leading to reduced coverage and increased premiums for consumers, including families and business. For that reason we urge the Committee to consider exempting insurance from any Border Adjustment Tax.

**Background to Insurance Business Models**

5. The essence of insurance is that in exchange for the payment of a premium, an insured party transfers the risk of loss, from a particular source, to an insurer. By pooling the risks of multiple insured parties, the insurer can spread the risk of loss. The insurer will estimate the risk of loss and hold assets to cover expected claims arising from the losses but will also hold an appropriate amount of capital, known as solvency capital, to ensure it will be able to pay any claims that arise beyond those expected,.

6. An insurer assumes a variety of risks in relation to the business it writes:

- The main risk is insurance (or underwriting) risk, i.e. that factors beyond the insurer's control result in claims that exceed premiums and other income and the insurer makes a net loss. Examples of these factors include severe or frequent natural disasters such as earthquakes, storms and floods, or people falling ill and / or living longer or not as long as expected.
- Other insurance specific risks exist, e.g.:
    - Reserve risk: the risk that original estimates of expected claims are ultimately too low due to changes in inflation, court decisions on damages, etc.
    - Market risk: the risk that the investment assets held to support both the claims reserves and the solvency capital of the insurer fall in value due to underlying market conditions
- Insurers must also manage general business risks such as credit risk, expense risk, and operational risk.

7. Risk management is at the heart of the insurance business; insurers cannot eliminate risk and volatility but their objective is to understand and manage it. The key decisions an insurer makes relate to which risks to take on and the premium to charge for taking on that risk. In order to make profits, an insurance company must get the correct balance between these two factors. Accordingly, the understanding and management of insurance risk is at the heart of an insurer's ability to create value and minimise costs to the consumer.

8. One of the key methods for managing risks is through diversification of risk, or in other words writing many different types of policies so as to reduce the concentration of one type of risk. Diversification of risk can be achieved by writing business in different geographical locations (because there is little correlation between losses in different locations, e.g. earthquakes in Japan versus Wind/Winter storm in Europe), or it can be achieved by writing products that partly offset each other (such as products which pay out on the death of the insured and products which provide an income in retirement for as long as the insured lives because there is a negative correlation between claims for these types of risks). "Diversification, particularly geographic, is fundamental to the insurance business"[1]. It reduces the overall risk of unexpected loss to the portfolio as a whole and therefore reduces the need for capital. As the cost of capital is a key factor in setting premiums, the efficient management of capital is critical to competition between insurers.

9. The capital position of an insurer is regulated by local regulators who set a minimum amount of capital which must be held by an insurer to cover expected liabilities plus Solvency capital, in order to ensure that policyholder claims will be met even where these are greater than anticipated. Under regulatory requirements, an insurer cannot underwrite a risk unless it has the necessary capital to do so.

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[1] Insurers Rating Methodology: Standard & Poor's, 7 May 2013

10. One of the most important ways that insurers balance risk and capital requirements is via reinsurance agreements. A reinsurance agreement takes a single large risk or a collection of risks written by the original insurer and cedes, i.e. transfers, them to a reinsurer, in return for a premium. The result is that risk is removed from the liabilities of the original insurer and the insurer is freed from the requirement to hold capital against that risk. This requirement is instead passed to the reinsurer who now bears the risk of loss.

11. By selectively ceding or taking on risks, both insurers and reinsurers can achieve a better balanced book of risks. This reduces capital requirements by reducing volatility of earnings, as excessive losses may be avoided, and allowing losses from one line of business to be offset by profits from another.

**12. Commercial drivers for insurers to reinsure risks**

**Protection from large losses**

- They can protect themselves from especially large losses, e.g. through excess of loss or stop loss treaties which allow the insurer to limit any loss arising from a particular risk.

**Transfer risk from balance sheets**

- Transferring risks from their balance sheets enables insurers to write an increased volume of business, enhancing ability to earn ancillary income from a broader policyholder base, and/or larger risks which are more profitable without being required to find more capital

**Improve solvency and capital ratios**

- Removing risks also improves insurers' solvency ratios and other capital ratios- these can be driven by regulatory, rating agency capital, or group internal guidelines

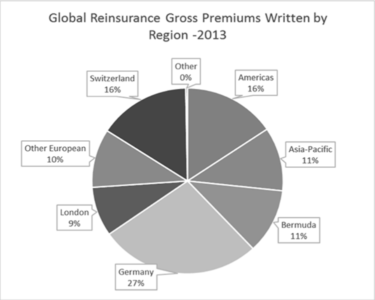
**Benefit from diversification of risk**

- By reinsuring large one-off risks or an unbalanced portfolio, the insurer can achieve a better balance of risks and benefit from diversification of risk which will also result in lower capital requirements (more on diversification below)

13. Consumers, including businesses, benefit from reinsurance in the form of more competitive premium prices, a stronger capital base for the insurer (making it more likely that their claims will be paid) and a wider range of risks that can be underwritten (making it less likely that they will be denied coverage for larger or more complex risks). In particular, as natural disasters have been increasing in frequency and severity and as individuals have been enjoying longer lifespans and are increasingly responsible for their own retirement incomes, consumers need well-priced solutions in order to achieve financial security.

14. It is important to remember that in order to obtain the desired solvency and capital effects, a reinsurance contract must comply with regulatory and accounting rules, be placed with a sufficiently capitalised counterparty, and must genuinely transfer risk from one insurance entity to another. Neither regulators nor accounting standards would recognise a reinsurance treaty that did not actually transfer risk, nor would it be recognised in law as insurance, so there would be no purpose in such a contract.

15. Reinsurance contracts are written both domestically and cross-border, depending on the circumstances of the parties and the types of risks being reinsured. As a result, reinsurance business is not concentrated in any particular location; it is a global business typically written by large, highly capitalized companies. This is demonstrated in the chart below (based on A.M. Best data it uses the location of the headquarters of the reinsurance group rather than the location of the reinsurance coverage). Geographical distribution of risks is important to enable better diversification of risks.



**Source: A.M. Best**

**Destination-Based Cash Flow Taxation and Border Adjustment proposal**

16. Currently there is no detail on how a destination-based cash flow tax would apply to insurance and, in particular the need to take into account the estimate of future liabilities (reserves) which represent estimated future cash flows to pay claims. If reserves are not taken into account then there would be a material divergence between commercial profits and taxable profits as compared with other industries. This suggests that a pure destination-based cash flow tax is not appropriate for insurance transactions.

17. The destination-based cash flow taxation proposals in the Blueprint[2] include a border adjustment for imports. We are very concerned about how such an adjustment might impact the insurance market.

18. Our understanding is that under the border adjustment proposals the cost of goods and/or services imported by a U.S. insured would not be tax deductible but purchases from within the U.S. would be tax deductible.

19. It has been suggested by supporters of a border adjustment that it is similar to the adjustment for imports found within VAT/GST regimes in jurisdictions outside the US and that such adjustments give US businesses a competitive disadvantage compared with businesses in that jurisdiction . We do not believe that is accurate.

20. Insurance and reinsurance transactions are exempt from VAT in the UK and the rest of the EU. As such a US (re)insurer is not at a competitive disadvantage as compared with a UK (re)insurer or any other jurisdiction which does not apply VAT to insurance transactions.

21. Furthermore, as explained in paragraph 15 above reinsurance business is not concentrated in any particular location, but is written in many jurisdictions around the world. This is important to enable better diversification of risks, and provide consumers with more competitive premiums.

22. It should also not be overlooked that the global nature of the reinsurance business means that every year substantial insurance claims, including those from the World Trade Centre tragedy, Hurricane Katrina and the hurricane outbreaks from 2010 to 2012, are paid by international insurers. International insurers paid:

    - 64% of claims from the World Trade Centre Tragedy at a cost of £17Bn; and
    - 48% of Hurricane Sandy losses were covered at a cost of £20BN.

    In 2015 alone there were US$120.9 billion[3] net insurance recoverables relating to US risk that were ceded to international insurers.

23. Additionally, a report by the Brattle Group[4] an independent financial consultancy, shows that the Border Adjustment Tax would result in a significant drop in insurance capacity in the US, as well as increasing insurance prices for US consumers – reinsurance is generally priced in US$ and there would therefore be no benefit from any exchange rate

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[2] A Better Way :Our Vision for a confident America - published by Ways and Means Republicans 24 June 2016

[3] Reinsurance Association of America Offshore report 2015

[4] The Brattle Group – The impact of offshore affiliate reinsurance tax proposals on the US insurance market: an updated economic analysis – January 2017.

movement. The significant drop in insurance capacity in the US could result in less diversification of risk for reinsurers globally, and thereby impair a core business practice.

24. Introducing a Border Adjustment Tax will inevitably cause other jurisdictions to reconsider their approach to the taxation of reinsurance leading to further negative impacts on the reinsurance market globally and cost increases for insurers and their customers.

25. In view of the likely increase in the cost of insurance for consumers and the likely adverse impact on the insurance market, we would therefore strongly urge that if a border adjustment is introduced as part of US Tax reform that insurance and reinsurance transactions are exempted.

Association of British Insurers
06 June 2017

ABI

GlobalAutomakers

Aston Martin ◦ Ferrari ◦ Honda ◦ Hyundai ◦ Isuzu ◦ Kia
Maserati ◦ McLaren ◦ Nissan ◦ Subaru ◦ Suzuki ◦ Toyota

June 6, 2017

The Honorable Kevin Brady
Chairman, Committee on Ways and Means
1102 Longworth Building
Washington, D.C. 20515

The Honorable Richard Neal
Ranking Member, Committee on Ways and Means
1102 Longworth Building
Washington, D.C. 20515

Dear Chairman Brady, Ranking Member Neal and members of the Committee:

The Association of Global Automakers, Inc. (Global Automakers) and its member companies have a keen interest in your committee's consideration of tax and trade issues. We are committed to working with you and the members of the Committee on Ways and Means in support of policies that will enhance the competitiveness of manufacturing in the United States and increase employment opportunities for all Americans.

Accordingly, this statement is to convey our views on the subject of the Committee's May 23, 2017 hearing, the border adjustment tax and international tax modernization. Global Automakers represents the U.S. operations of international motor vehicle manufacturers, original equipment suppliers and other automotive trade associations. Global Automakers' companies have invested $56 billion in U.S.-based production facilities, have a combined domestic production capacity of 4.6 million vehicles, and directly employ more than 98,500 Americans.

Global Automakers has very serious concerns about a border adjustment tax (BAT) and how it will adversely affect auto production, sales and employment in the United States.

While we understand that many precise details of a BAT have not been determined, the basic concept, as outlined in the "Better Way" Blueprint for tax reform from the House Leadership and the Committee chair, is clear. A border tax would tax goods that cross the border coming into the U.S.

This concept, however simple, has broad implications for all of American manufacturing, because just about every product made in the U.S. uses parts and components that come from all over the world.

This is especially true of autos manufactured in the U.S.

The Toyota Camry built in Kentucky, the Honda Accord produced in Ohio, and the Kia Optima manufactured in Georgia provide just three of many examples of the point. While each of these vehicles contain very high levels of US content (see NHTSA's AALA data), they are produced using a mix of domestic and internationally sourced parts. The aluminum in their engine blocks, for example, might have been refined from bauxite mined in Indonesia. The palladium or platinum that scrubs emissions in their catalytic converters may have come from South Africa or Russia. The batteries in the hybrid versions of their vehicles might contain lithium from Bolivia. The chips in the engine control modules or adaptive braking systems might contain silicon from various countries in Asia.

One study, from *Bloomberg News*, showed that a single seat sensor in a U.S.-made car went from Asia, to Europe, to Michigan, and to Mexico and back before going into a car built by U.S. workers in an American plant. (See: https://www.bloomberg.com/graphics/2017-trump-protectionism-alters-supply-chain/) A border tax would raise the prices of the components and commodities that go into these cars, with deleterious consequences for customers, workers, and businesses.

Studies by the Center for Automotive Research (CAR), Roland Berger and others have shown that a border tax would add $1,970 to $3,300 to the average cost of a vehicle sold in the U.S. Those costs will inevitably be passed along to the consumer. CAR also concludes that these costs will add as much as $34.6 billion in higher costs for American consumers. Higher prices will mean fewer sales. Fewer sales will mean less production. Less production will mean fewer jobs.

The burdens of a border tax will fall hardest on consumers in the middle of the market who rely on affordable transportation.

Global Automakers supports tax reform, but it should be tax reform that gives people and companies more reasons to invest in American manufacturing to create more American jobs making products all Americans can afford.

As previously stated, Global Automakers also shares the Committee's commitment to enhancing the competitiveness of U.S. companies and expanding jobs for American workers, and we look forward to working with you as you pursue this important tax reform effort. Should you have any questions or need additional information, please contact Paul Ryan on my staff at pryan@globalautomakers.org or (202) 650-5554.

Sincerely,

John Bozzella
President and CEO

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Independence drives us.

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May 23, 2017

**RE: Hearing on Increasing U.S Competitiveness and Preventing American Jobs from Moving Overseas**

Dear Ways and Means Committee Member:

I am writing today in opposition to any border adjustment tax (BAT), on behalf of the Auto Care Association with nearly 3,000 member companies that represent some 150,000 independent automotive businesses that manufacture, distribute and sell motor vehicle parts, accessories, tools, equipment, materials and supplies, and perform vehicle service and repair.

At the outset, I want to state that Auto Care's member companies are in total support of comprehensive tax reform with fair, effective tax rates, defined by what businesses actually pay in taxes expressed as a percentage of their income. These rates should be reduced for both corporations and pass-through entities, and the committee should strive to eliminate the now-wide disparities in effective tax rates paid by various industries.

The Auto Care Association is also a member of Americans for Affordable Products coalition and is in complete agreement with the implications that the BAT would cause rapid, significant damage to the economy by way of extensive increases to household expenses. This is made more troubling by the common-sense acknowledgement of the regressive nature of these increases.

Further, the Auto Care Association has analyzed our own industry data and found that a very conservative estimate pegs the BAT-caused increase in the cost of auto parts in the U.S. at approximately $20B annually.

This annual increase in the cost of auto repair would be about $160 per household, resulting in a total cost of the BAT approaching $2000 a year per household when added to the $1700 increase established by the AAP coalition. Our data also demonstrates that middle and lower income households tend to drive the oldest cars, meaning that these groups would be susceptible to even larger increases in their repair bills should the BAT become law.

The independent U.S. auto care industry employs nearly 5 million Americans in business that are largely categorized as small business and family-owned, and it is the likely harm from the BAT to these businesses that compels me to articulate the actual jeopardy to many of these family businesses if the BAT is enacted.

Numerous member companies have examined the impact that befalls their business with the loss of the cost of goods sold (COGS) deduction when calculating their taxes, and find themselves at a loss as to how they will stay in in business should the BAT be adopted. The auto care industry does not believe that it is the intention of the Republican tax reform initiative to create winners and losers across the U.S. but the denial of the fact the U.S. automotive industry is intricately bound with the global economy does exactly that.

For all of the reasons above, we encourage you to find other methods of tax reform that will not cause irreparable harm to consumers and to a $340B job-creating U.S. industry.

Sincerely,

Aaron Lowe

Aaron Lowe
Senior Vice President, Government Affairs

BILTIR
BERMUDA INTERNATIONAL LONG TERM
INSURERS AND REINSURERS

June 5, 2017

The Honorable Kevin Brady
Chairman
U.S. House Committee on Ways & Means
1102 Longworth House Office Building
Washington, DC 20515

The Honorable Richard Neal
Ranking Member
U.S. House Committee on Ways & Means
1139E Longworth House Office Building
Washington, DC 20515

Re: May 23, 2017 Hearing on Increasing U.S. Competitiveness and Preventing American Jobs from Moving Overseas

Dear Chairman Brady and Ranking Member Neal,

Bermuda International Long Term Insurers and Reinsurers (BILTIR) appreciates the opportunity to provide comments for the record of the hearing on May 23, 2017 on "Increasing U.S. Competitiveness and Preventing American Jobs from Moving Overseas" and particularly its application to life and annuity reinsurance transactions.

BILTIR was organized in June 2011 as an association representing the long-term insurers and reinsurers in Bermuda. The primary focus of BILTIR is to act as an advocate for Bermuda's life and annuity industry regarding public policy that supports the industry marketplace, regulatory requirements, other Bermuda Monetary Authority or Bermuda government issues, and tax matters with various jurisdictions. With membership of fifty-six companies, BILTIR strives to provide a consistent and coherent voice for concerns of the long-term (re)insurance sector in Bermuda.

BILTIR supports comprehensive tax reform that will simplify the U.S. tax system, lower the tax rates on individuals and business, strengthen the economy and encourage entrepreneurship and capital investment, including vital direct foreign investment in the U.S.

The tax reform plan released by House Republicans in June 2016 (the "Blueprint") proposes a shift to a destination-based cash-flow tax ("DBCFT"). The Blueprint states that "This means that products, services and intangibles that are exported outside the United States will not be subject to

U.S. tax regardless of where they are produced. It also means that products, services and intangibles that are imported into the United States will be subject to U.S. tax regardless of where they are produced." [1] It is unclear how the DBCFT would apply to financial transactions in general, and reinsurance transactions specifically.

A key component of a pro-growth U.S. economy is a strong U.S. capital market that continues to be a magnet for international investment. The U.S. is the largest recipient of foreign direct investment in the world. Foreign direct investment is a key supplier of equity capital to the U.S. market, promoting job creation, innovation and cross-border trade. Historically, profits on capital earned from direct foreign investment have generally been exempt from U.S. tax. The U.S. must actively compete to retain and attract foreign investment and preserving the current tax treatment is necessary to drive foreign investment to the U.S. capital markets.

Foreign capital investment is especially significant for industries like the insurance industry that, because of regulatory and market demands, have high capital requirements. Reinsurance provides access to regulated secondary market equity capital which effectively supplements the equity capitalization of the insurance industry. At the same time, reinsurance enables insurance companies to diversify their risk and more effectively secure the payment of insurance benefits to their customers. Without access to global reinsurance capital sources via reinsurance agreements, the U.S. insurance industry would be faced with higher capital costs or lower capacity to supply insurance to U.S. businesses and individuals.

## **The Importance of Reinsurance in the U.S.**

Reinsurance transactions and access to the global reinsurance markets have been vitally important to the financial stability of the U.S. insurance industry, including life insurers, and to the availability and affordability of insurance to U.S. businesses and individuals. This is because insurers use reinsurance to avoid accumulations of risk concentration, to achieve liability diversification objectives and to access reinsurance capital to support growth via reinsurance transactions. Reinsurance can be particularly important for smaller and regional U.S. insurers who have limited ability to diversify risk without access to reinsurance markets. Access to reinsurance markets allows U.S. insurers to enter new lines of business, offering new products with the support of a reinsurer with experience and relevant underwriting skills, and it allows insurers to exit from a line of business by transferring the risk associated with existing insurance policies without cancelling coverage of existing policy holders. Availability of global reinsurance capital to

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[1] Tax Reform Task Force "A Better Way: Our Vision for a Confident America," at 28 (June 24, 2016).

support growth also creates jobs in the U.S. as the result of the expansion of a U.S. insurers' distribution, underwriting, policy administration and claims payment functions.

Recently, global reinsurance capitalization has been at record levels, a development that has been accompanied by softening of reinsurance premium rates.[2] Aon Benfield reports that total global reinsurance capital in 2013 approximated $540 billion.[3] This is very good for U.S. insurers and policyholders, as approximately half of the global demand for reinsurance comes from the United States. In 2014 more than 60% of the reinsurance utilized by U.S. insurers came from foreign-based reinsurers or subsidiaries of reinsurers.[4]

In summary, U.S. Life insurers rely on domestic and international reinsurers to reduce losses, minimize exposure to significant risks, acquire or dispose of blocks of policies or business lines, and to provide additional capital for future growth. Ready access to diversified and well-capitalized reinsurance markets is important to maintain the financial strength of U.S. life insurers, to enable those insurers to meet policyholder obligations, and to expand access to affordable life insurance products in the United States.[5]

The Federal Insurance Office, U.S. Department of the Treasury ("FIO") concluded that the strength and viability of both the insurance and reinsurance sectors are vitally important to the United States. The FIO report states that "The global reinsurance market provides access to the financial strength of reinsurers and to alternative risk transfer capital, thereby assisting insurers in preparing for and responding to catastrophes and natural disasters. In addition, reinsurers assist insurers in stabilizing underwriting experience, increasing underwriting capacity and facilitating entrance to and exit from markets, thereby helping insurers maintain product pricing that is more available and affordable, which benefits the U.S. economy as a whole. Reinsurers also promote capital allocation among affiliates and address risk diversification."[6]

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[2] Press Release, Guy Carpenter & Co., *January 1, 2014 Renewals Bring Downward Pressure on Pricing* (December 30, 2013); Standard & Poor's Rating Service, "Pricing Slides as Reinsurers Strive for Competitive Footing," in *Global Reinsurance Highlights 2014*, 18 (2014). Association of British Insurers: "Role of Risk and Capital in Insurance" (November 14, 2014).

[3] Aon Benfield, *Reinsurance Market Update* (April 1, 2014) Association of British Insurers: "Role of Risk and Capital in Insurance" (November 14, 2014).

[4] Evaluating the Impact of an Offshore Reinsurance Tax, Tax Notes at 1421 (March 13, 2017).

[5] Federal Insurance Office, U.S. Treasury: "The Breadth and Scope of the Global Reinsurance Market and the Critical Role Such Market Plays in Supporting Insurance in the United States," at 15 (December 2014).

[6] *Id.* at 14.

## Overview of Reinsurance

One of the most important ways that insurers balance risk and capital requirements is via reinsurance agreements, or in other words insurance for insurers. A reinsurance agreement takes a single large risk or a collection of risks written by the original insurer and transfers them to a reinsurer, in return for a ceding commission, which is a payment equal to the present value of the expected earnings on the assets and liabilities transferred. The result is that risk is removed from the liabilities of the original insurer and the insurer is freed from the requirement to hold capital against the risk. This requirement is instead passed to the reinsurer who now bears the risk of loss.[7] In return, the reinsurer receives the future income generated from the policies and their associated reserve accounts.

Reinsurance comes in two basic types, assumption reinsurance and indemnity reinsurance. In the case of assumption reinsurance, the reinsurer steps into the shoes of the ceding company with respect to the reinsured policy, assuming all its liabilities and its responsibility to maintain required reserves against potential claims. The insured(s) must approve the substitution of the insurers. The assumption reinsurer thereafter receives all premiums directly and becomes directly liable to the holders of the policies it has reinsured. In indemnity reinsurance, it is the primary insurance company or "ceding company" that remains directly liable to its policyholders, and that continues to pay claims and collect premiums. The indemnity reinsurer assumes no direct liability to the policyholders. Instead, it agrees to indemnify, or reimburse, the ceding company for a specified percentage of the claims and expenses attributable to the risks that have been reinsured, and the ceding company turns over to it a like percentage of the premiums generated by the insurance of those risks.

## Current Tax Law

Subchapter L of the Internal Revenue Code contains intricate and specialized rules for the taxation of life insurance companies that reflect the industry's financial practices. Tax is imposed on life insurance company taxable income ("LICTI"), which is life insurance company gross income reduced by life insurance deductions. LICTI is computed similarly to the income tax imposed on regular corporations, except that insurance-specific modifications are applied to life insurance gross income to determine LICTI. A key component of the insurance-specific modifications is a deduction for an increase in loss reserves while a net decrease in loss reserves results in an item of

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[7] Association of British Insurers: "Role of Risk and Capital in Insurance" (November 14, 2014)

gross income. The Internal Revenue Code provides that computations to determine taxes imposed under Subchapter L shall be made in a manner consistent with the manner required for purposes of the annual statement approved by the National Association of Insurance Commissioners.[8]

Additionally, under current law, the U.S. imposes federal excise tax equal to one percent of the consideration paid for reinsurance placed with a non-U.S. company except where income tax treaties provide an exemption. There is no such exemption in the U.S./Bermuda income tax treaty.

## Tax Reform Blueprint

The tax reform plan released in June 2016 (the "Blueprint") proposes to shift to a destination-based cash-flow tax ("DBCFT"). The Blueprint states that "This means that products, services and intangibles that are exported outside the United States will not be subject to U.S. tax regardless of where they are produced. It also means that products, services and intangibles that are imported into the United States will be subject to U.S. tax regardless of where they are produced." [9] It is unclear how the DBCFT would apply to reinsurance transactions.

While some practitioners have questioned whether a payment to a non-U.S. reinsurer would be characterized as an import of a service, and thus possibly not deductible under a DBCFT, a reinsurance transaction with a non-U.S. reinsurer is a financial transaction and not an import of a service for reasons described in this letter. The deduction for reserves is central to the current framework for insurance company taxation. A cash flow approach to taxation of reinsurance transactions is counterintuitive to the central framework of taxation of insurance companies and completely ignores the existing foundation in statutory accounting.[10]

Unlike a reinsurance transaction, payments for services would not reduce required reserves or risks of the original insurer. Rather, in a DBCFT system the transfer of an asset (and the transfer of the risk related to that asset) is consistent with the economic substance of a reinsurance transaction.

In a reinsurance transaction, the insurer has reduced its risk and the reinsurer has acquired an asset. The reinsurance transaction reduces, for both regulatory and tax purposes, the reserves of the insurer and increases the reserves of the reinsurer. The Supreme Court concluded that in a reinsurance transaction, the reinsurer is purchasing an asset the insurer has created and the

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[8] Income taxation of non-life insurance companies is governed by similar rules under Subchapter L of the Internal Revenue Code.

[9] Tax Reform Task Force "A Better Way: Our Vision for a Confident America," at 28 (June 24, 2016).

[10] Reinsurance Transactions under a destination-based cash flow tax. Tax Notes March 6, 2017.

reinsurance transaction is the transfer to the reinsurer of the right to share in future profits, as well as the payment stream (the premium) representing that future profit:

"In the reinsurance setting … the ceding company owns the asset it is selling, and the reinsurer pays a substantial "commission" as part of the purchase price to induce the ceding company to part with the asset it has created; the payment, in other words, is for the asset itself rather than for services"[11]

This result is also consistent with the current regime of Subchapter L. To the extent that an insurer cedes a portion of the policy to the reinsurer, the reserve of the insurer will be decreased and the decrease in reserves will be taken into account in determining life insurance company taxable income. It is necessary to allow a deduction for amounts paid to the reinsurer. Otherwise the insurer will be taxed on the decrease in reserves as a result of the transfer of the right to share in future profits, as well as the payment stream (the premium) paid to the reinsurer representing that future profit.

A reinsurance transaction is clearly a financial transaction and not the consumption of a product. Financial transactions can be subject to tax only under an income tax, not under a consumption tax.[12] Consumption taxes in the form of a VAT exclude financial transactions from the tax base, as consumption taxes are designed to be imposed solely on the goods and services consumed by individuals. This is consistent with most previously proposed cash flow taxes, such as the "X tax" proposed by David Bradford and the "Flat Tax" proposed by Robert Hall and Alvin Rabushka.[13]

While the application of the proposed DBCFT to financial services is not clear, advanced economies that impose consumption based VATs exclude financial services. Imposition of a tax on reinsurance is not necessary to level the playing field against foreign competition for life and annuity reinsurance. European jurisdictions universally exempt insurance from the application of a VAT. Certain Asian jurisdictions subject insurance to a VAT, but those that do have certain class exemptions which include life insurance.

Treating a reinsurance transaction with a foreign reinsurer as an import of a service subject to a DBCFT would diminish diversification benefits and increase the concentration of risk among U.S. insurers. It has been estimated that if a 20% import tax is imposed on reinsurance transactions

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[11] *Colonial Amer. Life Ins. v. Commissioner 491 U.S. 244 (1989)* at 251

[12] David P. Hariton, Financial Transactions and the Border-Adjusted Cash Flow Tax, Tax Notes (Jan 3 2017).

[13] *Id.*

from U.S. insurance companies to insurers overseas, the reduction in reinsurance would reduce the supply of insurance from $15.6-$69.3 billion. At the same time the costs for insurance would increase by$ 8.4 -$37.4 billion.[14]

In sum, non-U.S. reinsurers play an integral role in the U.S. insurance market. Today, non-U.S. and foreign-controlled companies assume the majority of premiums ceded by U.S. insurers and provide a vital source of capital to the U.S. insurance industry. If a DBCFT is enacted, payments from an insurer to a non-U.S. reinsurer should not be treated as a nondeductible payment for an imported service and insurance companies should continue to be allowed to deduct reinsurance premiums paid to non-U.S. reinsurers as provided under current law.

We appreciate the opportunity to provide comments to the Ways and Means Committee on tax reform, and particularly the impact on financial transactions in the form of reinsurance.

Respectfully Submitted,

BILTIR

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[14] Evaluating the Impact of an Offshore Reinsurance Tax, Tax Notes at 1423 (March 13, 2017).

BLACK MINGO
OUTFITTERS
Georgetown, South Carolina

May 22, 2017

The Honorable Kevin Brady
Chairman
Committee on Ways and Means
1102 Longworth House Office Building
Washington, DC 20515

The Honorable Peter Roskam
Chairman
Committee on Ways and Means
Subcommittee on Tax Policy
1102 Longworth House Office Building
Washington, DC 20515

Dear Chairman Brady and Chairman Roskam:

I want to thank to the members and staff of the United States House Ways and Means Committee for allowing this hearing on the border adjustment tax and for us to explain why it is such a bad idea for America's small businesses.

My name is Tee Miller and I live in Georgetown, South Carolina where I own a retail store called Black Mingo Outfitters. I am married and my wife and I have two young children and we all depend on the success of this small family business.

For three years from 2013-2016, I was also active in helping create more new jobs as the City of Georgetown's Planning and Economic Development Director. As a result, I fully understand just how hard it is to run a small family business, create new jobs and keep the employees we currently have under the threat of the new border adjustment tax.

The border adjustment tax would raise taxes as high as 20% on imported goods that we use and also depend upon as goods for sale. This hurts us in many ways.

First, these increased business costs would not simply be able to be absorbed by our business. Instead these higher costs will deter customers from purchasing our goods and could ultimately force us to cut back on expenses and possibly eliminate jobs at the store.

Second, the higher costs on imports across the board will limit our family's buying power at the grocery store, the hardware store and everywhere else we all depend on popular goods.

BLACK MINGO
OUTFITTERS
Georgetown, South Carolina

Like many Americans I am convinced that these higher taxes will slow our economy and cost more jobs. I urge the members of the Ways and Means Committee to focus on real comprehensive tax reform that will not harm the economy, but rather stimulate small businesses like mine that actually drive our national economy. Thank you.

Sincerely,

[redacted]
Owner of Black Mingo Outfitters
Georgetown, SC

cc: The Honorable Richard Neal
Ranking Member
Committee on Ways and Means
1102 Longworth House Office Building
Washington, DC 20515

The Honorable Lloyd Doggett
Ranking Member
Committee on Ways and Means
Subcommittee on Tax Policy
1102 Longworth House Office Building
Washington, DC 20515

# STATEMENT FOR THE RECORD

## U.S. House Committee on Ways and Means

## Hearing on

## "Increasing U.S. Competitiveness and Preventing American Jobs from Moving Overseas"

**May 23, 2017**

**Bradbury H. Anderson**

**Former Chief Executive Officer of Best Buy Co., Inc.**

I, Bradbury H. "Brad" Anderson, started at Best Buy in 1973, and held various assignments of increasing responsibility before being named Vice President in 1981. In 1986, I was promoted to Executive Vice President and was elected to Best Buy's Board of Directors. I was named President and Chief Operating Officer for Best Buy in 1991. In 2002, I assumed the responsibility of Vice Chairman and Chief Executive Officer for Best Buy. I retired from the Chief Executive Officer role in June 2009 but remained a member of the Best Buy board of directors until my retirement in June 2010.

Earlier this year I was asked to comment about the Border Adjustment Tax (BAT), which is being considered in Congress by the House Republicans. Unfortunately, my remarks were the result of having been given inaccurate information, specifically related to the number of countries that have trade policies consistent with a BAT.

What I have come to understand is that the proposed BAT is not at all consistent with what other countries have and would be an outlier among industrial nations, despite what many advocates have been arguing.

Even more significantly, the BAT is a new tax on everyday items purchased by hardworking consumers which would lead to significant price increases on essential products and job losses for the retail industry, an industry that is responsible for 42 million jobs in the U.S.  It moves the country in the wrong direction by abandoning real tax reform aimed at lowering rates and eliminating loopholes, and instead introduces new loopholes for foreign sellers and picks winners and losers among various industries.  The BAT is an untested policy proposal with risks that far outweigh any theoretical benefits.

MAYER•BROWN

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**MEMORANDUM**

May 22, 2017

**TO:** The Honorable Kevin Brady, Chairman
Committee on Ways and Means
U.S. House of Representatives

**FROM:** Timothy Keeler
Warren Payne
Mayer Brown LLP (On behalf of
Caterpillar, Inc.)

**RE:** House Republican Tax Reform Blue Print
and US WTO Obligations

## Executive Summary

The House Republican Conference's tax reform proposal, the Blueprint, has been criticized for violating US WTO obligations. In particular, commentators have asserted that the border adjustment mechanism in the Blueprint violates US WTO obligations. This analysis shows that such claims regarding the Blueprint, an untested question in WTO jurisprudence, are premature, and presents the arguments as to how the Blueprint is consistent with US WTO obligations. This analysis conducts a review of both the obligations in the key WTO agreements, and the relevant WTO jurisprudence, and shows how the Blueprint is consistent with US WTO obligations.

Specifically, with respect to U.S. obligations under the Agreement on Subsidies and Countervailing Measures (SCM), the border adjustment mechanism does not constitute a subsidy, as Article 1 of the SCM and relevant jurisprudence require that revenue "otherwise due" is "foregone" for a subsidy to exist. An analysis of that question, taking into account the WTO's decision in the FSC/ETI case, shows that no revenue otherwise due is forgone, because the Blueprint moves the US tax system to a destination-based system where revenue is taxed only where the consumption of the goods and services takes place. This is buttressed by a footnote in the SCM text which clarifies that "the exemption of an exported product from duties or taxes borne by the like product when *destined for domestic consumption*…shall not be deemed a subsidy."[1] In addition, it is also not a prohibited subsidy under the SCM, because it meets the definition of an indirect tax, and the exemption of tax for exports is not "in excess" of those

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[1] Agreement on Subsidies and Countervailing Measures, Apr. 15, 1994, 1869 U.N.T.S. 14 (hereinafter SCM), at n.1 (emphasis added).

levied on the like product when destined for domestic consumption. Annex 1 to the SCM makes clear that a prohibited export subsidy exists only if any exemption from tax for exports is in excess of those levied on like products when sold for domestic consumption; the Blueprint does not appear to contemplate this.

With respect to U.S. obligations under the General Agreement on Tariffs and Trade (GATT) and General Agreement on Trade in Services (GATS), the border adjustment mechanism should not constitute a national treatment violation because both the domestic and imported like products are taxed under the Blueprint, taking into account the entire U.S. tax system. Where imports and domestic products are directly competitive the Blueprint meets the test that they are taxed similarly. For "like" products, as a practical matter, it also meets the national treatment test.

## Introduction

On June 24, 2016 the House Republican Conference released a tax reform proposal entitled "A Better Way, Our Vision for a Confident America: Tax" also commonly referred to as the "Blueprint."[2] The Blueprint provides an outline of a proposal for the reform of the US tax code. Since its release, there has been debate about whether the Blueprint proposals violate US WTO obligations. However, the Blueprint provides only an outline of a reform proposal. There are many details of how the tax system outlined in the Blueprint would operate in practice that need to be developed. Without these details it is impossible to conduct a complete analysis of the compatibility of the Blueprint with US WTO obligations. That being said, this paper provides a high-level overview of how US tax policy and US WTO obligations would interact under the Blueprint. The paper describes: 1) the most relevant aspects of the Blueprint; 2) the most relevant WTO obligations; 3) a summary of how the decisions in the FSC/ETI cases impact any analysis; 4) an initial analysis of the WTO consistency of the new tax system under the Blueprint; and 5) a summary of how the WTO dispute settlement system operates. Based on this analysis, the Blueprint does not violate US WTO obligations.

As described by its Congressional supporters, the tax reform envisioned by the Blueprint "represents a dramatic reform of the current income tax system" and provides "focus on business cash flow, which is a move toward a consumption-based approach to taxation, will allow the United States to adopt, for the first time in history, the same destination-based approach to taxation that has long been used by our trading partners."[3] The fact that the Blueprint envisions a wholesale reform and restructuring of the basic approach to taxation by the United States is a critical factor when considering the potential interaction between the policies outlined in the Blueprint and US WTO obligations. This factor, along with others, significantly distinguishes

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[2] House Republican Conference, "A Better Way, Our Vision for a Confident America: Tax" (2016), http://abetterway.speaker.gov/_assets/pdf/ABetterWay-Tax-PolicyPaper.pdf

[3] *Ibid*. at 15.

the circumstances around the Blueprint from those that were central to the WTO analysis of the FSC/ETI cases.

**Overview of Key Features of the Blueprint**

Key components of reform of the US business and international tax regimes as outlined in the Blueprint include:

- Reduction in tax rates,
- Provision of full expensing,
- Elimination of most deductions and credits, including elimination of deductions for interest,
- Implementation of 100-percent exemption for dividends paid by foreign subsidiaries of US corporations to their US parent (i.e., a full territorial regime), and
- Implementation of border adjustability for the tax treatment of cross-border sales of goods, services, and intangibles.

As noted in the Blueprint itself, the intent is for the US to adopt a destination-based, cash-flow tax regime. The proposal therefore makes a fundamental break from the current structure of the US tax regime that taxes income regardless of where it is earned to one that taxes revenues only when those revenues are generated from the sale of goods and services in the US. Thus, the Blueprint's structure acts as a proxy for consumption. This approach is common in a number of different forms of tax regimes that have developed over many years, including the "X-Tax," the "Growth and Investment Tax" and of course common to all value-added tax regimes.[4] This is a substantial break from the deferral of income and depreciation of expenses that is fundamental to an income tax regime.

Under a destination-based regime tax is levied on revenues generated from the consumption of goods and services in the US while all revenues associated with the consumption of goods and services outside of the United States would be exempt from US tax. Additionally, the changes outlined in the Blueprint are mandatory and permanent upon all taxpayers.

Revenues associated with the consumption of goods and services outside the US would be exempt from tax through either a 100 percent exemption established under the territorial regime or the border adjustment mechanism. Revenues associated with the consumption of goods and services abroad where those goods and services are provided through a foreign subsidiary of a US corporation are exempt from tax through the 100 percent territorial exemption. Such revenues could be repatriated (or returned) to the US parent of the foreign subsidiary without

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[4] *See* David Bradford, "The X Tax in the World Economy," AEI Press (2004); The President's Advisory Panel on Federal Tax Reform, 2005; Itai Grinberg, "Where Credit is Due: Advantages of the Credit-Invoice Method for a Partial Replacement VAT," Georgetown University Law Center (2010).

additional tax liability. Revenues associated with the consumption of goods and services abroad where those goods and services are provided through exports is exempt from tax through the application of the border adjustment policy. Under a border adjustment mechanism, revenues from the direct export of goods and services would be excluded from tax.

Similarly, revenues arising from the consumption of goods and services in the US would be subject to tax regardless of whether such goods and services are provided through an entity in the United States (whether a domestic entity or the subsidiary of a foreign entity) or through the direct importation of those goods and services. In the case of goods and services provided through an entity in the United States, the revenues earned by the provider would be subject to US tax. In the case of goods and services provided through direct importation, tax equivalence is achieved by denying the importer the ability to deduct the costs associated with those imported goods and services when determining its taxable revenues. Thus in an analogous manner just as revenue is taxed based on where it is generated, costs or expenditures are deductible based on where production takes place.

This structure is similar to how value-added taxes (VATs) typically operate. Broadly speaking, under a VAT regime when a good is exported the exporter is not subject to the VAT tax on the export price and also receives a tax rebate equal to the amount of VAT already paid. In particular, "taxpayers subtract from their VAT liability an amount of input credit that is calculated from aggregate amounts, based on total purchases from *domestic* entities."[5] Imported goods are subject to the full VAT at the time of importation.[6]

Commentators may attempt to distinguish a VAT system from the Blueprint by arguing that a VAT is a tax on a product while the Blueprint is a tax on an entity. Such an argument reveals a fundamental misunderstanding of the actual mechanics of VAT regimes. In the case of both a credit-invoice VAT and a subtraction method VAT the taxpayer does not net the tax for each individual product sold. In both cases, and as presumably contemplated by the Blueprint, the taxpayer nets the total amount of input credits against the total amount of tax liability.[7] Furthermore it ignores that the Blueprint fundamentally changes the structure of the US tax system to a destination based system, which is analogous to an indirect tax system. Thus, there is no meaningful distinction in the basic operation of the netting of input credits to tax liability under any of these forms of indirect taxation.

**Relevant WTO Obligations**

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[5] Itai Grinberg, "Where Credit is Due: Advantages of the Credit-Invoice Method for a Partial Replacement VAT," Georgetown University Law Center (2010), at 316 n.13 (emphasis added).

[6] Tuan Minh Le, "Value Added Taxation: Mechanism, Design and Policy Issues," World Bank (2003).

[7] *Ibid*. at 315.

The following sections outline and explain what US obligations are relevant to any analysis of the WTO compatibility of the reforms outlined in the Blueprint and provides an analysis of how such obligations have been previously interpreted in past disputes over US tax policy.

There are three core WTO agreements which contain obligations relevant to analyzing the consistency of any tax policy with US WTO obligations: 1) Agreement on Subsidies and Countervailing Measures (SCM); 2) General Agreement on Tariffs and Trade (GATT); and 3) General Agreement on Trade in Services (GATS).

*Agreement on Subsidies and Countervailing Measures (SCM)*

The SCM contains obligations that WTO member countries have adopted to discipline government subsidies. The SCM provides a general definition for the term "subsidy" and divides subsidies into two categories: prohibited subsidies and actionable subsidies.[8] Article 1 defines what constitutes a subsidy, which most relevantly includes circumstances when "government revenue that is otherwise due is foregone or not collected (e.g. fiscal incentives such as tax credits)."[9] A footnote regarding this definition clarifies that "*the exemption of an exported product from duties or taxes borne by the like product when destined for domestic consumption…**shall not be deemed a subsidy***. (emphasis added)"[10] Further, Article 3 of the SCM defines prohibited, or *per se* WTO-inconsistent subsidies, as: "the following subsidies, within the meaning of Article 1…: (a) subsidies contingent, in law or in fact, whether solely or as one of several other conditions, upon export performance, including those illustrated in Annex 1;" and "(b) subsidies contingent, whether solely or as one of several other conditions, upon the use of domestic over imported goods."[11] Thus, Article 3 further defines tax policies that can be prohibited subsidies provided such policies first meet the definition contained in Article 1.

As noted, an illustrative list of prohibited export subsidies is contained in Annex 1 of the Agreement and includes "the full or partial exemption, remission, or deferral specifically related to exports, of direct taxes or social welfare charges paid or payable by industrial or commercial enterprises."[12] Direct taxes are defined as "taxes on wages, profits, interests, rents, royalties, and all other forms of income and taxes on the ownership of real property."[13] Indirect taxes are defined as: "sales, excise, turnover, value added, franchise, stamp, transfer, inventory and equipment taxes, border taxes and all taxes other than direct taxes and import charges."[14]

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[8] Actionable subsidies are not relevant for this analysis.
[9] SCM, Art. 1.1(a)(1)(ii).
[10] SCM, n.1. The footnote in full reads: "In accordance with the provisions of Article XVI of GATT 1994 (Note to Article XVI) and the provisions of Annexes I through III of this Agreement, the exemption of an exported product from duties or taxes borne by the like product when destined for domestic consumption, or the remission of such duties or taxes in amounts not in excess of those which have accrued, shall not be deemed to be a subsidy."
[11] SCM, Art. 3.
[12] SCM, Annex 1(e).
[13] SCM, Annex 1(e), at n.58.
[14] SCM Annex 1(e), at n.58.

In each case, however, for tax policy to constitute a subsidy that violates WTO obligations, revenue that is "otherwise due" would need to be foregone, per the definition in Article 1. In addition, the SCM also provides an exception to the definition in Annex 1(e) for "measures to avoid the double taxation of foreign-source income."[15]

*General Agreement on Trade and Tariffs (GATT) and General Agreement on Trade in Services (GATS)*

Both GATT and GATS contain the same fundamental obligations intended to prevent countries from implementing discriminatory policies: National Treatment and Most Favored Nation Treatment. The National Treatment obligation is most relevant for this analysis.

a) National Treatment

The premise of National Treatment is that the laws and rules in a country should treat foreign interests no worse than domestic interests. Thus, imported and domestically produced or provided goods and services should be effectively subject to the same laws, rules, regulations, standards and practices. National Treatment is articulated in Article 3 of the GATT,[16] which covers trade in goods and Article 17 of the GATS, which covers trade in services.[17]

Specifically, Article III of the GATT[18] provides in Paragraph 1:

> The contracting parties recognize that internal taxes and other internal charges, laws, regulations and requirements affecting the internal sale, offering for sale, purchase, transportation, distribution or use of products … should not be applied to imported or domestic products so as to afford protection to domestic production.

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[15] SCM, Annex 1(e), at n.59.

[16] General Agreement on Trade and Tariffs, Oct. 30, 1947, 55 U.N.T.S. 154 [hereinafter GATT], at Art. II:1(b), regarding border measures that are duties or charges other than ordinary customs duties, is not the relevant analysis, because, as will be shown below, the Blueprint system is a destination-based indirect tax. Thus, the proper framework is GATT III:2, pertaining to internal measures enforced at the border.

[17] General Agreement on Trade in Services, Apr. 15, 1994, 1869 U.N.T.S. 183 [hereinafter GATS], at Art. I:2 defines "trade in services" as the supply of a service through four "modes":
(1) from the territory of one Member into the territory of any other Member;
(2) in the territory of one Member to the service consumer of any other Member;
(3) by a service supplier of one Member, through commercial presence in the territory of any other Member; and,
(4) by a service supplier of one Member, through presence of natural persons of a Member in the territory of any other Member.
Modes (1) (cross-border) and (3) (via commercial presence within the importing country) are most relevant here.

Further paragraph 2 expands on this principle, stating that:

> The products of the territory of any contracting party imported into the territory of any other contracting party shall not be subject, directly or indirectly, to internal taxes or other internal charges of any kind in excess of those applied directly or indirectly, to like domestic products. Moreover, no contracting party shall otherwise apply internal taxes or other internal charges to imported or domestic products in a manner contrary to the principles set forth in paragraph 1.

An annex to the agreement clarifies that a tax that is consistent with the terms of the first sentence of Paragraph 2 would nonetheless be considered inconsistent with the second sentence when "competition was involved between, on the one hand, the taxed product and, on the other hand, a directly competitive or substitutable product which was not similarly taxed." In sum, where products are similar enough to be considered "like", the tax rate on imported goods must not exceed that of the domestic good, while goods that are not like but compete in the marketplace or are substitutes for one another must be taxed "similarly."

Article XVII of the GATS provides in Paragraph 1:

> In the sectors inscribed in its Schedule, and subject to any conditions and qualifications set out therein, each Member shall accord to services and service suppliers of any other Member, in respect of all measures affecting the supply of services, treatment no less favourable than that it accords to its own like services and service suppliers.

The GATS National Treatment obligation only applies when the imported and domestic services and service suppliers are "like"; *i.e.*, in general, when there is a sufficiently competitive relationship between the domestic and foreign services and service suppliers.

**Relevant WTO Jurisprudence**

The WTO Dispute Settlement Body ("DSB") has addressed questions as to whether tax regimes violate a country's WTO obligations, and the most relevant decisions are the series of cases brought against the United States for a sequence of tax regimes, the Foreign Sales Corporation (FSC) and the Extraterritorial Income Exclusion Act (ETI).[19] The FSC regime provided US tax exemptions for the export-related foreign-source trade income of Foreign Sales Corporations. The ETI replaced the FSC and was passed by Congress in an effort to comply with the DSB decision regarding the FSC regime. The WTO Appellate Body ("AB") found that both of the tax regimes violated US WTO obligations because they were prohibited export subsidies under Article 3 of the SCM Agreement that exempted the remission of taxes otherwise due. Moreover,

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[19] The FSC/ETI cases were brought against the US by the European Union. Consultations were first requested in November of 1997 and the final AB report was issued in February 2006.

the AB found that the regimes did not fall within the exception to the definition of prohibited export subsidies as measures to avoid the double taxation of foreign-source income. There are several aspects of these decisions that are relevant to any analysis as to whether aspects of the Blueprint are inconsistent with WTO obligations.

First, in each case the AB addressed the question as to whether the FSC and ETI regimes actually resulted in the US foregoing revenue otherwise due in a manner that constituted a subsidy. In the FSC case the AB held that as long as a Member's WTO obligations are respected, "[a] Member, in principle, has the sovereign authority to tax any particular categories of revenue it wishes. It is also free *not* to tax any particular categories of revenues."[20]

More specifically, the AB found that "[T]he SCM Agreement does not prohibit a Member from foregoing revenue that is otherwise due under its own rules of taxation, even if this also confers a benefit under Article 1.1(b) of the SCM Agreement. However, if a Member's rules of taxation constitute or provide a subsidy under Article 1.1 and this subsidy is specific under Article 2, the member must abide by the obligations set out in the SCM agreement with respect to that subsidy, including the obligation not to 'grant [] or maintain' any subsidy that is prohibited under Article 3 of the Agreement."[21]

In conducting its analysis, the AB noted that in theory a country could tax all revenue but such an abstraction cannot be the basis for any analysis. Rather, the AB found that "[t]here must, therefore, be some defined, normative benchmark against which a comparison can be made between the revenue actually raised and the revenue that would have been raised 'otherwise.'"[22] Moreover, "panels should seek to compare the fiscal treatment of legitimately comparable income to determine whether the contested measure involves the foregoing of revenue which is 'otherwise due', in relation to the income in question."[23] The AB then went to great lengths in its decision to describe the prevailing US tax regime with a particular focus on describing how the US tax regime took a worldwide approach and that the specific language of the tax code was that the US normally taxes "all income from whatever source derived."[24]

Further, the AB focused on the provisions allowing a taxpayer to elect into ETI treatment, and the presumption that a taxpayer would elect into whichever treatment (ETI or "otherwise") that would result in the lowest possible tax burden.[25] These provisions led the AB to conclude that

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[20] Appellate Body Report, *United States – Tax Treatment For "Foreign Sales Corporations",* WTO Doc. WT/DS108/AB/R (adopted Mar. 20, 2000), at¶ 90.

[21] Article 21.5 Appellate Body Report, *United States – Tax Treatment for "Foreign Sales Corporations,*", AB-2001-8, WTO Doc. WT/DS108/AB/RW (adopted Jan. 14, 2002), at ¶ 86.

[22] *Ibid.* at ¶ 87.

[23] *Id.* at ¶ 91. *See also*, Appellate Body Report, *United States – Measures Affecting Trade in Large Civil Aircraft - Second Complaint*, WTO Doc. WT/DS353/AB/R (adopted Mar. 12, 2012), at ¶¶ 806-815.

[24] *Ibid.* at ¶ 99.

[25] *Ibid.* at¶¶ 93, 99 and 103.

the proper analysis as to whether any tax was foregone was to compare the tax burden under ETI to what that tax burden would be for the same income absent the opportunity to elect into the ETI regime. In addition, the Panel in the ETI case made clear that when analyzing such questions, the substance of tax provisions must be what is analyzed, and not the form.[26]

Thus, the FSC/ETI case, which requires any analysis to address the substance of how tax is imposed relative to a representative benchmark, is key to any analysis of the WTO consistency of the Blueprint.

**Compatibility of the Blueprint with US WTO Obligations**

The analytical framework established by the AB, namely, that any analysis of the compatibility of US tax policy with US WTO obligations must focus on how the specific tax policy in question operates relative to a benchmark of how the tax regime more broadly taxes similar income, is critical. The Blueprint outlines a *fundamental* change in approach in tax policy - away from the worldwide system and the attendant presumption that the US would tax all income from whatever source derived. As noted above, what drove the AB decision in the FSC and ETI cases was the belief that absent the taxpayer's voluntary decision to participate in the FSC and subsequent ETI regimes, such income was subject to tax.

In contrast, the Blueprint establishes a system under which revenues earned from the consumption of goods and services outside the US is exempt from US tax regardless of whether those goods and services are provided via direct export or through a US subsidiary operating in a foreign market. Likewise, the Blueprint would subject revenue earned from goods and services consumed in the US to tax regardless of whether such goods and services are provided through a US entity or through direct importation. This destination based approach to taxation is a significant contrast to the worldwide approach to taxation the US currently maintains and was central to the Appellate Body's analysis. The shift to a destination based system with border adjustment would match the destination-based approached utilized in VAT taxes.[27] Moreover, an important motivation for border adjustability in the context of a destination-based system is to mitigate the risk of base erosion, such as inversions and profit-shifting, a traditional feature of any tax system. The consequences of this fundamental shift are analyzed for each agreement below.

*Compatibility with Obligations of the SCM Agreement*

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[26] Article 21.5 Panel Report, *United States – Tax Treatment for "Foreign Sales Corporations,"* WTO Doc. WT/DS108/RW (Aug. 20, 2001), at ¶¶ 8.36, 8.41.

[27] For example, "[e]very country in the OECD imposes a VAT on the destination basis with respect to cross-border transactions." Itai Grinberg, "Where Credit is Due: Advantages of the Credit-Invoice Method for a Partial Replacement VAT," Georgetown University Law Center (2010), at 344 n.139.

The first question is whether the Blueprint's border adjustment meets the SCM's definition of a subsidy. As noted, the SCM definition of a subsidy includes "government revenue that is otherwise due is foregone."[28] The test is to "compare the fiscal treatment of legitimately comparable income to determine whether the contested measure involves the foregoing of revenue which is 'otherwise due', in relation to the income in question." The answer is clearly no, there is not revenue foregone which would otherwise be due. As detailed earlier, the Blueprint establishes a destination-based system of consumption taxation, under which the revenue earned from the consumption of goods and services outside the US are not subject to US tax, while those earned from consumption within are; at the same time, capital and other expenses are deducted relative to the location of production. This fundamental shift makes the analysis radically different from the worldwide system at issue in the FSC/ETI cases. The relevant benchmark for comparison is the corporate tax base as outlined in the Blueprint which exempts all revenue generated from the consumption of goods and services outside the US from tax; there are no special exemptions.[29] Moreover, this is buttressed by a footnote to the "revenue foregone" portion of the definition of a subsidy, which clarifies that "the exemption of an exported product from duties or taxes borne by the like product when destined for domestic consumption…shall not be deemed a subsidy."[30] The Blueprint clearly would institute a destination based corporate tax system, thus meeting the terms of what the footnote clarifies is not a subsidy.

The second question is whether the Blueprint's border adjustability is a prohibited subsidy. As noted, prohibited subsidies are: "the following subsidies, within the meaning of Article 1…: (a) subsidies contingent, in law or in fact, whether solely or as one of several other conditions, upon export performance, including those illustrated in Annex 1;" and "(b) subsidies contingent, whether solely or as one of several other conditions, upon the use of domestic over imported goods."[31] Again, the answer is no. A policy must be a "subsidy" to be prohibited; as shown above, the Blueprint does not create a subsidy because it does not result in the foregoing of revenue otherwise due. The Blueprint's destination-based structure exempts all revenue from taxation where consumption of the provided goods and services occur outside the United States and footnote 1 of the SCM clarifies such a tax system is not a subsidy.

The Annex 1 illustrative list of prohibited export subsidies follows these implications of the Article 1 definition of subsidy. Footnote 1 of the SCM begins by stating "[i]n accordance

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[28] SCM, Art. 1.1(a)(1)(ii).

[29] Many commentators have compared the destination based cash flow tax to a subtraction method VAT, which is currently in place in Japan. One difference is the deductibility of domestic wages. However, there is no reason why a subtraction method VAT must be the benchmark to determine if there is foregone revenue; the destination based cash flow tax stands on its own principles of taxation and methods of defining the tax base. Moreover, many VAT systems routinely exempt products or industries, based on their social utility or political sensitivity. Indeed, some exempt small businesses as a class.

[30] SCM, at n.1.

[31] SCM, Art. 3.

with…the provisions of Annexes I through III of this Agreement…" before clearly excluding from the definition of "subsidy" the exemption of export income from taxation in destination-based systems. Annex 1 examples of what are prohibited export subsidies include "the full or partial exemption, remission, or deferral specifically related to exports, of direct taxes or social welfare charges paid or payable by industrial or commercial enterprises."[32] Direct taxes are subsequently defined (through examples as opposed to a substantive definition) as "taxes on wages, profits, interests, rents, royalties, and all other forms of income, and taxes on the ownership of real property."[33]

However, with respect to indirect taxes, Annex 1 also makes clear that a prohibited export subsidy exists only if any exemption from tax for exports is in excess of those levied on like products when sold for domestic consumption; the Blueprint does not appear to contemplate this. Indirect taxes are defined (again, through examples) as: "sales, excise, turnover, value added, franchise, stamp, transfer, inventory and equipment taxes, border taxes *and all taxes other than direct taxes and import charges*" (emphasis added). The Blueprint does not create a prohibited export subsidy, as it is not a direct tax. The Blueprint fundamentally changes the structure of the US tax system from an income tax system to a cash flow tax system – a destination-based, consumption-proxy tax regime. The non-taxation of revenue generated from the consumption of goods and services outside the US and the taxation of cash-flow generated from the consumption of goods and services inside the US does not - as a formal, textual matter - squarely fall within the examples listed under the definition of a direct tax in Annex 1; therefore, at a minimum, it falls into the catchall language for indirect taxes of "all taxes other than direct taxes and import charges."[34] Such an interpretation is also the only way to read all three SCM provisions in harmony and not render any of them a nullity: destination-based taxes clearly fall within the footnote, and thus do not meet the Art. 1 definition of a subsidy; destination-based taxes also do

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[32] SCM, Annex 1(e).

[33] SCM, Annex 1(e), at n.58.

[34] Even without the catch-all language for indirect taxes, the Blueprint would still fit more comfortably with the examples listed in the indirect tax definition. Indeed, some commentators have noted that in a similar situation, a recent Appellate Body holding was based upon non-formalistic arguments regarding the commonality of criteria with an example provided in a list:

> In sum, the particular characteristics of the NASA procurement contracts and USDOD assistance instruments before us are such that, in our view, they are most appropriately characterized as being akin to a species of joint venture. Furthermore, these joint venture arrangements between NASA/USDOD and Boeing have *characteristics analogous* to equity infusions, one of the examples of financial contributions included in Article 1.1(a)(1)(i) of the *SCM Agreement*. We recall that, under subparagraph (i), there is a financial contribution where "a government practice involves a direct transfer of funds". Several examples of direct transfers of funds are provided. These examples are not exhaustive. Where, as here, there are *measures that have sufficient characteristics in common with one of the examples* in subparagraph (i), this *commonality* indicates to us that the measures fall within the concept of "direct transfers of funds" in Article 1.1(a)(1)(i).

Appellate Body Report, *U.S. – Measures Affecting Trade in Large Civil Aircraft - Second Complaint*, WTO Doc. WT/DS353/AB/R (adopted Mar. 12, 2012), at ¶ 624 (emphasis added).

not fall into the definition of direct tax, and thus fall into the catch-all definition of indirect tax.[35] Any attempt to read the Annex definitions as cramming a destination-based tax into the definition of direct tax, and thereby bootstrapping it into being a prohibited export subsidy, would render the text of footnote 1 a legal nullity.[36]

Moreover, some commentators have taken the overly narrow view that to be an indirect tax the tax must be applied directly to a specific product. This approach flips the fundamental nature of defining an indirect tax on its head, is contrary to the destination basis principle set forth in footnote 1 of the SCM, and would sweep in as a direct tax value added taxes that are not imposed directly on a product (thus contradicting the SCM definition of indirect tax). Well established analysis shows that direct taxes are those that are levied in the country where the producer resides (residence) or where the production is performed (origin).[37] Indirect taxes are those levied based on where the goods and services subject to taxation are consumed.[38] Therefore, a tax levied on a specific product is simply one approach to achieving the principle of destination-based consumption taxation. It does not preclude other approaches to taxing consumption. As already noted the Blueprint is structured to levy tax based on where goods and services are consumed. Thus, the legal and economic concepts of what constitutes a direct tax are consistent in showing that a destination-based tax system is not a direct tax system.

With the understanding that the Blueprint is an indirect tax, some may argue that it still runs afoul of the obligations in the SCM that the exemption or remission of taxes may not be "in excess of those levied in respect of the production and distribution of like products when sold for domestic consumption."[39] In the case of the Blueprint, the exemption of exports from tax is not "in excess" of those levied in respect of the production and distribution of like products when sold for domestic consumption. The "excess" question is answered by analyzing the tax rate and tax base applied to the revenue from the sale of the domestically produced and distributed like product when destined for export, versus when destined for sale in the domestic market. In the

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[35] With respect to SCM Article 3.1(b), which prohibits "subsidies contingent, whether solely or as one of several other conditions, upon the use of domestic over imported goods," the same analysis holds. This question focuses on the lack of a deduction for imported products versus the deductions available to domestic firms. Again, there is no subsidy because there is no revenue foregone. Moreover, as shown in the next section on GATT, when the total US tax system is taken into account, there is, in practice, no differential between the amount of taxes on imports versus domestic goods.

[36] It is well-established that an interpreter is not free to adopt a reading that would reduce whole clauses of a treaty to redundancy or inutility. *See*, for example, Appellate Body Report, *Brazil - Export Financing Programme for Aircraft*, WTO Doc. WT/DS46/AB/R (adopted Aug. 20 1999), at ¶ 179 and note 110.

[37] See Joint Committee on Taxation, *Destination-Based Taxation and Border Adjustments*, JXC-20-17, May 22, 2017, which states: "Indirect taxes that are imposed based on the place where production of goods or services occur, irrespective of the location of the persons who own the means of production, and where the goods and services go after being produced, are examples of origin-based taxation. If, instead authority to tax a transaction or service is dependent on the location of use or consumption of the goods or services, the tax system is an example of a destination-based tax."

[38] Andrew Guzman & Joost H. B. Pauwelyn, "International Trade Law" 250 (Wolters Kluwer 2nd ed. 2008).

[39] SCM, Annex 1(g).

case of the Blueprint, the tax rate and tax base are identical (other than the exemption for export revenues). The same deductions apply in each case and the same tax rate is applied in each case.[40] As already noted, countries are free to determine what revenue is subject to tax and all destination based tax regime exempt export revenue from tax. Commentators who fixate on examples in which the final-stage exporter has less tax liability or generates a tax loss as a result of the exemption of export revenue conflate the existence of a tax loss with the existence of a remission of tax "in excess," when those are two different analyses.[41] In fact, VAT tax systems routinely result in rebates when the product is exported.[42] The Blueprint, which provides the taxpayer with a net operating loss carryforward (NOL) that can be applied against future tax liability, is arguably less generous in this context than VAT regimes where the taxpayer receives a rebate (cash) from the government.

It should also be noted that the exemption from tax for exports under the Blueprint is not a countervailable subsidy (i.e., subject to anti-subsidy duties). That is, there is not revenue foregone, as this is a destination-based tax system, and it does not fall within the SCM Article 1 definition of subsidy; thus, it cannot be countervailed.[43]

*Compatibility with GATT and GATS National Treatment Obligations*

The Blueprint does not violate the National Treatment obligation of the GATT and GATS. As noted above, the National Treatment obligations, when applied to tax policy, require that when the imported and domestic products are similar enough to be considered "like" the tax rate on imported goods must not exceed that of domestic goods (Article III:2, first sentence), while goods that are not like but compete in the marketplace or are substitutes for one another must be taxed "similarly" (Article III:2, second sentence). Commentators have fixated on the presumption that the Blueprint maintains the deductibility of wages as an allowable expense deduction when entities subject to US corporate tax (regardless of whether they are a US entity or the subsidiary of a foreign entity) determine their tax liability, but an analogous deduction is

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[40] The question of whether a rebate from indirect taxes for exports is a countervailable subsidy has been examined many times by the US Department of Commerce. When determining whether the exemption from VAT taxes is "in excess" the Department has focused its analysis on whether the exported product and the like product destined for the domestic market are taxed at the same rate and on the same base. See for example, Pasta from Turkey, "Preliminary Results of Countervailing Duty Administrative Review," 81 FR 52825 (Aug. 10, 2016) and Certain Oil Country Tubular Goods from China, "Final Affirmative Countervailing Duty Determination, Final Negative Critical Circumstances Determination," 74 FR 64045 (Dec. 7, 2009).

[41] It should be noted that if the analysis of "in excess" were to extend to circumstances where a taxpayer may face different gross tax liabilities on exports versus sales of the like product in the domestic market it would call into question the ability of exporters to receive rebates under VAT regimes.

[42] "In a well functioning VAT, a registered trader with more input credits than VAT liability (for example, an exporter or firm that makes large capital investments) can obtain a refund for VAT paid in excess of input credits." Itai Grinberg, "Where Credit is Due: Advantages of the Credit-Invoice Method for a Partial Replacement VAT," Georgetown University Law Center (2010), at 314.

[43] *See* SCM, Art. 1, ¶ 2, and Art. 10. Moreover, a non-prohibited (i.e., actionable) subsidy must also be found to be "specific" in order to be countervailed. SCM, Art. 1, ¶ 2, and Art. 2.

not imputed to imported goods. More specifically, commentators suggest that the tax base for imported goods and services is broader than the tax base for US produced goods and services, and therefore the total amount of tax imposed on the imports is greater than the total tax imposed on domestically produced goods and services. However, under a complete analysis, when the total tax impact is analyzed, imported and domestically produced goods and services are taxed the same, and many domestically produced goods and services are likely taxed at higher rates than their imported counterparts. Thus, the Blueprint does not run afoul of the National Treatment obligation contained in either the GATT or the GATS.

An analysis of the National Treatment provisions requires 1) a determination of the total amount of taxes paid, and 2) a comparison of those amounts between like imported and domestically produced goods and services. In the context of the second part of the analysis, as noted above the WTO obligations require that the imported products not be subject to tax "in excess" of the domestic like product. For purposes of imported products that are directly competitive with the domestic like product the imported product must be taxed "similarly." Therefore, the analysis must be applied in a manner that is specific to a comparison between like products or directly competitive products. A broad claim against the tax system as a whole does not meet this prerequisite.

When comparing the total tax burden on either like or directly competitive products for purposes of the National Treatment analysis, taxes imposed elsewhere in the US regime that contribute to the total amount of tax imposed in the course of the production of the good or service in question must be included. Therefore, it is necessary to incorporate in the first part of the analysis a determination of how much tax is raised both from the taxation of revenue under the destination-based regime and how much revenue is raised through the imposition of taxes on labor factors of production in the form of wage and income taxes on individuals. It is the combination of those taxes imposed on the domestic like or directly competitive product that ultimately determines the total tax burden imposed on the good or service in question.

The Blueprint makes no changes to the current law payroll tax system. Under the payroll tax system wage income is subject to two different payroll taxes: Medicare taxes and Old Age, Survivors and Disability Insurance (OASDI). In combination these two taxes impose a total of 15.3 percent on domestic wages.[44] Thus, all domestic wage income is taxed at a minimum of 15.3 percent. This tax is applied to all wage income when such wages are earned in the US. The US does not apply it to wages earned in a foreign country that are a component of the total costs of production of a good or service imported into the US. Thus, such foreign wage costs avoids imposition of the tax while US wage costs are subject to tax. If the US were to deny a deduction for wages paid while also continuing to subject wages to payroll taxes, the US would in effect be

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[44] The Medicare portion is 1.45 percent for employer and employee and the OASDI portion is 6.2 percent for employer and employee. In addition, the total amount of wage income subject to payroll taxes may increase under the Blueprint if all income generated by pass through businesses that does not qualify for the business tax rate is subject to payroll taxes.

subjecting that wage costs to double taxation and thereby increasing the total tax burden imposed on the production of the good or service in question.

In addition to the payroll tax, most wage costs paid by the producer is also subject to individual income tax. Under the Blueprint, wage costs are subject to tax at the individual level at one of three tax rates depending on the total amount of income of the taxpayer: 12, 25, or 33 percent. Thus, for wage costs subject to even the lowest of the three tax brackets the total tax rate is 27.3 percent, which is higher than either the 20 or 25 percent tax rates applied to businesses in the Blueprint and therefore is the proxy for the burden that would be imposed as a result of the loss of the expense deduction for imported goods and services. For wage costs subject to higher income tax rates, the total tax is even higher.

Thus, a significant share of labor costs would be subject to significantly higher levels of tax for domestic entities than the actual tax equivalent would be when a wage deduction is not provided in the border adjustment for imports. Thus, for purposes of the second part of the analysis, comparison of the relative amounts of tax paid, it is clear that domestically produced goods and services are subject to similar and likely often higher levels of tax than competing imported goods and services. Therefore, a potential national treatment violation could occur only when the labor costs of the domestic like product are so low as to avoid the imposition of any individual income tax at all. Without a corresponding low-wage based (i.e., where no individual income tax is owed) like product there can be no Article III:2, first sentence, National Treatment violation. With respect to directly competitive or substitutable products (Article III:2, second sentence), the outcome is the same. While this may capture a broader swath of products to be compared, the test is that the products are taxed "similarly" and cannot be imposed for the purpose of providing protection to domestic production. As shown above, looking at the US tax system as a whole, imported and domestically produced goods are taxed similarly. Moreover, the design, architecture, and structure[45] of the Blueprint's tax rates and tax base (including border adjustability), as applied, are for the purpose of legitimate and recognized sovereign tax policy considerations, and not for protective purposes.

Some commentators have asserted that payroll and individual income taxes should not be included in the GATT national treatment analysis because they are not border adjustable or applied directly to a product.[46] Similarly to the SCM definition of an indirect tax, an overly

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[45] Appellate Body Report, *Japan – Taxes on Alcoholic Beverages*, WTO Doc. WT/DS8/AB/R, WT/DS10/AB/R, WT/DS11/AB/R (adopted Nov. 1, 1996), at 29.

[46] Some cite to a 1970 GATT Working Party Report on Border Tax Adjustments, which stated that "certain taxes that were not directly levied on products were not eligible for tax adjustment. Examples of such taxes comprised social security charges whether on employers or employees and payroll taxes." Working Party Report, *Border Tax Adjustments*, L/3464, BISD 18S/97 (adopted Dec. 2, 1970). However, the Working Party Report has not been followed in other aspects (such as its guidance on determining "likeness" among products), it has not been adopted by WTO panels or the Appellate Body, and the text itself of the GATT national treatment provisions on tax is what should govern. Namely, "[t]he products of the territory of any contracting party imported into the territory of any

narrow view of permitting border adjustability for taxes based on how clearly they apply to a product would disallow many forms of VAT taxes that are generally considered GATT consistent. Moreover, proposals to address this include removing the wage deduction (which would make the cash flow tax more similar to a subtraction method VAT), but providing a tax credit to businesses and individuals to offset payroll taxes. But this merely elevates form over substance; it is the same effective tax base subject to the same tax rates. As noted, the FSC/ETI jurisprudence counsels against elevating form over substance.[47] Many commentators argue disallowing the deduction for wages but providing a credit for wage taxes would be WTO consistent. If such a construction is WTO consistent then the current construction of the Blueprint should also be WTO consistent as it is the same tax base taxed at the same rates.[48]

**Background on WTO Dispute Settlement System**

Even if another country were to reject the analysis that the Blueprint does not violate US WTO obligations and chooses to pursue a WTO challenge, the process of the WTO challenge does not require the US to change its laws. Specifically, "[w]here a U.S. law or regulation is at issue in a WTO case, the WTO's adoption of a panel and, if appealed, AB report finding that the U.S. measure violates a WTO agreement does not give the WTO decision direct legal effect in this country. Thus, federal law is not affected until Congress or the executive branch, as the case may be, takes action to remove the offending measure."[49]

First, the WTO dispute settlement process is a multistage process that begins with consultations before any formal dispute resolution begins.[50] If the process proceeds beyond the consultation phase then a Panel to hear the dispute is formed. Countries may, and often do, appeal decisions of the Panel to the AB. Decisions are issued more quickly by the AB than a Panel.[51] Once a final decision is issued, WTO member have a reasonable period of time to comply, generally 15 months.[52] The dispute settlement process further provides for the adjudication of differences of opinion between parties as to whether the country found to violate its WTO obligations has properly remedied any violation.[53] Countries may in the event of an impasse seek permission to retaliate against another WTO member if it is ultimately determined that the country violating its

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other contracting party shall not be subject, *directly or indirectly*, to internal taxes or other internal charges of any kind in excess of those applied *directly or indirectly*, to like domestic products" (emphasis added).

[47] Moreover, WTO members may show some caution before seeking to use WTO obligations to require, in effect, that another WTO member make their tax code more regressive (i.e., less progressive), for purely formalistic reasons.

[48] The same analysis holds for the national treatment analysis of services under the GATS.

[49] Congressional Research Service, "Dispute Settlement in the World Trade Organization (WTO): An Overview" (Nov. 26, 2012), https://fas.org/sgp/crs/misc/RS20088.pdf.

[50] Dispute Settlement System Training Module, "The Process – Stages in a Typical WTO Dispute Settlement Case," https://www.wto.org/english/tratop_e/dispu_e/disp_settlement_cbt_e/c6s1p1_e.htm.

[51] WTO Analytical Index, "Dispute Settlement Understanding" [hereinafter DSU], at Art. 17.5.

[52] DSU, Art. 21.3.

[53] DSU, Art. 21.5.

WTO commitments has not sufficiently remedied the violation.[54] Retaliation takes the form of suspension of trade concessions against the non-compliant country and applies until the losing country comes into compliance with its WTO obligations and any retaliation is prospective in nature only.[55] The losing country has the ability to challenge a winning country's proposed level of suspension of trade concessions through an arbitration before the original Panel that heard the case.[56]

**Conclusion**

As shown in the analysis above the Blueprint does not violate US WTO obligations. It is neither a countervailable nor prohibited export subsidy and therefore does not violate US obligations under the SCM Agreement. It is not a violation of US obligations under the SCM because there is no tax foregone that is otherwise due, it is a destination-based indirect tax, and the exemption of exports from tax is not in excess of the indirect tax imposed on the like product when sold in the US market.

The Blueprint does not violate National Treatment obligations because where domestic and imported products are directly competitive the tax burden on them is similar, due to the imposition of wage and income taxes on the labor costs faced by the domestic product. For "like" products, as a practical matter, it also meets the national treatment test.

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[54] DSU, Art. 22.5.
[55] DSU, Arts. 22.3, 22.8.
[56] DSU, Art. 22.6.

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# Written Testimony Submitted by Andrew F. Quinlan

**President**
**Center for Freedom and Prosperity**

**To the House Committee on Ways and Means hearing on**
**"Increasing U.S. Competitiveness and Preventing American Jobs from Moving Overseas"**
**May 23, 2017**

**Submitted on June 6, 2017**

There's widespread agreement regarding the need for comprehensive tax reform. High U.S. corporate tax rates leave U.S.-based multinationals at a competitive disadvantage, while excessive complexity burdens taxpayers and the economy with unneeded costs. It is long past time to make correcting these problems a top legislative priority.

Unfortunately, the path to tax reform is being hindered by the prospect of adopting a destination-based cash-flow tax (DBCFT). The proposed switch to a "border adjustable" system has divided both businesses and the free-market advocacy community, constituencies whose full support is needed to help shepherd tax reform through the legislative process.

The strong opposition to the DBCFT is due to its significant political and economic risks. These include the similarity between the tax and European-style VATs that have fueled the growth of governments on the continent, the ambiguity of WTO rules regarding the tax structure, and the likelihood that currency appreciation will not fully offset the shifting of the corporate tax burden onto consumers, among other concerns.

**The False Promise of the DBCFT**

The DBCFT is being sold as a correction to a tax injustice, or what some call a “Made in America Tax.” Supposedly, U.S.-based exporters pay a tax penalty that foreign producers who sell in the U.S. do not, and the DBCFT is thus the solution. This understanding is flawed.

Proponents compare the U.S. corporate income tax to European VATs, but they ignore that these countries also have corporate income taxes, too. Only by misleadingly switching back and forth between domestic income taxes and foreign consumption taxes can it be claimed that there is not tax parity between imports and exports sold both within the U.S. and in foreign markets. Simply put, it makes no sense to complain that the U.S. does not border adjust like European nations when the reason is that the U.S. does not have a European-style VAT. To put it yet another way, you can't rebate a zero percent consumption tax.

The real source of imbalance between the U.S. and foreign governments is our excessively high corporate income tax and uniquely destructive worldwide tax system. The obvious solution to this problem is to lower the corporate income tax and move to a territorial system.

**The U.S. is Better Off Without a VAT**

VATs provide easy revenue because they are characterized by large tax bases that allow for the collection of significant revenue with only small rate hikes, while also being largely hidden from consumers. This combination helps explain why the widespread adoption of value-added taxes precipitated dramatic growth in the size of European governments, and why advocates for bigger government in the U.S. have long sought to impose such a tax here as well.

The DBCFT is very similar to a subtraction-method VAT, except in that labor compensation is deductible under the DBCFT. It's unclear, however, if the World Trade Organization would permit border adjustments on this type of tax. WTO rules distinguish between direct and indirect taxes, as border adjustments have been ruled to be allowed for the latter but not the former. And since the DBCFT is a direct tax that mimics the tax base of an indirect tax, it's not at all clear how the organization would rule should the DBCFT be challenged.

Not only would this uncertainty undermine some of the pro-growth benefits of tax reform, but an adverse ruling would almost certainly lead to the adoption of a full VAT as the most politically expedient solution. That would start the U.S. down the same path forged by our European counterparts of bigger government, higher tax burdens, and, ultimately, slower economic growth.

**Consumer Pain and Political Peril**

The DBCFT shifts much of the corporate tax burden from exporters to importers, though the former will also face higher priced inputs from their international supply chains. On its face that means consumers will take a hit. Proponents of the DBCFT claim higher costs for consumer goods will be offset by an accompanying appreciation of the dollar. Currency markets, they say, will immediately and perfectly adjust. Unfortunately, the evidence for this claim is mixed, and complications like the many foreign currencies that are pegged to the dollar leave the currency market less than perfectly efficient.

Even if currencies did entirely adjust, higher costs on consumer would remain a *perceived reality* if not an actual one. That would obviously pose an electoral challenge to lawmakers who backed tax reform, but more importantly from a policy perspective, would leave the new tax system vulnerable to demagoguery. Voters who felt they were bearing the burden of corporate tax reductions could demand that businesses pay their fair share. Advocates for bigger government and the higher taxes needed to fund it would be all to happy to offer the return of the corporate income tax, in addition to the DBCFT, to satisfy these complaints. Needless to say, such would completely undermine the entire purpose of this exercise.

**Dangers of a Destination-Based System**

A major downside of moving from an origin-based to a destination-based system that has received too little attention is the impact it would have on international tax competition. There's a reason why left-leaning economists like Alan Auerbach tout destroying tax competition as a primary feature of the DBCFT. He bragged that the DBCFT "alleviates the pressure to reduce the corporate tax rate," and would "alter fundamentally the terms of international tax competition."

Advocates for higher taxes and bigger governments understand the role that tax competition has played in discouraging excessive taxation globally. If your goal is to make it easier for governments to raise tax rates, then the DBCFT looks like a great idea. But if you want to maximize economic growth and keep political greed in check, then it's a big step in the wrong direction.

**Tax Reform Without the DBCFT**

Pro-growth tax reform should not need to be immediately and simultaneously paid for using an arbitrary and short-term budget window. The Kennedy and Reagan cuts were enacted without such constraints and the economy benefited as a result. If legislators nevertheless insist on paying for pro-growth tax cuts, the goal should be deficit rather than revenue neutrality, opening up the possibility of pairing pro-growth tax reform with much needed spending reductions.

Although some arguments have been put forward to suggest that the DBCFT is desirable in its own right, it is only being proposed as a "pay-for" to offset the provisions of tax reform that are actually pro-growth. But even if it is decided that offsets are necessary, it makes little sense to choose a bad policy to pay for tax reform when there are alternatives available that also represent good policy. Or taking another approach, the need for revenues from the DBCFT could be eliminated by removing the switch to full and immediate expensing from proposed reforms and focusing instead on competitive rate cuts and tax code simplification.

Current reform plans rightly call for the elimination of the state and local tax deduction. This is good policy because the deduction encourages states to raise their tax burdens. However, other distortion creating tax expenditures remain unchallenged, like the mortgage interest deduction, the municipal bond interest exemption, and the employer provided health care exclusion. Closing these loopholes would not only provide the means to pay for rate reductions, but would simultaneously remove costly distortions from their respective markets.

Removing the unnecessary constraint of "revenue-neutrality" would open up further pay-for alternatives to the DBCFT by allowing for spending reductions. Rather than presupposing that the government is entitled to a particular share of taxpayer dollars, the alternative "deficit-neutral" approach would recognize that true pro-growth reform requires not only fixing the tax code, but also tackling out-of-control federal spending. Rather than implementing a dangerous new government revenue stream in the form of a DBCFT, a fiscally responsible approach to reform would pair the pro-growth cuts and tax code simplification with a combination of eliminating tax distortions and cutting wasteful and counterproductive programs.

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# Comments for the Record
# United States House of Representatives
# Committee on Ways and Means and the Subcommittee on Tax Policy
# Hearing on Increasing U.S Competitiveness and Preventing American Jobs from Moving Overseas

*How Border Adjustment and Other Policies Will Boost Jobs,*
*Investment, and Growth in the U.S*

**Tuesday, May 23, 2017, 10:00 A.M.**
**1100 Longworth House Office Building**

**By Michael G. Bindner**
**Center for Fiscal Equity**

Chairmen Brady and Roskam and Ranking Members Neal and Doggett, thank you for the opportunity to submit these comments for the record to the Committee on Ways and Means and the Tax Policy Subcommittee.

These comments continue the conversation on Tax Reform over the past several years, including the most recent hearing of May 18th. Many of our comments are a restatement of those made in May of last year on Member Day on Tax Reform.

The Center offered a flurry of comments for the record during that period where Chairman Camp and his subcommittee held almost weekly hearings on tax reform, partly because tax reform was seen as a way to make lower taxes enacted by President Bush permanent, although the Republican and Democratic caucuses had differing views on whether there should be increased revenue from wealthier taxpayers, with the bipartisan Bowles-Simpson and Domenici-Rivlin commissions arguing for revenue positive reforms.

Chairman Camp offered his own comprehensive reform, which was essentially a "school solution" which lowered rates and broadened the base. The approach harkened back to the Tax Reform of 1986, although the historical model had its problems – the first being that it lowered rates on the highest taxpayers to such an extent that they had an incentive to demand labor cost savings with rewards for CEOs who accomplished that mission, leading to wage stagnation that plagues the economy even today, as well as too much money available for investment – leading ultimately to investments in home mortgages that caused the Savings and Loan crisis and the 2008 market crash. The second problem, also leading to the mortgage crisis and market crash was the deductibility of second mortgage interest, which encouraged borrowers in an ever increasing housing market to use their homes as an ATM machine. The Center for Fiscal Equity hopes that we do not go this way again.

President Obama offered solutions that year much like those of Domenici-Rivlin or Bowles-Simpson. Of course, after he secured passage of the American Tax Relief Act of 2013, which made the tax cuts for the bottom 98% of taxpayers permanent while renewing the Clinton era rates for the top 2%, all talk of tax reform ended, save for discussions of international and corporate reform, which seem to have gone nowhere until now. Let us caution that due to the number of businesses which file under the individual code, no reform that is not entirely comprehensive is appropriate.

As usual, we will preface our comments with our comprehensive four-part approach, which will provide context for our comments.

- A Value Added Tax (VAT) to fund domestic military spending and domestic discretionary spending with a rate between 10% and 13%, which makes sure very American pays something.
- Personal income surtaxes on joint and widowed filers with net annual incomes of $100,000 and single filers earning $50,000 per year to fund net interest payments, debt retirement and overseas and strategic military spending and other international spending, with graduated rates between 5% and 25%.
- Employee contributions to Old Age and Survivors Insurance (OASI) with a lower income cap, which allows for lower payment levels to wealthier retirees without making bend points more progressive.
- A VAT-like Net Business Receipts Tax (NBRT), which is essentially a subtraction VAT with additional tax expenditures for family support, health care and the private delivery of governmental services, to fund entitlement spending and replace income tax filing for most people (including people who file without paying), the corporate income tax, business tax filing through individual income

> taxes and the employer contribution to OASI, all payroll taxes for hospital insurance, disability insurance, unemployment insurance and survivors under age 60.

The proposed Destination-Based Cash Flow Tax is a compromise between those who hate the idea of a value-added tax and those who seek a better deal for workers in trade. It is not a very good idea because it does not meet World Trade Organization standards, though a VAT would. It would be simpler to adopt a VAT on the international level and it would allow an expansion of family support through an expanded child tax credit. Many in the majority party oppose a VAT for just that reason, yet call themselves pro-life, which is true hypocrisy. Indeed, a VAT with enhanced family support is the best solution anyone has found to grow the economy and increase jobs. Even then, a DBCFT is preferable to the current corporate income tax system, so what is said below about VAT is at least partially applicable to the DCBFT (with any increased subsidies for Children added to the personal income tax).

Value added taxes act as instant economic growth, as they are spur to domestic industry and its workers, who will have more money to spend. The Net Business Receipts Tax as we propose it includes a child tax credit to be paid with income of between $500 and $1000 per month. Such money will undoubtedly be spent by the families who receive it on everything from food to housing to consumer electronics.

American competitiveness is enhanced by enacting a VAT, as exporters can shed some of the burden of taxation that is now carried as a hidden export tax in the cost of their products. The NBRT will also be zero rated at the border to the extent that it is not offset by deductions and credits for health care, family support and the private delivery of governmental services.

Some oppose VATs because they see it as a money machine, however this depends on whether they are visible or not. A receipt visible VAT is as susceptible to public pressure to reduce spending as the FairTax is designed to be, however unlike the FairTax, it is harder to game. Avoiding lawful taxes by gaming the system should not be considered a conservative principle, unless conservatism is in defense of entrenched corporate interests who have the money to game the tax code.

Our VAT rate estimates are designed to fully fund non-entitlement domestic spending not otherwise offset with dedicated revenues. This makes the burden of funding government very explicit to all taxpayers. Nothing else will reduce the demand for such spending, save perceived demands from bondholders to do so – a demand that does not seem evident given their continued purchase of U.S. Treasury Notes.

Value Added Taxes can be seen as regressive because wealthier people consume less, however when used in concert with a high-income personal income tax and with some form of tax benefit to families, as we suggest as part of the NBRT, this is not the case.

The shift from an income tax based system to a primarily consumption based system will dramatically decrease participation in the personal income tax system to only the top 20% of households in terms of income. Currently, only roughly half of households pay income taxes, which is by design, as the decision has been made to favor tax policy to redistribute income over the use of direct subsidies, which have the stink of welfare. This is entirely appropriate as a way to make work pay for families, as living wage requirements without such a tax subsidy could not be sustained by small employers.

Moving the majority of Old Age and Survivors Tax collection to a consumption tax, such as the NBRT (or even a DBCFT), effectively expands the tax base to collect both wage and non-wage income while removing the cap from that income. This allows for a lower tax rate than would otherwise be possible while also increasing the basic benefit so that Medicare Part B and Part D premiums may also be increased without decreasing the income to beneficiaries.

If personal accounts are added to the system, a higher rate could be collected, however recent economic history shows that such investments are better made in insured employer voting stock rather than in unaccountable index funds, which give the Wall Street Quants too much power over the economy while further insulating ownership from management. Too much separation gives CEOs a free hand to divert income from shareholders to their own compensation through cronyism in compensation committees, as well as giving them an incentive to cut labor costs more than the economy can sustain for purposes of consumption in order to realize even greater bonuses. Employee-ownership ends the incentive to enact job-killing tax cuts on dividends and capital gains, which leads to an unsustainable demand for credit and money supply growth and eventually to economic collapse similar to the one most recently experienced.

The NBRT base is similar to a Value Added Tax (VAT), but not identical. 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.

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 choose 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 NBRT should fund services to families, including education at all levels, mental health care, disability benefits, Temporary Aid to Needy Families, Supplemental Nutrition Assistance, Medicare and Medicaid. If society acts compassionately to prisoners and shifts from punishment to treatment for mentally ill and addicted offenders, funding for these services would be from the NBRT rather than the VAT.

The NBRT could also be used to shift governmental spending from public agencies to private providers without any involvement by the government – especially if the several states adopted an identical tax structure. Either employers as donors or workers as recipients could designate that revenues that would otherwise be collected for public schools would instead fund the public or private school of their choice. Private mental health providers could be preferred on the same basis over public mental health institutions. This is a feature that is impossible with the FairTax or a VAT alone.

To extract cost savings under the NBRT, allow companies to offer services privately to both employees and retirees in exchange for a substantial tax benefit, provided that services are at least as generous as the current programs. Employers who fund catastrophic care would get an even higher benefit, with the proviso that any care so provided be superior to the care available through Medicaid. Making employers responsible for most costs and for all cost savings allows them to use some market power to get lower rates, but not so much that the free market is destroyed. Increasing Part B and Part D premiums also makes it more likely that an employer-based system will be supported by retirees.

Enacting the NBRT is probably the most promising way to decrease health care costs from their current upward spiral – as employers who would be financially responsible for this care through taxes would have a real incentive to limit spending in a way that individual taxpayers simply do not have the means or incentive to exercise. While not all employers would participate, those who do would dramatically alter the market. In addition, a kind of beneficiary exchange could be established so that participating employers might trade credits for the funding of former employees who retired elsewhere, so that no one must pay unduly for the medical costs of workers who spent the majority of their careers in the service of other employers.

Conceivably, NBRT offsets could exceed revenue. In this case, employers would receive a VAT credit.

In testimony before the Senate Budget Committee, Lawrence B. Lindsey explored the possibility of including high income taxation as a component of a Net Business Receipts Tax. The tax form could have a line on it to report income to highly paid employees and investors and pay surtaxes on that income.

The Center considered and rejected a similar option in a plan submitted to President Bush's Tax Reform Task Force, largely because you could not guarantee that the right people pay taxes. If only large dividend payments are reported, then diversified investment income might be under-taxed, as would employment income from individuals with high investment income. Under collection could, of course, be overcome by forcing high income individuals to disclose their income to their employers and investment sources – however this may make some inheritors unemployable if the employer is in charge of paying a higher tax rate. For the sake of privacy, it is preferable to leave filing responsibilities with high income individuals.

Dr. Lindsey also stated that the NBRT could be border adjustable. We agree that this is the case only to the extent that it is not a vehicle for the offsets described above, such as the child tax credit, employer sponsored health care for workers and retirees, state-level offsets for directly providing social services and personal retirement accounts. Any taxation in excess of these offsets could be made border adjustable and doing so allows the expansion of this tax to imports to the same extent as they are taxed under the VAT.

What is not needed are attempts to cut taxes on business or income to make capital more available. There is plenty of capital available now. It is not being used because demand is anemic. The last time we tried cutting capital gains tax rates to spur growth we got the tech bubble. People got capital for all sorts of projects for which there was no demand. Let us not repeat that mistake.

In the tech industry there exists the Computer-Aided Manufacturing – International Multi-Attribute Decision (MAD) Model. The first element of the model is the market. Not the stock market, but the product market. Questions of the cost of capital are buried in Return on Investment figures and are of little importance.

If a committee staffer joined a tech firm and tried to push investments because of low tax rates, he would be fired as an ideologue and sent packing back to the committee. If, however, he could promise more spending in the tech industry by the government – or even more money for social programs, then he would go far in industry. Of course, if he could get a $15 minimum wage enacted (along with the measures suggested above), which would spur pent up demand by the working class, they might make him CEO.

Let's not make the same mistakes as the late 90s. Instead, give families what they need and business will succeed beyond our wildest dreams.

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.

**Contact Sheet**

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**Committee on Ways and Means and the Subcommittee on Tax Policy**
**Hearing on Increasing U.S Competitiveness**
**and Preventing American Jobs from Moving Overseas**
**Tuesday, May 23, 2017, 10:00 A.M.**
**1100 Longworth House Office Building**

All submissions must include a list of all clients, persons and/or organizations on whose behalf the witness appears:

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.

COALITION FOR **COMPETITIVE INSURANCE RATES**

# Statement for the Record
# Submitted by the Coalition for Competitive Insurance Rates
# To
# U.S. Committee on Ways & Means
# Hearing on
# "Increasing U.S. Competitiveness and Preventing American Jobs from Moving Overseas"
# May 23, 2017

The membership of the Coalition for Competitive Insurance Rates ("CCIR"), which consists of s business organizations, consumer advocacy groups, insurers and their associations, fully supports the efforts by the President and Congress to enact reforms to the U.S. tax system that will lower tax rates and produce a more competitive and rational international tax regime. CCIR appreciates the opportunity to submit this statement for the record in support of maintaining full deductibility of all reinsurance premiums paid by U.S. companies to foreign affiliates or non-affiliates in conjunction with the U.S. Committee on Ways and Means' hearing on "Increasing U.S. Competitiveness and Preventing American Jobs from Moving Overseas."

CCIR has serious concerns about the potential application to insurance and reinsurance transactions of the Border Adjustment proposal (i.e. border adjustment tax or BAT) that is a feature of the House Republican Blueprint for Comprehensive Tax Reform. Foreign-based reinsurers play an important role in the U.S. economy by helping U.S. property owners recover and rebuild when catastrophe strikes. Foreign insurers have provided substantial support following recent disasters, paying nearly 50 percent of the estimated $19 billion in losses incurred from Hurricane Sandy; an estimated 85 percent of privately insured crop losses resulting from the 2012 drought (approximately $1.2 billion); and, in the aftermath of the 2001 terrorist attacks on New York, international insurance and reinsurance firms paid 64 percent of the estimated $27 billion in U.S. payouts for the claims.

CCIR urges the Ways & Means Committee to take the information set forth below into account if it considers any BAT-style proposals that would treat commercial insurance and reinsurance transactions as an import of a service that would result in the denial of the deduction for premiums paid for insurance or reinsurance acquired from non-U.S. insurance and reinsurance companies. Such proposals would have serious negative consequences on the U.S. insurance and reinsurance market as the expense of U.S. consumers.

## The House Republican Blueprint and the BAT

The Blueprint released in June 2016 does not provide sufficient details to determine the tax treatment of cross border insurance and reinsurance under the BAT proposal that would tax imports and provide for tax-free exports. It is our understanding that the authors of the Blueprint intended that the BAT apply to services as well as goods, but we also understand that the application of the BAT to financial services is a design issue -- the final details of which are still being developed. If policymakers were to follow the design of most other border adjustable tax systems imposed globally, generally through value added taxes, they would exempt such services from the BAT as most countries that impose VAT or GST taxes do not apply those taxes to insurance or reinsurance.

However, should legislation implementing the Blueprint impose a new tax on all cross-border reinsurance transactions, the distortions to the U.S. insurance markets could be devastating to U.S. consumers—according to a report issued by the Brattle Group, a leading economic consultancy:

- At the low end a 20 percent reduction in reinsurance would lead to a $15.6 billion drop in the supply of U.S. insurance. U.S. consumers would annually pay $8.4 billion more in higher insurance premiums to obtain the same coverage.
- At the high end, an 80 percent reduction in reinsurance would lead to a $69.3 billion drop in the supply of U.S. insurance. U.S. consumers would annually pay $37.4 billion more in higher insurance premiums to obtain the same coverage.

In further analysis of the potential impact of the BAT on consumers, R Street Institute scholars analyzed how a decrease in the supply of international reinsurance would impact property insurance premiums paid by consumers in states prone to natural catastrophe, specifically Texas, Louisiana, and North Carolina. Another study, completed by Florida Tax Watch, examined the impact of a BAT on policyholders in the Sunshine State. The results have been sobering:

- A BAT set at 20 percent would increase the cost of property-casualty insurance in Texas by $3.4 billion over the next ten years; in Louisiana, it would result in an increase of $1.1 billion over ten years; and, in North Carolina, it would result in an increase of $800 million over ten years.
- Most striking is the impact a BAT set at 20 percent would have on Florida. Research indicates premiums would need to increase between $1.4 and $2.6 billion *annually* simply to maintain coverage as it exists today.

R Street noted: "Deep and liquid global reinsurance markets are a vital component of the nation's approach to risk transfer. Having access to international reinsurance capital keeps insurance rates affordable and allows consumers to protect themselves without burdening fellow taxpayers. Our research indicates that virtually any scenario in which a BAT set at a rate of 20 percent were levied on the import of insurance or reinsurance would have significant negative effects for policyholders. Insurance, and the financial services sector as a whole, benefit from the ready availability of international capital. Policy developments limiting the availability of such capital produce a cascade of negative effects for Americans across the country and from all walks of life."[1]

**Keep Disaster at Bay. Keep Insurance Competitive.**

Reinsurance plays a vital role in spreading risk in the global marketplace. *All* insurance companies, U.S.-based and foreign-based, utilize reinsurance in order to most efficiently and safely pool catastrophic and other risks and match capital to support those risks. Such pooling

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[1] R Street Institute. www.Rstreet.org. Impact of a border adjustment tax on the North Carolina Insurance Market, May 17, 2017; Impact of a border adjustment tax on the Louisiana Insurance Market, May 4, 2017; Impact of a border adjustment tax on the Texas insurance market, April 27, 2017; Policy studies by Dr. Lars Powell.

diversifies risk into a global portfolio providing substantial price and capacity benefits to insurance markets globally.

The BAT is designed to put the United States on a level footing with much of the rest of the world that imposes border adjustable consumption taxes. However, since most of the world excludes cross-border insurance and reinsurance from their VAT systems, application of the BAT to reinsurance would seem to be unnecessary and counterproductive. It would not follow the global best practices for a VAT/GST and could cause major disruptions in the U.S. reinsurance markets impacting the amount of affordable reinsurance available.

Reinsurance is the backbone of the safety net that U.S. businesses and consumers depend on to help rebuild when disaster strikes, and they rely on an efficient and stable global reinsurance market that provides access to affordable reinsurance. There is no reason why a policymaker would have chosen to compel Gulf Coast policyholders and U.S. investors to shoulder the entire costs of Hurricane Katrina – sharing these losses with global shareholders affords better benefits in lower prices and more competitive insurance markets to U.S. consumers.

We urge you to maintain the current law treatment of deductions for reinsurance premiums paid by U.S. companies to foreign insurers, reinsurers or their affiliates.

Sincerely yours,

Tom Feeney
President and CEO of the Associated Industries of Florida and former member of Congress (FL)
On behalf of the Coalition for Competitive Insurance Rates

◆

Columbia
Sportswear Company

May 19, 2017

The Honorable Kevin Brady
Chairman
Committee on Ways and Means
1102 Longworth House Office Building
Washington, DC 20515

The Honorable Peter Roskam
Chairman
Committee on Ways and Means
Subcommittee on Tax Policy
1102 Longworth House Office Building
Washington, DC 20515

Dear Chairman Brady and Chairman Roskam:

I write today on behalf Columbia Sportswear Company, which was founded by my family in 1938 in Portland, Oregon. Columbia is still based in Portland, but from what was a small hat company we have become a significant contributor to the U.S. and global economies, supporting thousands of high paying jobs and selling high quality apparel and footwear to keep our customers warm, dry, cool, and protected the world over.

For the past several months, we have engaged with the Congress – indeed with the Ways & Means Committee – regarding the opportunity to reform our country's outdated tax code. In particular, Columbia has become very concerned with the border adjustment proposal described in the *Better Way* tax reform "Blueprint" unveiled by the Speaker last year.

But before detailing those concerns, I would like to give you more context about Columbia. My mother, now Columbia Chairman, Gert Boyle's parents fled Nazi Germany with their young family in 1937 and settled in Portland, Oregon. In 1938, they purchased a small Portland hat company and named it Columbia Hat Company after the mighty river that flowed through their new home. This humble beginning was of huge significance to our family, marking new-found freedom and a fresh start. My father eventually led the company until he died suddenly in 1970, leaving my mother to demonstrate her Tough Mother character, going from housewife to executive overnight.

Today, I preside over a $2.4 billion global business that ranks among the FORTUNE 1000. The company has over 4,300 U.S. employees in more than 40 states, as well as more than 1,700 employees across Asia, Europe and Canada. The company's products are sold in nearly 100 countries, manufactured in 17 countries, and connect people everywhere with their passion to live active, healthy, outdoor lifestyles.

Those jobs in the U.S. depend upon a supply chain the near entirety of which left this country long ago and has continued to move around globe, seeking manufacturing costs to produce quality goods for which Americans are willing to pay. Some have made well intentioned claims about moving parts of the supply chain back to our shores, but those claims depend upon near total automation that is likely not possible for decades at any useful scale.

Even if only coincidental, it is notable that Columbia was started as the U.S. was still digging out of the Great Depression given that remnants of the Great Depression-exacerbating Smoot-Hawley Tariff Act still apply to apparel and footwear imports. Columbia pays double digit tariffs on imports into the U.S., making it the 49th highest duty payer out of 375,000 importers. I assure you that Columbia is not nearly the 49th highest importer by dollar value. One need look no further for proof that such manufacturing will not move back to our shores.

Given these dynamics, we believe that the border adjustment proposal, as we understand it, would be devastating to the apparel business and the domestic jobs it supports, American consumers, or both. Based on our modeling, we believe it would significantly raise our effective tax rate, even if the corporate rate were reduced to 20 percent. We believe this would lead to significantly higher consumer prices, and that is on top of the current import taxes.

Again, unlike other industries that may have an opportunity to move their supply chains into the U.S. and avoid the significant blow of border adjustment, Columbia and other retailers must settle for another economic reality that trades overseas manufacturing for thousands of very good paying technical and creative jobs in the U.S.

In addition, our team of tax, trade, and currency professionals have worked through the putative benefits to importers that would come as the result of a strengthened dollar. In sum, we do not believe to any requisite certainty that such an adjustment would occur, but even if it did, there are several problems with our business model that are likely similar to other retailers and perhaps businesses in other sectors. First, we transact with our foreign partners and contractors exclusively in U.S. dollars, essentially eliminating any relative advantage that would come from such a strengthening of the currency. Second, we now derive a significant portion of total revenue from overseas sales. A strengthened dollar would do nothing but limit those customers from purchasing our products.

It is difficult to think of how a border adjustment tax, when applied to the apparel and footwear business, could result in anything other than significantly increased prices for consumers. As I understand it, this is true of retail as a whole. We do appreciate your work on tax reform as a general matter. Simplification, fairness, and efficacious administration are sorely missing from our current code and regulations. Columbia is very appreciative of the time we have been able to spend with Committee staff and we will endeavor to remain engaged and collaborative as this process moves forward. Thank you again for your service and that of your colleagues.

Sincerely,

Tim Boyle

Chief Executive Officer

cc: The Honorable Richard Neal
Ranking Member
Committee on Ways and Means
1102 Longworth House Office Building
Washington, DC 20515

The Honorable Lloyd Doggett
Ranking Member
Committee on Ways and Means
Subcommittee on Tax Policy
1102 Longworth House Office Building

# Hearing on How Tax Reform Will Grow Our Economy and Create Jobs

## Statement of the Committee for Economic Development Of The Conference Board

Although Washington's ability to drive the $18 trillion US economy is easy to exaggerate, a major change in the US income tax system may be the most economically consequential step that Washington can take—for good or ill. Today, the greatest interest and emphasis lie in the debate over the corporate income tax. Companies are struggling to generate pennies of income and save pennies of expense to remain globally competitive, so corporate tax reform matters—for economic growth, budget sustainability, and perceptions of fairness.

### CED's Recommendations: Summary

Corporate tax policy changes can affect the well-being of businesses, and the economy as a whole, for good or ill. Radical change—notably different systems that collect approximately the same amount of revenue but in a dramatically different way—can cause such severe dislocation and even failure for so many businesses that it would disrupt the entire economy. In addition, the nation's public debt has grown so large that major changes in tax policy must not worsen that critical problem. CED recommends steady, rather than radical, change that does not worsen the federal budget deficit. The principal components of our approach are:

1. Eliminate corporate tax preferences.
2. Eliminate the corporate alternative minimum tax (AMT).
3. Reduce the statutory corporate tax rate as much as possible, consistent with maintaining revenue.
4. Maintain the general current-law treatment of pass-through entities.
5. Maintain the current system of deferral of taxation of profits of US-based multinational corporations.

### *The US Corporate Income Tax: Today and Yesterday*

Over time, the vital signs of the US corporate income tax have fluctuated significantly. As one key indicator, corporate income tax revenue as a share of total federal revenue has generally declined from more than 30 percent in 1954 to barely 10 percent today.

Similarly, corporate income tax revenue as a share of gross domestic product (GDP) was almost 6 percent shortly after World War II and then fell as low as 1 percent in the early 1980s. Since then, revenue has been below 2 percent of GDP in most years. But this pattern in corporate tax revenue generally has not mirrored trends in corporate profits, or their share in the economy. Corporate profits as a share of gross domestic income (GDI) did decline over the post-World War II years into the early 1980s, but they have since recovered almost to their original level.

Corporate income tax revenue has not recovered in step with corporate profits for several reasons—five of which are highly pertinent to the current debate.

**1. Use of "pass-through entities."** In 1980, Subchapter C corporations—corporations subject to the corporate income tax—accounted for more than 90 percent of the net income attributable to all corporations. The balance of income received by corporations was reported by various forms of "pass-through entities," which were taxed only under the individual income tax and offer limited personal liability and simplicity of organization.

Following several changes to the tax law since 1980, the Subchapter C share of net income attributable to all corporations generally has declined. Since the late 1990s, Subchapter C corporations generally have accounted for just over half of all net corporate income in the United States. In 2008, during the worst of the financial crisis, the share dropped to less than 37 percent.

Thus, *corporate income tax revenue* has lagged relative to the overall economy, but *income tax revenue from corporations* most certainly has not. In effect, income that was once taxed as corporate income still is taxed, but as individual income. The difference lies in the growing use of pass-through entities to take advantage of limited personal liability and certain advantages of simplicity of creation and organization, but also in part to avoid paying the additional layer of corporate tax. Particularly following the Tax Reform Act of 1986, which reduced individual income tax rates and therefore made the pass-through form more attractive, there have been changes in law and regulations to simplify and permit expanded use of these pass-through entities. And their use has indeed expanded.

**2. Globalization.** The development and growth of pass-through entities could have occurred even if the United States were a totally closed economy. But other causes of deterioration in corporate income tax revenues were driven in whole or in part by our economy's growing globalization.

US technological leadership led to high-value production in the United States for export. Both US imports and exports (including service exports, facilitated by instantaneous electronic communication) grew enormously as a result. Elaborate supply chains, in which complex components produced in the United States are cross-shipped to other countries for lower-value, simpler assembly, have pushed this globalization still further. Measured relative to the low levels of post-World War II (pre-1970s) America, US trade as a share of our total economic activity has tripled, and a growing share of US corporate profit is earned overseas—which itself has reduced the share of profits of US multinational corporations that is immediately subject to tax. The direct and inevitable result of this growing globalization is that national economies and income tax systems interact much more today than they did several decades ago.

**3. Tax preferences.** Tax provisions providing selective relief for businesses—such as particular industries, lines of business, or business locations—deplete tax bases and distort the allocation of scarce economic resources. Such legal or regulatory provisions are often referred to as "tax expenditures." Such tax preferences are primarily responsible for the sometimes wide divergence of "effective tax rates" (the percentage of profit paid in tax) among corporations in different industries.

Tax expenditures are taken by some as evidence of "crony capitalism." That is, preferential provisions for select firms are alleged to be favoritism—a diversion of funds from the federal Treasury into the coffers of the politically connected. Such unjustified tax preferences are demoralizing to the body politic and can corrode our nation's public life. Other critics argue that, whatever merit they might have had previously, many (if not all) preferential provisions have become obsolete, and, though designed to incentivize, they have evolved into inefficient subsidies, providing additional and unnecessary profit ("rents") rather than a necessary inducement to invest.

US tax experts have concluded that total elimination of all US tax preferences for corporations would reduce the corporate income tax rate on a strictly revenue-neutral basis from its current 35 percent to about 28 percent—a substantial change in terms of the amount of tax on a marginal dollar of profit, coming much closer to the middle range of OECD statutory tax rates, but less of a reduction than some US policymakers now seek. Deeper rate reduction would require greater deficit reduction from other sources, such as tax law or spending changes or economic growth, to avoid adding to the federal deficit, which is already excessive.

**4. Intangible assets.** Another fundamental change in the economic environment that significantly has affected the performance of corporate income taxes both in the US and globally is intangible assets, which have become a better-identified and larger component of the corporate balance sheet. Intangible assets include intellectual property (e.g., patents, copyrights, or research and development), computerized information, and goodwill. Although the value in broad terms of intangible capital is undeniable, its precise monetary value and physical location are, to a considerable degree, unknowable or arbitrary. This creates challenges for the taxation of its return to the firm.

**5. International tax competition.** Yet another issue in corporate taxation is the ongoing tax competition among developed nations. One view is that competition among nations as taxing jurisdictions spurs innovation and growth. But some policy observers believe that some nations attempt to achieve competitive advantage through clever legal language, not by creating a better, more productive environment for economic growth. Such language offers businesses tax savings by moving *income recognition* rather than the *production* that actually generates that income. This kind of maneuver, observers believe, unavoidably encourages a "race to the bottom" in which all nations lose some of their ability to raise revenue.

## The US Federal Budget Deficit

An issue lurking around this entire US corporate tax debate is the federal budget deficit. As CED has reminded many times since the 1980s, the federal budget is on an unsustainable path. After a few brief months of respite in the middle of this decade, the federal debt is set to resume a growth rate significantly faster than that of the economy (out of which that debt must be serviced). In other words, the nation's debt-to-GDP ratio is rising, and that cannot go on without eventual severe adverse consequences. Although the corporate income tax is not a major contributor to federal revenue, the current federal debt requires that corporate tax reform must not leave the overall budget problem even worse than it is today.

### Three Broad Policy Alternatives

The enduring objectives of tax policy—which CED shares—are economic efficiency, fairness, simplicity, and revenue sufficiency. For corporations, economic efficiency means an allocation of capital and other economic resources according to value in the marketplace, not political influence or other criteria. Fairness in the corporate-tax context flows from economic efficiency, which is to say that investors who follow true economic value should be rewarded. Simplicity requires not only ease of compliance, but also ease of choosing business strategy; a tax code that interferes with market forces will impose additional and unproductive criteria onto business strategy making. Revenue sufficiency has been a much-ignored criterion of tax policy over the last several decades, but CED has formulated all of its policy recommendations with fiscal sustainability in mind.

From that perspective, we consider several of the big-picture choices that the nation must make to achieve meaningful tax reform.

#### 1. The "worldwide" versus the "territorial" corporate tax model

The United States persists with a corporate tax model that the rest of the world has abandoned: a so-called worldwide or "residence-based" tax. Under this model, US multinational firms pay income tax in the countries in which they operate, but also pay tax domestically, having received a credit for the foreign taxes that they paid. Thus, US firms wind up paying no more than the US rate, which they would have paid if they kept operations within the United States. So our corporate tax offers US firms the option to operate in the United States or overseas and face the same tax rate either way. The US corporate tax on foreign earnings is not due until that income is repatriated—that is, until it is brought back to the United States. This allows a benefit of tax deferral, during which period the profits can earn the time value of money. The deferral period can be quite long if the firm invests those profits in continued and expanded operations overseas.

However, other developed nations use a "territorial" tax model, under which their firms pay tax only where income is earned. So, for example, a German firm operating in France would pay French tax, not German tax, on the portion of its income earned in France.

US multinational corporations have contended about our nation's worldwide tax approach, and their behavior has made that complaint tangible. Because the US statutory corporate income tax rate is the highest in the developed world, US corporations invariably face an income tax liability if or when they repatriate their foreign earnings, even with the benefit of the foreign tax credit. Responding to that prospective tax bill, many US firms have held or invested their foreign profits overseas. The total of those overseas balances has been estimated at $2.5 trillion as of 2016.

Firms contend that they have been deterred from repatriating and reinvesting overseas balances in the United States by the tax liability that would be due upon repatriation. These firms and some economists have expressed concern that holding these profits overseas reduces investment and job creation in the United States. Therefore, they argue for a permanent (or at least a temporary) preferential rate on repatriated earnings. Their preferred outcome probably would be to eliminate the US tax on foreign earnings of multinationals permanently—that is, adopting a territorial tax system that is used by all other developed countries.

That general approach has strong support, but it is not universally accepted. There are different degrees of movement toward a territorial system that raise somewhat different potential benefits— and concerns.

One approach, a **temporary and voluntary repatriation "holiday"** at a preferential rate, would encourage the return of overseas holdings of corporate earnings. This would make funds flow to their preferred uses, gradually making their way through demand, consumption, and financial markets into a more robust economic expansion. It is on that basis that a repatriation holiday should compete with alternative public policy steps.

Some argue that such a holiday would result in a leap of domestic corporate investment—in physical plant, equipment, and intellectual capital. But the proceeds likely would be used for paying dividends or buying back outstanding corporate stock, not for investment. Analyses of past repatriation holidays have indicated that, despite supposed requirements that overseas funds repatriated at preferential rates be reinvested, the fungibility of money has won out and the additional after-tax cash flow was ultimately directed to dividend payments and stock buybacks. Some would contend that these are attractive uses of the funds.

Others argue that no one-time holiday would likely motivate any long-term program of investment—for the simple reason that it provides only a one-time increase in US cash flow. The temporary nature of the holiday would, by definition, inhibit change in long-term investment behavior because it would produce no change in the cost of capital. So no one-time repatriation holiday is likely to provide a long-lived bonus of investment and economic growth.

Some corporate tax proposals have followed a different tack and contemplated **mandatory repatriation** on all current overseas balances, sometimes as part of a transition to a fundamentally different system, and generally at a reduced (but non-zero) tax rate. However, some firms surely would protest. Chief among them likely would be US corporations that reinvested their earnings overseas so that they could better service foreign markets, or where their growth prospects are international. (In other instances, surely, US firms have engaged in "off shoring" to re-import their foreign production.) These firms may have expected to use those earnings overseas over long periods of time to become more competitive globally. A mandatory repatriation would violate the expectations of such US-based corporations that they could continue to invest their overseas earnings to improve their overseas operations. They will argue that this unexpected tax will make them less globally competitive and that the surprise element of the tax will aggravate the impact. It also could encourage preemptive "inversions" or sales to foreign companies.

There is the further and much more structural option of **changing the US worldwide system into a territorial system permanently**, thereby allowing foreign earnings to be permanently tax free.

To some firms, this option would be extremely attractive. But the applications of territorial systems by other countries are far from uniform. Other nations, for example, do not passively cede to their competitor nations the power to tax whatever share of the income that corporations deem “foreign.” There are “controlled foreign corporation” rules, “transfer pricing” rules, rules related to intra-corporation financial transactions aimed at the deductibility of interest (“thin capitalization” rules), and other rules to prevent domestic income from fleeing to foreign tax systems with lower tax rates.

A pure US territorial system, however, relative to the current worldwide system and so long as the United States continues to have the highest statutory corporate tax rate, could make it cheaper to repatriate *past* foreign profits to the United States. (It is to recapture some of these tax savings for multinational firms that many such proposals would impose a mandatory repatriation, albeit at a reduced rate.) At the same time, however, a territorial system could encourage US firms to make future investments in, and move their intangible capital and their income to, other nations with lower statutory tax rates. Thus, it would be much better to reduce the US statutory rate.

### 2. A Destination-Based Cash-Flow Tax

Yet another option, much more recently developed, is most often called a destination-based cash-flow tax (DBCFT). It would be a replacement for the entire current corporate income tax. The DBCFT would be a single-rate tax on cash receipts, less current costs of labor, materials, etc., and the total cost of all investment (“expensing”—no delay for depreciation deductions), but, unlike the current income tax, with no deduction for interest paid. And very much unlike the current income tax, the tax attributable to exports would be rebated at the border, and a corresponding tax calculated for imports would be imposed when they cross the border. (This would be done by deducting receipts from exports and by disallowing deductions for the costs of foreign purchases.) This structure is aimed squarely at current concerns about the implications of our corporate income tax for international competitiveness and trade. By taxing imports and exempting exports, the DBCFT is thought by some to be— potentially—an effective weapon to increase the competitiveness of US products on world markets and domestically, as well.

A further potential advantage of the DBCFT is that the border rebate would be available only to domestic production. Therefore, the tax on US- produced goods bound for other markets would be nullified by the border adjustment, and there would be no ostensible incentive to seek out a foreign tax haven for production destined for third markets.

However, there are several complications with a DBCFT. One is that the mere imposition of a border-adjustable tax does not necessarily make a nation more competitive in trade. Economists expect that, starting from the equilibrium conditions of the market at the time of the tax’s inception, such a tax would cause the value of the tax-imposing nation’s currency to appreciate to restore the previous equilibrium terms of trade. In the case of the United States, a higher value of the dollar would make US exports more expensive again, while returning the prices of imports into the United States to their previous lower level. To be sure, there are financial market influences, as well as trade (goods/services market) influences on the exchange value of the dollar. But there is no denying that some of the first-round benefits of the DBCFT would be lost to the foreign exchange markets.

Some US manufacturers use foreign goods as inputs to their products and have expressed concern that taxing imports would reduce their competitiveness. Retailers of foreign products have voiced the same concern. In response, some DBCFT advocates have tried to reassure these businesses that the value of the dollar will rise and restore their purchasing power with respect to imports, thereby holding them harmless. But if the dollar rises for the imports these manufacturers buy, it necessarily rises for all other US purchasers of imports, who were supposed to be deterred from buying imports because of that same border adjustment. And the dollar necessarily would rise as well for all foreign purchasers of our exports, who were supposed to be enticed to buy US goods because of the border adjustment. So this reassurance would seem to undercut the entire trade- competitiveness rationale of the proposal.

Another selling point for the DBCFT to businesses and some policymakers is that it has been proposed with “expensing” (immediate full deduction) for all investment costs (which others have proposed as a separate step under our current income tax). The current income tax allows only depreciation of investment expenses—that is, deduction in annual installments based approximately upon the investment’s anticipated useful life. To many businesses and some policymakers, this is an extremely attractive feature. However, expensing can only be justified by eliminating the deduction for interest expense. Of course, many US businesses, particularly smaller businesses that cannot readily sell stock to finance investments or purchases of inventory, rely heavily on borrowed money and, therefore, on the deductibility of interest expense. Eliminating deductibility could very well render many such businesses non-viable.

Yet another question mark hanging over the DBCFT is in regards to international trade law. International trade agreements allow border adjustments for consumption taxes. The DBCFT will likely be represented to the international trade authorities and to our trading partners as a consumption tax so that it can be border adjusted.

But for domestic political purposes, it is being marketed as a (corporate) income tax, which to be politically acceptable must allow firms to deduct wages paid. However, almost by definition, a consumption tax does not allow a deduction for wages paid. This puts the DBCFT on the horns of a dilemma: if it is put forward with a deduction for wages, it very likely will be ruled ineligible for the border adjustment that is essential to make it effective and attractive. Should it be ruled to be legally border-adjustable, however, then we can expect other nations to replace their corporate income taxes with DBCFTs in the very near future. Although some advocate adopting the DBCFT as a trade advantage, it is not certain whether the United States will gain or lose competiveness under that scenario; it will depend upon the terms of the DBCFTs that other nations adopt, including their tax rates.

A critical assessment of the DBCFT might be that its motivation is either random or opportunistic. There is no obvious economic reason why the US should choose a quantum tax-system change that bears much more heavily on US production that involves foreign value added (which includes sectors that are high-wage, high-value, and high- tech) and favors purely US production (which tends to be low value-added). There are perhaps two systematic reasons: One, the US happens to currently run a large trade deficit and therefore can collect substantial additional revenue (an estimated $1 trillion over 10 years) by taxing imports more than exports. Two, there is a strong popular sentiment against trade—as has been common in our modern history whenever the US economy has been perceived to perform poorly. Neither of these motivations would seem a sound basis for quantum choices about permanent US tax policy.

To export successfully, a nation must import. That is especially true in today's world of complex (but economically efficient) supply chains that can cross multiple borders, even several times each, before goods ultimately reach the consumer (and, notably, US consumers). A DBCFT could well leave both US producers less competitive and US consumers worse off after all effects are fully felt. Still, the debate over the DBCFT reflects a concern that US business is playing on a tilted field and that, under the current system, US corporations are incented to invest elsewhere, engage in "inversions" and other transfers of ownership, and otherwise find ways to compete more successfully in the global marketplace. Proposals to shift to a territorial corporate tax system or to a DBCFT are two attempts to "normalize" policy to encourage firms to invest and produce in the United States.

### 3. A 1986-style tax reform

Another broad general path toward better corporate tax policy is change along the lines of the Tax Reform Act of 1986. This Act eliminated a number of significant corporate tax preferences and used the proceeds to reduce the statutory corporate tax rate. After its enactment, the United States had one of the lowest statutory corporate tax rates in the developed world. Since that time, the United States has increased its statutory corporate tax rate by one percentage point, while other nations have outdone us in statutory rate reduction, leaving us with the highest statutory rate in the OECD.

An aggressive repeat of the 1986 tax reform could achieve substantial rate reduction (from the current 35 percent to perhaps 28 percent) without losing revenue. However, at this time, there are not enough remaining corporate tax preferences to repeal that could achieve a statutory corporate tax rate below that of our international competitors without losing revenue. Thus, given the United States' dire need to achieve fiscal sustainability (which is high among CED's policy objectives), the nation would need to find additional budget savings if policymakers were to insist on a corporate tax rate below approximately 28 percent.

However, policymakers should keep in mind that, while tax rates matter, not all business activity has moved to the developed nation with the lowest corporate tax rate. There are sound business reasons to locate production close to a business's target market. Proximity reduces transportation costs. If such a location gives proximity to talented labor and natural resources, including low energy costs and efficient regulation, so much the better. And nearness to the sales market always allows a better understanding of and quicker and more accurate response to the wishes of the customer. Thus, the corporate tax rate is only one factor in business location decisions, and the United States will be a highly attractive location if we have a competitive—even if not the lowest—tax rate.

## *CED Recommendations*

There is no silver bullet by which corporate tax reform can simultaneously maximize all of the stated objectives; trade-offs are unavoidable.

History is replete with proposals of radical new tax ideas that have been argued to have enormous advantages. But there is an inherent limitation to all such alleged great leaps forward. Except for highly unusual circumstances of fiscal plenty, any such new tax must generally collect as much revenue as the tax it replaces. Collecting the same amount of tax in a radically different way is likely to create many happy winners and just as many unhappy losers. But perhaps even more important, in a truly radical tax change, the economic enterprises that are the worst losers may not be able to survive, which would have broader economic consequences. Policymakers should consider the potential fallout of such dislocation carefully, along with the important role in economic growth of simple deficit reduction.

In this spirit, CED has recommended incremental, but significant, reform:

1. **Eliminate corporate tax preferences.** This would level the playing field across different types of firms, allocate capital more efficiently, and facilitate economic growth.

2. **Eliminate the corporate alternative minimum tax (AMT)**. The corporate AMT was designed to prevent profitable corporations from paying zero or near-zero income taxes *in any single year*. The number and importance of true tax preferences that are potentially washed out by the corporate AMT is very small. Rather, the corporate AMT has become more of a timing device. A firm that undertakes a large investment in a particular year may have substantial depreciation deductions in that and a few succeeding years. In our view, forcing that firm to pay more in corporate income taxes in those few years, and then giving the suspended depreciation deductions back in later years, serves no enduring purpose. The same can be said of suspending operating losses if a profitable firm happens to have a few bad years. The incentives for firms to manipulate the timing of their investments to avoid falling prey to the AMT likewise serve no economic and social purpose. We believe that any genuine tax preferences that are appropriately included in the AMT would better be eliminated outright for purposes of the ordinary corporate income tax, with the revenue gained applied to general corporate tax rate reduction.
3. **Reduce the statutory corporate tax rate as much as possible, while maintaining current revenue levels.** The lower the statutory corporate income tax rate, the greater the attractiveness of earning profits in the United States. The lower the statutory tax rate, the less the economic distortion caused by any remaining tax preferences and the less the difference between the tax charged on any ordinary income and that on any preferred uses.
4. **Maintain the general current-law treatment of pass-through entities.** With lower and equal statutory corporate and top-bracket individual tax rates (given that much of the income from pass-through entities is taxed at the highest individual rate), the potential for manipulation of either form could be minimized with sound regulation and administration.
5. **Maintain the current deferral of taxation of profits of US-based multinational corporations, and the foreign tax credit when those profits are repatriated.** Conversion to a territorial system has strong support. However, the revenue loss that would accompany a true territorial system is problematic. The nation's deficit must be controlled or a debt problem or crisis at some future date (though not necessarily an imminent date) is inevitable. Therefore, we recommend continuation of the deferral

system as an appropriate compensation for US-based firms that compete with other firms operating under territorial systems. We note especially that, with substantial reduction of the US statutory corporate tax rate (for example, the Bipartisan Policy Center's Debt Reduction Task Force recommended a reduction to 27 or 28 percent), the difference from the statutory tax rates of our major trading partners will be much reduced and the significance of the entire issue of taxation of foreign profits will be commensurately smaller. If policymakers choose a territorial tax system as a high priority, then some additional sources of budget savings will be essential. The deficit problem looms so large that good options already may be scarce. Policymakers would need to consider new revenue sources and spending cuts to make room for a territorial system in our nation's fiscal future.

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# Why the Border Adjustment Tax is Bad for America

**May 22, 2017**

**Gary Shapiro, President and CEO, Consumer Technology Association (CTA)**

The House Ways and Means Committee will meet Tuesday for a hearing about the proposed Border Adjustment Tax (BAT), which could impose a 20 percent tax on goods imported into the United States and, in turn, raise consumer prices nationwide.

Commonly referred to as the BAT, the proposal lacks support in both the House and Senate – and for good reason. It would have a devastating impact on American families, who, on average, would have to pay at least $1,700 more every year for necessities such as food, clothing, prescription drugs and gasoline – a massive tax hike robbing consumers of $1 trillion over the next decade.

This unpopular proposal would also have a disproportionately negative impact on U.S. retailers, our nation's largest private sector employer. If the BAT were to become law, many businesses' tax bills would outpace what the average consumer could afford. That would ultimately shutter some businesses and put 42 million American jobs at risk, hampering local economies and shortchanging the national economy by reducing growth and opportunities.

The BAT is more than a waste of government time and resources – it's a bad proposal that would throttle our economy and weaken its potential instead of strengthening it. President Reagan's Economic Policy Advisory Board Member Arthur Laffer called the BAT "a major mistake," adding, "It's a huge bureaucratic mess, to be honest with you...don't touch a border tax adjustment. It makes no sense."

Mercatus Center Senior Research Fellow Daniel Griswold said the BAT would likely be challenged by the World Trade Organization, and could result in retaliatory tariffs against U.S. exports. "U.S. manufacturing exports will suffer," Griswold wrote. "We'll lose good-paying jobs making jet engines and computers for export in exchange for lower-paying jobs making sneakers, t-shirts, and bouncy balls. That is not a formula for national greatness."

Instead of destabilizing the American economy and making life harder for American families, we should be protecting jobs and ensuring that innovators have what they need to build and develop tomorrow's technologies and solutions. We need proposals that will strengthen our country's competitiveness in the global market.

We cannot afford to pursue a proposal that is this bad for American families and businesses. The U.S. is long overdue for a corporate tax overhaul. But reform must not come at the expense of the working class. Let's focus on solutions that foster robust job creation, economic growth and innovation – rather than stifling America's potential.

The Consumer Technology Association is a member of the Coalition of Americans for Affordable Products. Visit the Coalition of Americans for Affordable Products to learn more about why BAT is bad for America, and contact your Member of Congress to ask them to oppose BAT.

*Gary Shapiro is president and CEO of the Consumer Technology Association, the U.S. trade association representing more than 2,200 consumer technology companies.*

# Statement for the Record

## House Committee on Ways and Means

Hearing on

## Increasing U.S. Competitiveness
## and
## Preventing American Jobs from Moving Overseas.

May 23 2017

Submitted by
Eric Blackledge
For the National Small Business Network

**The "Border Adjusted Cash Flow Tax" (BACFT) has been promoted as a way to "prevent jobs from moving overseas", but if adopted it would do exactly the opposite.**

The proposal, which would prevent US resellers from deducting their cost-of-goods-sold on foreign products or components, is unworkable and would devastate the US retail economy. The change would essentially add a new cost burden on all US tax nexus businesses, at their marginal federal and state income tax rate on all items they import for resale. Smaller US retailers who sell foreign produced goods, but do not directly import them, would also face significantly higher costs from their distributors who would have to pass along the high tax penalty cost. US manufacturers who use imported components and raw materials would also have some cost impacts.

Because end user consumers and non-business organizations cannot deduct the cost of consumption purchases, they can easily avoid this extra cost impact by purchasing directly from a non-US tax nexus internet seller in Canada, Mexico, Europe or Asia. Foreign sellers would probably also not collect the typical 3% - 9% state sales taxes which even many US internet sellers regularly evade. As a result, a BACFT would create a permanent 25% to 45% cost disadvantage against foreign direct sellers that US retailers and distributors could never overcome. Because of the high percentage of foreign produced goods sold in the US, this would quickly put most US retailers out of business. It would also cause a loss of tens of millions of US retail and distribution jobs, and the loss of trillions of dollars in tax revenue. All the necessary internet sales technologies and direct to consumer distribution systems, for both small and large items, already exist for foreign sellers to use. Exhibit 1 compares the probable average minimum sustainable selling price to US consumers for large physical store or internet retailers, smaller US s who purchase from wholesale distributors, and foreign direct shipping retailers assuming average financial ratios.

| Exhibit 1 | US Direct Import Retailer | US Indirect Retailer | Canadian Internet Direct Retailer |
|---|---|---|---|
| Actual landed cost of goods to Distribution Center | $1000 | $1000 | $1000 |
| Added tax cost of BAT at 25% tax rate | $250 | $250 | |
| Wholesale distributor markup at 7% | | $87 | |
| Freight to retail store at 8% of actual cost | $80 | $80 | |
| Total cost of goods sold including BAT tax impact | $1330 | $1417 | $1000 |
| Min. Sustainable retail price – Physical store at 45% GM | $2420 | $2580 | |
| Min. Sustainable retail price – Internet sales at 35% GM | $2040 | | $1560 |
| 6.5% avg. State sales tax | $133 | $167 | |
| Total min. sustainable physical store price to a US consumer (45% GM). or | $2553 | $2747 | |
| Total min. sustainable US internet seller with state nexus price to US consumer (35%GM). | $2173 | | |

The potential to get a 39% lower price from a foreign direct seller than from a US physical store retailer would dramatically change consumer shopping patterns. US retail sales of non-perishable foreign goods would drop dramatically along with employment levels and federal and state tax revenues. Large US sellers of imported goods would probably close and re-incorporate in Canada to eliminate US tax nexus, but most smaller retailers would simply go out of business. Any attempt to add a border tariff or customs charge on imports would quickly result in WTO action and retaliatory tariffs on all US exports, hurting US manufacturing. Because it would be a dramatically different tax system, used nowhere else in the world, a BACFT would also place major new regulatory and enforcement burdens on the IRS and major new administrative disruptions and cost burdens on businesses.

**There is a much simpler and less disruptive solution to stimulate US exports and solve the problem of tax avoidance by multi-national businesses (MNB) caused by profit shifting, corporate inversions, and tax deferral. The solution would use Formulary Allocation (FA) of the tax due on worldwide corporate income, combined with elimination of tax deferral on past foreign subsidiary profits. FA is a well-established method that most states use to allocate state income tax obligations for both national and international corporations.**

FA would be the simplest of all the "border adjustable" options, with few transition or regulation issues, and no negative impacts on domestic businesses. It would utilize the existing corporate tax code and international accounting standards, up to the final per country allocation step. MNBs, with US tax nexus would calculate taxable income on a worldwide basis, but only pay US income tax based on their percentage of sales, or other economic impact factors, in the US. FA meets the stated bi-partisan Congressional objectives for international tax reform, including removal of US income tax cost on American exports.

FA would make it easier for corporations to correctly calculate their US taxes, and for the IRS to accurately audit them since it would more closely match the unified reports MNBs produce for financial reporting purposes. The US states, and political subdivisions in some other countries, have used a sales factor, or multi factor allocation system including sales, employment, and assets, for many years. Most corporations with US state nexus already report their state income tax liability on that basis. The US already taxes multinationals on a worldwide basis, except for foreign corporations, who are treated on an activity nexus basis very similar to the way they would be treated under a formulary allocation system. Although there is some potential for misrepresenting sales destinations, the rules used by the states should provide a good basis for accuracy.

FA removes the incentive for profit shifting" to lower tax countries by dividing total world-wide profit to be taxed based on a fairly clearly definable percentage of sales, or other factors, by country. Businesses would not want to reduce sales in the US, regardless of the tax rate. FA also removes the incentive for corporate inversions by taxing both domestic and foreign corporations that have US tax nexus, on the same percentage of sales basis which should meet WTO standards for equal treatment.

FA removes the need for the US, and also for other nations, to try to "bid down" their corporation tax rates to undercut other countries and encourage profit shifting and asset relocation in their direction. If FA was adopted by other countries, it would also allow them to return their tax rates on MNBs to higher levels without losing revenue due to profit shifting.

FA would not be a "New Tax" that could be blamed on either political party.

FA is inherently border "adjusted". It would remove some or all of the US federal income tax cost from goods sold outside the US, making them more competitive.

FA would not disrupt the state corporate income tax systems, which are generally based on the current federal corporation code, the way a BACFT would. It would follow the formula allocation of unitary profits system that most states already use.

FA could also solve the problem of “trapped" profits and lost tax revenue from deferral of off-shore profits if combined with elimination of deferral and forced recognition of prior year foreign subsidiary profits over a 5-year period. Repatriation will probably not result in any major US economic benefit from new domestic corporate investment based on economist analysis. Analysis of the last voluntary repatriation incentive found the funds were primarily used for increased dividends and stock buy-backs. There is no reason to reduce the tax rate on these deferred profits since they resulted from past sales. The tax rate does not affect current business competitiveness and businesses have already applied the credits for foreign taxes paid against other income. This deferred tax is owed, and forced recognition and taxation of the $2 Trillion + in deferred off-shore profits would add significant tax revenue to reduce the deficit, or provide alternate tax relief.

FA would give US multinational businesses permanent tax relief on export sales, rather than locking in permanent tax avoidance from MNB profit shifting if we change to a territorial system. The tax savings for exporting corporations provides a good offset for ending deferral of taxes on prior profits.

FA would restore tax equability to all the domestic corporations and pass-through businesses who have no international tax avoidance or deferral options, and have had to pay a higher share of business taxes over the last 25 years, as MNBs have avoided taxes through profit shifting.

FA could also increase overall US corporation tax revenue, based on prior years data, by reducing tax avoidance and broadening the tax base, without creating a disincentive for US investment due to comparative tax rates. JCT should be asked to do an analysis using the most current and projected data, but FA would appear to be revenue positive. The increased tax revenue could be used to reduce the tax rate, or pay down the deficit.

Unlike the “BACFT”, FA would not increase the cost of imported goods, or increase taxes, or costs, on domestic companies or US consumers. It also would not have the economic consequences of a "border tax" tariff war, or the complexity, problems and transition issues of a "cash flow" basis tax system, or a VAT.

At some point the US may also want to fully evaluate a true Value Added Tax, for use in conjunction with the business income tax, to raise revenue and provide better tax cost equability for goods imported from producers who have no income tax nexus in the US. Although a true VAT is worth researching as a consumption tax alternative, there would be significant issues in converting to it, and it has met with significant political opposition even though it is common in other countries.

EUROPEAN UNION
DELEGATION TO THE UNITED STATES OF AMERICA

The Head of Delegation

Washington, June 6, 2017
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DOS/DL/IP

The Honorable Kevin Brady, Chairman
The Honorable Richard Neal, Ranking Member
Committee on Ways & Means
U.S. House of Representatives
1102 Longworth House Office Building
Washington, DC 20515

Ref: Hearing on Increasing U.S Competitiveness and Preventing American Jobs from Moving Overseas

Dear Chairman Brady and Ranking Member Neal,

The European Union (EU) hereby wishes to submit comments for the record on the hearing entitled "Increasing U.S Competitiveness and Preventing American Jobs from Moving Overseas".

The EU and the United States have the most integrated economic relationship in the world. The EU is by far the largest foreign investor in the US economy and we believe that this relationship has been mutually beneficial. In 2014, EU-headquartered firms employed 3.2 million people in the US and, in 2015, exports to the EU generated 2.64 million jobs in the US. The EU benefits from being one of the most open economies in the world and remains committed to free trade. The average applied tariff for goods imported into the EU is very low. The EU's services markets and public procurement markets are open and we arguably have the most open investment regime in the world.

We recognise that reform of the tax code is a priority in the US. We would expect that any overhaul of the code will respect our mutual obligations in the World Trade Organization.

In the context of the tax reform debate, there have been some inaccuracies and misrepresentations in the discussion of value-added taxes, which are applied by over 160 countries. We would like to comment on the EU's system of Value Added Taxes, or VAT, and point out that it impacts on international trade is completely neutral.

The VAT in the EU is a broadly-based consumption tax assessed on the full value of all products and services sold for consumption <u>in</u> the EU. EU products and services which are *exported* to customers outside the EU are <u>not</u> subject to VAT in the EU because this is an indirect or consumption tax and these exported goods or services should be, and are, subject to consumption taxes in their destination markets, if any, on the same terms as goods and services of domestic or other foreign origin sold on those markets. Hence not applying the EU's VAT on these exported products and services is not giving them an unfair tax advantage. Rather, it avoids their double taxation, just as does the non-imposition of US state sales taxes on US exports. It ensures, in each destination market, competition on equal terms between goods and services from different origins.

The same is true of applying VAT or other consumption taxes on EU *imports*: they in no way penalise these imports, as compared with EU goods or services, and thus do not modify the competitive relationship between imports and domestic goods and services.

In the example of a car made in the EU, for which the wheels are sourced either domestically or from abroad, VAT will be applied to the full sale price of the domestic wheels, but equally on imported wheels. Within the supply chain, a refund is given both for the input VAT on domestic wheels, as well as for the input VAT on imported wheels and VAT will be levied on the full value of the finished car. The same mechanism is applied with regard to an imported car. Domestic wheels are taxed to the same extent as imported wheels, and so are domestic cars as compared with imported cars.

Import tariffs as well as taxes applied to imports at a higher level than to domestic goods or services are completely different in this respect. That is also why trade rules, including those of the World Trade Organization, impose limits on such import tariffs and ban the application of internal taxes in a way that discriminates against imports. Similarly, the rules of the World Trade Organization prohibit export exemptions for taxes other than consumption taxes.

EU companies producing goods or services in the EU and exporting them to the US (and any other country) are also of course subject to direct taxes in the EU: they pay corporate tax on their profits from the economic activity in the relevant EU country.

Therefore, today US and EU firms selling goods or services in the US or in the EU are treated the same way because they are both subject to corporate taxes on their profits where the economic activity takes place. When an EU firm and a U.S. firm sell their goods or services in the EU, an absolutely identical VAT is applied irrespective of the origin. When they sell their goods or services in the US, no VAT applies, but sales taxes at State level do, wherever they exist.

You will find in Annex additional information of the EU value added tax regime. My team and I remain at your disposal should you have any questions.

Yours Sincerely,

David O’Sullivan
Ambassador

Annex: Info-graphic on the EU's VAT

# What is **VAT?**

## In brief

**Value added tax** (VAT) is a general tax on goods and services which is applied on every transaction in the production and distribution chain

### RATES

- VAT rates are different across the European Union
- They go from 17% in Luxembourg to 27% in Hungary
- Reduced rates also exist for some categories of goods and services

### NEUTRALITY

- VAT is neutral for businesses - they can deduct VAT on purchases (input VAT) and charge it on sales of goods or services (output VAT)
- VAT is also neutral for imports, since the same VAT rate is applied as for domestic supplies of goods

### REVENUE SOURCE

- An important source of revenue for countries' budgets
- VAT makes up 18% of EU Member States' budgets on average

**Input VAT**
(VAT paid on purchases)
**Output VAT**
(VAT received on sales)
**Payable = Output – Input**
(the amount to be paid to the tax administration)

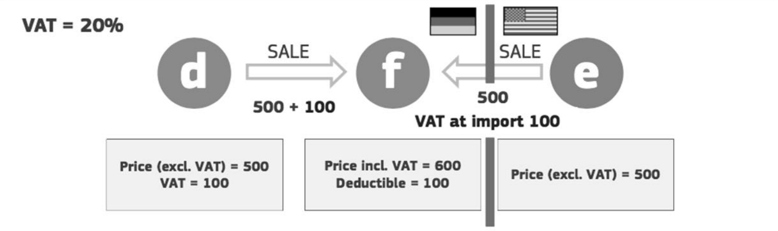
## EXAMPLE OF INTERNAL EU TRANSACTIONS

**VAT = 20%**

| | | |
|---|---|---|
| **Input = 0**<br>**Output = 20**<br>**Payable = 20–0 = 20** | **Input = 20**<br>**Output = 50**<br>**Payable = 50–20 = 30** | **Consumer pays total VAT = 50** |

For companies **a** and **b** VAT is neutral – they pay VAT on purchases and receive VAT on sales, but it all evens out to 'zero'. The VAT is ultimately borne by the final person in the chain – the consumer who pays the total amount of VAT at the end. VAT is paid periodically to the tax administration by **a** and **b**

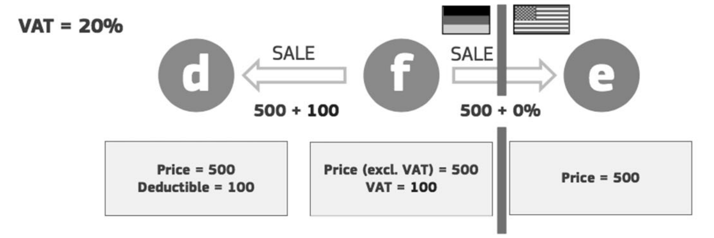
## EXAMPLE OF IMPORTS



Purchases by company f from company **d** (based in the EU) and **e** (based outside the EU) are subject to the same VAT rate
**VAT is neutral** because the same rate applies for both domestic sales and imports.

**Deductible**
The amount of 'input VAT' that company **f** has the right to deduct.

## EXAMPLE OF EXPORTS



Company **f** (based in the EU) sells the product to companies **d** (based in the EU) and **e** (based outside the EU).
When exporting, products are ***zero-rated*** and they are not subject to VAT.

**Zero-rating**
Exports are zero-rated, to allow the products to have the same tax treatment in the destination country.
Credit is given for taxes paid on inputs for **d**.

BDI
Bundesverband der
Deutschen Industrie e.V.

DIHK
Deutscher Industrie- und
Handelskammertag

Committee on Ways and Means
U.S. House of Representatives
1102 Longworth House Office Building
Washington, DC 20515

waysandmeans.submissions@mail.house.gov

June 6, 2017

**Public Submission in response to the hearing on "Increasing U.S. Competitiveness and Preventing American Jobs from Moving Overseas"**

## About BDI

The Federation of German Industries (Bundesverband der Deutschen Industrie, BDI) is the umbrella organization of German industry and industry-related service providers. The BDI speaks for 37 sector associations, 15 regional offices, and approximately 100,000 companies with a total workforce of about eight million people.

## About DIHK

The Association of German Chambers of Commerce and Industry (Deutscher Industrie- und Handelskammertag, DIHK) is the central organization for 79 Chambers of Commerce and Industry, CCI (Industrie- und Handelskammern, IHKs) in Germany. All German companies registered in Germany, with the exception of handicraft businesses, the free professions and farms, are required by law to join a chamber. Thus, the DIHK speaks for more than three million entrepreneurs – not only big companies but also retailers and innkeepers. It does not represent any specific corporate group but all commercial enterprises in Germany.

## Introductory Comment

BDI and DIHK very much welcome the opportunity provided by the Committee on Ways and Means of the House of Representatives to publicly discuss tax reform with interested stakeholders.

In our comments, we focus, as requested, on border adjustment and international tax modernization as core elements of comprehensive tax reform and on the implications of these policies for increasing jobs, investment, and economic growth in the United States.

## Executive Summary

BDI and DIHK are aware of the need to modernize the U.S. tax system. However, we are opposed to the introduction of a border adjustment tax (BAT), which would effectively tax imports to the United States while subsidizing exports from the United States. We believe that such a measure would harm trade flows and would therefore have negative repercussions for both foreign-based companies and U.S.-based companies. This measure would thus be detrimental to the aim of fostering economic growth and increasing jobs in the United States.

We would like to highlight the following three reasons for this assessment:

I) **Open markets are at stake:** A BAT would have negative effects on any company in the U.S. that is dependent on imports - U.S. companies and U.S. affiliates of foreign-owned companies. These affiliates have created 6.4 million jobs in the United States. German companies and their subsidiaries alone account for 672,000 highly-qualified and well-paid jobs, with almost half of them in manufacturing. These jobs depend on open markets and could be at stake if a BAT were introduced.

II) **A BAT is not a VAT:** While a VAT is neutral vis-à-vis the origin of the products and leads to a level playing field for foreign and domestic products, a BAT would be a protectionist measure and would discriminate against foreign goods.

III) **Inconsistency with the international tax system:** A BAT is inconsistent with the existing global tax regime, which is based on taxing profits where value is created. For large and small companies with global value chains, a coherent international tax system is very important.

In effect, a BAT would disrupt global value chains for foreign-based and U.S.-based companies. In a globalized world with countless interlinkages between companies, markets, and technologies, a BAT would affect companies in the U.S. regardless of the location of their headquarters. There would be winners and losers, but it would not be a zero-sum-game. Trade flows would suffer, and there would therefore be an overall loss. The intended stimulus for growth and investment within the United States could actually have the opposite effect.

Moreover, exchange rates do not exclusively depend on international trade flows, but also on other factors such as cross-border investment decisions at capital markets. Therefore, while some have predicted an appreciation of the U.S. dollar that would offset the effects of the BAT, such an appreciation is not a given. Thus, besides distorting international trade, taxing imports will also raise costs for consumers, households, and the manufacturing industry in the United States.

## Specific Comments

### I) Open markets are at stake: Effects of a BAT on jobs created by U.S. subsidiaries of German companies

The economic relationship between the United States and Germany is very close. Both countries are important partners in shaping globalization. Deep transatlantic economic integration is based on a trusting business environment, a reliable framework, and open markets. This is what BDI and DIHK support – on both sides of the Atlantic.

With regard to the proposed BAT, we are very concerned that these important pillars of transatlantic and global trade are at risk – to the detriment of all large and small companies with global value chains, whether U.S.-based or not. While the protectionist effect of a BAT may indeed be intended to increase U.S. competitiveness and foster growth in the United States, we would like to take the opportunity to highlight some considerations that might shed a different light on this intention.

German direct investment in the U.S. reached a total of around $255 billion by the end of 2015. German affiliates play an important role in the U.S. economy, contributing to its economic health and prosperity. Most importantly, these affiliates create jobs in all states and are a vital part of the daily life of American employees and their families:

- About **672,000 American jobs** were “insourced” and supported by the roughly 4,700 German-owned affiliates located in states across the country.
- German affiliates are the **third-largest foreign employer** and thus account for 10.5 percent of the total 6.4 million U.S. jobs created by all foreign affiliates.
- According to the German Federal Ministry for Economic Affairs and Energy, the **average salary** in German affiliates in the U.S. **is higher than both in domestic and other foreign-owned companies**.
- **Nearly half of the jobs** created by German affiliates in the United States are in **manufacturing.**

German companies therefore play a key role in the United States’ efforts to strengthen its industrial base. These affiliates represent innovative technologies, a high degree of value added, and attractive jobs. Moreover, a lot of them are successfully implementing cutting-edge workforce development programs following the German dual model of public-private partnership that combines on-the-job training with targeted classroom education. These programs help close the skills gap.

Thus, German investment contributes to boosting U.S. competitiveness in many ways. A BAT would harm these trade and investment relationships between the U.S. and Germany – and between the U.S. and any other country.

## II) A BAT is not a VAT: A VAT is neutral vis-à-vis the product origin and leads to a level playing field for foreign and domestic products. A BAT would discriminate against foreign goods and thus have a protectionist effect.

An often-heard argument in favor of the BAT has three parts:

1) First, proponents claim that it would be similar to the Value Added Tax (VAT) regime applicable in other parts of the world, including the European Union.
2) Second, they argue that the VAT system is protectionist and puts U.S. businesses at a competitive disadvantage vis-à-vis local (ex. European) producers.
3) Third, they conclude that a BAT in the U.S. would level the playing field for U.S. businesses and thus increase U.S. competitiveness.

This conclusion is a common misperception. A VAT system as it exists within the European Union and a BAT have very different effects on businesses. They are not the same and are not even comparable:

***EXPLANATION: What is a VAT?***

*According to the official definition provided by the European Commission[1], a Value Added Tax, or VAT, is a general, broadly based consumption tax assessed on the value added to goods and services. It applies more or less to all goods and services that are bought and sold for use or consumption within the VAT jurisdiction.*

*Value added tax is*

- *a general tax that applies, in principle, to all commercial activities involving the production and distribution of goods and the provision of services.*
- *a consumption tax because it is borne ultimately by the final consumer – like a sales tax. It is not a charge on businesses.*
- *charged as a percentage of price, which means that the actual tax burden is visible at each stage in the production and distribution chain.*
- *collected fractionally, via a system of partial payments whereby taxable persons deduct from the VAT they have collected the amount of tax they have paid to other taxable persons on purchases for their business activities.*
- *paid to the revenue authorities by the seller of the goods, who is the "taxable person", but it is actually paid by the buyer to the seller as part of the price. It is thus an indirect tax.*

There are some important differences between a BAT and VAT:

1) **A VAT is neutral with regard to competitiveness**. Everything that is sold in a VAT country gets taxed at the same tax rate, which depends on the local VAT rate (ex. 19 percent). This is the case for both imports and domestic production. Thus, a VAT results in equal treatment of

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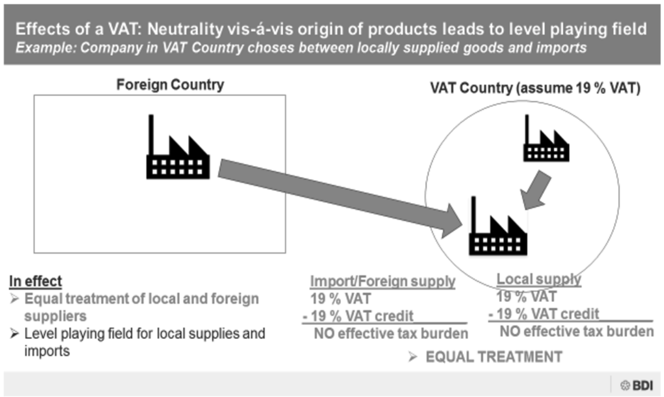
[1] http://ec.europa.eu/taxation_customs/business/vat/what-is-vat_en

imports and domestic production. Exports are sold outside the VAT country and are therefore not subject to a VAT in the VAT country. This is not an export subsidy.

Therefore, a VAT provides a level playing field for all producers and suppliers selling to consumers within the jurisdiction of the VAT country, so there is no difference in the overall VAT burden of domestic producers or suppliers and importers. The VAT is neutral towards the origin of the products sold in the VAT country; their origin does not make any difference with respect to the tax burden. Therefore, the concept of a VAT is not protectionist. Rather, the VAT system is neutral with regard to competitiveness. It does not distort trade chains and importers of foreign products are not discriminated against.

This can be illustrated by the following example:



**Effects of a VAT: Neutrality vis-á-vis origin of products leads to level playing field**

***Example: Company in VAT Country choses between locally supplied goods and imports***

**Foreign Country**

**VAT Country (assume 19 % VAT)**

**In effect**

- Equal treatment of local and foreign suppliers
- Level playing field for local supplies and imports

**Import/Foreign supply**
19 % VAT
- 19 % VAT credit
NO effective tax burden

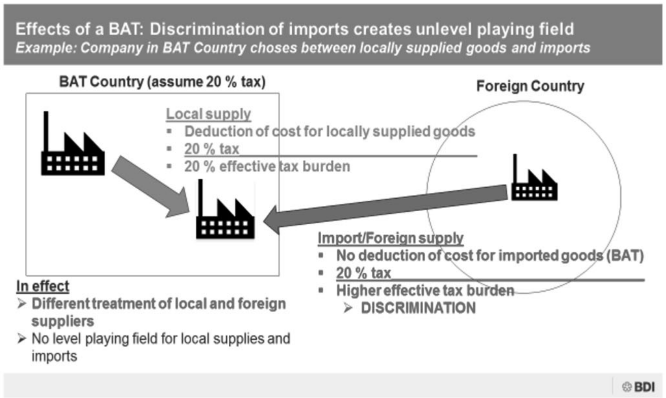
**Local supply**
19 % VAT
- 19 % VAT credit
NO effective tax burden

- EQUAL TREATMENT

BDI

2) **A BAT is a protectionist measure.** The BAT entails a discrimination of imports into the United States against local production: while the purchase of local products would still be deductible from the tax base, imported intermediates could not be deducted. U.S. importers as well as clients of domestic producers would both pay a 20 percent tax. But the corporate tax base for importers would be much higher.

This effect is illustrated by the following example that shows the distortive effect that a BAT would have on importers. Effectively, a BAT would not level the playing field for local sellers and foreign importers in the United States, but rather is a protectionist measure with regard to imports.



**Effects of a BAT: Discrimination of imports creates unlevel playing field**

*Example: Company in BAT Country choses between locally supplied goods and imports*

**BAT Country (assume 20 % tax)**

**Foreign Country**

<u>Local supply</u>

- Deduction of cost for locally supplied goods
- 20 % tax
- 20 % effective tax burden

<u>Import/Foreign supply</u>

- No deduction of cost for imported goods (BAT)
- 20 % tax
- Higher effective tax burden
  - ➢ DISCRIMINATION

<u>In effect</u>

- ➢ Different treatment of local and foreign suppliers
- ➢ No level playing field for local supplies and imports

BDI

To sum up, there are at least two major misconceptions when comparing a BAT to a (European-style) VAT:

- First, a VAT does not put U.S. exporters to the EU at a competitive disadvantage against EU companies. Therefore, the argument that the United States needs a BAT to compensate for the alleged disadvantage is flawed.
- Second, introducing a BAT would not be the same as a VAT, as it would not be neutral with regard to the origin of the products. The key difference between a BAT and VAT is their respective impact:

  - ➢ The total VAT cost across a supply chain is solely dependent upon the location of the final consumer. With a consumer in a VAT country, the total VAT cost, which is borne by the final consumer, will always be the same VAT rate (ex.19 percent) regardless of whether the goods and services are produced and supplied by businesses from the EU, the United States, China or any other region of the world. With a foreign consumer, the total VAT cost will always be zero, regardless of the location of the suppliers. This is why a VAT is neutral with regard to competitiveness.

  - ➢ With a BAT – on the other hand – the overall tax burden for businesses does not solely depend on the location of the final consumer. It will also be influenced by the location of the supplier. While the supplier or producer who buys domestic products and the buyer of imports are subject to a 20 percent tax, the buyer of domestic products can deduct the cost from its corporate tax base. The buyer of imports is not allowed this deduction. This is a direct discrimination of imports and is why a BAT is *per se* a protectionist measure.

### III) Inconsistency with the international tax system

We acknowledge the need to modernize the U.S. tax system and the priority of a comprehensive tax reform. However, deliberations on elements of reform should be within the internationally agreed path to a modernization of the international tax system. A BAT would deviate from this path and would adversely affect the international tax system as a whole. It is inconsistent with the existing global tax regime based on taxing profits where value is created. Under a BAT, companies would be taxed based on where they sell their goods or services, i.e. on a destination basis rather than – as in current corporate taxes – primarily on an origin basis.

Thus, a BAT would diverge from the globally accepted basic concept in international taxation. No country in the world disallows the deductibility of imports. For companies with global value chains, a consistent international tax system is very important. Inconsistency leads to uncertainty, uncertainty increases compliance risks and the risk of double taxation, which eventually leads to a rise in disputes. What is needed for sustainable investment that boosts economic growth in the United States is legal certainty, also for cross-border transactions. This can only be achieved by globally coherent tax rules and international cooperation.

### IV) Conclusion

A BAT is a protectionist measure. It therefore cannot be compared to a VAT, as a VAT does not differentiate between locally supplied and imported goods. A BAT would harm U.S. affiliates of foreign-based companies and also U.S. companies that are dependent on imports. Open markets are at stake and free trade would suffer. Even more so, as a BAT is not in line with internationally agreed taxation principles. Many well-paid and highly-qualified jobs in the United States could be at risk. We therefore urge you to refrain from implementing a BAT. Such a measure would be detrimental to the aim of fostering economic growth and increasing jobs within the United States.

### Contact information

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Please accept this submission to the U.S. House Ways and Means Committee with regards to the May 23, 2017 hearing on the proposed Border Adjustment Tax.

My company is a producer and marketer of consumer household products headquartered in Seattle, WA with offices in Oak Brook, IL and Las Cruces, NM as well as a 150,000 squrae foot distribution center in Memphis, TN. Our brands include Rabbit wine products and accessories, Taylor kitchen and bath scales and measurement tools and Chefn kitchen tools and gadgets. Our products can be found in almost any retail channel in the United States. We employ directly 160 people in the U.S. excluding the Memphis warehouse location. Similar to the majority of consumer products company's selling durable goods, substantially all of our products are imported from Asia due to economic necessity and the consumer market demand for retail price points at a certain level. The proposed Border Adjustment Tax will result in greatly increased prices that the consumer will need to pay for these goods and will result in a substantial decline of sales of these products. In turn, there will be a tremendous negative impact on retail store operators and many companies such as mine will be forced to drastically reduce employment and investment if we were to survive which would be at risk should the Border Adjustment Tax proceed.

Similar to a well known company such as Apple, the majority of the economic value added functions of our company are performed by our employees in the United States. There is limited value added in the manufacture of these products which has led to the use of contract manufacturers working on thin margins based in Asia to manufacture these products. The introduction of the proposed Border Adjustment Tax will not result in on shoring of manufacturing. It will, however, force higher retail prices for these goods as well as create significant economic burdens for product companies such as ours, retailers, transportation companies, logistic companies and the many industries that make up the consumer sector of our economy. As noted by many experts, the

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consumer will be adversely impacted but equally important, this will have a meaningful negative impact on sales of consumer products and a negative impact on the U.S. economy.

I implore the US Congress and the Ways and Means Committee of the House to fully investigate the many negative long term implications of this ill advised tax/tariff proposal. It will wreak havoc across many companies such as ours and jeopardize our very existence.

Respectfully,

Robert Kay

Chairman & CEO

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FMI
THE VOICE OF FOOD RETAIL
Feeding Families Enriching Lives

Testimony of

# Food Marketing Institute

**House Committee on Ways and Means**
**Hearing on**
***Increasing U.S. Competitiveness and Preventing American Jobs from Moving Overseas:***
***How Border Adjustment and Other Policies Will Boost Jobs, Investment, and Growth in the U.S.***

**May 23, 2017**
**10:00 am**
**1100 Longworth House Office Building**

**Submitted for the Record**
**Andrew S. Harig**
**Senior Director of Sustainability, Tax and Trade**
**Food Marketing Institute**

Chairman Brady and Ranking Member Neal –

Thank you for the opportunity to submit testimony for today's hearing on behalf of the Food Marketing Institute (FMI).[1] FMI is a trade association that represents food retailers and wholesalers, as well as their suppliers of products and services. Our members are located in every congressional district across the country. FMI's tag line when referring to its member companies is "Feeding Families and Enriching Lives," a responsibility we take very seriously.

**The Food Wholesale and Retail Industry Stands to Gain from Comprehensive Tax Reform That Creates a Level Playing Field**

The food wholesale and retail industry is an important economic sector that employs more than 4.8 million people and helps support almost 3 million additional jobs in supplier and upstream industries. In 2015, the industry contributed more than $81 billion to the U.S. Treasury in federal taxes.[2] The industry makes these contributions to the economy despite having an average profit margin below 2 percent. In fact, in the more than 30 years that FMI has tracked the industry's net profits after taxes, the margin has never exceeded 1.91 percent in any given year.[3]

FMI's members are also heavily regulated and highly taxed. Both our "C" corporations and pass-through companies pay effective rates at or near the top marginal rate. The industry's business model simply does not allow it to take advantage of tax expenditures – such as the R&D tax credit - that many other sectors use to bring their effective rates down. FMI members often read media reports about companies in other industries that have years in which they owe no taxes or have tax planning so sophisticated they average effective rates below 12% and find it incredibly hard to believe that that they are operating under the same set of rules.

The industry has an enormous amount to gain from Congress' efforts to reform the tax code in a way that lowers effective rates for all industries and creates a level playing field that does not advantage one sector or business model over another. FMI and our members are, thus, extremely excited that the Committee has begun the process of developing legislation that will create this type of comprehensive and even-handed reform. We feel confident that – if successful - these efforts will not only create a more profitable industry but will have enormous positive impacts on job creation and consumer spending.

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[1] Food Marketing Institute proudly advocates on behalf of the food retail industry. FMI's U.S. members operate nearly 40,000 retail food stores and 25,000 pharmacies, representing a combined annual sales volume of almost $770 billion. Through programs in public affairs, food safety, research, education and industry relations, FMI offers resources and provides valuable benefits to more than 1,225 food retail and wholesale member companies in the United States and around the world. FMI membership covers the spectrum of diverse venues where food is sold, including single owner grocery stores, large multi-store supermarket chains and mixed retail stores. For more information, visit www.fmi.org and for information regarding the FMI foundation, visit www.fmifoundation.org.

[2] Data provided to FMI by John Dunham and Associates as part of research on "the Economic Impact of the Food Retail Industry in the United States."

[3] This margin was achieved in FY2006. The average net profit after taxes in 2015 (the last year for which data is available) was 1.7%. See https://www.fmi.org/our-research/supermarket-facts/grocery-store-chains-net-profit.

**What is Good for the U.S. Economy is Good for the Food Wholesale and Retail Industry**
The food wholesale and retail industry is often seen by outside observers as "recession proof" since people will always need to eat and will prioritize spending in this area over most other concerns. While it is true that there is a baseline of spending that is almost always going to be in place, the recession that began in 2008 and the recovery that followed should have made it clear to any observer that FMI's members are impacted by even slight swings in the economy.

Consumer spending on food is, in many ways, the "canary in the coal mine" of larger trends in the U.S. economy. There is an adage in the industry that you can tell how the country is doing simply by looking at consumers' shopping baskets. As such, what is good for the U.S. economy is good for the industry as a whole.

Very few of FMI's members operate internationally, so many observers might think that efforts to move toward a territorial system will not have an impact on the industry as a whole. But to the extent this transition helps to create jobs and raise wages in the United States, the food wholesale and retail industry will reap the benefits of enhanced consumer spending. As we saw during the recession, consumers will scale back their spending on food to reflect tighter budgets, but as things improve this spending bounces back and even encourages the addition of "indulgence" purchases (e.g. higher-margin proteins such as steak over hamburger). A stronger economy simply creates a stronger food industry even if the means that bring about this growth are not specifically geared toward the retail sector. A territorial system may not directly impact our members, but it can help boost the industry as a whole and we are supportive of the Committee's efforts on this front.

**Border Adjustments Should Not Be Included As Part of the Move to a Territorial System**
Although the industry is supportive of efforts to move to a territorial system, one proposed aspect of the efforts should not be considered – there is no room for border adjustments in tax reform.

Over the past thirty years, supermarkets have developed supply chains that allow them to provide safe, high-quality and affordable choices to American consumers during the entire year. Trade and engagement with international partners has made this evolution possible. If you were to compare a grocery's produce department in the middle of winter 1987 with that same department during the winter of 2017, the difference would be stark to even the most indifferent of consumers. Beautiful fruits and vegetables that were either completely unavailable or only available during narrow windows of the year are now accessible to consumers in even the bleakest winter months at an affordable cost that would have been unthinkable thirty years ago. A border adjustment that imposes a tax on these items would not only drive up costs, it could also start to limit consumer choice and turn us back to the more limited options of a bygone era.

FMI is a strong supporter of U.S. agriculture and the incredible work the nation's farmers do to keep people fed and healthy, but consumers also desire products that are simply not available domestically. There is no such thing as a "U.S. banana" and people's morning coffee often has its origins overseas. During the shoulder season when certain products like peppers and melons would not be available, imported product is used to fill demand. This is a positive development in the food wholesale and retail industry that translates into more choice and affordability for the average consumer.

The type of border adjustment being discussed – stripping the deduction for cost of goods sold on imports – would inevitably lead to higher consumer prices. Even with a lower marginal rate of 15 or 20 percent, many of FMI's members are calculating that their effective tax rates would increase under this proposal beyond the current top rate of 35% because of border adjustment. Tax reform with a border adjustment would amount to a tax increase for many in our industry.

As previously discussed, the food wholesale and retail industry operates on a tight margin below two percent. We simply do not have the ability to either absorb a cost increase from this tax provision or force it back upstream on our suppliers. As a result, many companies will have no choice but to either pass this cost along or face real questions about their continued viability in the face of these cost increases. Unfortunately, it is consumers who are going to have to bear the brunt of a border adjustment as they see prices rise on a host of their purchases and their weekly trips to the supermarket become more expensive. Many of them will not even know why the bananas they put in their children's lunch or the coffee they drink to get them going in the morning cost more; they'll just see more money going out of their pockets.

This is not the recipe for a more competitive economy, but rather one that forces consumers and importers to pay for benefits enjoyed by exporters (many of whom, it should be pointed out, already pay effective rates well below the national average). Tax reform should create a level playing field for all industries, not pass along new costs to American businesses and consumers.

A border adjustment is not a necessary part of either the shift to a territorial system or tax reform more generally – even many supporters of border adjustment agree with this principle. It is simply a revenue raiser that imposes costs on sectors that cannot afford them and threatens to mitigate the benefits of reform for many industries.

In closing, it is important to address the idea that currency changes can ultimately pay for the border adjustment and eliminate the need to pass along increased costs to consumers. This is obviously an incredibly appealing idea since it turns the revenue raised by border adjustments into essentially free money (or at least money financed not by consumers, but by investors who see the value of their overseas investments drop as the dollar grows stronger). This is untested economic theory that depends upon a perfect symmetry between the movement of goods and services and the response of currency markets. Many currency traders who make their living in this market strongly question whether this symmetry actually exists[4] and even economists

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[4] Andrea Wong, "*Currency Traders Spot Fatal Flaw in Republicans' Border Tax Plan*," **Bloomberg Markets**, April 18, 2017.

working for the Joint Committee on Taxation question whether there is currently sufficient evidence to warrant such a claim[5].

Border adjustment is, even under a best case scenario, a gamble. The wager, unfortunately, is a bigger tax bill for many food retailers and/or higher prices for consumers. There is no reason to make this bet; tax reform can and should proceed without a border adjustment.

Thank you for your consideration.

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[5] Aaron Lorenzo, "*Evidence Lacking on Currency Impact from Border Adjustment, JCT Economist Says,"* **Politico Pro**, April 20, 2017.

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FDRA
FOOTWEAR DISTRIBUTORS AND RETAILERS OF AMERICA

# Testimony of the Footwear Distributors & Retailers of America (FDRA) for the House Ways & Mays Committee Hearing on Increasing U.S Competitiveness and Preventing American Jobs from Moving Overseas

**May 23, 2017**

On behalf of the Footwear Distributors & Retailers of America (FDRA), we appreciate the opportunity to provide written testimony to the House Ways & Means Committee as it considers the Border Adjustment Tax (BAT) proposal in the House Tax Reform Blueprint as part of today's hearing.

Founded in 1944 by the U.S. footwear industry, FDRA represents the entire industry from small family-owned footwear businesses to global companies selling to consumers around the world. We also serve the full supply chain from research, design and development, to manufacturing and distribution, to retailers selling to global consumers. In all, FDRA supports over 150 companies and 250 brands, or 80 percent of total U.S. footwear sales, making it the largest and most respected American footwear trade association. In the 70-plus year history of the association, FDRA has supported the footwear industry as its business intelligence hub and voice in Washington, D.C. and around the globe.

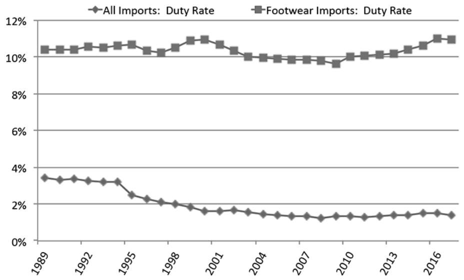
The U.S. footwear industry remains deeply concerned that the House Tax Reform Blueprint would impose a new $1.2 trillion tax in the form of a BAT, which would fall disproportionately on American footwear consumers and companies. A one-size-fits-all policy for taxing every import that crosses our borders simply does not add up for workers in our industry and would bankrupt many U.S. footwear companies. This policy proposal risks halting the recent progress made in domestic footwear manufacturing, and the academic theory behind the BAT is anything but certain in the real world.

Our industry is hit particularly hard by this proposed policy, because footwear companies utilize global supply chains to deliver more than 2.3 billion pairs of shoes to U.S. consumers each year. These global supply chains take decades to build and require substantial capital investment and a large workforce committed to learning the intricate skills of shoemaking, which can involve more than 100 touches to make a basic pair of leather dress shoes. These supply chains reflect the many changes in manufacturing the U.S. has seen over the past century, as over time, our nation has invested its resources in producing items of increasingly higher value and in sectors in which we have a strong comparative advantage globally.

While the U.S. has transitioned away from the large-scale footwear manufacturing of the early 20th century, it has invested heavily in high-value sectors that range from industrial machinery to chemical production to automobiles. Investing in high-value U.S. manufacturing has supported good-paying U.S. production jobs and facilitated large gains year-over-year in the productivity of U.S. workers. In today's global economy, companies are unable to simply move these complex supply chains, established over decades, to the U.S. in order to prevent being penalized with a substantial new tax burden, regardless of how long a transition period is established for the BAT under tax reform.

In addition, the U.S. footwear industry already operates under a heavy burden from the U.S. Government in the form of outdated tariffs on footwear, implemented in 1930 by the Smoot-Hawley Tariff Act. While the average tariff rate on all consumer goods crossing U.S. borders is just 1.5 percent, footwear tariffs average 11 percent (see Figure 1). Depending on the type of shoe and the material used to manufacture the shoe, these tariffs can reach rates as high as 37.5 percent, 48 percent, and 67.5 percent.

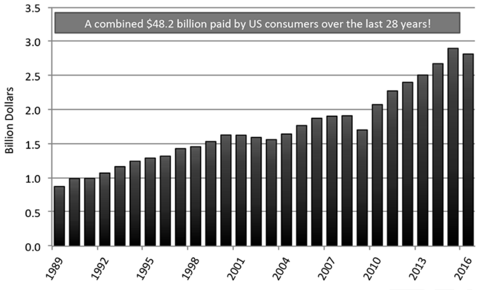
Figure 1: Duty Rate Comparison of Footwear Imports vs. All Imports



Source: USITC

Though footwear accounts for only one percent of the value of U.S. imports, it generates over eight percent of all tariff revenue for the U.S. Government. Over the last 28 years, footwear companies and consumers have paid $48.2 billion in footwear tariffs – $2.8 billion in 2016 alone (see Figure 2).

Figure 2: Duties Paid on US Footwear Imports



Source: USITC

Adding on top of this tariff burden a new Border Adjustment Tax would mean that footwear companies would have no choice but to raise consumer prices just to stay in business under the weight of significant new tax increases.

Footwear is an extremely price sensitive industry. If companies are forced to raise prices by 20 to 25 percent in order to adjust to the BAT, they will sell considerably fewer pairs of shoes. Not only would the BAT force customers to buy shoes at higher price points with no additional value added, the decrease in shoe sales would require large reductions in trucking, warehousing, retail, and support staff jobs across the U.S. and threaten the viability of many footwear companies operating at an already challenging time for retail.

At the same time, some outside groups are trying to paint the picture that a BAT would strengthen all U.S. domestic manufacturing. This is simply not the case, because all manufacturing is not the same. The tax rebates provided to some companies under the BAT would reduce the effective tax rates of a few large net exporters such that they would pay virtually nothing in Federal tax, while companies that make shoes in America to sell in America would be hit with significant tax increases. This is because global supply chains support footwear manufacturing, just as they support many other U.S. manufacturing sectors. 21st century U.S. manufacturing requires many inputs that are not available in this part of the world. Footwear companies, like other U.S. manufacturers, have to import certain component parts in order to fully produce footwear in the U.S.

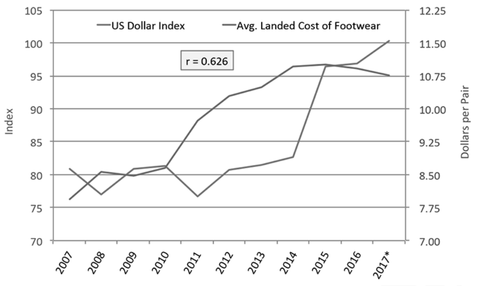
Many of the leading footwear companies that produce shoes domestically in factories in all parts of the country – from Oregon to Michigan to Wisconsin to Pennsylvania to Georgia to Maine – also import shoes to meet the needs of their customers. For example, a company may make high-end leather boots in the U.S. for a certain market segment and also import less expensive children's shoes to meet an even larger customer base. This allows companies to meet the needs of all types of consumers and deliver greater choice and value to individuals and families buying shoes.

An across-the-board tax on all imports that come into the U.S. would impact footwear manufacturers as well as retailers. For companies that still produce footwear in the U.S., it would mean less investment in current domestic operations and fewer resources available for the research, design, and innovation needed for further advances in footwear manufacturing. At a time when manufacturing shoes in America is actually starting to grow again, the BAT would not only stymie that growth but contract it.

FDRA is also concerned that the academic theory used to support the BAT is anything but certain in the real world. The House Tax Reform Blueprint makes the assumption the BAT would not violate World Trade Organization (WTO) prohibitions against border adjustments on direct taxes and would not result in subsequent retaliation against U.S. exports, which would harm American farmers, manufacturers, and small businesses. The Blueprint assumes exchange rates will adjust upwards of 25 percent to balance the policy's impact on exports and imports. It remains unclear, however, how long the currency adjustment would take, the degree of instability this would create for the U.S. economy as well as economies of other nations, and whether companies that depend on imports could survive during the amount of time it would take for the currency to adjust (at which point there would then be a disadvantage for U.S. exports).

Although theory suggests that a stronger domestic currency typically results in lower domestic costs for imported goods, this does not hold true for every industry. Over the last decade, the correlation of the average annual value of the dollar to the average annual landed cost of U.S. footwear imports is 0.626. Note this figure is positive, meaning the dollar and import costs have risen or fallen largely in step with one another. In other words, over this time period, as the dollar has strengthened since reaching a multi-decade low in 2008, which normally suggests lower costs for imports, the annual average landed cost of footwear has actually risen (see Figure 3). For footwear, this is in direct conflict with the general assumption that if the dollar appreciates import costs will go down.

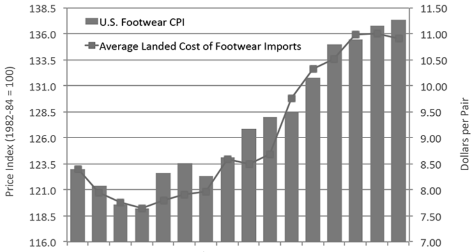
Figure 3: Dollar vs. Footwear Import Costs, Not the Relationship One would Expect



Sources: ICE Futures U.S. & USITC. * Year-to-date

As these average landed costs rise, they are passed directly on to consumers in the form of higher retail prices (see Figure 4).

Figure 4: Higher Landed Costs of Footwear Imports are Passed on to Consumers



Sources: USITC & BLS

As many of our members have pointed out, even if there are currency adjustments, because of the diverse nature of our supply chains, there is no distinct clarity as to which part of the supply chain will be most impacted by the adjustment. The Committee cannot accept as a forgone conclusion that footwear consumers will directly benefit from any positive currency adjustment to the BAT.

As the Committee considers the impact a BAT would have on the United States it should consider the tremendous benefits that imports currently provide to American consumers and the U.S. economy. Imports allow American individuals and families to have greater value and choice in a range of products including footwear and apparel. Generating savings for American consumers has the greatest positive impact on working class families across the U.S., since spending on everyday necessities like food, clothing, and shoes requires a larger portion of their income.

Imports allow American consumers to access products not available in our region of the world, whether it is enjoying a cup of coffee or having certain grocery items year-round or being able to purchase affordable leather shoes, a majority of which cannot be produced domestically in the absence of a large number of U.S. tanneries. Imports also support the incredible demand for shoes, 2.3 billion pairs for the U.S. market in 2016 alone. While increasing taxes on these imports might generate savings to achieve other goals in the plan, such as lowering corporate tax rates, it should not be done at the expense of U.S. consumers.

In conclusion, there are a number of important, pro-growth features in the House Tax Reform Blueprint, such as allowing companies to bring foreign earnings back to the U.S., establishing a more competitive corporate rate, and simplifying the Tax Code for businesses and individuals. However, the current version of the Blueprint – by including the controversial BAT – is unworkable since it would threaten our competitiveness, make our companies unprofitable, and negatively impact U.S. workers and consumers. We stand ready to work with the Committee on tax reform that will grow our economy and strengthen jobs across our industry, and we appreciate the opportunity to provide testimony to the Committee on this critical issue.

Respectfully submitted,

Matt Priest
President & CEO
Footwear Distributors & Retailers of America (FDRA)

FORTUNE
•FISH & GOURMET•
THE SEAFOOD & GOURMET SPECIALISTS

May 22, 2017

| | |
|---|---|
| The Honorable Kevin Brady | The Honorable Richard Neal |
| Chairman | Ranking Member |
| House Committee on Ways and Means | House Committee on Ways and Means |
| 1102 Longworth House Office Building | 1139E Longworth House Office Building |
| Washington, DC 20515 | Washington, DC 20515 |

Dear Chairman Brady and Ranking Member Neal:

I am writing today to express concerns regarding the proposed Border Adjustment Tax (BAT). It is my understanding that this will be part of the discussion during the May 23, 2017 hearing on "Increasing U.S Competitiveness and Preventing American Jobs from Moving Overseas".

My name is Sean J. O'Scannlain and I am President and CEO of Fortune Fish & Gourmet based in Bensenville, IL right behind the O'Hare Airport. We are a seafood and gourmet food distributor. I started this business in 2001 with 13 employees and 3 trucks serving customers within a 1 hour drive of our site, I am proud to say that we have grown the company to just more than 300 employees, and now have 80 trucks and locations throughout the Midwest. We cut, package, and manage fresh and frozen seafood and sell hotels, restaurants, grocery stores, and other retailers throughout the Midwest. We have calculated that Fortune accounts for feeding 120 million meals a year to American families.

While I do believe that lowering the corporate tax rate will help the American economy grow, the proposed BAT would cripple so many American small businesses and is the wrong way to go. Under a BAT, businesses would be forced to raise their prices which in turn would hit the pocketbooks of their customers. For my business in particular, I would need to raise my prices by almost 18 percent in order to maintain my status quo. How is that growing the economy?

At Fortune, we sell both domestic and imported product. I sell as much domestic seafood as I can get my hands on, and is asked for—but some of what we crave is not domestic. The United States has the best managed fisheries in the world, and we harvest as much as we can to keep the fish coming year after year. I need to be able to bring in fish from wherever the species lives, in order to meet my customers' demands.

All the fish that comes into Fortune is processed on-site before it goes to our customers. Those are the jobs that we provide, and many of my colleagues throughout the industry do the same—totaling over 500,000 US jobs just from imported seafood. The BAT would terminate those jobs, and make nutritious seafood much more expensive and harder to come by. It is a bad idea to hurt working families, when we should be looking at ways to grow the economy.

It is my sincerest of hopes that this Committee will find a solution that will get us the tax reform we have all been waiting for, but without a Border Adjustment Tax. This proposal not only threatens consumer access to affordable food but also threatens the jobs that produce it. Thank you for your consideration.

Sincerely,

Sean J. O'Scannlain
President & CEO

1068 Thorndale Avenue
Bensenville, IL 60106
www.fortunefishco.net

FREEDOM
PARTNERS

May 23, 2017

Dear Members of the Ways and Means Committee:

I write today to urge the members of this Committee to remain focused on delivering positive, pro-growth tax reform by abandoning the divisive border adjustment tax (BAT) proposal. The longer BAT continues to stand in the way of a unifying vision, the harder it will be to pass tax reform by the end of this year.

Comprehensive tax reform has the potential to jumpstart growth and expand opportunity for millions of Americans – especially the least fortunate. The House Republican plan includes many positive proposals that would help achieve that goal. However, the harmful $1.2 trillion BAT would undermine many of the crucial benefits that would come with comprehensive reform.

A recent Freedom Partners Chamber of Commerce and Americans for Prosperity analysis found that the BAT would hurt the very industries that tax reform is intended to help. The manufacturing, energy, retail, financial services, and agricultural industries – which together employ nearly one-third of all private domestic employees – are especially susceptible to harm. In many cases companies would see their tax bills soar higher than their profits. And for those businesses that survive, the additional costs will be passed directly onto consumers.

Supporters of this tax proposal claim that the dollar will automatically and fully adjust, offsetting the increased cost of imports and blunting the pain for American businesses and consumers. But there is no real-world evidence to support this theory. In fact, “traders and strategists who make a living in the $5.1-trillion-a-day currency market say such notions are preposterous,” according to a recent report by *Bloomberg*. The risk that the BAT poses to our economy is too great to take that chance.

A 2016 poll found that 72 percent of Americans feel that the “economy is rigged to advantage the rich and powerful.” They are right. The current tax code is too burdensome, too complex, and fundamentally unfair. It is riddled with loopholes and carve outs for the well-connected few, while leaving behind those most in need.

Un-rigging the U.S. economy is no small task. While the House Republican plan addresses many of these problems, the BAT would effectively replace an old burden with a new one, and squander the best opportunity in a generation to achieve the kind of bold change that Americans deserve.

We agree that tax reform should be a top priority for Congress. That’s why we urge Congress to drop the BAT and work with our organization to focus on a positive vision of comprehensive tax reform that can bring all Americans together.

Sincerely,

Nathan Nascimento

Nathan Nascimento
Vice President of Policy,
Freedom Partners Chamber of Commerce

◆

GAMES by James
WE'RE VERY SERIOUS ABOUT F. U. N.

May 22, 2017

The Honorable Kevin Brady
Chairman
Committee on Ways and Means
1102 Longworth House Office Building
Washington, DC 20515

The Honorable Peter Roskam
Chairman
Committee on Ways and Means
Subcommittee on Tax Policy
1102 Longworth House Office Building
Washington, DC 20515

Dear Chairman Brady and Chairman Roskam:

Good morning, members of the US House of Representatives Ways and Means Committee. And good morning in particular to Congressman Erik Paulsen who represents the area where 3 of my 8 stores are located. Congressman Paulsen thank you for all of your hard work on behalf of Minnesota and small businesses owner like myself.

Games by James is a retail specialty store selling board games and puzzles. We do not sell any electronic games. We believe that playing games with other real people, face to face, is a good thing.

Games by James was founded 1978. Ten years later, they started a franchise program and I was their first franchisee in 1988, buying the existing store at the Galleria Shopping Center in Edina, Minnesota.

Since that time, the franchisor and most of the other franchisees have gone out of business primarily because of poor cash management during some very tough economic times for all of us.

In our case, we are a family business. My wife and I have been running the business with my son who is taking more and more responsibility with plans to someday own the business. Over the last 29 years we have had our ups and downs but have managed to grow slowly and just last week opened our 8th store in Ridgedale Shopping Center. Congressman Paulsen, we would love to have you visit us at Ridgedale when you are home. It is our largest store.

We now have about 50 employees. We feel fortunate because back in 2009 during the recession we were struggling just to keep the doors open.

Retail seems like a simple business – just open a storefront and sell things for more than you paid for them. Turns out, it's not quite that simple. We are a feast or famine business. During November and

December, business is booming and we feel like we won the lottery. However, during the rest of the year we typically lose money. Luckily, every few years a super hot new game or toy comes along to help us get through the slower periods.

I quickly learned that there is a difference between profit and cash flow. We have had some profitable years where I could barely take a paycheck because the cash was used to expand the business. However, I still had to pay income tax on the paper profits. Welcome to the world of Sub-Chapter S. In addition, rising costs, government mandates, and internet competition each create additional challenges.

The key to survival is to plan ahead, manage the cash flow and operate as cost efficiently as possible. We also hope that nothing outside of our control, or costly public policy creates an obstacle to success.

In our business, it's difficult for us to quantify exactly how a Border Adjustment Tax would affect us. We don't manufacture anything. We don't buy containers of games from overseas. In fact, we rarely buy anything directly from suppliers outside of the United States. However, we buy from manufactures and distributors who do.

My suppliers tell me that some of the proposals floating around could result in wholesale prices increases of as much as 20%. All other things being equal, that would totally wipe out my entire profit and then some. For my company, there really isn't much we can do absorb a price increase as significant as that by cutting other expenses. Perhaps we could eliminate some employees but that would damage the quality of our customer service of which we are so proud. And it would hurt those families.

We could simply pass the cost along to the consumer. In fact we would have to. But that hurts the consumer, and the goods we sell are not necessities, so this outside cost increase could simply lead to people not buying our products forcing us to close poor performing stores. Again, our only options are to significantly raise retail prices, eliminating jobs, or closing stores. Probably some of each.

There are a lot of complicated economic theories around this discussion. To simplify this; for me and our family, employees and customers, this proposal will hurt us all.

We hope that the Border Tax Adjustment idea is simply dropped.

Sincerely,

[redacted]
Owner of Games By James
Multiple locations in Minnesota

cc: The Honorable Richard Neal
Ranking Member
Committee on Ways and Means
1102 Longworth House Office Building
Washington, DC 20515

GAMES by James
WE'RE VERY SERIOUS ABOUT F. U. N.

The Honorable Lloyd Doggett
Ranking Member
Committee on Ways and Means
Subcommittee on Tax Policy
1102 Longworth House Office Building
Washington, DC 20515

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THE GREENBRIER COMPANIES

The Greenbrier Companies

One Centerpointe Dr. Suite 200
Lake Oswego, OR 97035
800 343 7188 Fax: 503 684 7553

May 18, 2017

The Honorable Kevin Brady
Chairman
House Committee on Ways and Means
1102 Longworth HOB
Washington D.C. 20515

The Honorable Richard E. Neal
Ranking Member
House Committee on Ways and Means
1139E Longworth HOB
Washington D.C. 20515

Dear Chairman Brady and Ranking Member Neal:

Thank you for providing The Greenbrier Companies with an opportunity to offer our perspective on legislation overhauling the U.S. tax code, including a potential border adjustment tax on U.S. companies. In advance of the Committee's planned hearing on this topic, I am writing to share my concerns about the impact such a tax could have on Greenbrier, our investments, and the 3,500 workers we directly employ in our U.S. businesses across 24 states. I respectfully request that this letter be entered into the hearing record.

## About Greenbrier

Greenbrier is a U.S.-based company with roots in manufacturing in Portland, Oregon, and a proud history of creating good-paying jobs in America since 1919. Our flagship manufacturing business remains centered in Oregon and in Texas. Our U.S. businesses include highly skilled jobs in direct manufacturing; railcar repairs and related services; and management of 266,000 freight cars, representing about 20% of the active North American fleet. Greenbrier also operates globally on four continents throughout South America, Mexico, Canada, Europe, Saudi Arabia in the Gulf Cooperation Council, and Eurasia. By the end of this year, our businesses globally will employ almost 16,000 workers. Our international business includes exports from the United States to these foreign jurisdictions, as well as manufacturing and technical services for local markets supported by U.S. know-how and technology.

In addition to Greenbrier's direct employment in the United States, our supply chains support more than 20,000 good-paying jobs in 26 states at U.S. firms that produce steel, precision castings, braking systems, and other components. The multiplier effect in U.S. job creation is approximately three times our U.S. employment base. We source most of our supplies and raw materials from the United States and more than half of our asset base is in the United States. Our railcars contain between 51% and 95% U.S. components. Our nearly $2.7 billion in annual revenue for fiscal 2016 supports jobs and economic activity throughout our broad U.S. supplier network that includes more than 210 American-based businesses.

## The Border Adjustment Tax's Impact on Manufacturers and Consumers

Encouraging companies such as Greenbrier to establish integrated supply chains in North America has been the U.S. government's policy under multiple administrations and Congresses. And rightly so. By integrating our assembly plants abroad with largely U.S. sourced steel and other materials and supplies, we are able to keep our products affordable for our American customers, invest in our American workforce and operations, and remain competitive with Asian and European manufacturers. Some producers seeking to compete with

Asian and European manufacturers now transfer components across North American borders up to 14 times in the process of completing final goods.[1]

A border adjustment tax like the one envisioned in the House's "A Better Way" blueprint[2] would significantly impact Greenbrier's business and injure American consumers. It would not merely affect Greenbrier but also hundreds of thousands of American jobs in the interdependent North American industrial supply chains similar to the one developed by Greenbrier since the late 1990s. Greenbrier has the innovative capacity, flexibility, and boldness to adapt to a new tax framework. However, American consumers, who rely on goods imported to the United States, will pay more for clothing, food, household appliances and countless other goods that are transported by rail while moving in international commerce, due to the increased tax and transport costs. An analysis by the National Retail Federation indicates that a border adjustment tax could cost the average family $1,700 in the first year alone.[3]

Supporters of a border adjustment tax dispute this analysis. They say once the tax is imposed, the U.S. dollar will appreciate immediately. This assumption is questionable at best and has been challenged by some of the nation's most respected financial institutions.[4] But if they are correct and the dollar rises, it is unclear how that will benefit American exporters. A stronger dollar will *inhibit* U.S. exports because U.S. products of all kinds will be more expensive relative to other countries. A key goal of tax reform should be to provide certainty for job creators and the market, however, a border adjustment tax injects more uncertainty due to the potential fluctuations in the dollar.

**Conclusion**

Greenbrier recognizes the importance of comprehensive tax reform. We also believe any overhaul of the tax code must proceed in a thoughtful and deliberative manner, to minimize the potential for unintended consequences and to ensure all sectors of the economy benefit. A border adjustment tax will not achieve this outcome. Nor is it necessary to achieve the goal of making America's tax code more competitive, as Douglas Holtz-Eakin, former director of the nonpartisan Congressional Budget Office, and other noted economic experts have observed.[4]

As the 115th Congress moves forward on comprehensive tax reform, Greenbrier looks forward to working with you to achieve the goals we all share of boosting economic growth, creating jobs, and keeping America competitive. Thank you for considering Greenbrier's concerns and for your service to America.

Sincerely,

William A. Furman
Chief Executive Officer and Chairman of the Board
The Greenbrier Companies

CC: Representatives Sam Johnson, Kevin Nunes, Pat Tiberi, Dave Reichert, Peter Roskam, Vern Buchanan, Adrian Smith, Lynn Jenkins, Erik Paulsen, Kenny Marchant, Diane Black, Tom Reed, Mike Kelly, Jim Renacci,

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[1] https://www.wsj.com/articles/by-trashing-mexico-trump-hurts-the-u-s-1492983840
[2] http://abetterway.speaker.gov/_assets/pdf/ABetterWay-Tax-PolicyPaper.pdf
[3] https://nrf.com/news/border-adjustment-tax-would-cost-american-households-1700-first-year-alone
[4] http://libertystreeteconomics.newyorkfed.org/2017/02/why-the-proposed-border-tax-adjustment-is-unlikely-to-promote-us-exports.html
[4] https://www.youtube.com/watch?v=XUP3GCSWzug

Pat Meehan, Kristi Noem, George Holding, Jason Smith, Tom Rice, David Schweikert, Jackie Walorski, Carlos Curbelo, Mike Bishop, Sander Levin, John Lewis, Lloyd Doggett, Mike Thompson, John Larson, Earl Blumenauer, Ron Kind, Bill Pascrell, Joseph Crowley, Danny Davis, Linda Sanchez, Brian Higgins, Terri Sewell, Suzan DelBene, Judy Chu

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This submission is on behalf of the approximately 160 associates employed in the United States by Honey-Can-Do International LLC of Berkeley, IL.

Honey-Can-Do International LLC is a leading brand of home storage, organization, laundry care and general housewares products. Our products may be found in leading retailers in the United States and over 60 other countries. Our products are made in the United States as well as other nations. We have been recognized by Inc. magazine and Crain's Chicago Business as a fast growing company since our founding in 2008.

We wish to formally state our objections to the proposed Border Adjustment Tax (BAT) being considered this week by the House Ways and Means Committee. The BAT will lead to higher prices for consumers, a loss of jobs in the United States and lead to crippling negative consequences for a number of currently thriving US companies. We believe that the intent of the proposal is well-meaning, though the consequences will be disastrous for the US economy.

Housewares products are often commodities with high labor inputs and, for the economy to run at its most efficient manner, should be made in nations with low labor rates for unskilled workers. There can be environmental, safety, low wage and other negative associations with these types of production jobs and they are generally not desirable for a high GDP nation such as the United States. If these products which are non-essentials are penalized with a large BAT which is eventually passed along to consumers, fewer of them will be bought as they are no longer affordable. Consumers will pay higher pricing for essential food, medicine, consumables and other items. Lower income and middle class individuals will suffer the hardest and will have fewer funds available for household durables such as housewares. Even with the BAT, these products will not be made in the USA. The dollar will likely not increase in value to a high enough level to compensate for the BAT and, if it does, it will severely hurt the ability for US companies to export products.

Housewares companies typically operate on low margins. If imported products are no longer allowed to be expensed, the tax rate would then be significantly higher than our earnings causing profitable companies to essentially become insolvent and impacting employment of over a million American workers who work for or support those companies.

Thank you for your consideration of this submission,

Steve Greenspon

Chief Executive Officer

Honey-Can-Do International LLC

5300 St. Charles Road

Berkeley, IL 60163

1-708-240-8110

1-708-240-8170 (fax)

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iwpa
INTERNATIONAL
WOOD PRODUCTS
ASSOCIATION

May 23, 2017

The Honorable Kevin Brady
Chairman
Committee on Ways and Means
1102 Longworth House Office Building
Washington, DC 20515

The Honorable Richard Neal
Ranking Member
Committee on Ways and Means
1139E Longworth House Office Building
Washington, DC 20515

Dear Chairman Brady and Ranking Member Neal:

Thank you for this opportunity to submit a statement for the record of today's House Ways and Means Committee hearing on Increasing U.S. Competitiveness and Preventing American Jobs from Moving Overseas. While we at IWPA strongly support your Committee's efforts to enact tax reform that reduces the burden of taxation both on the businesses in our industry and the thousands of American workers they employ, we are opposed to the proposed Border Adjustment Tax that would effectively serve as a new tax on the goods the American business that IWPA represents import from around the world.

IWPA is the leading international trade association for the North American imported wood products industry, representing 200 companies and trade organizations engaged in the import of hardwoods and softwoods from sustainably managed forests in more than 30 nations across the globe. IWPA Members consist of three key groups involved in the import process: U.S. importers and consuming industries, offshore manufacturers and the service providers that facilitate trade. The vast majority of these companies are small- to medium-sized family- owned businesses.

It is critical to note that the wood products found throughout our homes and in the buildings where we Americans work and play, as well as in the manufactured goods we use each day, are not made from a simple interchangeable commodity. Many of the wood species that IWPA Members import simply do not grow in North America. As such, a Border Adjustment Tax would not serve to "level the playing field" for U.S. manufacturers, it would increase the tax burden for U.S. manufacturers and retailers that depend on wood products imports to provide the highest quality products to the customers at the most competitive price. American businesses in the homebuilding, furniture, kitchen cabinet, recreational vehicle, and boating industries would see their input costs soar and their profit margins shrink if a new Border Adjustment Tax were to be implemented.

Many supporters of a Border Adjustment Tax argue that some economists have stated it will cause the U.S. dollar to appreciate, thereby reducing the negative impacts on U.S. businesses that import goods. In an industry like ours, where profit margins are often tight, U.S. employers cannot simply wait for the dollar to adjust to make long-term business decisions with respect to staffing and capital investment. This new tax would have an immediate negative impact, causing increased costs and reduced profits. When discussing the possibility of a Border Adjustment Tax, one IWPA Member indicated that if it were to be enacted, his company would simply cease to exist, causing dozens of Americans to lose their good paying jobs. And that is one company out of hundreds in our industry that would be greatly harmed.

While recent years have seen steady growth in our industry, now is not the time to implement a brand new tax that is based on untested economic assumptions that many economists and business leaders strongly dispute. IWPA is committed to working with Members of the House Ways and Means Committee to advance tax reform that reduces the tax burden on companies and workers in our industry and promotes strong growth that will allow every American the opportunity to find meaningful work.

Please have your staff contact Joe O'Donnell, IWPA's Senior Manager of Government Public Affairs, by e-mail at joe@iwpawood.org or by phone at (703) 820-6696 if you have any questions or need additional information.

Sincerely,

Cindy L Squires

Cindy L. Squires, Esq.
Executive Director

**Subject:** Border Adjustment Tax
**Date:** Monday, May 22, 2017 at 11:15:08 AM Eastern Daylight Time
**From:** Larry Prince
**To:** waysandmeans.submissions@mail.house.gov

**J. B. Prince Company, Inc.**
**36 East 31 Street**
**New York, NY 10016**
Tel: 212-683-3553
Fax: 212-683-4488

Subject: The Border Tax Adjustment

This proposal says that U.S. corporations would no longer be allowed to deduct the cost of imported products (either finished goods or process parts) when they prepare their income tax filings. Thus, any company using imported products would report a much higher profit for tax purposes than they actually make. The proponents of this change say that they will lower the corporate profits tax rate to compensate for the artificially higher taxable income.

It is believed by the backers of this proposal that there will be a large decline in imports into the U.S. and therefore an increase in U.S. production and jobs. They also say that the value of the U.S. Dollar will increase making the remaining imported items cheaper for the American consumer.

Here¹s the problem. Our exports, the products we sell abroad, will decline immediately and precipitously. Because the Dollar becomes more expensive for Europeans, Asians, Africans, and Latin Americans, they will be unable to purchase as much from us as before. Even more important, other countries will impose similar tariffs on U.S. made goods thereby depressing our exports further. This is exactly what happened after the Smoot Hawley Tariff was enacted by the U.S. in 1930. It is generally accepted that Smoot Hawley was one of the major causes of the worldwide depression of the 1930¹s

Further, while there could be an increase in U.S. factory production after The Border Tax Adjustment, it would take a long time for the U.S. to reopen plants, develop and install machinery, and train new workers. Unfortunately, the decrease in exports would happen much faster. Result a downturn in the U.S. economy as exports decrease faster than domestic production grows.

Lastly, the price of imported products would increase sizably, and many imported items may no longer be available to us here in the U.S. The American people would end up paying more for cars, cell phones, furniture, electronic devices, clothing, household appliances, food and more.

Lawrence Prince,
Chairman

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AMERICANS FOR PROSPERITY
FREEDOM PARTNERS
CONCERNED VETERANS FOR AMERICA
THE LIBRE INITIATIVE
GO

Tuesday, May 23, 2017

Dear Members of the Ways and Means Committee,

On behalf of 3.2 million activists in all 50 states, I write to urge the members of this Committee to oppose efforts to include the Border Adjustment Tax (BAT) proposal from further consideration in the context of broader tax reform. American families and businesses deserve a plan that grows the economy and brings relief from the current federal tax code.

The BAT—a proposed $1.2 trillion tax on imports—threatens American businesses and consumers and would undermine many of the other positive proposals we have seen in the tax reform discussion, like lowering rates and eliminating special interest handouts. However, a blanket tax on imports would threaten the livelihood of the very businesses tax reformers seek to help.

Our research has also shown that certain U.S. industries—including manufacturing, energy, and agriculture—stand to be harmed by a BAT since they rely heavily on imports and international trade. Even taking into account a lower overall corporate tax rate, companies that rely on imports to run their business will find themselves faced with skyrocketing effective tax rates.

We agree that American companies are at a disadvantage to their global competitors—but it isn't because we don't tax our imports. It's because the U.S. has one of the highest corporate tax rates in the world, and it is crushing American businesses. Congress can relieve this burden by lowering the corporate rate and ending our harmful system of worldwide taxation in order to spur growth and investment in our domestic economy, without saddling consumers with a trillion-dollar tax hike.

This Committee has a tremendous opportunity to deliver comprehensive, pro-growth tax reform this year that will jumpstart the economy and ease the burden on American families. This reform can happen without a new trillion dollar consumer tax. We encourage you and your colleagues to eliminate the proposal from consideration in order deliver on the promise of positive, comprehensive reform this year.

Sincerely,

Americans for Prosperity
Concerned Veterans for America
Generation Opportunity

Freedom Partners Chamber of Commerce
The LIBRE Initiative

*Americans for Prosperity (AFP) exists to recruit, educate, and mobilize citizens in support of the policies and goals of a free society at the local, state, and federal level, helping every American live their dream – especially the least fortunate. AFP has more than 3.2 million activists across the nation, a local infrastructure that includes 36 state chapters, and has received financial support from more than 100,000 Americans in all 50 states. For more information, visit www.AmericansForProsperity.org.*

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## Statement of Richard Woldenberg on Border Adjustment Tax

**Submitted to the Subcommittee on Tax Policy**
**of the House Committee on Ways and Means**
**The United States House of Representatives**

**May 23, 2017**

My name is Richard Woldenberg, and I am CEO of Learning Resources, Inc. located in Vernon Hills, Illinois. I am submitting this testimony on behalf of our company. Our company is a family business which develops and markets educational products and educational toys in the United States and dozens of other countries. We outsource the manufacturing of our products overseas, and as a result, we are a significant importer (of our own products) into the United States.

We have grave concerns about the Border Adjustment tax proposal being considered by the House Ways and Means Committee as originally described in the "*A Better Way*" plan. The proposal is rife with risk and unintended consequences. I fear that the future of our company, and the jobs we provide, are at stake. We are a small business under the Federal government definition and believe that the problems we will face under the Border Adjustment tax proposal will be experienced by thousands of other small business importers in the United States.

### **Our Company**:

Learning Resources, Inc. (LR) was founded in 1984 and is located in Vernon Hills, Illinois and has about 150 employees in the U.S. and U.K. The company is part of our family business group which turned 100 years old in 2016; I am in the third generation of my family to run this business, and we were proud to welcome the first member of the fourth generation into our business this year. LR develops and markets proprietary educational toys and materials in Vernon Hills but manufactures its 1400 products overseas. Jobs at our company pay well, turnover is low and we are an important part of our community, injecting many millions of salary and benefit dollars into the local economy annually. In 2013 and again in 2016, LR tried and failed to find U.S. molders interested in making our products here. In other words, we know from recent experience that we have no realistic option to make our products in the U.S., with or without the incentive of a reconceived Federal tax regime.

### **The Issues Created by Border Adjustment Tax (BAT)**:

1. We will become the involuntary subject of an historic exchange rate experiment. The BAT plan is unprecedented in U.S. history and its effects are unknown and unknowable. The plan is premised on a surging dollar that erases import costs. Betting the U.S. economy on a rising dollar is irresponsible – we shouldn't confuse being "bold" with being reckless. Tax policy based on presumed changes in the value of the U.S. dollar is simply gambling. We cannot afford tax policy based on hunches, regardless of the resumes of those who pound the table promising dollar nirvanas.

Economists Auerbach and Holtz-Eakin assert that U.S. dollar appreciation after implementation of the BAT will reduce importers' Cost of Goods Sold (COGS) enough to pay the new Federal tax bill. This is the basis of the contention that the plan simply "levels the playing field" without affecting cash flows. The economists offer little more than bland assurances, however.

The plan's flaws are manifest:

- Congress can't accurately predict the course and direction of financial markets and hence can't be certain of future exchange rates. What if the predictions of massive U.S. dollar appreciation are wrong? What if the changes are smaller or larger than expected, or arrive later, or fade over time? After all, foreign exchange markets are massive, and dominated by large pools of capital not tied to trade. Tax policy is hardly the only factor which drives exchange rates. Interestingly, economists have given a name to the inability to predict exchange rates: The Exchange Rate Disconnect Puzzle. See https://www.google.com/url?sa=t&rct=j&q=&esrc=s&source=web&cd=2&ved=0ahUKEwjt1LSc4YLUAhXL5YMKHZrnArkQFggtMAE&url=https%3A%2F%2Fwww.dallasfed.org%2Fassets%2Fdocuments%2Fresearch%2Feclett%2F2008%2Fel0806.pdf&usg=AFQjCNGGj0SNFH-Q5SRwd2vcQBn-SrkTEA&sig2=LiFrN9xlIWK6Mr-MqLxR6A It is an accepted fact that movement in exchange rates cannot be foretold.

- The cost of imported goods will always include foreign content. For instance, foreign-made clothing often includes U.S. cotton or U.S. thread. Toys made in China often use imported plastics, paper or wood. Oil and gasoline are also foreign inputs. Foreign inputs rise in cost as the dollar rises, while only local content falls in cost. Our factories estimate 30-65% of our product cost is foreign-sourced. This means that our factories' overall costs will likely RISE when the dollar rises. The economists' assertion of cost savings is illusory.

- Dollar-denominated costs are the norm for U.S. importers. As the dollar rises, dollar-based costs don't decline – they are fixed by contract. Realizing savings will require a line-by-line renegotiation of our entire business, essentially a zero-sum game with our factories. Factories may well refuse to cooperate with any effort to ratchet down dollar-based costs. In any event, cost reductions required to balance out the BAT will be epic and FAR beyond any cost reduction achievement in our company history. To fund the BAT, we will need to lower costs by as much as 19% which is frankly absurd. This cost savings is presumed by supporters of the BAT, but it's entirely unrealistic.

- We believe there are other risks to the exchange rate scheme, including resistance by other countries (in the form of currency manipulation or interest rate changes). There is no guarantee that the dollar will move equally in all markets, for any number of reasons, so there is likewise no guarantee that costs will actually decline. We also believe we will be subject to significant changes in the terms of our bank line of credit owing to novel currency risks imposed by the BAT. Instability in bank financing could be devastating for many companies.

*Unlike the 1986 Reagan tax plan, the BAT has no fallback position*. If the Reagan plan didn't work, the Federal government had the option to raise tax rates and no company would have been damaged. Under the BAT, corporate restructuring for many businesses seems inevitable and significant job losses likely. If the theory behind the BAT doesn't hold, Congress will not be able to resurrect the companies killed by the BAT. Humpty-Dumpty can't be put together again. Policy makers should not take such risks with American livelihoods.

2. The BAT will likely trigger a highly-regressive inflationary firestorm. When it becomes clear that importers will have no realistic way to capture sufficient cost savings to pay the enormous increase in taxes caused by the BAT, there will be no choice but to pass the costs along to consumers. And of course, consumers always bear the cost and consequences of tax increases like the BAT. We estimate that costs will ultimately rise as much as 20% under the BAT.

   The mechanism for the price hike is being demonstrated in the U.K. right now. The collapse in the value of the British Pound from $1.50 (on the evening of the Brexit vote) to a recent low of $1.21 mimics the inflationary pressures likely created by BAT-induced dollar appreciation. Sharply rising U.K. consumer prices from import cost inflation strongly suggests that consumer inflation will naturally occur here under the BAT. Like a value-added tax, this rise in consumer costs will be regressive in nature and strike hardest the most vulnerable in our economy. A large population of defenseless constituents will find their standard of living slipping into decline post-BAT.

   For example, see these news reports of U.K. price hikes:

   https://www.wsj.com/articles/brexit-comes-with-price-shock-at-checkout-1489512547 (Brexit price shocks hits consumer products)

   https://www.theguardian.com/business/2016/dec/14/lego-to-raise-its-prices-in-uk-from-january-sterling (LEGO raises prices due to British Pound weakness)

   http://www.toynews-online.biz/news/read/lego-reportedly-raising-prices-in-the-uk-by-5/047893 (LEGO letter explaining price increase)

   http://toyworldmag.co.uk/blog/the-end-of-days-its-the-friday-blog/ (Battle between retailers and suppliers over cost of the British Pound decline)

   http://www.independent.co.uk/news/business/news/brexit-microsoft-prices-rise-pound-slump-value-software-impact-a7378181.html (Microsoft hikes prices 22% over British Pound decline)

   http://www.independent.co.uk/news/business/news/brexit-pound-value-christmas-pudding-prices-rise-a7445476.html (Supply chain costs cause 21% rise in cost of Christmas pudding) http://www.cyclingweekly.co.uk/news/latest-news/brexit-will-be-the-cause-of-possible-brompton-cost-increase-in-uk-298369 (UK bike manufacturer may raise prices because of currency-related supply chain cost increases)

http://europe.autonews.com/article/20161006/ANE/161009940/ford-vauxhall-nissan-raise-uk-car-prices-after-brexit (Ford, et. al., raises car prices because of component costs in locally-made cars).

https://www.thesun.co.uk/news/2517213/marks-spencer-to-increase-prices-by-up-to-15-despite-making-post-brexit-promise-to-protect-shoppers-from-devaluing-pound/ (Marks & Spencer reverses course and increases prices 15% because of the Pound).

3. The BAT will almost certainly spark trade wars. Economists supporting the BAT confidently predict an "immediate" 25% appreciation in the U.S. dollar after the BAT is implemented (based on a 20% Federal tax rate for "C" Corps). Simple math indicates that this translates into a British Pound at parity (the lowest exchange rate ever), the Euro at $.80 (near its all-time low of $.70 in 1985), and almost certainly a broken peg for the Hong Kong Dollar and other key currencies tied to the dollar. Such sharp U.S. dollar appreciation can be expected to devastate U.S. exports. The theory that the BAT will stimulate export sales seems dubious in light of a skyrocketing dollar, and therefore the value of the BAT tax holiday on export sales is of limited value.

   The likely financial impact of this Congress-induced currency manipulation certainly seems calamitous. It seems delusional to believe that other countries will simply sit idly by and let the United States inflict this kind of harm on their economies. Consider Canada as an example. Canada was the third largest exporter to the U.S. in 2016, with total exports of $278 Billion. The BAT on that flow will be approximately $56 Billion, half the projected annual "take" under the BAT. Some estimates indicate that 75% of Canadians live within 100 miles of the U.S. border. Consider the impact of that tax on the Canadian economy and the population living near the U.S. Will Canada elect to just "take it"? No chance. Add to this the fact that Canada also imported $266 Billion from the U.S. The BAT will give American exporters a significant edge in competing with Canadian suppliers by eliminating income tax. Canada will get it coming and going under the BAT. I am sure Canadian legislators will quickly find inspiration to give the Americans a taste of their own medicine.

   It is implausible that these effects will be ignored. To seriously entertain the notion that other countries won't find ways to retaliate is to engage in happy talk.

4. Preventing inversions but opening up other gaping tax loopholes at the expense of our jobs and our company is unacceptable. Eliminating the inequity of companies implementing tax gambits like inversions would make the U.S. tax system fairer, certainly. We feel the pain because we pay a far higher tax rate (43.6%) on our worldwide pretax income as an Illinois-based "S" Corp. We do not shop internationally for low tax rate jurisdictions. We believe we are typical of American small

businesses. While it may be galling that some taxpayers pay much less, *unjust enrichment of others does not actually make us poorer.* It is even MORE galling, however, to know that we are being asked to sacrifice our businesses so large highly-profitable mega-corporations can be excused from paying any tax under the BAT. That's even more unfair than the current situation and will outrage ordinary taxpayers once they realize what has happened. We would be much better off if Congress did nothing.

5. We are a Small Business job creator but our job creation engine will be eviscerated by the BAT. Our products were developed by Americans in the United States, our intellectual property is owned in this country, and we created about 150 jobs by developing a market for our educational products. We are not ashamed of our decades-long record of helping American kids learn and American families improve their standard of living with products that we make offshore. If we must nevertheless reorganize to fund the BAT, however, we will be incentivized to eliminate as many high paying jobs as possible – we will recapture 75 cents for each dollar of expense eliminated at the new tax rate. Investments in automation will become much more attractive – and will be immediately deductible under "*A Better Way*" plan. How does the BAT create enough jobs to compensate for job losses like these all over the country?

   Notably, 97% of U.S. importers are Small Businesses, according U.S. Census data from 2014. The average import value per annum per congressional district is about $1.5 billion from Small Business alone, meaning that each district will pay $300 million in extra taxes under the BAT. The annual import value (2015) for the U.S. Small Business community - $631 billion (https://www.census.gov/foreign-trade/Press-Release/edb/2015/exh1d.pdf) – would fully fund the projected $1.2 trillion ten-year revenue raised by the BAT. In other words, the BAT is a Small Business tax. According to the U.S. Census Bureau, there were more than 191,000 small business importers in 2015 in the United States. That's a lot of small business jobs at risk under this proposal.

6. Long-promised lower Federal corporate tax rates will not translate into lower tax bills under the BAT. Despite the expected 25% rate for "S" Corps under "*A Better Way*", our company's Federal tax bill is expected to increase by 4-5x. Based on our actual 2016 results, we project paying a 165% tax bill at the 25% rate for "S" Corps. The negative impact of BAT math intensifies as Cost of Goods Sold (COGS) grows as a percentage of sales. In other words, the tax is regressive in the corporate community, by pinching the lowest margin companies most deeply.

   *Notably, importers will face giant tax bills even in years when they are losing money.* This is simple math – importers might have no GAAP earnings but high imported COGS, and thereby will generate a huge Federal tax bill with no money to pay it. Does the House Committee on Ways and Means want such companies to die quickly? We believe that companies facing financial difficulties or going through a turnaround will shed jobs in droves post-BAT just to survive, or simply go out of business. The BAT will lead to death by Federal taxes.

7. The shift of tax base from GAAP earnings will create great risk for companies and unpredictable tax outcomes. We finance our business based on predicted cash flows. Taxes under American law have always been a fraction of earnings, which facilitates planning and certainty. As an importer under the BAT plan, our Federal tax bill will greatly exceed our GAAP earnings, and our ability to pay will depend on various factors largely out of our control. Planning and certainty are no longer possible. If we fail to capture savings from dollar appreciation for any reason (meaning that we must sharply reduce our product costs, bring the inventory in, sell it at unprecedented profit margins and collect the cash, all in time to fund a quadrupled tax bill) we will either incur losses to pay taxes or have to restructure our business to survive. We don't know what our business looks like under these conditions.

8. Foreign VAT systems do not put American products at a disadvantage. The BAT purportedly addresses a longstanding disadvantage created by foreign value-add tax systems (VAT). This is an urban myth. In fact, VAT is a tax paid by consumers in lieu of personal income tax. The BAT is a corporate income tax, not a personal income tax substitute. This is apples-and-oranges. VAT is paid in full by the last buyer in the chain of commerce, the consumer. No one pays anything in the chain other than the consumer by definition under a VAT. Foreign corporations pay tax on their earnings just as we do in this country (corporate income tax). U.S. tax treaties ensure that no corporate profit dollar is taxed twice. [The fact that U.S. corporate tax rates are the third highest in the world, behind the U.A.E. and Chad, is probably the root cause of inversions, not the "attractiveness" of VATs.] VAT does not convey advantage to anyone.

   Second, the VAT "border adjustment" on export is simply a governmental rebate of excess tax receipts to the company that paid the taxes. It is not a subsidy. This is a mathematical fact, but we also know this from personal experience. Since 1994 we have operated a company in the U.K. and export from the European Union regularly. If VAT border rebates were actually an export subsidy as has been alleged, we would have been receiving this subsidy since 1994. Although we produce audited financials for our U.K. business, there is no line in those financials for VAT revenues or VAT profits. There is no such thing. Large multinational corporations have been chirping about the "unfairness" of VAT border adjustments in support of the BAT, but notably they are also significant exporters from VAT jurisdictions. If it is possible to profit from VAT, as they assert, they themselves must be receiving this subsidy. The Committee should request information on the benefits large multinationals have received over the last 20 years under VAT tax regimes. Such requests will be greeted with silence.

   Finally, the assertion that VAT border adjustment is unfair to Americans is implausible given the careful scrutiny given to trade disputes under GATT. Since 1947, the U.S. has been involved in 379 cases at the WTO either as a plaintiff, defendant or other participant. That's a major WTO lawsuit involving the U.S. approximately every two months for 70 years. If VAT "border adjustments" have

> been so prejudicial to American exporters since 1947, why hasn't it been litigated by the United States? Such a serious charge deserves much greater scrutiny.

**Financial Models**: I have attached below model financials for two hypothetical toy companies, one with gross margins of 38% (yellow highlights) and one with gross margins of 25% (orange highlights). The 25% gross margin company operates on lower expenses to make similar money (for instance, they might be a "make-to-order" company without a warehouse). Both companies are modeled with simplifying assumptions under the BAT, focusing on the impact of the loss of the COGS deduction. Both companies are modeled as an Illinois-based "S" Corp with steady State taxes.

There are four scenarios presented for each company: (A) current tax law, (B) "*A Better Way*" Blueprint, (C) Post-ABW (details below), and (D) Economists Optimistic Scenario (details below). Scenarios C and D are essentially opposite scenarios. Scenario D illustrates what economists predict, namely that companies will capture COGS savings from U.S. dollar appreciation to fully pay their new BAT tax bills. Scenario C models what happens when companies capture none of the predicted currency benefits, leaving the model companies no choice but to raise prices (up 34%) and reduce expenses (down 20%) to preserve their financial results. This response will also trigger an immediate sharp decline in sales (down 40% in units). These two scenarios produce the same cash flow as the current law scenario (A) but only with major operational changes. None of scenarios B, C or D are better than the status quo for the model companies, or our company, or the thousands of similarly-situated companies all over the United States.

I would like to draw your attention to the relationship of Payroll expense to net taxable income in the models. Payroll expense (jobs) is much greater than pre-tax profit in most companies. The true social impact of independent businesses stems from their payroll expenses (in other words, jobs, jobs, jobs). This is certainly the case for multi-generational family businesses like ours which are the bedrock of communities through good times and bad. But the BAT threatens payrolls at small business importers. Consider how much Federal taxes increase in the new plan (B v. A) despite the reduction in rate from 39.6% to 25%. The Federal tax bill skyrockets. In the examples here, the Federal tax bill goes up between 8.1x and 11.4x. [A more thorough modeling against our actual financials shows taxes rising between 4-5x over today's 39.6% Federal tax bill.] Clearly new Federal taxes will endanger payroll expenses (jobs). Is this what taxpayers want?

It is important to note that in the examples here, the model companies must recover 24% of COGS, presumably through resetting dollar contracts after the dollar appreciates by the promised 25%. That's a fantasy of massive and unachievable savings. We are ecstatic if we can shave 1% off our COGS in any given year. Suspending disbelief, please consider what this asserted exchange rate value transfer means to the guy on the other side of the trade (our vendors). The BAT proposal will suck wealth from every country in the world over to the U.S. By manipulation of the Federal income tax code, Congress will thus force us to become the agent which lands this big wealth transfer . . . all so we can hand it over to Uncle Sam. Not a very appealing prospect, especially because it must be played out against our long-time, trusted vendor partners. This will devastate critical business relationships. Shaking down our supply chain to pay a huge increase in Federal taxes means we become the government's shills. This is obviously bad tax policy.

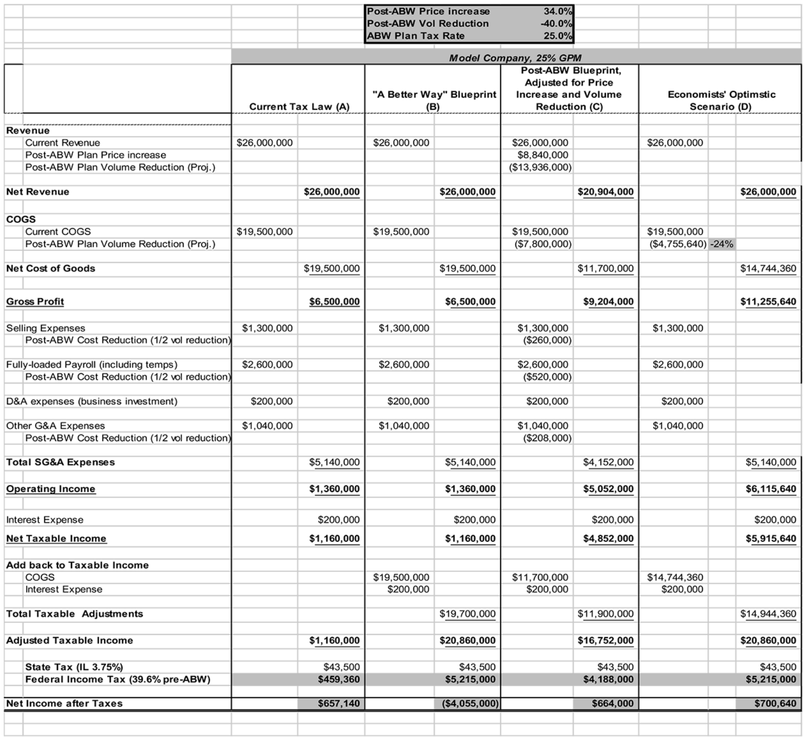
No matter how the BAT is spun by the talking heads, no one is going to miss the point that importer tax bills are going to multiply under the BAT. As more business owners and their accountants do the math, and realize that they face unimaginable tax burdens never seen since the institution of the Federal Income Tax system in 1913, they will rise up against the politicians who devised the plan. The voters' anger will only mount as job losses pile up and prices rise.

There must be another, better way to fix the tax system in this country, and it is Congress' responsibility to find it. Thank you for considering my views.

| | |
|---|---|
| **Post-ABW Price increase** | **34.0%** |
| **Post-ABW Vol Reduction** | **-40.0%** |
| **ABW Plan Tax Rate** | **25.0%** |

***Model Company, 38% GPM***

| | **Current Tax Law (A)** | | **"A Better Way" Blueprint (B)** | | **Post-ABW Blueprint, Adjusted for Price Increase and Volume Reduction (C)** | | **Economists' Optimstic Scenario (D)** | | |
|---|---|---|---|---|---|---|---|---|---|
| **Revenue** | | | | | | | | | |
| Current Revenue | $26,000,000 | | $26,000,000 | | $26,000,000 | | $26,000,000 | | |
| Post-ABW Plan Price increase | | | | | $8,840,000 | | | | |
| Post-ABW Plan Volume Reduction (Proj.) | | | | | ($13,936,000) | | | | |
| **Net Revenue** | | **$26,000,000** | | **$26,000,000** | | **$20,904,000** | | | **$26,000,000** |
| **COGS** | | | | | | | | | |
| Current COGS | $16,120,000 | | $16,120,000 | | $16,120,000 | | $16,120,000 | | |
| Post-ABW Plan Volume Reduction (Proj.) | | | | | ($6,448,000) | | ($3,878,520) | -24% | |
| **Net Cost of Goods** | | $16,120,000 | | $16,120,000 | | $9,672,000 | | | $12,241,480 |
| **Gross Profit** | | **$9,880,000** | | **$9,880,000** | | **$11,232,000** | | | **$13,758,520** |
| Selling Expenses | $2,000,000 | | $2,000,000 | | $2,000,000 | | $2,000,000 | | |
| Post-ABW Cost Reduction (1/2 vol reduction) | | | | | ($400,000) | | | | |
| Fully-loaded Payroll (including temps) | $4,500,000 | | $4,500,000 | | $4,500,000 | | $4,500,000 | | |
| Post-ABW Cost Reduction (1/2 vol reduction) | | | | | ($900,000) | | | | |
| D&A expenses (business investment) | $300,000 | | $300,000 | | $300,000 | | $300,000 | | |
| Other G&A Expenses | $1,500,000 | | $1,500,000 | | $1,500,000 | | $1,500,000 | | |
| Post-ABW Cost Reduction (1/2 vol reduction) | | | | | ($300,000) | | | | |
| **Total SG&A Expenses** | | $8,300,000 | | $8,300,000 | | $6,700,000 | | | $8,300,000 |
| **Operating Income** | | **$1,580,000** | | **$1,580,000** | | **$4,532,000** | | | **$5,458,520** |
| Interest Expense | | $200,000 | | $200,000 | | $200,000 | | | $200,000 |
| **Net Taxable Income** | | **$1,380,000** | | **$1,380,000** | | **$4,332,000** | | | **$5,258,520** |
| **Add back to Taxable Income** | | | | | | | | | |
| COGS | | | $16,120,000 | | $9,672,000 | | $12,241,480 | | |
| Interest Expense | | | $200,000 | | $200,000 | | $200,000 | | |
| **Total Taxable Adjustments** | | | | $16,320,000 | | $9,872,000 | | | $12,441,480 |
| **Adjusted Taxable Income** | | **$1,380,000** | | **$17,700,000** | | **$14,204,000** | | | **$17,700,000** |
| **State Tax (IL 3.75%)** | | $51,750 | | $51,750 | | $51,750 | | | $51,750 |
| **Federal Income Tax (39.6% pre-ABW)** | | **$546,480** | | **$4,425,000** | | **$3,551,000** | | | **$4,425,000** |
| **Net Income after Taxes** | | **$781,770** | | **($3,045,000)** | | **$781,000** | | | **$833,520** |



| | |
|---|---|
| Post-ABW Price increase | 34.0% |
| Post-ABW Vol Reduction | -40.0% |
| ABW Plan Tax Rate | 25.0% |

*Model Company, 25% GPM*

| | Current Tax Law (A) | | "A Better Way" Blueprint (B) | | Post-ABW Blueprint, Adjusted for Price Increase and Volume Reduction (C) | | Economists' Optimstic Scenario (D) | | |
|---|---|---|---|---|---|---|---|---|---|
| **Revenue** | | | | | | | | | |
| Current Revenue | $26,000,000 | | $26,000,000 | | $26,000,000 | | $26,000,000 | | |
| Post-ABW Plan Price increase | | | | | $8,840,000 | | | | |
| Post-ABW Plan Volume Reduction (Proj.) | | | | | ($13,936,000) | | | | |
| **Net Revenue** | | **$26,000,000** | | **$26,000,000** | | **$20,904,000** | | | **$26,000,000** |
| **COGS** | | | | | | | | | |
| Current COGS | $19,500,000 | | $19,500,000 | | $19,500,000 | | $19,500,000 | | |
| Post-ABW Plan Volume Reduction (Proj.) | | | | | ($7,800,000) | | ($4,755,640) | -24% | |
| **Net Cost of Goods** | | $19,500,000 | | $19,500,000 | | $11,700,000 | | | $14,744,360 |
| **Gross Profit** | | **$6,500,000** | | **$6,500,000** | | **$9,204,000** | | | **$11,255,640** |
| Selling Expenses | $1,300,000 | | $1,300,000 | | $1,300,000 | | $1,300,000 | | |
| Post-ABW Cost Reduction (1/2 vol reduction) | | | | | ($260,000) | | | | |
| Fully-loaded Payroll (including temps) | $2,600,000 | | $2,600,000 | | $2,600,000 | | $2,600,000 | | |
| Post-ABW Cost Reduction (1/2 vol reduction) | | | | | ($520,000) | | | | |
| D&A expenses (business investment) | $200,000 | | $200,000 | | $200,000 | | $200,000 | | |
| Other G&A Expenses | $1,040,000 | | $1,040,000 | | $1,040,000 | | $1,040,000 | | |
| Post-ABW Cost Reduction (1/2 vol reduction) | | | | | ($208,000) | | | | |
| **Total SG&A Expenses** | | $5,140,000 | | $5,140,000 | | $4,152,000 | | | $5,140,000 |
| **Operating Income** | | **$1,360,000** | | **$1,360,000** | | **$5,052,000** | | | **$6,115,640** |
| Interest Expense | | $200,000 | | $200,000 | | $200,000 | | | $200,000 |
| **Net Taxable Income** | | **$1,160,000** | | **$1,160,000** | | **$4,852,000** | | | **$5,915,640** |
| **Add back to Taxable Income** | | | | | | | | | |
| COGS | | | $19,500,000 | | $11,700,000 | | $14,744,360 | | |
| Interest Expense | | | $200,000 | | $200,000 | | $200,000 | | |
| **Total Taxable Adjustments** | | | | $19,700,000 | | $11,900,000 | | | $14,944,360 |
| **Adjusted Taxable Income** | | **$1,160,000** | | **$20,860,000** | | **$16,752,000** | | | **$20,860,000** |
| **State Tax (IL 3.75%)** | | $43,500 | | $43,500 | | $43,500 | | | $43,500 |
| **Federal Income Tax (39.6% pre-ABW)** | | **$459,360** | | **$5,215,000** | | **$4,188,000** | | | **$5,215,000** |
| **Net Income after Taxes** | | **$657,140** | | **($4,055,000)** | | **$664,000** | | | **$700,640** |

**LEVI STRAUSS & CO.**

**Written Testimony for the Record**

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

Increasing U.S. Competitiveness and Preventing American Jobs from Moving Overseas:
*How Border Adjustment and Other Policies Will Boost Jobs, Investment, and Growth in the U.S.*

1100 Longworth House Office Building
May 23, 2017

Levi Strauss & Co. appreciates this opportunity to submit comments for inclusion in the record of the Committee's hearing on corporate tax reform. Our message is simple: The Committee should adopt a framework that does not include border adjustment or a border adjustment tax (BAT). While we strongly support corporate tax reform, we are concerned about the negative impact the BAT would have on our company, the retail industry, and our customers.

Levi Strauss & Co. is one of the world's largest brand-name apparel companies and a global leader in jeanswear with products sold in more than 110 countries. There is no other company with a comparable global presence in the jeans and casual pants markets. Our market-leading apparel products are sold under the Levi's®, Dockers®, Signature by Levi Strauss & Co.™ and Denizen™ brands.

The blueprint currently under consideration would convert the United States' existing corporate income tax into a cash flow tax that is "destination-based" and "border-adjusted" – meaning that the full value of all U.S. imports, and not just profits made in selling those imports, would be subject to tax at a rate of at least 20 percent. This one element is so harmful that it undermines everything else in the proposed tax package. The likely result would be significant price increases for the consumer, leading to contraction of the U.S. economy rather than much-needed economic growth.

Modernization of the U.S. tax code is an important objective and one we support. Reduction of the nominal rate of U.S. corporate income tax, to bring it more in line with global norms, belongs in any reform package. But bringing the cost of imports into the tax base – removing the deductibility of every good, input and service that corporate taxpayers acquire outside the United States – is not a viable way to pay for a rate reduction. It would punish businesses, and indeed entire industries, that utilize imported components, while at the same time negatively affecting consumers who buy items sourced abroad.

Preliminary estimates show that the proposed BAT would increase the tax rate of our U.S. operations from 39 percent today to over 100 percent, and would immediately eliminate our global net profit, forcing us to increase consumer prices in the United States by 14 to 20 percent just to stay in business. These estimates take account of other elements of the proposed tax package. Economists agree that product price hikes often lead to a decrease in consumption and often result in reduced employment, leading to the conclusion that the BAT will reduce U.S. jobs across many industries.

Levi Strauss & Co. itself operates 185 stores in the United States, and our products are sold in another 9,000 retail stores in the United States, such as Macy's, Kohl's and JCPenney. A dramatic reduction in consumption brought on by price increases will further undermine an already challenged segment of our economy which supports 42 million jobs—or 1 in 4 jobs in the United States.

The BAT would have a particularly devastating impact on the apparel industry as virtually all apparel purchased in the United States is imported and more than 80 percent of it has been hit, at the time of importation, with customs duties that are among the highest the U.S. imposes. Making import value subject to both customs duties and cash flow tax is a crystal-clear example of double-taxation.

Converting a levy on corporate profits into a regressive and job-destroying consumption tax would be a bad idea regardless of the reactions of U.S. trading partners. But given the widely-expected finding of World Trade Organization (WTO) inconsistency, the BAT is also likely to spur trade retaliation measured in the billions of dollars, and therefore to be harmful on balance to the U.S. exporters who are the BAT's supposed beneficiaries.

While pro-BAT advocates contend the U.S. dollar would appreciate 25 percent, making retailers "whole" under the new structure over time, economists are not in agreement on how currencies would adjust. Moreover, while BAT proponents appear to be assuming that retailers pay for goods in the local currency of product origin, most contracts for imported products are based on U.S. dollars, not the local currency. This renders currency fluctuations essentially meaningless in offsetting higher prices for imports. It is worth noting that China and Vietnam, the two largest suppliers of apparel imported into the United States, do not have floating currencies in any event.

Tax reform should be fair and bring simplicity and greater certainty. The BAT, however, will bring uncertainty as to its legality, create disproportionate winners and losers, and drive volatility to global trade and foreign exchange. It is a misguided proposal whose adoption would irreparably harm not only our business and its many stakeholders – including our American workers and customers – but the entire U.S. economy. We urge the Committee to cast-off the BAT from consideration and develop an equitable, economy-boosting approach for tax reform.

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May 31, 2017

The Honorable Kevin Brady
Chairman
House Ways and Means Committee
1102 Longworth House Office Building
Washington, D.C. 20515

The Honorable Richard Neal
Ranking Member
House Ways and Means Committee
1139E Longworth House Office Building
Washington, D.C. 20515

Dear Chairman Brady and Ranking Member Neal:

In connection with the House Ways and Means Committee's recent hearing on *Increasing U.S. Competitiveness and Preventing American Jobs from Moving Overseas*, we are submitting as a statement for the record the attached letter urging you to preserve the current availability of like-kind exchange treatment as part of any business tax reform. Thank you for your consideration and your leadership on these important issues.

Sincerely,

**The Like-Kind Exchange Stakeholder Coalition**

THE LIKE-KIND EXCHANGE STAKEHOLDER COALITION

November 29, 2016

Mr. Jim Carter
Tax Policy Lead
Presidential Transition
1800 F Street NW
Washington, DC 20006

Dear Mr. Carter:

As you consider ways to create jobs, grow the economy, and raise wages through tax reform, we strongly urge that current law be retained regarding like-kind exchanges under section 1031 of the Internal Revenue Code ("Code"). We further encourage retention of the current unlimited amount of gain deferral.

Like-kind exchanges are integral to the efficient operation and ongoing vitality of thousands of American businesses, which in turn strengthen the U.S. economy and create jobs. Like-kind exchanges allow taxpayers to exchange their property for more productive like-kind property, to diversify or consolidate holdings, and to transition to meet changing business needs. Specifically, section 1031 provides that taxpayers do not immediately recognize a gain or loss when they exchange assets for "like-kind" property that will be used in their trade or business. They do immediately recognize gain, however, to the extent that cash or other "boot" is received. Importantly, like-kind exchanges are similar to other non-recognition and tax deferral provisions in the Code because they result in no change to the economic position of the taxpayer.

Since 1921, like-kind exchanges have encouraged capital investment in the U.S. by allowing funds to be reinvested back into the enterprise, which is the very reason section 1031 was enacted in the first place. This continuity of investment not only benefits the companies making the like-kind exchanges, but also suppliers, manufacturers, and others facilitating them. Like-kind exchanges ensure both the best use of real estate and a new and used personal property market that significantly benefits start-ups and small businesses. Eliminating like-kind exchanges or restricting their use would have a contraction effect on our economy by increasing the cost of capital, slowing the rate of investment, increasing asset holding periods and reducing transactional activity.

A 2015 macroeconomic analysis by Ernst & Young found that either repeal or limitation of like-kind exchanges could lead to a decline in U.S. GDP of up to $13.1 billion annually.[1] The Ernst & Young study quantified the benefit of like-kind exchanges to the U.S. economy by recognizing that the exchange transaction is a catalyst for a broad stream of economic activity involving businesses and service providers that are ancillary to the exchange transaction, such as brokers, appraisers, insurers, lenders, contractors, manufacturers, etc. A 2016 report by the Tax

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[1] *Economic Impact of Repealing Like-Kind Exchange Rules,* ERNST & YOUNG (March 2015, Revised November 2015), at (iii), *available at* http://www.1031taxreform.com/wp-content/uploads/Ling-Petrova-Economic-Impact-of-Repealing-or-Limiting-Section-1031-in-Real-Estate.pdf.

Foundation estimated even greater economic contraction – a loss of 0.10% of GDP, equivalent to $18 billion annually.[2]

Companies in a wide range of industries, business structures, and sizes rely on the like-kind exchange provision of the Code. These businesses—which include real estate, construction, agricultural, transportation, farm / heavy equipment / vehicle rental, leasing and manufacturing—provide essential products and services to U.S. consumers and are an integral part of our economy.

A microeconomic study by researchers at the University of Florida and Syracuse University, focused on commercial real estate, supports that without like-kind exchanges, businesses and entrepreneurs would have less incentive and ability to make real estate and other capital investments.[3] The immediate recognition of a gain upon the disposition of property being replaced would impair cash flow and could make it uneconomical to replace that asset. This study further found that taxpayers engaged in a like-kind exchange make significantly greater investments in replacement property than non-exchanging buyers.

Both studies support that jobs are created through the greater investment, capital expenditures and transactional velocity that are associated with exchange properties. A $1 million limitation of gain deferral per year, as proposed by the Administration[4], would be particularly harmful to the economic stream generated by like-kind exchanges of commercial real estate, agricultural land, and vehicle / equipment leasing. These properties and businesses generate substantial gains due to the size and value of the properties or the volume of depreciated assets that are exchanged. A limitation on deferral would have the same negative impacts as repeal of section 1031 on these larger exchanges. Transfers of large shopping centers, office complexes, multifamily properties or hotel properties generate economic activity and taxable revenue for architects, brokers, leasing agents, contractors, decorators, suppliers, attorneys, accountants, title and property / casualty insurers, marketing agents, appraisers, surveyors, lenders, exchange facilitators and more. Similarly, high volume equipment rental and leasing provides jobs for rental and leasing agents, dealers, manufacturers, after-market outfitters, banks, servicing agents, and provides inventories of affordable used assets for small businesses and taxpayers of modest means. Turnover of assets is key to all of this economic activity.

In summary, there is strong economic rationale, supported by recent analytical research, for the like-kind exchange provision's nearly 100-year existence in the Code. Limitation or repeal of section 1031 would deter and, in many cases, prohibit continued and new real estate and capital investment. These adverse effects on the U.S. economy would likely not be offset by lower tax rates. Finally, like-kind exchanges promote uniformly agreed upon tax reform goals such as economic growth, job creation and increased competitiveness.

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[2] *Options for Reforming America's Tax Code*, Tax Foundation (June, 2016) at p79, *available at* http://taxfoundation.org/article/options-reforming-americas-tax-code.

[3] David Ling and Milena Petrova, *The Economic Impact of Repealing or Limiting Section 1031 Like-Kind Exchanges in Real Estate* (March 2015, revised June 2015), at 5, *available at* http://www.1031taxreform.com/wp-content/uploads/Ling-Petrova-Economic-Impact-of-Repealing-or-Limiting-Section-1031-in-Real-Estate.pdf.

[4] *General Explanations of the Administration's Fiscal Year 2017 Revenue Proposals*, at 107, *available at* https://www.treasury.gov/resource-center/tax-policy/Documents/General-Explanations-FY2017.pdf.

Thank you for your consideration of this important matter.

Sincerely,

Air Conditioning Contractors of America
American Car Rental Association
American Rental Association
American Seniors Housing Association
American Truck Dealers
American Trucking Associations
Associated Equipment Distributors
Associated General Contractors of America
Avis Budget Group, Inc.
Building Owners and Managers Association (BOMA) International
C.R. England, Inc.
Equipment Leasing and Finance Association
Federation of Exchange Accommodators
International Council of Shopping Centers
NAIOP, the Commercial Real Estate Development Association
National Apartment Association
National Association of Home Builders
National Association of Real Estate Investment Trusts
National Association of REALTORS®
National Automobile Dealers Association
National Business Aviation Association
National Multifamily Housing Council
National Ready Mixed Concrete Association
National Stone, Sand and Gravel Association
Truck Renting and Leasing Association

MERCATUS CENTER
George Mason University

# GETTING TO TRUE TAX REFORM IN 2017: A BETTER WAY

https://www.mercatus.org/publications/2017-tax-reform

The fundamental goal of tax policy should be to raise enough revenue to meet the government's minimal spending requirements without significantly changing behavior in a market economy. The US tax code has long failed to achieve this goal; by severely distorting market decisions and the allocation of resources, it impedes economic growth and reduces tax revenue.

The nation's persistently sluggish economic growth and dire long-term fiscal outlook have increased the urgency of the need to reform the federal revenue system. However, true tax reform is about more than cutting tax rates; it requires thoughtful reforms to lower administrative burdens and lessen economic distortions.

The most notable current example of concrete steps toward tax reform is the House Republican Tax Reform Task Force Blueprint, "A Better Way." The Blueprint, whose broad strokes follow the general contours of an ideal tax reform, is a noble first pass at comprehensive reform, although some proposals still deserve substantive debate about whether they should be included in any final reform legislation.

This paper outlines the key goals of successful tax reform and applies them to specific policy proposals. The first two sections discuss the economic benefits of lowering tax rates and addressing chronic excess spending rather than accepting the false narrative that tax reform necessitates finding new revenue sources. In the following sections we discuss the extent to which proposed reforms beneficially broaden the tax base and eliminate true tax privileges, while managing the income tax's penchant for double-taxing some forms of saving and investment. We conclude by placing US tax reform in the context of the international tax system, which has largely left the current American system of high tax rates behind.

## THE GOALS OF SUCCESSFUL TAX REFORM

Before diving into the details of any specific reforms, it is helpful to review the basic agreed-upon pillars of an "ideal" tax code. Academic research suggests that a successful revenue system should be:

- *Simple*. The complexity of the tax system makes compliance difficult and costly. Complexity also encourages tax avoidance. A simpler and more transparent tax code promotes compliance and increased revenues.

- *Efficient*. The current tax code impedes economic growth by distorting market decisions in areas such as work, saving, investment, and job creation. An efficient tax system provides sufficient revenue to fund the government's essential services with minimal distortion of market behavior.

- *Equitable*. Americans of all income levels believe the tax code is unfair. This perception is largely fueled by the code's "loopholes"—provisions intended to benefit or penalize select individuals and groups. “Tax fairness” should reduce or eliminate provisions that favor one group or economic activity over others, especially among equal-income earners.

- *Predictable*. Tax certainty is a necessary condition for robust economic growth and investment, and it enhances competitiveness. An environment conducive to growth requires a tax code that provides both short- and long-term predictability.

There is broad consensus across academic research about which key public policies are most likely to promote solid, sustainable economic growth and which policies are most likely to fail. Furthermore, instead of focusing on ways to increase revenue, policymakers should focus on ways to create tax policy that encourages economic growth through private-sector activity, saving, and investment; a larger economy will result in larger tax revenue. Focusing solely on increasing revenue is misguided. The United States needs a more coherent and sustainable revenue system.

## SPENDING REDUCTIONS, NOT TAX INCREASES

Predictable tax policy is essential to long-term economic growth. But tax certainty cannot be achieved without addressing the driver of fiscal uncertainty: unsustainable levels of spending and the resulting deficits and debt. The Washington mantra for revenue-neutral tax reform is misleading in that it forces policymakers who would otherwise support pro-growth tax reforms into making a false binary choice. Fixing America’s broken revenue system does not require finding new revenue sources. Moreover, sustainable tax reform can be deficit neutral without being revenue neutral.

Certain types of business and capital tax reforms may lose some revenue in the short run, but as the economy grows, revenue will increase, offsetting much or even all of the near-term losses. Proposals such as expensing and lower corporate tax rates generally fall into this first category. In addition, as will be discussed below, there are billions of dollars in special carve-outs and privileges in the tax code that narrow the tax base and distort economic decision-making. Although eliminating some of these provisions may result in a net tax increase for certain taxpayers, any tax reform should eliminate true privileges without hesitation.

It should be recognized that not all pro-growth tax reforms will pay economic dividends in excess of the lost revenue, but this should not leave lawmakers searching for new or different forms of revenue. Policymakers should instead turn their attention to the other side of the ledger and address spending reform. It is an uncomfortable fact that chronic deficits are the symptom of overspending rather than of insufficient taxation. Additionally, there is a growing academic consensus that “spending-based fiscal adjustments are not only more likely to reduce the debt-to-GDP ratio than tax-based ones but also less likely to trigger a recession.”

Tax reform can be accomplished without adding to the national debt and without creating new taxes somewhere else to pay for the reform. By following the simple principles of a good tax system and by expanding reform discussions to include Washington’s spending problem, true tax reform is possible.

## LOWER RATES

Exhaustive economic research repeatedly proves this most basic effect: the more you tax capital or labor, the less you get. It also makes clear that incentives matter. Successful reform will lower current individual and corporate tax rates.

One thing the government should *not* do is raise tax rates. A substantial body of research demonstrates the negative consequences to economic growth of raising tax rates. Research by economists Christina Romer (former chair of President Obama's Council of Economic Advisers) and David Romer suggests, "A tax increase of 1 percent of GDP reduces output over the next three years by nearly three percent." According to research by Harvard University economist Jeffrey Miron, "Both macroeconomic and microeconomic perspectives suggest that [higher] taxes slow economic growth, thereby limiting the scope for revenue gains."

### *Corporate*

For those advocating higher taxes on business, it is important to note two things. First, the US corporate tax rate is among the highest in the industrialized world; this increases businesses' flight to countries with lower tax rates, taking their jobs, money, and tax dollars with them. Second, and perhaps more importantly, a tax on corporations is actually a tax on labor—everyday people. Businesses ultimately pass their tax burdens on to individuals. A Congressional Budget Office working paper finds that "domestic labor bears slightly more than 70 percent of the burden of the corporate income tax." Because people, not businesses, ultimately pay taxes and because capital is increasingly mobile, most of the corporate income tax falls on workers through lower pay and less generous benefits.

By most accounts, the corporate tax is inefficient because it double-taxes income and penalizes business activity. The case for completely repealing the corporate income tax is compelling. A National Bureau of Economic Research working paper finds that eliminating the corporate income tax produces "major economic benefits and welfare gains in the U.S." The paper's modeling further shows dramatic increases in "investment, output, and real wages, making the tax cut self-financing to a significant extent." Other researchers have also shown significant growth dividends from lowering or eliminating the corporate income tax.

Responsibly repealing the corporate income tax would require the addition of offsetting provisions to discourage counting labor income as corporate income and to maintain the necessary neutral treatment of pass-through corporations. Looking just at the top-line rate, the Blueprint provides a good middle ground for reform by lowering the corporate income tax rate to 20 percent. For a politically sustainable reform of the corporate income tax, this is a great start, although an even larger reduction would help the United States get ahead of other countries that have recently lowered their corporate income tax rates.

### *Individual*

The popular refrain "the more you tax something, the less you get" also applies to labor income. So on principle, individual income tax rates should be kept as low as possible to avoid labor market distortions.

Additionally, the income tax has been shown to be a poor policy tool for addressing income inequality. Research from the Brookings Institution indicates that "a significant increase in the top income tax rate wouldn't substantially alter income inequality." This is largely because federal income taxes are already highly progressive. Households in the lowest income quintile paid an average federal tax rate of about 3 percent. The middle and top quintiles paid about 13 and 26 percent, respectively. The top quintile paid almost 70 percent of federal income taxes.

The Blueprint consolidates the current seven tax brackets into three: 12, 25, and 33 percent. Under this system, the top marginal rate is lowered from 39.6 percent. Lowering marginal rates is important for economic growth, and having fewer tax brackets simplifies tax administration. Lowering marginal rates reduces the disincentives many people face for engaging in economic activity—for example, allowing a marginal worker, such as a stay-at-home parent, to enter the workforce part-time without facing potentially steep tax penalties. The economic literature supports our normative position that governments should take as little of their citizens' money as possible and should always strive to reduce costs before increasing taxes.

## BROADEN BASE, ELIMINATE LOOPHOLES

One of the keys to successful fiscal reform is to build a stable system that is neither dramatically affected by economic change nor easily manipulated by policymakers on behalf of special interests. Taxes should have a broad base in order to tax all types of activity more equally, rather than singling out certain types of firms or individuals. A broad-based tax has the additional feature of providing more stable revenues for the government. If a substantial portion of tax revenue comes from a small number of individuals or businesses, an economic downturn may unnecessarily reduce revenue collection.

One way the tax base is systematically narrowed is by carving out special interests or privileged activities. In the corporate tax code, these carve-outs include things like the R&D tax credit, the deduction for US production activities (Section 199), and the credit for certain railroad track maintenance. The individual tax code subsidizes larger homes through the mortgage interest deduction and more expensive college tuition through education tax credits.

These special carve-outs are called tax expenditures because they can sometimes act like direct government spending. However, not all so-called tax expenditures are spending through the tax code. The current system wrongly labels as tax expenditures many important corrections that remove economic distortions inherent in an income tax system. These corrections promote the neutral treatment of consumption and savings, facilitating economic efficiency. A true tax expenditure grants a privilege through the tax code.

The individual and corporate cost of tax compliance is estimated to be as high as nearly $1 trillion annually, driven in part by special carve-outs for privileged individuals, firms, and activities. Each new provision is written by legislatures, interpreted by regulators, and litigated in court—often adding little clarity to the law. Interpreting and complying with each page of the tax code is a complex and unforgiving task requiring a bevy of lawyers and accountants and a specialized tax court.

All true tax expenditures, defined as favoritism in the tax code, should be eliminated. They "add complexity to the code, don't achieve the desired results, benefit the wrong people, and encourage ‘gaming’ by those in a position to take advantage—typically the well-connected or well-to-do, who can afford accountants who understand all the provisions.”

As written, the Blueprint goes a long way toward eliminating loopholes and favoritism in the tax code, but more work needs to be done. On the corporate side, the plan calls to generally “eliminate special-interest deductions and credits in favor of providing lower tax rates.” The one special provision that explicitly remains is a credit for research and development expenditures. Evidence from other countries and economic research on the credit as currently designed suggest that the R&D tax credit’s unseen costs undermine its predicted benefits. This credit should therefore be eliminated along with the rest of the special-interest deductions, credits, and exemptions.

Proposed reforms on the individual side are not so straightforward. The Blueprint consolidates the five basic family tax deductions into two, simplifying the disparate rules governing each; maintains the earned income tax credit (EITC); and calls for an unspecified simplification of the various education subsidies. The Blueprint also “reflects the elimination of all itemized deductions except the mortgage interest deduction and the charitable contribution deduction.”

There is a substantial body of economic research that supports the elimination of the home mortgage interest deduction (MID) and higher-education subsidies. The MID is often characterized as a privilege for middle- and high income homeowners, but it is mainly a subsidy for the real estate industry that correlates with larger home sizes—and larger commissions on home sales— because the tax gains to homeowners are largely offset by increases in home prices. The MID also encourages home debt, not necessarily home ownership. Subsidies for college tuition are also largely passed on to colleges and universities because of the tuition increases made possible by the subsidies.

On the other hand, the proposal in the Blueprint to eliminate the state and local tax deduction that subsidizes higher taxes and spending at the local level, while exporting much of the tax jurisdiction’s higher tax burden to taxpayers in other states, is encouraging. Further, certain credits and deductions, such as the child tax credit, the EITC, and deductions for charitable contributions, have mixed results meeting stated policy goals and show evidence of being both poorly targeted and poorly administered. These credits and deductions could benefit from some of the reforms hinted at in the Blueprint.

## NO DOUBLE TAXATION

For economic efficiency, it is important that income be taxed once and only once. There is much concern that those who report significant earnings from capital gains or dividends pay a lower tax rate than those with ordinary income. But this concern fails to accurately reflect the incidence of the corporate income tax.

Currently, corporate profits are generally subject to “double taxation,” whereby firm profits are taxed first at the corporate level and then again at the individual level. One of the reasons for a lower tax rate for individuals on capital gains is because capital income received by individuals was already taxed at the corporate level up to 35 percent. Hence, if a corporation first pays the maximum statutory tax rate of 35 percent on each $1 of profit, leaving $0.65 of retained profit to be either distributed as a dividend or realized as capital gain, then applying the individual's 23.8 percent tax rate (the statutory 20 percent top marginal rate, plus the 3.8 percent surtax on net investment income) to the $0.65 leaves only $0.495 out of the original $1, resulting in a combined top marginal effective tax rate of about 50.5 percent on capital investments.

Thus, we can see that increasing the rate on capital gains and dividends would further raise the effective tax rate on investment, dramatically reducing the incentive to invest, which would slow capital formation and wage growth. Additionally, the behavioral response to higher tax rates would decrease the expected static revenue projections.

The Blueprint outlines three reforms that would reduce the burden of double taxation on capital formation. First, it proposes lowering the top capital gains rate to 16.5 percent (structured as a 50 percent deduction of net capital gains, dividends, and interest income). Second, it proposes eliminating the estate and generation-skipping taxes, which tax lifetime earnings—earnings that have already been taxed, sometimes multiple times—and which further discourage capital accumulation. Third, the Blueprint maintains some form of the various tax exclusions for saving (Roth and traditional IRAs, 401(k) accounts, and pension plans). Although each of these tax treatments for savings is often characterized as a tax expenditure or dubbed a "loophole," these tax exclusions for saving are necessary corrections to the income tax's penchant for double-taxing saving and investment.

A more complicated issue is the Blueprint's treatment of the deductibility of business interest payments. The proposal allows a deduction for interest expense against interest income, but it disallows the current, more general interest deduction to otherwise reduce taxable income. The current tax treatment of interest deduction keeps debt-financed investment from undergoing an additional layer of taxation. However, this creates a bias in favor of debt financing and against equity financing because the same project faces two different effective tax rates depending on how it is financed.

Eliminating the interest deduction would allow for the equitable treatment of debt and equity financing under the corporate income tax. But it would also add an additional layer of taxation from debt-financed investment. Changing the treatment of debt in the tax code could also have significant ramifications for the business structures of banks and other financial institutions that rely on interest as both a tax planning strategy and a legitimate business purpose.

The root of the problem is the inherent double taxation that is built into the income tax system. The preferred way to remedy the problem of interest deductibility is to tax corporate income only once by eliminating the tax either at the corporate level (by eliminating the corporate income tax) or at the shareholder level (by removing the tax on capital gains and dividends). Given the political constraints tax reform faces, the proposed elimination of the standard interest deduction, combined with a significant corporate rate reduction and expensing, is an imperfect but reasonable idea that is certainly worth further consideration.

## INTERNATIONAL COMPETITIVENESS

The United States has fallen behind its trading partners and almost every other industrialized country by not updating its tax code for a global 21st century economy. The US corporate tax rate is among the highest in the industrialized world, and the United States is one of very few countries that attempt to tax the worldwide income of domestically headquartered businesses. This pushes investment and US companies offshore (often taking the form of an "inversion") to countries with lower tax rates—pushing jobs, money, and tax dollars out, too.

The worldwide tax systems employed by the United States tax all income of domestically headquartered businesses, including income earned by subsidiaries operating abroad. Firms are allowed to defer paying taxes on "active" foreign income that has not yet been repatriated. While some refer to deferral as a tax "loophole," deferring taxes on foreign income until repatriation is an attempt to mirror a territorial tax system and allow US firms to effectively compete abroad. Moving to a territorial system where foreign-sourced income is exempt from US taxation would increase economic growth and improve tax simplicity and efficiency.

Taxing income where it is earned levels the playing field, so operations in one jurisdiction are taxed at the same rate, regardless of parent ownership. Under a territorial system, corporate profits can flow to their highest-value use, helping expand the economy. The US system of worldwide taxation locks corporate profits out of the US economy, forcing corporations to either reinvest or park the profits abroad while they wait for a lower US corporate tax rate. The tax penalty paid on repatriated earnings keeps an estimated $2 trillion of US corporate profits permanently reinvested overseas.

The US corporate tax system also discourages capital investment by requiring that business purchases—such as farm equipment and manufacturing plants—be depreciated over arbitrary timelines, adding unnecessary complexity and economic distortion to the return on capital investments. "Full expensing," which allows businesses to write off all expenditures in the year they are purchased, encourages job creation and economic growth by treating all business expenditures, including labor, equally. Moving toward full expensing and territorial taxation would help retain and attract new business investment. This is not a risky move; Organisation for Economic Co-operation and Development countries around the world have already implemented one or both of these reforms, leaving the US economy behind.

Instead of simply lowering the rate and moving toward a territorial corporate income tax system with full expensing, the Blueprint proposes a destination-based cash flow tax with a border adjustment. The proposed cash flow tax would allow businesses to immediately deduct all expenses from revenue, including capital investments and labor. To keep the US tax from being levied on consumption in other countries, the tax would be "border adjusted," or removed from exports and added to imports. In effect, this means imports would be taxed and exports would receive a form of tax subsidy.

Many proponents believe that this system is more efficient than an income tax and mistakenly view it as a less economically distortionary form of consumption tax, similar to a European-style value-added tax. The efficiency claims of proponents rely on several key assumptions that are required for the tax to be nondistortionary. Mainly, the border adjustment must be implemented completely, and international currency markets must fully adjust (the dollar would need to appreciate by 25 percent). Because such a large currency adjustment is unlikely, this system creates an unnecessary economic gamble.

Academic research has consistently shown major benefits to economic growth and efficiency from lowering the corporate income tax rate and moving toward a territorial system and full expensing. These changes should be the focus of any corporate tax reform proposal.

## CONCLUSION

As policymakers further develop their tax reform agenda for 2017, it is helpful to learn from the past. Predictable tax policy is an essential component to long-term economic growth, and temporary tax provisions should generally be avoided, especially when trying to correct permanent problems.

The last major US tax reform, the Tax Reform Act of 1986, was remarkable for its bipartisan passage and sweeping reforms. But because the legislation failed to fix the revenue system's large institutional problems, reforms were clawed back almost immediately. As a result, the tax code looks even worse today. History has shown that tax reforms seldom last when special interests have large incentives to lobby Congress for tax breaks. Keeping the tax code as simple and transparent as possible—by taxing a broad base at the same low rate—will help reduce the ability and incentives to reverse future tax reforms.

The United States has an infamously dense and complicated tax code that is in dire need of simplification. The current tax code is detrimental to the economy. The tax system severely distorts individual and business decisions and the allocation of their respective resources; it hampers job creation and impedes both economic growth and tax revenue.

The House Republican Tax Reform Task Force Blueprint provides an overall good plan to reform the tax code. The plan excels by eliminating hundreds of special tax privileges for both individuals and corporations, simplifying tax administration and broadening the tax base. However, there are a few additional tax provisions left that should also be removed or reformed, most notably the MID and incentives for R&D and education. The plan lowers the rates on individual and corporate income and works to reduce the double taxation of investment. The novel proposal of a border adjustment tax presents an unnecessary risk to the US economy and should be avoided. The proposed border adjustment should be recognized as little more than a new source of revenue because it is not a pro-growth reform. Policymakers should focus on more conventional and pro-growth reforms going forward.

Jason J. Fichtner, Adam N. Michel, Veronique de Rugy, and Angela Kuck, "Getting to True Tax Reform in 2017: A Better Way" (Mercatus Policy Primer, Mercatus Center at George Mason University, Arlington, VA).

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**May 24, 2017**

**Statement for the Hearing Record**
**Increasing U.S. Competitiveness**

The Honorable Kevin Brady
Chairman, Committee on Ways and Means
1102 Longworth Building
Washington, D.C. 20515

The Honorable Richard Neal
Ranking Member, Committee on Ways and Means
1102 Longworth Building
Washington, D.C., 20515

Dear Chairman Brady, Ranking Member Neal, and members of the committee:

The Motor & Equipment Manufacturers Association (MEMA) and its four specialized divisions comprise a leading international trade association in the fast-changing mobility industry. Representing motor vehicle suppliers that manufacture and remanufacture components, technologies, and systems for use in passenger cars and heavy trucks, MEMA serves as a critical bridge between high-tech capabilities in new vehicles – such as autonomous vehicles and vehicle connectivity – and the "nuts and bolts" of vehicle manufacturing. Motor vehicle suppliers contribute more than 77 percent of the value in today's vehicles.

MEMA works at state, federal, and international levels to ensure that the marketplace and public policies support the development of advanced, transformative technologies that enable safer, smarter, and more efficient vehicles. MEMA's members are represented through four divisions: Automotive Aftermarket Suppliers Association (AASA), Heavy Duty Manufacturers Association (HDMA), Motor & Equipment Remanufacturers Association (MERA), and Original Equipment Suppliers Association (OESA). For more information on how MEMA is leading transformation in the mobility industry, visit www.mema.org.

Earlier this year, MEMA released an important economic impact study that clearly defines the critical role motor vehicle parts suppliers play in the U.S. economy.[1] Motor vehicle component manufacturers are the largest employer of manufacturing jobs in the U.S., contributing nearly 3 percent of the U.S. gross domestic product. Suppliers directly employ more than 871,000 Americans, up 19 percent since 2012, and generate a total direct and indirect employment impact of 4.26 million jobs, up nearly 18 percent since 2012.

The motor vehicle component manufacturing industry in the U.S. has experienced robust growth due to increased demand and vehicle sales. The stability of the highly-integrated North American supply chain has also been particularly beneficial to suppliers, contributing to growth in both jobs

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[1] "Driving the Future: The Employment and Economic Impact of the Vehicle Supplier Industry in the U.S." MEMA and The Boston Consulting Group, January 2016. https://www.mema.org/sites/default/files/MEMA_ImpactBook.pdf

and investments in the United States. Many suppliers located in the U.S. import *and* export vehicle parts and components within the North American market. Depending on supply chain logistics, parts are often exported to be combined with other parts, then imported back to the U.S. for final vehicle assembly.

This supply chain and production integration is critical to the strengths of the U.S. market, which supports U.S. manufacturing jobs and competitiveness over other regions of the world, including the European Union, South America, and Asia.

MEMA is aligned with the goals of the Trump administration and Congress to strengthen America's global manufacturing competitiveness and to create more American jobs. To reach these goals, MEMA supports a simplified, more predictable tax code that would generate investment, economic growth, and job creation in the United States.

Tax reform is crucial for American competitiveness as many competing countries have an edge in the global marketplace due to their country's tax requirements. MEMA urges Congress to include these priorities in any tax reform legislation:

- **Lower corporate rates.** The current 35 percent corporate tax rate in the U.S. is one of the highest in the world; the average rate in other OECD countries is less than 25 percent. Reducing the rate in the U.S. will free up capital needed for growth and for investments in new products and manufacturing facilities, stimulating job growth.
- **Business investments.** Motor vehicle suppliers must invest in new equipment, machinery, tooling, and technology needed for today's manufacturing of advanced vehicle parts, systems, and components. These investments are expensive and often take years to be amortized or depreciated. Tax credits for these and similar business investments will foster renewed development and deployment of vehicle technologies and products in the U.S.
- **Foreign earnings.** Motor vehicle suppliers operate in a global marketplace, and American-based companies have accumulated trillions of dollars in earnings held overseas due to high U.S. tax rates. By lowering the tax rate for accumulated foreign earnings, capital held offshore can be repatriated in support of growing U.S. businesses.

**While MEMA supports tax reform that promotes manufacturing competitiveness, U.S. job growth, and productivity, we do not believe the Border Adjustment Tax (BAT), as currently outlined, will achieve those objectives.**

## Border Adjustment Tax

The BAT in the House Republican tax reform blueprint could disrupt the integrated supply chain for many vehicle suppliers and cause a ripple effect throughout the U.S. economy. The imposition of a BAT would increase costs for suppliers and vehicle manufacturers, which would result in higher vehicle prices for consumers, leading to a decline in vehicle sales. In addition, the imposition of a BAT would result in decreasing supplier content in vehicles, impacting supplier volume and manufacturing jobs.

MEMA recently commissioned a study by The Boston Consulting Group to quantify the effects and impact a BAT would have on the motor vehicle supplier industry. The key findings of the study include the following:

- The economic impact of the U.S. motor vehicle parts manufacturing industry grew at a rate of 7 percent year over year from 2012 through 2015. The largest manufacturing sector in the U.S. is motor vehicle parts manufacturers, representing over 871,000 direct jobs.[2] The entire motor vehicle industry in the U.S. employs some 4.5 million people, representing approximately 3 percent of the U.S. workforce. (Appendix, Slides 1, 2)
- Supporting the growth in U.S. motor vehicle supplier jobs, the industry relies on a complex and globally integrated supply chain, built over the last 25 years and highly dependent on free trade. In 2016, the U.S. motor vehicle industry exported $120 billion of components and vehicles, and imported $270 billion of components and vehicles.
- The imposition of a BAT of 15 percent would create an additional $34 billion in cost for the U.S. automotive market, also impacting heavy-duty truck manufacturers and adding an additional $5 billion in costs to the aftermarket parts chain. (Appendix, Slide 3)
- With respect to vehicle prices, a BAT would add up to $1,800 on average to vehicle production costs across U.S. vehicle manufacturers. Consumers facing higher costs would consider switching to makes and models less impacted by a BAT, creating winners and losers among vehicle manufacturers and suppliers. (Appendix, Slide 4)
- Reduced consumer spending power would force vehicle manufactures and their dealers to work to decrease prices by forcing costs downward on suppliers. Vehicles would be "de-contented" with fewer parts, including advanced safety features and driver-assist technologies, such as emergency braking systems and lane keeping functions. Supplier content per vehicle would drop 3 percent, impacting supplier volume and placing up to 45,000 manufacturing jobs at risk. (Appendix, Slide 5)
- Finally, with respect to appreciation of the U.S. dollar to "offset" the effect of the BAT, there is significant uncertainty about the currency response following the introduction of a BAT. As the cost of imports increased, any appreciation in the dollar would make U.S. exports more expensive. There is a risk of cost increases and market distortion as currency fluctuates. (Appendix, Slide 6)

## Initiatives and Policies Can Improve Competitiveness and Job Growth

MEMA believes there are specific initiatives and policies that will lead to improving the competitiveness of U.S. manufacturing and continued job growth. They include:

### *Trade Modernization*

Free and fair trade is imperative for a strong domestic supplier industry. MEMA encourages the Trump administration to update and engage in trade agreements in a manner that does not disrupt

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[2] *Ibid.*

supply chains or increase production costs. MEMA believes that the focus of the debate should be on policies that will make U.S. manufacturers more competitive by creating more jobs and cultivating capital investments to achieve greater economic stability.

Yet it is important to realize that motor vehicles suppliers are dependent on a worldwide network of suppliers and customers for continued viability and growth. Increasingly we have seen other countries use free trade agreements as a tool to encourage growth in their motor vehicle parts manufacturing sector. MEMA would encourage the administration to lead other nations in this endeavor and keep pace with these developments. In addition, suppliers are often required to locate within a short distance of, if not immediately adjacent to, final assembly of motor vehicles. Therefore, it is impossible to focus solely on trade deficits as the signal of unfair trade.

Furthermore, deliberations on trade deficits should center on those countries that have consistently maintained tariff and non-tariff barriers to trade. Too many countries consistently impose excessive tariffs as well as testing, marking, and domestic content requirements.

Trade of motor vehicle parts within the North American Free Trade Agreement (NAFTA) region is closely balanced and even export and import volume worldwide are not significantly disparate. Yet, trade with countries like Argentina, Brazil, China, India, Indonesia, Thailand, and South Africa maintain significant tariffs on motor vehicle parts. Also, many countries impose significant domestic content and testing requirements that impede free trade of parts and components worldwide.

MEMA supports a renegotiation of the NAFTA that creates a more competitive U.S. manufacturing environment and urges that care be taken to balance re-shoring of U.S. jobs with the unintended risks to jobs and the supply base. The final NAFTA product must continue to provide for a vibrant North American supply chain, which supports U.S. jobs and competitiveness.

As NAFTA is updated it should utilize draft components of previous agreements that are beneficial for all three countries (e.g. services, IPR, and rules of content of origin).

### *Workforce Development*

Motor vehicle parts suppliers rely on a strong technical workforce, particularly in the wake of the transformation in vehicle technology and mobility. For the supplier industry to continue to innovate and remain competitive, companies need the right workers with the right skills at the right time. Workforce development and training is a necessary tool to provide workers the right skills to satisfy employment needs.

The hiring and retention of skilled workers is a key challenge. According to a recent study, “Over the next decade nearly 3.5 million manufacturing jobs likely need to be filled. The skills gap is expected to result in 2 million of those jobs going unfilled.”[3] The motor vehicle industry faces additional hurdles in attracting the right talent, as many young adults may not view this industry in the same light as other high tech-oriented industries.

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[3] The Skills Gap in U.S. Manufacturing 2015 and Beyond, Deloitte and The Manufacturing Institute, 2015.

Throughout the country however, the supplier industry plays an important role by participating in a variety of state, local, and regional workforce-related endeavors to acquire talent and enhance employee training.

MEMA urges Congress to move forward with additional policies that will provide new and greater incentives to both employers and workers, including:

- The Leveraging and Energizing America's Apprenticeship Programs (LEAP) Act. This bipartisan legislation provides tax incentives for hiring apprentices. MEMA member companies – ranging from very large, global corporations to local, small manufacturers – partner with the U.S. Department of Labor, community and technical colleges, states, and private entities to provide apprenticeship programs. The LEAP Act will assist suppliers in offsetting the investments made into these apprenticeship programs.
- The Career Technical Education (CTE) Excellence and Equity Act. This legislation calls for redesigns of education at the high school level with a focus on career technical education. Career technical education is critical to help address the skills gap faced by many in the supplier industry.

### *Technology Development in the U.S.*

Suppliers are invested in and lead the way in developing and deploying a wide range of passive and active safety systems. More than 94 percent of traffic crashes are the result of human error. Thus, the potential impact of innovative, transformative safety technologies is wide reaching and unprecedented. Examples include numerous types of advanced driver assistance systems (ADAS), vehicle-to-vehicle and vehicle-to-everything (V2V/V2X) communications, and components and systems that enable highly automated vehicles.

MEMA urges Congress and the administration to support measures to further enhance vehicle safety, including:

- Completion by the Department of Transportation of an update of the New Car Assessment Program (NCAP) to provide "crash avoidance information" next to the NCAP 5-Star Rating crashworthiness information on new vehicle stickers. An improved NCAP will better inform consumers about advanced safety features and lead to greater adoption of ADAS technologies in new vehicles without necessitating new mandates.
- Creating effective policies to foster innovation of automated vehicles (AV). MEMA applauded the U.S. Department of Transportation's "Federal Automated Vehicles Policy" guidelines issued in September 2016, but did express concerns on subjects such as safety assessment letters and model state policy. MEMA encourages Congress to support policies that creates a single national framework for automated vehicles that does not impede suppliers' ability to test and evaluate prototypes on public roads.
- Protecting the spectrum for vehicle safety communications. Suppliers have dedicated considerable resources and years of rigorous development to validate communications technologies between vehicles ("V2V). MEMA does not support the Federal Communications Commission (FCC) proposal to "share" the 5.9 GHz spectrum currently

reserved for intelligent transportation systems. Proposals to share the "Safety Spectrum" may interfere with signals and compromise cybersecurity. For these reasons, MEMA urges Congress and the FCC to ensure the preservation of the 5.9 GHz spectrum.

### *Infrastructure Investment*

Motor vehicle supplier's products are produced, manufactured, and delivered by light- and heavy-duty vehicles that travel on our nation's roads, highways and bridges. A network of modern, efficient, and safe highways is critical to the U.S. economy, and to maintaining the competitiveness of vehicle suppliers in a global economy.

In recent years, short term extensions of the Highway Trust Fund have not kept pace with increased construction costs and demand for highway projects; as a result, our existing highways and bridges are in need of repair, and our broader surface transportation infrastructure needs to be modernized.

MEMA supports funding of long-term, sustained infrastructure improvements to adequately plan, prioritize, and fund projects throughout the national network of transportation systems in the United States.

## Conclusion

MEMA is committed to working with the committee and the administration in support of our shared objectives of increasing competitiveness and growing U.S. jobs.

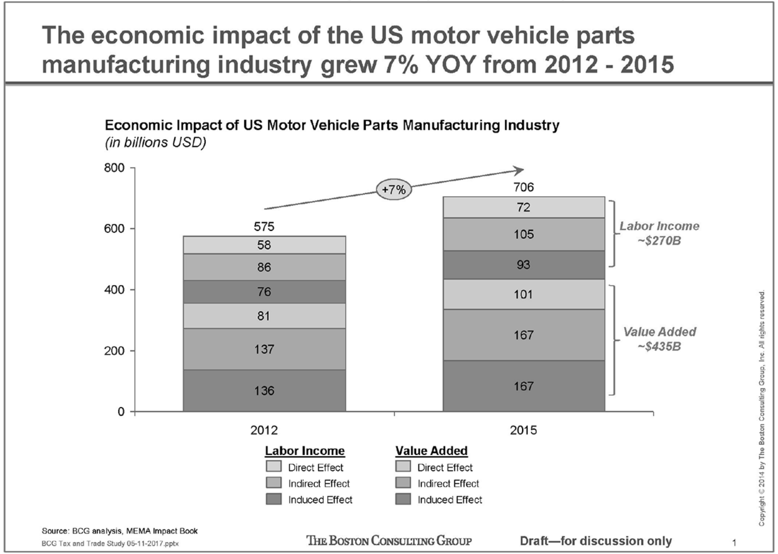
We believe reforming tax rates, combined with trade, workforce, technology, and infrastructure initiatives will promote U.S. growth and innovation in the motor vehicle supplier industry and the U.S. economy.

We look forward to working with you; please contact Ann Wilson at awilson@mema.org or (202) 312-9246 for additional information. Thank you.

* * *

APPENDIX

**MEMA Statement: Increasing U.S. Competitiveness May 24, 2017**



## The economic impact of the US motor vehicle parts manufacturing industry grew 7% YOY from 2012 - 2015

**Economic Impact of US Motor Vehicle Parts Manufacturing Industry**
*(in billions USD)*

Source: BCG analysis, MEMA Impact Book

BCG Tax and Trade Study 05-11-2017.pptx

THE BOSTON CONSULTING GROUP

**Draft—for discussion only**

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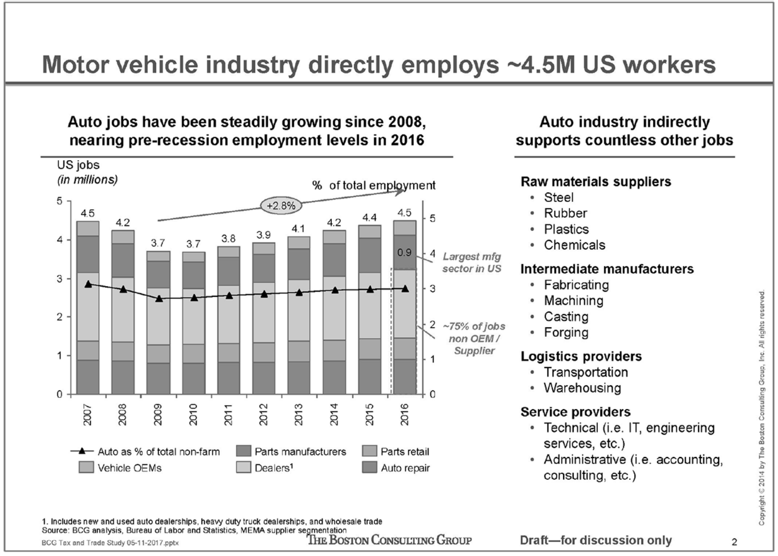

## Motor vehicle industry directly employs ~4.5M US workers

**Auto jobs have been steadily growing since 2008, nearing pre-recession employment levels in 2016**

**Auto industry indirectly supports countless other jobs**

**Raw materials suppliers**
- Steel
- Rubber
- Plastics
- Chemicals

**Intermediate manufacturers**
- Fabricating
- Machining
- Casting
- Forging

**Logistics providers**
- Transportation
- Warehousing

**Service providers**
- Technical (i.e. IT, engineering services, etc.)
- Administrative (i.e. accounting, consulting, etc.)

1. Includes new and used auto dealerships, heavy duty truck dealerships, and wholesale trade

Source: BCG analysis, Bureau of Labor and Statistics, MEMA supplier segmentation

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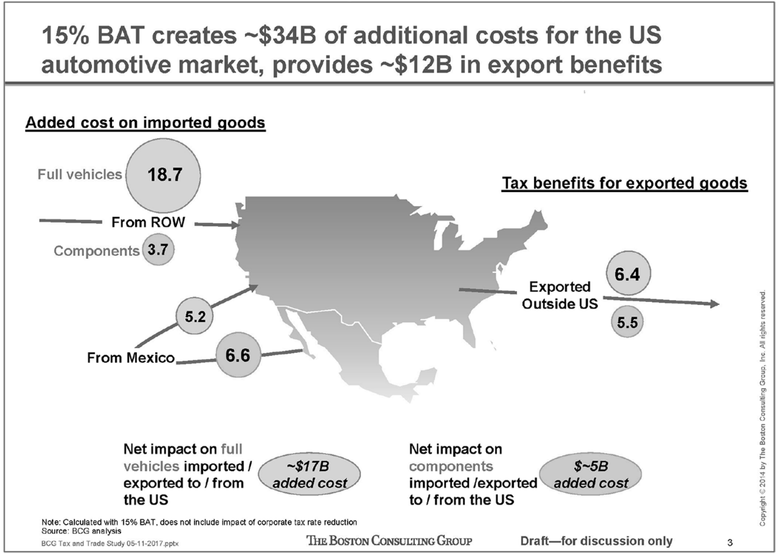
2

**MEMA Statement: Increasing U.S. Competitiveness May 24, 2017**



## 15% BAT creates ~$34B of additional costs for the US automotive market, provides ~$12B in export benefits

**Added cost on imported goods**

**Tax benefits for exported goods**

**Net impact on full vehicles imported / exported to / from the US** — *~$17B added cost*

**Net impact on components imported /exported to / from the US** — *$~5B added cost*

Note: Calculated with 15% BAT, does not include impact of corporate tax rate reduction
Source: BCG analysis

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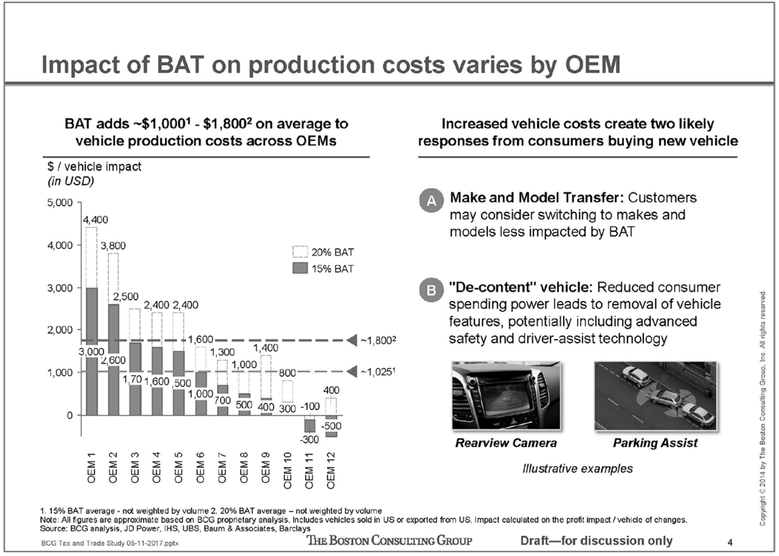

## Impact of BAT on production costs varies by OEM

**BAT adds ~$1,000[1] - $1,800[2] on average to vehicle production costs across OEMs**

**Increased vehicle costs create two likely responses from consumers buying new vehicle**

- Ⓐ **Make and Model Transfer:** Customers may consider switching to makes and models less impacted by BAT
- Ⓑ **"De-content" vehicle:** Reduced consumer spending power leads to removal of vehicle features, potentially including advanced safety and driver-assist technology

***Rearview Camera*** ***Parking Assist***

*Illustrative examples*

1. 15% BAT average - not weighted by volume 2. 20% BAT average – not weighted by volume
Note: All figures are approximate based on BCG proprietary analysis. Includes vehicles sold in US or exported from US. Impact calculated on the profit impact / vehicle of changes.
Source: BCG analysis, JD Power, IHS, UBS, Baum & Associates, Barclays

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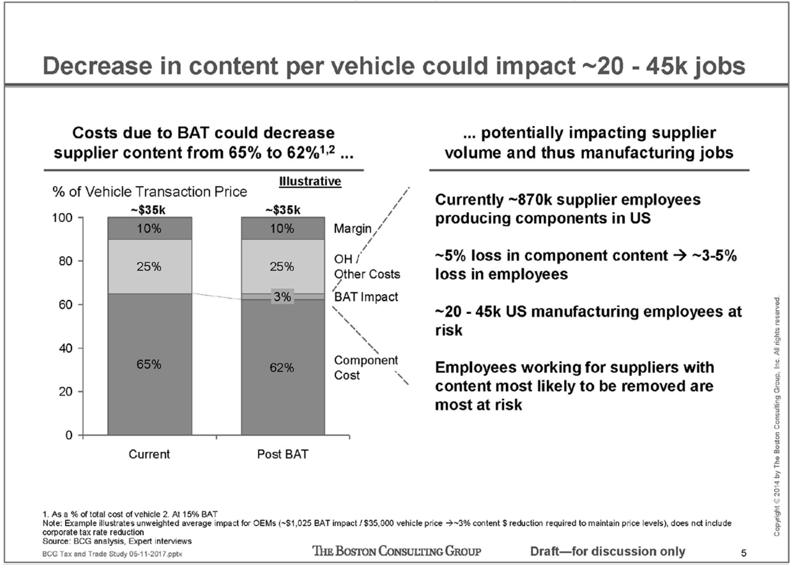
# APPENDIX



## Decrease in content per vehicle could impact ~20 - 45k jobs

**Costs due to BAT could decrease supplier content from 65% to 62%[1,2] ...**

**... potentially impacting supplier volume and thus manufacturing jobs**

**Currently ~870k supplier employees producing components in US**

**~5% loss in component content → ~3-5% loss in employees**

**~20 - 45k US manufacturing employees at risk**

**Employees working for suppliers with content most likely to be removed are most at risk**

1. As a % of total cost of vehicle 2. At 15% BAT
Note: Example illustrates unweighted average impact for OEMs (~$1,025 BAT impact / $35,000 vehicle price →~3% content $ reduction required to maintain price levels), does not include corporate tax rate reduction
Source: BCG analysis, Expert interviews

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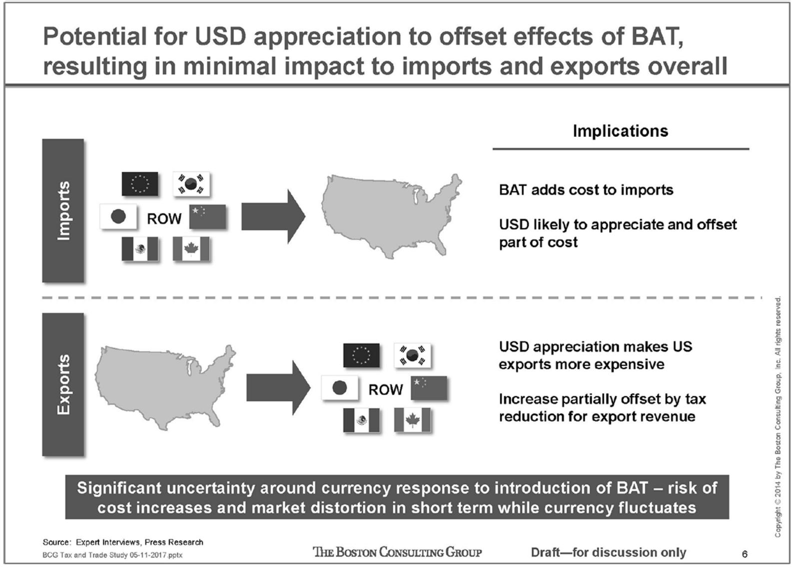

## Potential for USD appreciation to offset effects of BAT, resulting in minimal impact to imports and exports overall

**Implications**

**BAT adds cost to imports**

**USD likely to appreciate and offset part of cost**

**USD appreciation makes US exports more expensive**

**Increase partially offset by tax reduction for export revenue**

**Significant uncertainty around currency response to introduction of BAT – risk of cost increases and market distortion in short term while currency fluctuates**

Source: Expert Interviews, Press Research

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NACDS NATIONAL ASSOCIATION OF CHAIN DRUG STORES

# Statement
# Of
# The National Association of Chain Drug Stores

For

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

Hearing on:
Increasing U.S. Competitiveness and Preventing American Jobs from Moving Overseas
May 23, 2017
10:00 A.M.

1100 Longworth House Office Building

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National Association of Chain Drug Stores (NACDS)
1776 Wilson Blvd., Suite 200
Arlington, VA 22209
703-549-3001
www.nacds.org

## Introduction

The National Association of Chain Drug Stores (NACDS) thanks Chairman Brady, Ranking Member Neal, and the Members of the Committee on Ways and Means for the opportunity to submit the following statement for the record regarding "Increasing U.S. Competitiveness and Preventing American Jobs from Moving Overseas." More specifically, our testimony reflects our concerns with the negative impact of a border adjustment tax (BAT) on retail pharmacies within the United States. As employers of 3.2 million Americans, the chain pharmacy industry committed to partnering with Congress to promote American job growth, but a BAT would financially harm chain pharmacies, interfere with patient access to affordable medications, and potentially cause chain pharmacies to cut jobs.

NACDS represents traditional drug stores, supermarkets and mass merchants with pharmacies. Chains operate 40,000 pharmacies, and NACDS' more than 100 chain member companies include regional chains, with a minimum of four stores, and national companies. As previously mentioned, chains employ more than 3.2 million individuals, including 178,000 pharmacists. They fill over 3 billion prescriptions yearly, and help patients use medicines correctly and safely, while offering innovative services that improve patient health and healthcare affordability. NACDS members also include more than 850 supplier partners and over 60 international members representing 21 countries.

## BAT Would Increase Healthcare Costs

While NACDS supports corporate tax reform, a BAT is not the proper means to achieve this goal. NACDS represents small and large pharmacies across the United States, and almost universally, these businesses and their customers will suffer damaging consequences if

Congress passes a BAT. Broadly, 60 to 70% of a pharmacy's business involves selling products that originate overseas, including drug products. Under a BAT, the cost to pharmacies to purchase these products rises, which yields a host of negative consequences for both pharmacies and their customers. Retail bears the lion's share of the burden of a BAT, and pharmacies are especially burdened where a BAT applies to foreign manufactured drugs.

A significant concern with applying a BAT to retail pharmacies and foreign manufactured pharmaceuticals is the impact on patient access to prescription drugs. Pharmacies rely heavily on purchasing drugs that have been manufactured overseas in FDA-approved facilities under FDA oversight. This is particularly true for generic drugs, many of which are manufactured in India. If these drugs are subject to a BAT, then the price to purchase these drugs rises and that higher price is ultimately passed on to patient. Therein lies the access problem. Consumers may not be able to afford the BAT-induced drug price increases. Even patients with health insurance coverage for their medications may not be able to afford the increase to their cost sharing, such as increased co-pays and deductibles.

Patients' failure to take their medication due to high costs is a medication adherence problem. These patients are not taking the drugs they need to stay healthy or manage a chronic illness. The result is not only a decrease in patient health care quality and outcome, but a fiscal loss for the payer, whether that payer is the government or private insurance. For example, in the context of TRICARE, the CBO studied the impact of increases in prescription drug copays for TRICARE beneficiaries and found:

> [W]hile the higher copayments may deter some beneficiaries from filling prescriptions they no longer need or use, those higher copayments also could

> cause some chronically ill beneficiaries to stop taking their medications, resulting in more doctor visits and hospitalizations. As a result, CBO estimates that the $4.9 billion in direct pharmacy savings would be offset by a $1.1 billion increase in other federal spending for medical services (mostly from Medicare).[1]

Similarly, a *Health Affairs* study found that a 1% increase in overall prescription drug use is associated with decreases in overall Medicaid costs by as much as $760 million annually.[2] Both findings demonstrate that higher cost drugs lead to lower drug utilization by patients, which leads to higher health care costs in the long run, whereas lower drug costs lead to better drug utilization by patients and health care cost savings in the long run. A BAT incentivizes the former, while discouraging the latter.

A BAT is particularly damaging to patient access to generic drugs. Many generic drugs originate in foreign countries. These low cost alternatives to high cost brand name drugs become more expensive once a BAT is introduced. Instead of lowering drug costs by incentivizing the use of low cost generics, a BAT creates a disincentive to use these generics because their cost goes up with the application of a BAT. A BAT undermines federal and state government efforts, as well as insurer efforts to promote generic drug utilization. A BAT hinders the common public policy goal of many lawmakers to lower drug costs by encouraging generic drug utilization.

Worse yet, some generic drugs are only available overseas. There is no domestic alternative. If one of the purposes of a BAT is to discourage outsourcing drug manufacturing in foreign countries, it fails as applied to generic drugs. The intellectual property rights for some drugs

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[1] Congressional Budget Office, Cost Estimate: S. 1376 National Defense Authorization Act for Fiscal Year 2016 (June 2015), pp. 29-30. https://www.cbo.gov/sites/default/files/114th-congress-2015-2016/costestimate/s13761.pdf

[2] Increased Use of Prescription Drugs Reduces Medical Costs in Medicaid Populations; *Health Affairs,* September 2015, vol. 34, no. 9, 1586-1593.

are located overseas. It is not possible to incentivize manufacturers to move their FDA-approved manufacturing facilities to the United States to avoid a BAT. Wholesaler, pharmacy, and ultimately consumer purchasers have no choice except to purchase the inflated foreign manufactured generic drug prices, assuming they are still able to afford those drugs.

## **BAT would have Negative Impact on Economy**

Secondary to patient access concerns, a BAT would be extremely financially damaging to many chain pharmacies. Retail pharmacies rely so heavily on imported products that a BAT would have wide application within a pharmacy's inventory. Not only would pharmacies pay a higher price for these imported products, but also they would no longer be allowed to take a tax deduction on the cost of imported drugs. To make matters worse, chain pharmacies have no way to take advantage of financial benefits of exports under a BAT because chain pharmacies sell all of their products almost entirely within the United States.

To emphasize the devastating impact of a BAT on retail pharmacy, it is important to note that chain pharmacies would bear the burden of a BAT without any of the benefit. Our members have indicated that any lower corporate tax rate used to offset a BAT would not be a sufficient offset for them. Many retail chain pharmacies would have a higher tax bill than they have today. The higher purchasing costs, loss of import tax deductions, and lack of exports would severely depress pharmacy bottom lines. Of particular relevance to this hearing are retail pharmacy layoffs. If pharmacies suffer financial losses because of a BAT, then they would have to streamline their businesses and one path that some will choose will be cutting staff. The goal of this hearing is to discuss ideas for job growth within the United

States, but as far as pharmacy is concerned, a BAT likely reduces the number of pharmacy jobs in the United States; it does not increase them.

## **Conclusion**

In conclusion, NACDS supports corporate tax reform to lower the corporate tax rate and we support United States jobs. Chain pharmacies are major employers across the country. However, a BAT is a misguided method to achieving tax reform and promoting United States job growth. For chain pharmacies, a BAT has the opposite of its intended impact, which is harmful for the pharmacy business and would raise healthcare costs. NACDS thanks the Committee for consideration of our comments. We look forward to working with policymakers and stakeholders on these important tax issues.

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NRF
THE VOICE OF RETAIL

# Submission of the National Retail Federation

to the

House Ways and Means Committee

Hearing on Border Adjustment and Increasing U.S. Competitiveness and Preventing American Jobs from Moving Overseas

May 23, 2017

**David French**
Senior *Vice President, Government Relations*
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National Retail Federation
May 23, 2017

The **National Retail Federation** NRF is the world's largest retail trade association, representing discount and department stores, home goods and specialty stores, Main Street merchants, grocers, wholesalers, chain restaurants and Internet retailers from the United States and more than 45 countries. Retail is the nation's largest private sector employer, supporting one in four U.S. jobs — 42 million working Americans. Contributing $2.6 trillion to annual GDP, retail is a daily barometer for the nation's economy. NRF.com

The National Retail Federation believes that the most important aspect of any tax reform measure is its impact on the economy and jobs. Consumer spending represents two-thirds of GDP, and one-in-four Americans are employed in the retail industry. The NRF believes that tax reform that shifts the tax burden from businesses to consumers will present an unnecessary risk to our economy. The NRF believes that a reform of the income tax, by providing a broad base and low rates, will bring the greatest economic efficiency and will stimulate economic growth without harming the American consumer and causing the economic dislocations inherent in the transition to a new consumption tax system.

## Impact of the Border Tax Adjustment on the Retail Industry

The Ways and Means Committee's Better Way Tax Reform Plan would deny importers the ability to deduct the cost of their imports. A substantial percentage of goods sold in retail stores are imported. The goods are either directly imported by the retailer or by one of their suppliers. The vast majority of these items (footwear, apparel, toys, etc.) are not manufactured in the United States so there is no opportunity to substitute American made inventory. The tax also applies to other goods that must be imported like fuel, chemicals, coffee and cocoa.

Retailers are high effective taxpayers under current law, paying more than 37% of their income in state and local taxes. The border tax proposal would cause the tax burden on retailers to skyrocket. Under this proposal, many retailers will have a tax burden that is larger than their profits. In specialty apparel, for example, retailers import 90-100% of what they sell. These retailers will end up with effective tax rates that are 3-5 times larger than their profits. Obviously, they will have no choice but to pass the tax cost forward to their customers. However, their customers will not see their wages go up by 15% even with growth in the economy. So they will consume less with the dollars they have, and essentials, like food and gasoline, will receive a larger share of consumer dollars. Many Wall Street analysts have predicted this could destabilize retailers that are currently financially viable.

Small businesses may be particularly vulnerable to the impact of the border tax on prices. Because they do not have the economies of scale to be able to negotiate with their suppliers, they will be more likely to have to absorb the full impact of the tax increase and will be less competitive to the extent they try to pass that price forward to their consumers. Small businesses make up 98 percent of the retail industry and provide 40% of the industry's 42 million jobs.

National Retail Federation
May 23, 2017

**Impact of the Border Adjustment Tax on Prices**

Our retailers predict that they would have to raise price by approximately 15% to break even under the House Blueprint. An NRF analysis of the plan predicts that the plan could cost the average family of four $1700 in the first year alone, which includes a 35 cent increase in the cost of a gallon of gas. Hardest hit would be low and middle income consumers, especially those on fixed incomes.

Economic theory suggests that the dollar will strengthen to offset any impact of the tax on prices of imports. However, many currency experts dispute that a strengthening of the dollar will happen quickly or that it will completely offset any impact on prices caused by the border tax. According to Kenneth Rogoff, Harvard economics professor and former Chief Economist for the International Monetary Fund, "40 years of research have taught us that it is unrealistic to assume that a border tax will quickly lead to a sharp offsetting movement of the dollar, because exchange rates can move wildly away from their fundamentals for many years at a time. The process could take many years, and the short-term effects on U.S. unemployment easily could be negative."[1] Even if the dollar strengthens in the long-term, we still expect a decline in sales of goods sold by retailers because economists believe the tax will create a preference for non-tradeable goods over tradeable goods.[2]

**Overall Impact of the House Blueprint on Growth in the Retail Industry**

Proponents of the House Blueprint have argued that it is important to evaluate the proposal as a whole in terms of its impact on a business or industry, rather than look at any particular provision in isolation. The NRF engaged Ernst & Young to conduct a macroeconomic study of the impact of the House Blueprint on the retail industry, with a focus on retail spending and retail employment. The study[3] found that even without taking into account the impact of the border adjustment tax, retail spending and retail employment would decline for six years under the proposal compared to where they would be under current law. If the border adjustment tax were layered onto the model, the declines in retail spending and employment were presumed to be more severe.[4] The reason that retail spending and employment decline under this analysis is because the House Blueprint moves our current income tax system towards a consumption tax.

Figure 1 shows the estimated impact of the House Blueprint on retail spending, without taking into account any possible impact of the border adjustment tax.

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[1] https://www.bostonglobe.com/opinion/2017/03/20/trump-damaging-border-tax/uz9OsK5BJet06pYlOfndsL/story.html

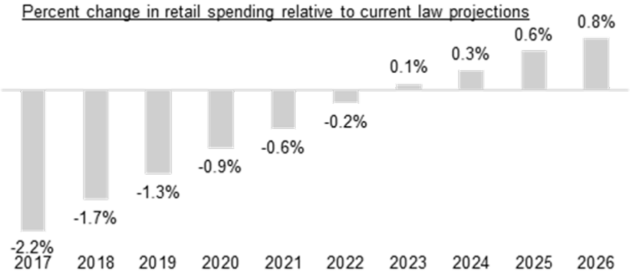
[22] See, for example, Martin Feldstein and Paul Krugman, 1990, "International Trade Effects of Value-Added Taxation."

[3] Ernst & Young, Macroeconomic Analysis of the Impact of House Republican Blueprint for Tax Reform on the US Economy and Retail Spending, prepared for the National Retail Federation. May 2017.

[4] Because of the debate over whether the dollar would strengthen to offset any possible impact of the border adjustment tax, how long any adjustment might take, and whether the adjustment would completely offset a potential price increase on all products, they did not make assumptions with respect to when or how much adjustment would occur in their model.

National Retail Federation
May 23, 2017

**Figure 1. Estimated Impact of the House Blueprint on Retail Spending**



Retail spending scaled to $4.3 trillion US economy in 2015 (in billions)

| | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| Current law | $4,298 | 4,298 | 4,298 | 4,298 | 4,298 | 4,298 | 4,298 | 4,298 | 4,298 | 4,298 |
| House Blueprint | $4,204 | 4,225 | 4,242 | 4,259 | 4,272 | 4,289 | 4,302 | 4,311 | 4,324 | 4,332 |
| Change | -$90 | -70 | -60 | -40 | -30 | -10 | * | 10 | 30 | 30 |

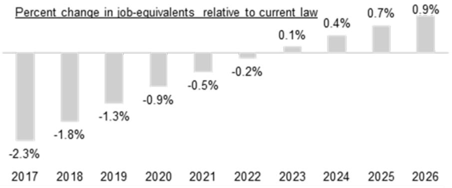
*Smaller in magnitude than $5 billion.

Note: These estimates do not reflect the potential impact of the border adjustment provisions. The analysis assumes the House Blueprint to be fully effective January 1, 2017, with no transition rules. For models of this type, roughly two-thirds to three-quarters of the long-run effect is generally reached within a decade, although this period would be longer for consumer and retail spending due to the shift towards a consumption tax under the House Blueprint.

Source: EY analysis.

Figure 2 shows the estimated impact of the House Blueprint on retail employment, without taking into account any possible impact of the border adjustment tax.

**Figure 2. Estimated Impact of the House Blueprint on Retail Trade Job-Equivalents**



Job-equivalents scaled to the 13.6 million retail trade sector in 2015 (in millions)

| | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| Current law | 13.6 | 13.6 | 13.6 | 13.6 | 13.6 | 13.6 | 13.6 | 13.6 | 13.6 | 13.6 |
| House Blueprint | 13.3 | 13.4 | 13.4 | 13.5 | 13.5 | 13.6 | 13.6 | 13.7 | 13.7 | 13.7 |
| Change | -0.3 | -0.2 | -0.2 | -0.1 | -0.1 | * | * | 0.1 | 0.1 | 0.1 |

*Smaller in magnitude than 0.05 million.
Note: These estimates do not reflect the potential impact of the border adjustment provisions. The analysis assumes the House Blueprint to be fully effective January 1, 2017, with no transition rules. Job-equivalents impacts are defined as the change in total labor income divided by the baseline average labor income per job. For models of this type, roughly two-thirds to three-quarters of the long-run effect is generally reached within a decade, although this period would be longer for consumer and retail spending and retail job-equivalents due to the shift towards a consumption tax under the House Blueprint. Figures may not sum due to rounding.
Source: EY analysis.

This economic analysis demonstrates that the overall impact of House Blueprint on the retail industry is not positive, and, in fact, the retail industry would be expected to decline for at least 6 years under the proposal. When the border adjustment tax is analyzed in this context, it is even worse for the retail industry.

## Conclusion

The retail industry has been a strong proponent of income tax reform. We believe that income tax reform that lowers the rates and broadens the tax base can provide economic growth for the economy as a whole and can be good for the American consumer. We do not believe that a new tax system that shifts the burden of taxation to the consumer is good for our industry, which is the nation's largest employer, or good for the American consumer. We urge you to reject the border adjustment tax and modify the House Blueprint so that it does not shift the tax burden to consumers.

NEW ENGLAND FUEL INSTITUTE
www.NEFI.com

OHI Oil Heat Institute of L.I.

NEW YORK STATE ENERGY COALITION

NEW YORK OIL HEATING NYOHA ASSOCIATION Inc.

April 6, 2017

President Donald J. Trump
The White House
1600 Pennsylvania Avenue, N.W.
Washington, DC 20500

**Subject:** Comprehensive Tax Reform & the Northeast Heating Oil Market

Dear Mr. President:

Considering your policy statements and priorities, we believe you share our goal of providing American consumers with a reliable and competitive home heating fuel. As you begin work to simplify the federal tax code and bring meaningful relief to millions of families and small businesses, we ask that you consider the unique needs of heating oil marketers and their consumers in New England and New York.

The heating oil industry remains an integral part of the region's energy economy, supporting tens of thousands of jobs and delivering a safe, efficient, and environmentally-responsible product to nearly five million homes and businesses. Comprehensive tax reform is one of many areas in which our industry can work with your administration and Congressional leaders to promote domestic energy security and provide American businesses with greater freedom to invest in their companies, employees and customers. We feel it is important that you consider the supply needs of energy consumers in our region as you move forward with this noble effort.

New England and New York lack petroleum production and adequate refining capacity and must look outside the region to meet existing demand. Unfortunately, the transportation of liquid fuels from elsewhere in the country is limited due to a fragmented rail system, limited pipeline capacity and port-to-port shipping restrictions under the Jones Act. Thus, imports of motor fuels and heating oil remain a vital component to the regional supply mix, especially during extended periods of cold winter weather.

Given its many economic and environmental benefits, our industry has embraced the blending of sustainable biodiesel with conventional heating oil, a product commonly referred to as Bioheat® Fuel. Adequate supplies of biodiesel are essential to the continued growth and availability of this "next generation" heating fuel. Due to feedstock constraints and other considerations, the region's production capacity for biodiesel is limited and like petroleum-based heating oil, much of it is imported. For example, Canada is a major supplier of petroleum products and biofuels to the Northeast.

The blueprint document released by the Congressional Task Force on Tax Reform on June 24, 2016, titled *A Better Way: Our Vision for a Confident America*, describes potential changes to the tax code in many areas. Of interest to our industry are proposed changes to corporate and individual tax rates and the treatment of pass-through entities, interest and depreciation deductions, the treatment of tangible and intangible assets, and the deduction of expenses for imported goods. We appreciate that changes made to any one area could affect the "mathematical puzzle" that aims to maximize economic growth while remaining revenue-neutral.

An important component of the blueprint calls for a "border adjustment tax" (BAT) which could effectively impose a 20 percent tax on all imported goods, including home heating oil and biodiesel. The BAT would also apply to imports of furnaces, boilers and water heaters, and could affect construction costs for U.S.-made appliances. Absent a corresponding increase in the value of the U.S. dollar, we are concerned the proposed BAT might increase the cost of these imports and make it more expensive for consumers to heat their homes. Further, if the BAT is structured in such a manner as to encourage energy *exports*, it could inadvertently increase the risk of regional supply disruptions. Energy shipped from U.S. refining centers to New York, New Haven, Providence, Boston, Portsmouth or Portland might be more likely to be exported overseas and the region could end-up even more dependent on imports.

As you proceed with the important goal of rewriting and simplifying the federal tax code, we hope you and your partners in Congress will consider and assess the economic impact to consumers and businesses in our region. We are eager work with your administration as it moves forward on this and other policy initiatives such as infrastructure, energy development, and regulatory relief.

Thank you in advance for your consideration.

Sincerely,

New England Fuel Institute
New York Oil Heating Association
New York State Energy Coalition
Oil Heat Institute of Long Island

cc: The Honorable Steven Mnuchin, U.S. Secretary of the Treasury
Gary Cohn, Director, National Economic Council
New England Congressional Delegation
New York Congressional Delegation

**Submitted by Bill Parks, President NRS Inc.,** 2009 South Main Street, Moscow, Idaho 83843

Written Testimony Before the Committee on Ways and Means, U.S. House of Representatives
Washington, DC
May, 2017 Statement of Bill Parks

Chairman Brady, Ranking Member Neal, and members of the committee: I am a retired professor of finance and the founding President of NRS, a 100% employee-owned company, which is the largest supplier of paddle sports accessories in the world. I have also published numerous articles in respected journals including Tax Notes.

**Introduction**

I want to address the problem of base erosion that has plagued the corporate system for many years. Some advocate ending deferral and others just changing to a territorial system. The "Built for Growth" proposal opens the way to a solution because it changes to a destination based corporate tax.

The best way to limit base erosion under a territorial system would be for the U.S. to use Sales Factor Apportionment (SFA) to value a company's taxable profit. It is the only system that places all companies—U.S. domestics and U.S. and foreign multinational enterprises—on a level playing field.

Under SFA, a company's taxable profits would be allocated in the same proportion as its sales. If 40 percent of a company's sales were in the U.S., then the U.S. could tax 40 percent of its profit. Within a territorial system, SFA can reduce the offshoring of U.S. jobs and the incidence of corporate inversions. SFA will also encourage exports and raise revenue without raising tax rates.

Let me explain.

**Present Corporate Tax Environment**

Income shifting is a common multinational tax-avoidance strategy. Reducing accounting income correspondingly reduces the income tax obligation. If a U.S. multinational enterprise (MNE) with an effective tax rate of 30% shifts a million dollars of U.S. earnings to a subsidiary in Cayman Islands, which has no corporate income tax[1], then it has reduced its U.S. tax obligation by $300,000.

There are three common strategies for income shifting: (1) Transferring intellectual property such as a patent or copyright to a tax haven subsidiary, which then charges the U.S. parent high rates for its use. (2) Using internal "transfer prices" to reduce the parent company's profit, when the tax haven subsidiary is part of the firm's supply chain. (3) Having the tax-haven subsidiary issue loans to the U.S. parent because interest payments on those loans are tax-deductible for the parent. In addition to reducing taxable income, these strategies also give the parent access to overseas profits without the repatriation tax.[2]

These are just the simplest and most common methods. Today there is a proliferation of extremely complex methods that help MNEs lower their effective tax rates. In addition to the tax revenue lost, these practices undermine the competitiveness of U.S. domestic businesses, which can pay 40 percent or more in federal and state taxes when competing with MNEs that pay little or no U.S. taxes.

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[1] Pomerleau, "Corporate Income Tax Rates around the World, 2014" *Tax Foundation Fiscal Fact No. 436,* Aug. 20, 2014.

[2] Udell and Vashist, "Sales-Factor Apportionment of Profits to Broaden the Tax Base", *Tax Notes,* July 15, 2014.

So what can be done to fix the problem?

Most people agree that it's wrong for large MNEs to pay far less tax than a domestic company. Still, there is broad disagreement between those who want to end deferral and tax foreign income on a worldwide basis, and those who argue that U.S. MNEs cannot compete due to our current worldwide tax system. Setting aside those who want to end corporate taxes altogether, what should tax reform look like? One of the most important criterion for a more equitable tax system must be that a MNE, whether U.S. or foreign, pays the same tax as a domestic company in the same situation.

So what should be done?

**Permanent Establishment Rules**

The permanent establishment rules may have been appropriate in the age of sailing ships, but they are wildly inappropriate in today's digital economy. Today a foreign MNE can establish a sales office in Ontario, drive across the bridge to Detroit, and sell $1 billion in goods without ever creating a permanent establishment. With the use of Skype, the company could avoid a physical presence altogether. To correct this problem, New York State changed its rules so that every company that sells more than $1 million in the state is deemed to have permanent establishment. This should be done nationwide with $5 million in sales being sufficient to deem permanent establishment.

**More Competitive Rates**

The need for more competitive tax rates is real. If U.S. MNEs were to pay statutory rates on their foreign income they would be at a competitive disadvantage to foreign MNEs. Ending deferral will not fix the problem. While it would put domestic companies and U.S. MNEs on a more equal footing, it would do nothing to correct foreign MNEs' competitive advantage. They would have a huge advantage in world markets and be able to pay more for U.S. companies of all kinds due to their tax advantage.

**The Problem of Transfer Pricing**

In this global economy, it's a fantasy that one can use a transfer price based on the Arms Length Price or Principle, ALP. While commodities can be priced this way (given the transaction between one buyer and one seller acting in their own self interest) that's not how most of today's business is done. Most products are not commodities and most transactions happen between related parties. Furthermore, companies build their transfer prices based on cost accounting. It is a mantra of cost accounting that there are different costs for different purposes. Given this, there will always be a range of acceptable prices, and a company will invariably choose the one that minimizes its total tax bill. Transfer pricing books state that the purpose of transfer pricing is to minimized the global tax bill of MNEs. Because of transfer pricing's inherent defect, no system that includes it can treat domestic companies fairly.

So what's the answer to these and other problems? I say adopt the Built for Growth destination basis to move to Sales Factor Apportionment.

**Sales Factor Apportionment**

With SFA, a company's profits are allocated in the same proportion as its sales. As mentioned in the earlier example, if 40% of its sales were in the U.S., then the U.S. would consider 40% of its profits taxable. However, that would open up the system to various tax avoiding strategies. Therefore, to prevent abuse, all profits would be assumed taxable, and the company would have the responsibility to document that its sales remained outside the U.S. With this approach—subtraction method SFA— every company, including ones that have inverted, would pay the same taxes on its profit from sales (whether the company is domestic, a U.S. MNE, or a foreign MNE). The same would apply to firms that had inverted. And as an added bonus, states would be able to increase their tax revenue by as much as $15 billion because MNEs would, for the first time, show their true domestic profits. This would end the so-called lockout effect.

SFA would make tax rates irrelevant to the worldwide competiveness of U.S. firms. Though it's always desirable to lower rates, the main objective must be that all MNEs, foreign and domestic, pay equal taxes on their U.S. sales. Only SFA can accomplish that.

SFA has been calculated to raise more than $100 billion annually (based on 2014 corporate earnings). In my other related submission, I suggest using some of that revenue to support small business.

**Conclusion**

Subtraction method SFA has real economic benefits and is virtually foolproof. U.S and foreign MNEs would face an appropriate corporate tax, which would bring billions in locked-out funds back to the U.S. That would raise more tax revenue even at the current tax rates.

Domestic firms that export would also see their taxes reduced, because profits from their exports would not be taxed. Distortions would be minimized because sales are the last thing a company will give up. And finally, because SFA taxes all companies the same, the U.S. will no longer be at a competitive disadvantage in world markets.

Adopting SFA would make MNE avoidance of U.S. taxes essentially impossible.

## STATEMENT FOR THE RECORD
## SUBMITTED TO THE
## HOUSE WAYS AND MEANS COMMITTEE

# A "Made-in-America Carbon-Funded Tax Cut"
# Would Increase U.S. Competitiveness

**June 6, 2017**

**Submitted By:**

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Partnership *for*
Responsible Growth

### A "Made-in-America Carbon-Funded Tax Cut" Would Increase U.S. Competitiveness

*Gregg Sherrill, Bob Litterman, William Eacho*

The tax reform goals set by Republican leaders and the Trump administration are ambitious. Tax reform that enhances growth, simplifies the Code, addresses base erosion, and lasts is both long overdue and difficult to accomplish.

Chairman Brady says that the border adjustment tax will help address those priorities by reversing the trade deficit while raising the revenue necessary to cut the statutory rate and simplify the tax code.[1] But according to tax experts and business analysts, the border adjustment tax (BAT) will negatively affect import-heavy industries, raise consumer prices and, in fact, decrease federal government revenue.[2] Though the BAT is designed, in part, to pay for business tax reductions, many have pointed out that the short-term revenue gain is at the expense of future taxpayers – when trade deficits turn to surpluses, the BAT is a revenue loser.[3] Yet, despite widespread opposition, some continue to call for a BAT, contending that it will boost sales of American made goods.

An excise fee on carbon fuels, on the other hand, *would* raise significant revenue over the next ten years and beyond – more than the BAT or what could be raised by eliminating any of the other tax preferences that have been recently targeted by reformers.[4] For example, a $25 per metric ton of $CO_2$ price imposed on coal, oil and gas producers upstream, reflecting the carbon content of their products, would likely generate over $1 trillion over 10 years.[5] A $49 per metric ton of $CO_2$ price could generate more than $2.2 trillion.[6] Half of this revenue could be used to reduce the corporate tax rate to 20 percent, House leadership's stated goal. The remainder could be returned to low- and moderate-income families to protect them from expected small increases in fuel and energy prices.[7]

No other approach to providing new revenue to pay for tax reform comes anywhere close. Incorporating this carbon-funded tax cut into comprehensive tax reform legislation would achieve all of the goals that House leadership has enumerated:

- By using carbon royalties to cut the corporate tax rate and provide tax relief to middle-class families, Congress would spur investment and boost growth.[8]
- By collecting carbon revenue upstream on a small base of taxpayers (fewer than 2300[9]), Congress could avoid "transition rules" that many agree would be needed to implement a BAT.

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[1] Fox, "Border adjustment tax is 'critical' part of tax reform, chief GOP tax writer says" (CNBC, 25 May 2017).

[2] Nunns et al., *An Analysis of the House GOP Tax Plan* (Tax Policy Center, 2016).

[3] Clausing, *Statement Before the House Ways and Means Committee* (23 May 2017).

[4] McKibbin et. al., *The Role of Border Adjustments in a U.S. Carbon Tax* (Brookings, 2017) showing that revenue growth would continue beyond the first ten years well into the following two decades.

[5] Congressional Budget Office, *Options for Reducing the Deficit: 2017 to 2026* (Congressional Budget Office, December 2016), 211. CBO estimates include a reduction in tax bases for income and payroll taxes. The appropriate offset for tax interaction under a carbon price is a matter of debate. See footnote 6.

[6] Horowitz et al., *Methodology for Analyzing a Carbon Tax* (Office of Tax Analysis, The Department of the Treasury, 2017). Horowitz et al. estimates gross revenue of $2.96 trillion, with a 25% offset, and notes that further "analysis of the offset in the carbon tax context may be warranted" (11).

[7] Stone, *The Design and Implementation of Policies to Protect Low-Income Households under a Carbon Tax* (Center on Budget and Policy Priorities, 2015).

[8] Jorgenson et al., *Double Dividend* (The MIT Press, 2013). 302-315.

[9] Ramseur et al., *Carbon Tax: Deficit Reduction and Other Considerations* (Congressional Research Service, 2012).

- By appropriately pricing risks associated with carbon pollution, Congress could enact lasting reform rather than simply temporarily cutting taxes with no pay-for.

But equally important, and the subject of this statement, is that a pro-growth price on carbon could increase U.S. global competitiveness and prevent American jobs from moving overseas. In our current economy, with many wondering how the U.S. can regain a leadership position in manufacturing and international trade, perhaps the best argument for carbon pricing is that it would allow the U.S. to impose a border adjustment on imports, defending U.S. domestic production.

The BAT contemplated in the House blueprint, many agree, is vulnerable to lengthy and costly challenges under existing World Trade Organization rules.[10] Defeat under such rules could cost the U.S. $385 billion annually in trade retaliation, according to a recent analysis.[11] And defeat is likely because, unlike the border adjustment provisions of the value-added taxes imposed in many European countries, the House leadership's BAT will be interpreted as a tariff that illegally subsidizes American exporters while penalizing foreign producers.[12] In fact, the EU and other trading partners have begun preparing a legal challenge to the House proposal based on a similar claim that the BAT is not compliant under the WTO Subsidies and Countervailing Measures (SCM) Agreement.[13]

In the "America First" era, it is clear that President Trump and House leaders are not afraid to buck traditional global institutions. We believe that, in order to keep the American middle class first, prudence requires that we buck convention strategically. Given that, Congress can better protect American manufacturing by taking advantage of Article XX of the General Agreement on Tariffs and Trade (GATT). Under the General Exception provision of that Article, the WTO permits border adjustments for environmental costs – including carbon pricing.[14]

This exception would allow us to rebate energy-intensive trade-exposed firms that export to countries without similar carbon pollution reduction strategies, and impose an adjustment on imports from those countries. Doing so would force other countries to either respond or pay up, helping us reassert American trade leadership. It would protect American manufacturing and help unleash the power of market innovation necessary to achieve 21st century energy dominance. Carbon Leakage Measures and Border Tax Adjustments under WTO Law

We know that the vast array of energy choices available to U.S. manufacturers – the diversity of our energy economy – is a powerful asset. That asset can be leveraged to enhance American competitiveness and keep manufacturing jobs here at home, if only we appropriately price pollution, incentivizing our trading partners to do the same.

Not only would a "Made-in-America Carbon-Funded Tax Cut" enhance growth by spurring domestic investment and middle class tax relief and by simplifying the code in a permanent manner; but by incorporating such policy into a tax reform package, Congressional leaders could help reassert American trade competitiveness for years to come.

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[10] Harrison, "Weighing the Impact of a U.S. Border Adjustment Tax" (University of Pennsylvania, 2017).

[11] Donnan, "EU and others gear up for WTO challenge to US border tax" (The Financial Times, 13 February 2017).

[12] Avi-Yonah and Clausing, *Problems with Destination-Based Corporate Taxes and the Ryan Blueprint* (Columbia Journal of Tax Law, 2017); Cui, *Destination-Based Taxation in the House Blueprint* (Tax Notes Today, 2016).

[13] See SCM Annex I and Footnote 58 and 59.

[14] Pauwelyn, *Carbon Leakage Measures and Border Tax Adjustments under WTO Law* (*Research Handbook on Environment, Health and the WTO*, Cheltenham, UK: Edward Elgar, 2013), See Article XX of the GATT.

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### "Increasing U.S. Competitiveness and Preventing American Jobs from Moving Overseas"

### Ways and Means Committee Hearing on May 23, 2017

### Submission for the record

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The key to evaluating the border adjustment is to keep in mind the big picture benefits of the overall Brady-Ryan tax reform: lower tax rates mean a stronger US economy with more jobs, higher incomes, more spending by families, and more investment by businesses. The Brady-Ryan plan also addresses the tax bias in favor of debt over equity financing, leading to not just a stronger economy but a more stable one as well. With the Brady-Ryan plan, the United States will have a much more competitive tax system, and become a more attractive destination for global investment and economic activity.

The border adjustment makes it possible to achieve the most progress in these dimensions. Without the border adjustment, tax reform would involve either smaller improvements in terms of lower tax rates, or larger budget deficits over the foreseeable future. The border adjustment allows for a more pro-growth tax reform.

The border adjustment in its own right has important positive effects on the U.S. economy because it removes the tax incentives for American firms to use accounting techniques to shift profits overseas, or to invert their corporate structures to relocate headquarters outside of the United States. In the Brady-Ryan plan, firms are taxed based on the place in which their sales are made, and thus are not induced by the tax system to move production abroad or to use transfer pricing to shift profits overseas.

The destination-based tax treatment provided by the border adjustment removes a current bias in the tax system that affects firms deciding whether to expand production in the United States or in other countries. The border adjustment makes it so that US firms face the same tax treatment as foreign firms selling into the United States, because all products sold in the United States, whether produced here or abroad, will be subject to the same tax. In contrast, the current U.S. tax system typically subjects American firms to higher tax rates than foreign firms, leaving U.S. businesses at a disadvantage. At the same time, the border adjustment ensures that U.S. firms selling products abroad are on a level playing field with firms in the countries to which they export. American firms that export will face the same foreign tax paid by their overseas competitors. Indeed, the advanced economies with which we trade already have border adjustments in their tax systems (typically with their value-added taxes, or VATs). The border adjustment thus ends the current U.S. tax treatment in which American firms pay a higher tax rate than their foreign competitors, making the U.S. tax system more competitive.

The impact of the border adjustment in removing the incentives in our tax system for inversions and profit-shifting is a better approach than trying to devise rules against these activities. Attempts to get at inversions and profit-shifting by layering rules upon rules—the route taken by the Obama administration—are bound to fall short because firms will find ways around the restrictions, even while increasing costs for businesses and the government. Indeed, removing the tax biases for inversions and profit-shifting will mean fewer resources dissipated on tax avoidance activities such as accounting maneuvers. A tax measure that reduces the U.S. corporate tax rate without the other pro-growth features of the Brady-Ryan plan would also make the U.S. tax system more competitive and reduce incentives for profit-shifting and inversions, but by less than the complete reform including the border adjustment, which eliminates the perverse incentives altogether.

Tax reform leads to a stronger economy today as lower tax rates improve incentives for work, while lower corporate tax rates improve incentives for saving and investment. More investment in turn will lead to increased capital and thus improved productivity. Importantly, wages over time track with labor productivity. Increased investment and improved productivity over time would thus be expected to translate into higher wages for American workers.

The beneficial outcomes brought about by the Brady-Ryan plan help everyone, including firms such as retailers who criticize the border adjustment. The benefits for retailers come about in two ways. First, retailers themselves will face a lower corporate tax rate. Indeed, retailers would be among the industries most helped by the lower tax rate, because they often now actually pay the 35 percent corporate rate, while other sectors generally have lower effective tax rates. Somewhat ironically, this is documented by the group Americans for Affordable Products (AAP), which has shown that retailers face higher effective tax rates than firms that support the border adjustment. But this means that retailers would benefit the most from the lower rates in the Brady-Ryan – and would therefore benefit from the impact of the border adjustment that makes it possible to reduce tax rates by more than without the border adjustment. There is a sense in which this implication of the data collected by AAP sits awkwardly with the group's own message.

The second and perhaps even more important benefit of the Brady-Ryan plan for retailers is that their customers will have higher incomes and thus more to spend in stores and online. What is good for customers ultimately is good for merchants. That is the big picture positive of tax reform.

This is not to deny that there will be costs along with the benefits—some of these costs are discussed below. Evaluating the Brady-Ryan tax proposal involves weighing the costs against the benefits. The big picture evaluation is that the plan comes out ahead in terms of net positives for the U.S. economy.

One way to see this is to consider the counterfactual situation in which the United States had instituted the Brady-Ryan plan with its lower rates and border adjustment long ago. Is there any chance that we would change to our current tax system? Not by a long shot. We would not want to go to a tax system with higher rates that reduce saving and investment, or tax-induced biases that provide incentives for corporations to invert or shift earnings overseas. We would not want to move to a tax system that puts U.S. firms at a disadvantage relative to their foreign competitors. This conclusion is strengthened by the observation that most other advanced economies already have border-adjusted taxes that are economically equivalent or nearly-so to the setup in the Brady-Ryan proposal. None of those other countries seek to move toward the U.S. tax system. The U.S. tax system is a hindrance to our prosperity.

This observation highlights that the main costs of moving to the border-adjusted tax in the Brady-Ryan proposal are involved with the transition from the current system to the new one. This is a familiar situation in that tax reform creates winners and losers, even if the net is positive, as is the case here.

Criticisms of the border adjustment have focused on the impact of the 20 percent tax on imports, often while ignoring or discounting the associated response by which the dollar will strengthen with the border adjustment. In principle, there should be a 25 percent dollar appreciation that offsets the 20 percent tax on imports. No one can know for sure how much of this textbook response will be seen in practice and how quickly, but we should expect most of the 25 percent dollar appreciation to take place and to take place quickly, because currency markets adjust rapidly to economic developments. To be sure, this will still be an adjustment, but the impact of the border adjustment in raising import prices is vastly exaggerated by critics of the border adjustment. It is important to remember that the 20 percent tax applies only to the value of the imported item as purchased from the foreign supplier, and not to the price at which an item is sold to American consumers. Retailers add substantial value to the U.S. economy—they do not merely buy things from China and push them out to American families. Instead, retailers provide valuable services that are appropriately compensated with the retail markup that is the difference between the wholesale price paid to suppliers and the higher price at retail. The value embedded in this markup is not subject to the 20 percent tax. That means even if the dollar adjustment is not complete, the impact in raising prices of consumer products is greatly muted.

A related concern over the border adjustment is that the approach in the Brady-Ryan plan might run afoul of WTO proceedings and expose American businesses to retaliation in the form of other countries raising barriers to U.S. products. In considering this concern, the first thing to have in mind is that the arrangement in the Brady-Ryan plan is essentially economically equivalent to the value-added tax (VAT) systems of our major trading partners, plus a wage subsidy (which is allowed by the WTO). The possible WTO problems of the Brady-Ryan plan are thus matters of form over substance. It would say more about the WTO and other countries if a pro-growth U.S. tax policy that mirrors those of Europe in economic substance is not acceptable—such a finding would raise serious doubts about the validity of the WTO system, more than about the Brady-Ryan tax plan. Again, our major trading partners already have the border adjustment. It would be improper for them to retaliate against the U.S. moving to such a system.

A further concern related to currency movements is that the stronger dollar brought about by the border adjustment means that foreigners' holdings of US assets would be worth more in terms of those foreigners' currencies, and Americans' holdings of foreign assets would be worth less in terms of dollars. In other words, the concern is that the dollar appreciation associated with the border adjustment would bring about a wealth transfer from Americans to foreigners. The irony of this concern is that it comes about because of the dollar appreciation, in contrast to the concern over import prices, which requires a disbelief in the response of the dollar. Set that irony aside, however. Such a change in wealth is what happens when the US economy becomes more vibrant for any reason, because after all, a stronger US economy means a stronger dollar. Any action taken by the Congress and President that improves the US economy would lead to a stronger dollar and have a similar implication for the value of cross-border asset holdings. But this does not mean that we should not hold back from taking steps to improve the US economy.

A different concern over the border adjustment is that the resulting tax system is much more efficient in the sense of raising revenue with a smaller distortion to the economy than the present US tax code. Instead of seeing this as a positive of tax reform, the argument goes that a more efficient tax code will facilitate additional government spending. I understand the political economy argument involved here. At the same time, I am confident that convincing arguments can be made on why a more limited government is better than the expansive one feared under this concern. The way to ensure low taxes is to keep government spending in check. I prefer to win the argument for the appropriate size and role of government than to intentionally hobble the United States with an inefficient system of collecting revenue.

A stronger economy with rising incomes and better job creation means more money for families to spend in stores and online. These desirable outcomes are what the Brady-Ryan tax plan will bring about. And importantly, this stronger economy is good for retailers and other critics of the border adjustment. The key is to focus on the big picture benefits of tax reform for the overall economy—and thus for the customers of retailers and all other parts of the U.S. economy.

prodotto

May 19, 2017

RE: Testimony for Hearing on Border Adjustment Tax

Dear Ways and Means Committee,

We are writing to explain how our business will be affected by the Border Adjustment Tax (BAT). While we are very supportive of Tax Reform, the BAT will be detrimental to our business and force us to shut down.

We import unique toys from all over the world, via the Port of Baltimore. We are based in the state of Maryland and generate close to $1 million in sales. We re-sell our imports in the USA to major retailers Target, Nordstrom, Amazon and many others. We are also woman-owned and run business. This year, we will bring in 12 containers of product for re-sale in the USA.

The proposed BAT, if successful, would force us to close our business and take a tremendous loss in income. We represent hundreds of employees who would lose jobs due to the BAT:

- Our company, Prodotto: 3 employees and growing
- Maryland freight provider Shapiro (www.shapiro.com): 10 employees
- Maryland based trucker, Lightning Transport (https://lightningtrans.com): 15 employees
- Total Biz Fulfillment (www.totalbizfulfillment): 100 employees
- Port of Baltimore: hundreds of employees

In addition to the loss of jobs in the state of Maryland, we must consider how the Toy industry would be affected: 97.7% of toy manufacturers, wholesalers and distributors in the USA are small businesses. The industry represents 500,000 jobs and $25 billion in sales. The majority of toys are made overseas. The toy industry requires low skill, low wage jobs. These are not the jobs that Americans need or want.

We appreciate your time and consideration for Tax Reform **without** the Border Adjustment Tax. Don't kill Christmas for American children.

Best regards,

Lauren McFerrin
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INDUSTRIALES
PUERTO RICO
MANUFACTURA ■ SERVICIO ■ COMPETITIVIDAD ■

Statement by Mr. Rodrigo Masses
President of the Puerto Rico Manufacturers Association

For the Hearing Record of the
Committee on Ways and Means
U.S. House of Representatives
Hearing on

# **Increasing U.S Competitiveness and Preventing American Jobs from Moving Overseas**

Tuesday, May 23, 2017

Thank you Chairman Brady, Ranking Member Neal and distinguished Members of the Committee.

It is my pleasure to present this statement as President of the Puerto Rico Manufacturers Association (PRMA) and note that I also speak on behalf of the largest employer in Puerto Rico. The PRMA is a private, voluntary, non-profit organization established in 1928 to serve as the voice of manufacturing in the U.S.'s largest and most important Territory.

The Private Sector Coalition is comprised of thirty employer, business and professional organizations representing the primary job creators and taxpayers on our island. Puerto Rico needs more jobs and taxpayers. We recognize that the only solution is economic growth and Tax Reform will play a key role.

First, it's important to note that jobs in Puerto Rico are American jobs facing unique competitive challenges. Tax reform can make or break our economy and we wish to work with you to ensure Puerto Rico can compete with our foreign competition for jobs and investment.

As Congress considers moving forward on the issues of reforming the tax code we wish to provide some background on the Federal Tax Code's unique treatment of U.S. companies operating in Puerto Rico as well as the importance of manufacturing to our overall economy. **We also ask for your consideration and inclusion of our concerns regarding the need for a competitive differential for Puerto Rico during your deliberations over Tax Reform.**

**We believe that you would agree that a net tax increase on products produced in Puerto Rico will have a detrimental effect not only on the economy of Puerto Rico but the entire U.S. supply and values chain.**

Puerto Rico has been part of the U.S. Customs Zone since enactment of the Jones Act in 1917 and today, after a century of customized Federal policies, we are a key component of the U.S. supply and values chain due to the major role of American manufacturing in Puerto Rico.

**RECENT DECISIONS BY CONGRESS:**

Congress enacted the Puerto Rico Oversight, Management, and Economic Stability Act (PROMESA) and imposed a Federally appointed Oversight Board to oversee a resolution to our local government's fiscal crisis. This places an even greater level of importance on the need for economic growth initiatives which jumpstart our weakened economy in order to generate new tax revenues to ensure the schools stay open and debts are repaid.

PROMESA also created a Bipartisan Bicameral Congressional Task Force on Puerto Rico to recommend measures to revitalize our economy and clearly Puerto Rico's manufacturing sector is best positioned to play the lead role. Notably, Tax Reform and its impact on Puerto Rico's vulnerable economy was given priority.

The Task Force makes the following recommendations in its report to Congress:

- *The Task Force believes that Puerto Rico is too often relegated to an afterthought in congressional deliberations over federal business tax reform legislation.*
- *The Task Force recommends that Congress make Puerto Rico integral to any future deliberations over tax reform legislation. The Task Force recommends that Congress continue to be mindful of the fact that Puerto Rico and the other territories are U.S. jurisdictions, home to U.S. citizens or nationals, and that jobs in Puerto Rico and the other territories are American jobs.*
- The Task Force is open to the prospect of Congress providing U.S. companies that invest in Puerto Rico with more competitive tax treatment as long as appropriate guardrails are designed to ensure the company is creating real economic activity and employment on the island.

***TAX POLICY HAS DRIVEN PUERTO RICO'S ECONOMY SINCE THE 1920'S***

Puerto Rico has been part of the U.S. since 1898 and today is the home for 3.5 million U.S. Citizens. No jurisdiction of the U.S. is more dependent on manufacturing than Puerto Rico. In fact, manufacturing is currently the leading private sector employer and represents almost one-half of Puerto Rico's economy, far more than any State.

It's important to remember that manufacturing jobs in Puerto Rico are U.S. jobs employing U.S. citizens. And frankly, it's important to note that Puerto Rico is highly dependent on manufacturing due to ninety years of targeted Federal tax policy designed to foster and attract manufacturing. These policies were ended in 2006 and contributed to the depressed economy now suffered by Puerto Rico which has seen a contraction in our economy by 15% and over 500,000 U.S. Citizens residing in Puerto Rico have migrated elsewhere looking for economic opportunity.

Today, most subsidiaries of U.S. companies operating in Puerto Rico are organized as Controlled Foreign Corporations (CFCs) under the current tax code. However, they are treated as domestic in every other way as they operate under U.S. laws just the same as business operating elsewhere in the U.S. which in turn positions Puerto Rico in a non-competitive position versus our foreign neighbors.

Approximately, 90% of products manufactured in Puerto Rico are included in the U.S values and supply chain. Puerto Rico has been part of the U.S. Customs Zone since 1917 and since 1899 no tariffs or levies have been imposed on U.S. products produced in Puerto Rico that are consumed in the domestic market .

## ***MANUFACTURING GROWTH AND TRANSITION:***

Federal tax policy has traditionally recognized the unique relationship of Puerto Rico to the United States. Initially the provisions adopted as part of the Revenue Act of 1921 and later through the activities of the 1948 Operation Bootstrap (of which PRMA was a major participant) and the creation of IRC Section 936 as part of the Tax Reform Act of 1976, the U.S. Congress has traditionally adopted targeted policies, particularly tax policies, towards Puerto Rico that were “pro-growth” and spurred the conversion of Puerto Rico from an agrarian economy to one based on manufacturing.

Although initially a largely agrarian economy, the decades after World War II saw manufacturing replace agriculture as the driving force of the economy of Puerto Rico. In the 1940’s, direct employment by the manufacturing sector was approximately 56,000. That number dramatically increased in the late 1980s after the enactment of IRC Section 936 to approximately 106,000 and to a high of 155,000 by 1995. It was primarily due to the jobs offered by the manufacturing sector that living standards, wages and educational levels rose dramatically.

Thanks to Congressionally driven tax policy, the economic ecosystem has grown from labor intensive basic manufacturing to a capital intensive industrialized sector to now a knowledge based advanced manufacturing model. Because of these tax policies and in spite of the recent economic recession impacting our island for the past nine years, Puerto Rico's manufacturing sector has shifted from one based on labor such as the manufacturing of food, tobacco, leather and apparel to the more capital-intensive industries of pharmaceuticals, chemicals, machinery and electronics operating nearly 2,000 plants on our island.

By itself, Puerto Rico ranks the fifth in the world for pharmaceutical manufacturing with more than 70 plants. As of 2014, Puerto Rico based plants produced 16 of the top 20 best selling drugs on the U.S. mainland.

Puerto Rico is also the world's third largest biotech manufacturer with more than two million square feet of dedicated plant space and is the seventh largest medical device producer hosting more than 50 plants on the island. Manufacturing accounts for 48.6 % of Puerto Rico's Gross Domestic Product (GDP) and directly employs 8% of the workforce or about 74,000 people. We estimate an additional 160,000 Puerto Rico residents are indirectly employed by our sector by enterprises providing services and inputs..

We also estimate an additional 80,000 Stateside jobs supported by Puerto Rico's manufacturing companies (CFCs). Therefore, our manufacturing sector has the multiplier effect of contributing 320,000 jobs (direct, indirect and induced) to the US and Puerto Rico economies. For example, one of our member companies reports that it annually transports over $140 million worth of product from Puerto Rico just through the Port of Jacksonville, Florida. The Port of Jacksonville notes that one-half of its annual business volume is due to Puerto Rico.

Manufacturing companies paid $1.4 billion in income taxes in 2009 or 57.9% of all corporate income tax collected. The role of CFCs in Puerto Rico's economy is of such importance that during the current fiscal year, seven (7) of these companies doing business in Puerto Rico represent close to 20% of the revenues of the Government of Puerto Rico's budget or $2 billion.

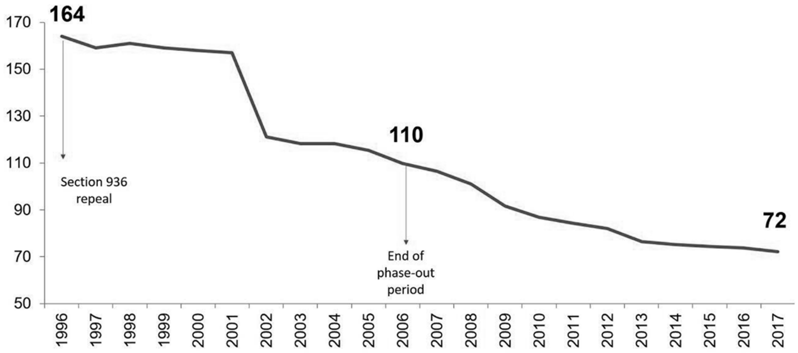
Manufacturing offers better wages for U.S. Citizens in Puerto Rico. Unfortunately, while approximately 42% of our population lives below the " federal poverty threshold" and the current unemployment rate is at 14%, workers in the manufacturing sector earn an average wage of $39,000, which is actually 30% higher than the per capita average. We are also proud to report that in an economy in which fully 40% of the workers earn minimum wage, manufacturing wages are a major factor in improving the standard of living for all of Puerto

Rico's residents.

## IRC SECTION 936 WAS KEY TO FOSTERING MANUFACTURING

In spite of these positive numbers, the overall economic picture for Puerto Rico generally and for manufacturing specifically must be balanced by the "hard" facts that manufacturing has lost a significant number of jobs particularly since the repeal of IRC Section 936 in 1996.

DIRECT MANUFACTURING JOBS (tHOUSANDS))



In it's 1993 Report to the Chairman of the Senate Finance Committee, the General Accounting Office (GAO) summarized the IRC Section 936 credit as follows: *Under section 936, the tax credit equals the full amount of the U.S. income tax liability on possessions source income. Firms qualify for the credit if, over a three year period preceding a taxable year, 80 percent or more of their income was derived from sources within a possession and 75 percent or more of their income was derived from the active conduct of a trade or business within a possession. This provision effectively exempts all possessions source income from U.S. taxation. Dividends repatriated from a U.S. subsidiary to a mainland parent qualify for a dividends-received deduction, thus allowing tax-free repatriation of possessions income. In addition, the provision exempts from U.S. taxation the income earned on qualified investments made by section 936 firms from their profits earned in the possessions. This income is called* *qualified possessions source investment income, or QPSII. Puerto Rico established rules to ensure that QPSII funds invested through the island's financial intermediaries meet the act's requirements.*

The enactment of IRC Section 936 had a positive and direct impact on Puerto Rico's economy. In 1989, the GAO noted that 13 years after enactment of IRC Section 936, manufacturing firms in Puerto Rico employed 105,500 individuals directly comprising 11% of the total employment of 952,000. By 1997, that number stood at 155,000 Americans directly employed by the Puerto Rico manufacturing sector.

However today, the number of U.S. citizens employed directly by manufacturing has been reduced to approximately 74,000. It's fair to say that this drastic reduction is mostly due to the elimination of IRC Section 936 more than any other single factor. In fact, a number of corporate decision makers cited the loss of IRC Section 936 as the primary reason for either the closure or relocation of facilities to Mexico, China and the Dominican Republic.

Unfortunately, as manufacturing jobs have disappeared few other local employment opportunities remain. This has caused a sizeable "brain drain" as tens of thousands of skilled workers have left Puerto Rico in search of new employment. Over the past decade, an estimated 500,000 US citizens representing approximately 12% of the total population (mostly the young and those with higher educational levels) left the island for better opportunities on the mainland. This troubling trend suggests greater social consequences if the shrinking manufacturing sector were to continue. Economic circumstances are driving this "brain drain" leaving many of our talented citizens with little choice but to immigrate to the mainland or remain on the island becoming dependent on social programs.

Even in the context of IRC Section 936 repeal, the U.S. Congress recognized the consequences of this repeal and its impact on Puerto Rico and provided for a ten-year transition period. Subsidiaries of U.S. companies were given the opportunity to re-organize as Controlled Foreign Corporations. Although not as generous as IRC Section 936, the CFC mechanism provides a special tax incentive offering a potent financial reason for U.S. companies to remain or expand operations in Puerto Rico.

We believe Puerto Rico is the only jurisdiction in the United States where CFCs employ U.S. Citizens, operating under U.S. law and on U.S. soil. This is truly a unique situation to consider during Congress' deliberations on Tax Reform.

INDUSTRIALES
PUERTO RICO
MANUFACTURA ■ SERVICIO ■ COMPETITIVIDAD ■

***RECOMMENDATIONS FOR TAX REFORM 2017:***

Considering Congress' historical use of the Federal tax code as a tool to foster and support economic growth in the U.S. Territory of Puerto Rico, we urge full consideration of the impact of Tax Reform on Puerto Rico's economy and job base. We believe Congress shares a bi-partisan goal of fostering manufacturing and encouraging investment in American jobs. Again, we note that Puerto Rico jobs are American jobs.

The GAO's 1993 Report also reviewed the factors that U.S. corporations consider when they contemplate establishing a plant or similar facility in a foreign location. The GAO identified six primary considerations including energy costs, transportation costs, labor costs, stability, infrastructure, and tax structure.

Puerto Rico, by itself and with recent Congressional action, has a stable government and excellent infrastructure given the millions of dollars invested in recent years on infrastructure improvements. We have world-class seaports, airports and a modern ground transportation network.

Conversely, the Island has a highly skilled and educated workforce but labor costs are the highest in the Caribbean. In addition, local and federal labor laws make Puerto Rico one of the most heavily regulated jurisdictions in the U.S. and certainly much higher than others in the Caribbean basin area.

Puerto Rico is an island and highly dependent on imports of raw materials, food and oil; increasing costs for manufacturing and business operations. While there is a planned conversion over to higher efficiency energy production including liquefied natural gas (LNG), currently, energy is currently generated using imported oil in obsolete government run plants resulting in higher energy costs. A recent comparison with Florida found that energy costs in Puerto Rico are two times that of Florida: on average 23 cents per kilowatt-hour in Puerto Rico versus 9 cents in Florida. The average for the United States is 11 cents per kilowatt-hour.

The bottom line is that we perform well with several factors that are commonly considered when we compete to foster investment in manufacturing operations in Puerto Rico. Our neighbors in the region as well as our global competitors are aggressively enticing our manufacturing company base so that they relocate their operations from Puerto Rico by offering more attractive tax treatment, lower labor costs, cheaper energy costs, less restrictive regulation and access to the U.S. market. Any actions taken by Congress that would adversely impact the Puerto Rico operations of U.S. based multinational groups are likely to result in a shift from manufacturing in Puerto Rico to foreign jurisdictions, not to the mainland U.S., thus taking jobs away from U.S. citizens both in Puerto Rico and in the U.S.

Therefore, the ability of Puerto Rico to remain economically competitive internationally may well depend on how the U.S. Congress treats U.S. companies operating subsidiaries in Puerto Rico under reforms to the tax code.

**We note the Chairman's proposal included in the Blueprint provides for border adjustability regarding importation and exportation of products to and from the U.S. market. Further, other proposals may call for the implementation of a tariff also on the importation of products to the U.S. market. Since Puerto Rico has been included in the U.S. Customs Zone for the past 100 years, we would anticipate that the border adjustment provisions in the Blueprint or any other will be drafted not apply to products produced in Puerto Rico. Again, the contrary would produce a net loss both to the U.S. stateside and Puerto Rico economies and harm the U.S. values and supply chain.**

Also, as part of our discussions with members of Congress, we have perceived potential interest in modifying the tax rules that currently allow Puerto Rico to be the only jurisdiction in the United States where CFCs employ U.S. Citizens, operating under U.S. law and on U.S. soil. While this seems to be a speculative initiative, we urge that careful consideration be taken in this regard as any such change could have the same detrimental repercussions as the applicability of border adjustment provisions. Until such initiatives become clear, it would be premature to assert any level of impact on Puerto Rico, but whatever the result is, there must be, at least, reasonable transition rules that do not penalize the choices made by companies that have invested in Puerto Rico and that are, in a very real sense, a large component of the fiscal plans that have been laid out for the recovery of the Puerto Rico's economy. Again, not doing so, would only produce an unnecessary net loss situation where both the Puerto Rico and U.S. stateside employment base and economies would suffer.

We share your goal of giving U.S. manufacturing a competitive edge when Tax Reform is enacted. We also ask for the opportunity to work with you on this task while ensuring no harm to manufacturing jobs in Puerto Rico. Puerto Rico is a vital element of the U.S. manufacturing sector and we wish to continue fostering opportunity for U.S. citizens on our island as well as

Stateside.

In conclusion, I would like to thank the Committee for your consideration and ask that we be invited to appear before your Committee during any upcoming hearings on tax reform. I'm looking forward to working with you as Congress deliberates the future of the Federal Tax Code.

Contact:

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# PVH CORPORATION

SUBMISSION TO THE HOUSE WAYS AND MEANS COMMITTEE

*HEARING ON INCREASING U.S COMPETITIVENESS AND PREVENTING AMERICAN JOBS FROM MOVING OVERSEAS*

SUBMITTED FOR THE RECORD JUNE 6, 2017

PVH Corporation (PVH) appreciates the opportunity to submit these comments for the record of the House Ways and Means Committee's May 23, 2017, hearing titled "Increasing U.S Competitiveness and Preventing American Jobs from Moving Overseas." Headquartered in New York City, New York, the company employs 18,000 people across 41 states and another 12,000 people outside the United States. PVH is the second largest global apparel company with approximately $8 billion in global sales in 2015. As an American company with a global footprint we fully understand the need for tax reform in the United States, but we are deeply troubled with the implementation of the proposed border adjustability tax measure (BAT), which will have an undeniable and negative economic effect on PVH and apparel companies overall (See also Statement of the American Apparel & Footwear Association, submitted to the Committee on May 23, 2017).

We urge the Committee to consider the state of business for apparel companies. First, 98% of the apparel consumed in the United States today is imported. American companies are already producers of some of the cotton, raw materials and textile products needed for apparel production, but the final mass assembly of the products is generally a routine and low-skilled process that is hardly the type of jobs that Americans demand. The imposition of new taxes on these imports will have virtually no impact on sourcing decisions, but will only impact the profitability of U.S. companies and their ability to keep stores open and good paying jobs in America.

Second, apparel and footwear products are already subject to the highest average tariff rate, approximately 14%. Apparel and footwear goods totaled more than 43% of the $33 billion annual U.S. custom and duty revenue. PVH is the 10th largest payer of duties in the U.S. Thus, the addition of the BAT will disproportionately target an industry that is already one of the highest taxed. It is a double tax: a 20% tax on the full cost of goods sold, which include another 14-36% tax already paid in the form of tariffs.

Third, understanding the realities of apparel production, Congress itself has sought to incentivize U.S. investment and business ventures in this industry through the creation of special apparel production rules in U.S. free trade agreements with apparel producing countries and in preferential access programs such as the African Growth and Opportunity Act (AGOA). Unfortunately, one effect of the BAT will be to increase sourcing costs across all suppliers and erode the incentives created by Congress to engage with specific regions around the world.

Fourth, retail and apparel businesses are experiencing elevated levels of U.S. margin erosion because of the highly competing market. More and more retail stores are closing daily. Yet, the BAT proposes to tax apparel companies on their gross income, instead of their net. This action will undoubtedly result in higher costs for consumers, at least in the short-term, at a time when companies can least afford it.

In general terms, the BAT appears to be an extraordinary and unfair measure to tax U.S. companies and consumers. It is extraordinary in that no other major country has a BAT in the form that is proposed.

Proponents of the BAT mistakenly point at other countries' border adjustments and import taxes as a justification for a BAT. However, they selectively fail to show that most of the border adjustments in other countries are on value-added taxes (VAT), which have nothing in common with the BAT other than their similar sounding names. VAT taxes are imposed across the board on all products consumed, regardless of where they are sourced. As far as PVH is aware, the BAT is uniquely unfair in that no other country has the BAT purported measure that would tax U.S. companies on gross rather than on the net income.

The BAT is such a unique measure that countries around the world are paying close attention and may challenge the BAT as an illegal tax measure at the World Trade Organization (WTO). We were deeply troubled by the testimony offered by one of the panelists at the hearing who suggested that if the WTO finds the BAT illegal the U.S. should simply walk away from its WTO commitments. As a global company, we value the efforts of the WTO to create a balanced trading system and we are concerned about the impact of such rhetoric. With the BAT, the concern is not only that the U.S. may lose a WTO challenge, but that some may use such action by the WTO as a valid reason for the U.S. to withdraw from it. We discourage the Committee from providing fodder for those who seek to disengage the United States from the globalized economy.

PVH understands that proponents of the BAT theorize that currency adjustments in the long term will offset the initial costs. If that is true, our company will still suffer significantly. Significant increases in the U.S. currency value will affect tourism and many of our large flagship stores rely heavily on sales to tourist given that they generally find lower priced and high-quality goods in the United States. An equally large concern is that where the negative costs of the BAT will be immediate and real, the presumed offset value and timing of the adjustments are unpredictable. Furthermore, ours and many of the supply contracts and goods for similar companies are U.S. dollar denominated. Thus, the idea that the company can quickly modify prices given sudden currency adjustments is simply not true. Finally, PVH is a global company and we know that when the dollar appreciates, non-US affiliate performance is negatively impacted. We must live and adapt to the complex realities of currency fluctuations in the market, but the implementation of the BAT will only add greater uncertainty.

Some Members of Congress who support the BAT stated during the hearing that they understand some of these concerns and as a result they are discussing ways to implement the BAT during a phase-in period. We are pleased that concerns are being heard, but we continue to caution against the implementation of the BAT, regardless of the time granted for companies to adjust. The measure will unfairly target retail and apparel companies, subject them with double taxation, conflict with US trade policy, and impose taxes on American companies and consumers that will not be offset by the proposed reductions in the overall tax package, nor by currency appreciation.

Simplification and reduction of the U.S. tax code and rates is a laudable goal, but it should be done in a way that is fair across the board and does not pick winners and losers. PVH supports the overall intent, but we are concerned that the BAT will be too much of a disruptive change to our industry, which is already under tremendous economic pressure. We are convinced that the BAT is not a job creator and that if forced to choose between the BAT in its present form and the current tax system, the status quo is preferable. We urge you to keep PVH a strong and vibrant US company by walking away from BAT discussions.

◆

QuadGraphics

N61 W23044 Harry's Way
Sussex, WI
53089-2827

June 6, 2017

The Honorable Representative Kevin Brady
Chairman, House Ways and Means Committee
1011 Longworth House Office Building
Washington, D.C. 20515

The Honorable Representative Richard Neal
Ranking Member, House Ways and Means Committee
341 Cannon House Office Building
Washington, D.C. 20515

**RE: Hearing on Increasing U.S. Competitiveness and Preventing American Jobs from Moving Overseas**

Dear Chairman Brady and Ranking Member Neal:

Quad/Graphics is an American company manufacturing in the United States for the United States. Quad was founded in 1971 by Harry Quadracci in a 20,000 square foot facility along with one press and one stitcher. Today the company has grown into a leader in the printing industry employing nearly 20,000 people in 57 printing facilities across 25 states. Quad and the nation's printers are part of an overall mailing industry that maintains a substantial place in our nation's economy with 7.5 million jobs and $1.4 trillion of economic activity. While printers are a key component to the mailing industry it is retailers and marketers that drive the volume for the industry. We are concerned that the proposed Tax Reform that includes the proposed Border Adjustment Tax (BAT) will significantly impact our industry and those that we depend on in order to maintain and grow our company and our industry.

Quad/Graphics supports the ongoing efforts to reform the corporate and individual tax codes in a way that will spur growth and increase economic activity across the country. However, Congress should ensure that growth in one part of the economy is not at the expense of another aspect of our economic engine. Many of the nation's retailers have been proactive in their efforts to communicate their concerns over the Border Adjustment Tax and its impact on an industry that provides one in four jobs in America – equaling 42 million jobs. Those same retailers have explained that the costs resulting from the Border Adjustment Tax will fall on the nation's consumers and the average family would spend over $1,700 more on essential items such as food, gas, medicine, clothing, electronics and home-goods. Needless to say, all of these items are marketed through print and there is great concern that as retailers look to cover the increased costs of the BAT not only will they be forced to increase prices for consumers they will also be compelled to cut costs within their individual companies. The National Retail Federation has warned that the BAT may lead to job losses within the retail sector but our economy would also suffer other unintended consequences with respect to the supply chain they support. If the retailers pull back on using the mail and printed materials as a means of offsetting the cost impacts of the BAT it will have a significant impact on the economic activity explained above and put 7.5 million jobs and $1.4 trillion of economic activity at risk.

Quad's concerns over the Border Adjustment go beyond the impacts to many of our customers. While Quad supports buying American-made goods and manufacturing in America at every opportunity the BAT does not take into account the reasons why a company may be importing raw materials. The tax code should not punish a company for importing raw materials when the realities of a global marketplace result in the simple fact that not all raw materials that we as a printer require can be or is available in adequate supply within our borders. Needlessly increasing our costs for products that we simply have no choice but to purchase from a foreign country does nothing to protect American jobs within our industry and in fact will likely place jobs in jeopardy.

To illustrate this point take for instance the availability of paper – which of course is at the core of the printing industry. There are several different grades of paper. For many major magazine, catalog and direct mail clients (which of course includes the nation's retailers) they require us to print on a paper grade named Super Calendared "A" (SCA). There are 225,000 tons of SCA paper produced in the United States each year. On its face this sounds like a large supply of SCA paper. However, this production is the product of only one paper mill in the United States and Quad/Graphics on our own consumes 745,000 tons per year. Quad alone consumes mover than three times as much of this kind of paper than can possibly be sourced domestically. Quad has a natural incentive to buy as much paper from the United States as possible. Inventory management and time it takes to deliver the paper to our plants alone make the domestic marketplace our preferred option. However, there is no escaping the reality that Quad's demand far out strips the domestic marketplace's ability to produce the needed supply. Once Quad has exhausted the domestic options the rest comes mostly from Canada and Scandinavia. Increasing the cost of paper that cannot be sourced in adequate supply will not change our sourcing decisions – it will only serve to increase costs on an industry already dealing with significant market disruption. It will not create a business climate that fosters growth but rather be the catalyst for more job loss.

The same situation occurs for many raw materials that Quad/Graphics uses throughout our network of domestic manufacturing plants. Pigments that Quad uses to manufacturing ink in Wisconsin, Iowa, West Virginia and Illinois are not available in abundant enough supply to meet our needs and therefore certainly pigments must be imported – again out of necessity not choice. The same goes for "activated charcoal" which is used in our pollution abatement equipment designed to comply with the Federal Clean Air Act. This use of this type of "activate charcoal" is the preferred compliance option for the Environmental Protection Agency and it is not available at all in the United States. Therefore in order to comply with the Federal Clean Air Act we are compelled to import the "activated charcoal" and the BAT will increase the costs of this federal requirement by 20%.

Just these three examples of raw materials used to manufacture goods here in the United States will cost Quad a significant amount of money. Resources that could otherwise be used to invest in our employees, upgrade our network of printing plants and allow us to grow our business and create jobs. It is imperative that Congress be successful in reforming our tax code to promote growth. Quad/Graphics stands ready to work with Congress to achieve a tax code that will promote growth

– unfortunately that will not occur if the Border Adjustment Tax is enacted. We believe that significant progress can be made on tax reform and our economy will growth but inclusion of the BAT will hinder those efforts.

Sincerely,

**Patrick Henderson**
*Director, Government Affairs*
*Quad/Graphics, Inc.*

resolute
Forest Products

# Statement of Seth Kursman, Vice President,
Corporate Communications, Sustainability and Government Affairs
Resolute Forest Products
*Comments on the Proposed Border Adjustment Tax*
House Ways and Means Committee
June 23, 2017

On behalf of Resolute Forest Products ("Resolute"), I appreciate the opportunity to submit comments outlining the company's views on the House Tax Reform Blueprint, and specifically raise concerns that we have regarding the proposed Border Adjustment Tax (BAT).

Resolute is a United States tax reporting company that is a global leader in the forest products industry with a diverse range of products, including market pulp, tissue, wood products, newsprint and specialty papers, which are marketed in over 70 countries. The company owns or operates some 40 manufacturing facilities, as well as power generation assets in the United States and Canada.

Resolute believes that the current U.S. tax system needs reforming, and we support efforts to lower tax rates so that U.S. rates are more aligned with our key trading partners. We look forward to working with the Ways and Means Committee in the coming months as they undertake crafting a reform package that will encourage job growth, particularly in the U.S. manufacturing sector.

## Consequences of BAT on Resolute & Customers

As currently drafted, Resolute has major concerns regarding the harm we would face under the proposed Border Adjustment Tax (BAT). From a tax perspective, the anticipated impact for Resolute is devastating, because we have $1.6 billion in costs associated with products we manufacture in Canada and sell into the U.S. Further, we are also concerned about the unintended consequences of a BAT, including potential retaliation from major trading partners and the negative impact that the expected strengthening of the dollar would have on U.S. manufacturers like Resolute.

Resolute has grown over recent years and invested in assets in both the U.S. and Canada, always operating as if though we had a seamless border between the two countries. Approximately 60% of the total pulp and paper produced by Resolute mills in Canada is sold to U.S publishers, commercial printers and other paper manufacturers. It is unrealistic to assume that the increase in costs due to this new tax will be absorbed by our publishing and newspaper customers. They, like Resolute, operate with narrow margins, and if costs increase, these customers are likely to shift to alternative mediums such as switching from print to digital.

Likewise, 65% of the lumber manufactured at Resolute's Canadian sawmills is sold in the U.S, helping satisfy the growing demand for new homes. Nationally, the U.S. lumber industry is only able to produce about 70% of the lumber needed to meet the national demand. The rest comes almost entirely from Canada. A tax on imported lumber, particularly when combined with the recently imposed tariffs on softwood lumber, means that housing costs will rise, making home ownership increasingly difficult in many U.S. markets. This will only compound the home affordability challenges many American's are facing today.

The BAT would also have a negative impact on future capital investment in U.S. mills and other operations on both sides of the border. Over the past 3-4 years, Resolute has invested close to $650 million in our U.S. operations to help ensure they remain competitive and to allow us to expand in key growth markets. Much of this spending has been financed through our Canadian operations. The BAT would seriously decrease the amount of capital available to continue to make these types of investments in our U.S. mills as we seek to grow and modernize our operations.

## Risk of Retaliation from Key Trading Partners

If enacted, Resolute also fears the risk of retaliation from key U.S. trading partners. In 2016, 22% of the total products manufactured in our U.S mills were sold to foreign countries, including Canada and Mexico. Even without retaliation, our U.S. operations will be at a severe competitive disadvantage in global markets if, as predicted, a BAT results in a stronger dollar. Already the relative strength of the dollar is impacting our ability to export, and further appreciation, as contemplated by most economists, would have a devastating impact on U.S. manufacturing.

## Conclusion

Again, I appreciate the opportunity to submit comments to the Ways and Means Committee, and look forward to continuing to discuss our concerns with Committee members and professional staff in the coming months.

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RILA
RETAIL INDUSTRY LEADERS ASSOCIATION
Educate.Collaborate.Advocate.
1700 North Moore Street, Suite 2250, Arlington, VA 22209

# Statement for the Record

**U.S. House Ways and Means Committee**
**Hearing on**
**"Increasing U.S. Competitiveness and Preventing American Jobs from Moving Overseas"**
**May 23, 2017**

**Jennifer Safavian**
**Executive Vice President, Government Affairs**
**Retail Industry Leaders Association**

The Retail Industry Leaders Association (RILA) appreciates the Ways and Means Committee holding this hearing on increasing U.S. competitiveness and preventing American jobs from moving overseas. RILA welcomes the opportunity to simultaneously express our support for comprehensive tax reform that enhances U.S. competitiveness while expressing our strong opposition to a proposal that runs counter to this goal – the border adjustable tax.

RILA is the trade association of the world's largest and most innovative retail companies. RILA members include more than 200 retailers, product manufacturers, and service suppliers, which together account for more than $1.5 trillion in annual sales, millions of American jobs, and more than 100,000 stores, manufacturing facilities, and distribution centers located both domestically and abroad.

More than 42 million jobs in the United States are either a retail job or a job that relies on retail. With more than $553 billion in labor income and more than $3.8 trillion in sales, retail is one of America's most powerful economic engines. In fact, consumer spending represents two-thirds of U.S. gross domestic product (GDP).

## Leveling the Playing Field through Comprehensive Tax Reform

Retailers have long supported comprehensive tax reform that will benefit industry and our customers alike. We continue to call for a reduction in the corporate tax rate with a fresh scrutiny of all deductions and credits in the code, particularly ones that are not applicable to all taxpayers. While there are some positive aspects of the House Republican Tax Reform Blueprint – specifically the reduced corporate tax rate to a globally-competitive 20 percent and the territorial tax approach – the inclusion of the border adjustable tax will significantly hurt retail customers and the country's largest private-sector employing industry.

American companies are at a huge competitive disadvantage with our international competitors. This is not because of a mythical "Made in America" tax. Instead it is a result of the U.S. statutory corporate tax rate being extremely high by international standards. The U.S. top combined federal and average state corporate income tax rate of 38.9 percent is the highest among the 35 member countries of the Organization for Economic Cooperation and Development (OECD) and is 14.7 percentage points above the OECD average of 24.2 percent. In fact, the U.S. corporate tax rate is the third highest among countries throughout the world. Furthermore, the U.S. stands virtually alone among countries in taxing companies on their world-wide income rather than just on income earned domestically.

The retail industry's treatment under the current tax code belies its prominent place in the economy and stifles job creation, investment, and consumer savings. A few years ago, RILA commissioned PricewaterhouseCoopers (PwC) to conduct a study on the tax rates paid by the retail industry. The study, entitled "U.S. Retail Trade Industry: Employment, Taxes, and Corporate Tax Reform," concluded that the retail industry's effective tax rate of 36.4 percent is the fourth highest domestic effective tax rate of all the 18 major U.S. industrial sectors – nearly 10 percentage points higher than the average rate.

The high effective tax rate imposed on the retail industry largely undermines U.S. competitiveness. A growing number of U.S. retailers are expanding into the global marketplace through the establishment of both retail operations in other countries as well as subsidiaries that strengthen the supply chain of goods and services they provide to their customers in this country. Our current system in the U.S. of taxing worldwide income not only constrains a retailer's ability to grow internationally but also costs the U.S. well-paying jobs that a company must add to oversee such global operations.

Similarly, foreign-based retailers are entering the U.S. market with advantages over U.S businesses due to a favorable tax structure in their home country. While these foreign-based companies compete on a level playing field in the U.S., the favorable tax conditions under which they operate in their home country ease the task of generating profits there, and those profits are in turn invested in U.S. expansion and aggressively competing with U.S. based retailers.

To improve U.S. international competitiveness, the corporate tax rate must be reduced, putting the U.S. more in line with the rest of the world, and a territorial tax system, where the U.S. taxes corporate income earned only in the U.S., should be adopted. **The border adjustable tax would not improve U.S. competitiveness. Instead, the border adjustable tax would impose price increases on American families, while also causing a devastating financial impact on the retail sector – so much so that the financial viability of many companies would be put into question.**

### Impact of the Border Adjustable Tax on American Consumers

For decades, the House Ways and Means Committee led efforts to expand international trade opportunities that have benefited all sectors of the economy, including retail. U.S. free trade agreements, for example, provide American exporters the opportunity to ship their products to consumers around the world. Over 95 percent of the world's consumers live outside the United States and expansion of these opportunities is vital to America's prosperity. Trade also benefits American consumers by providing increased consumer choice. International trade enables thousands of products, such as bananas and coffee, which are not grown here in the United

States, to be more affordable and readily available. As we work to grow the U.S. economy, RILA is at the forefront pushing for expanded international trade opportunities for U.S. businesses.

The border adjustable tax, which would in effect place a new 20 percent tax on imports while completely eliminating the tax on exports, will force retailers to significantly raise prices on everyday consumer staples such as food, medicine, clothing, electronics, and home improvement items. Many personal necessities like life-saving drugs and items essential to the operation of U.S. small businesses, such as cell phones, have no domestically manufactured equivalent and will not in the foreseeable future. While margins on retail goods are already low, adding the border adjustable tax on top of the cost of those goods means that retailers have no other choice than to pass this additional tax onto American families.

A May 2017 study commissioned by RILA from Capital Economics states, "[i]t is probable that the pass through of costs for other sectors may be less than it is in the case of retailing, but, if 70 percent of the burden of this tax were to be transmitted to consumer prices, American inflation in the near term could increase by 2.1 percent versus what it would otherwise be." The study continues: **"[l]ooking at the typical expenditure of a consumer unit or household in the United States each year, a 2.1 percent increase in consumer prices is equivalent to an increase in costs to consumers of $1,218 on average, based on extrapolated 2017 consumer expenditure levels. If pass through of costs was instead complete (100 percent), the increase would be as high as $1,739."**

The study further notes "… the impacts on consumers will be disproportionate, with consumers buying (durable and non-durable) goods being more affected than those who spend more on services such as healthcare and housing (which, inevitably, are more domestically sourced). As noted above, given that the incidence of this tax will fall on consumer spending and goods in particular, it is likely that the impacts will be regressive in nature, with poorer consumers (proportionately) most affected."

**Impact of the Border Adjustable Tax on American Retailers**

Retail supply chains and sourcing operations are complex and involve many factors, such as pricing, access to raw materials, availability, and cost of labor. Taxing imports would have a disproportionate impact on U.S. retailers, who by necessity import much of their product.

If the border adjustable tax were to be enacted, retailers in the aggregate would be subject to a huge tax increase under the House Republican Blueprint proposal. In some cases, effective tax rates would exceed 100 percent, resulting in companies paying more in tax than their net income. Earlier this year, RILA surveyed our member companies for estimates of their tax liability assuming implementation of the border adjustable tax and the provisions of the House Republican Tax Reform Blueprint in their entirety (i.e. 20 percent rate, full expensing, territorial tax system). **The results were uniformly devastating for the retail industry.** Examples of the representative responses, protecting company names, were as follows:

- **One retailer stated that their historic effective tax rate is 39 percent. Based on a three-year analysis, their effective tax rate would be between 140-288 percent.**
- **Another retailer found that their effective tax rate would go from 37 percent to 102 percent as a result of the border adjustable tax.**
- **Still another retailer's analysis showed their effective tax rate would go from 38 percent to between 84-94 percent.**
- **Beyond the increase in effective tax rates, one retailer explained that overall, they would go from a $1.5 billion net income to a $3.5 billion loss.**

The above results are indicative of the retail industry as a whole. A December 6, 2016, report by RBC Capital Markets found that "if the U.S. moved to a border-adjusted tax system, most retailers would be forced to raise prices or meaningfully change their import/domestic sourcing mix, or their earnings would be materially reduced…in some cases, taxes due would exceed the company's existing profit." Businesses in this position would have to not only raise prices on consumers, but also significantly cut capital expenditures and reduce their workforces. Even then, some would clearly not be able to remain viable as ongoing businesses.

**Impact of the Border Adjustable Tax on Retail Employees and Communities**

There are few industries that have a greater impact on the United States economy than retail. The retail industry employs millions of Americans throughout the supply chain and provide American consumers the products they want to buy at the price they want to pay. Retailers pay billions of dollars in federal, state, and local taxes each year, and collect and remit billions more in sales taxes to state and local governments. Brick and mortar retailers, large and small, provide a significant tax base for core local and state services such as police, fire and rescue, and schools.

According to the April Bureau of Labor Statistics jobs report, 30,000 retail workers lost their jobs in March, about equal to the number of retail jobs lost in February. The two-month job loss was the worst back-to-back monthly retail job loss since the Great Recession in 2009. Approximately 2,880 stores have closed in the first quarter of 2017, compared with 1,153 at the same time last year. Given the enormous employment footprint of the retail industry, comprehensive tax reform could stimulate job growth in the retail sector and the industries supported by retail. **To implement the border adjustable tax at a time when the industry is already on its back, would be a crippling blow to the retail sector, retail employees and local communities.**

Flexibility and the power to choose one's own path is the hallmark of the retail industry and the reason why millions of Americans choose careers in retail. Retailers offer flexible schedules that enable individuals to spend more time with their families or complete a degree, and provide employees with extensive training at all job levels and skill sets that lay a core foundation for fundamental career development. Millions of high-tech and high-paying jobs are created by retailers as consumer demand and industry innovation continually advance and change. RILA is committed to preserving the benefits valued by retail employees and shaping sound policies that allow retailers to support employees with meaningful careers, flexible schedules and affordable benefits that help them care for themselves and their families.

Retailers often serve a central role as stewards of communities. Beyond investing resources in store operations and job creation, brick and mortar retailers: provide billions of dollars annually to tens of thousands of local and national charities; hire American veterans; sponsor local sports and recreation teams; provide tangible goods donations to schools and homeless shelters; support community workforce development and training programs; and often provide shelter during storms and are the first on the ground after disasters strike to provide families with relief and help communities rebuild. Additionally, even the largest retailers rely on small business vendors in communities, such as plumbers and electricians, to keep stores open and operating.

**Additional Risks of the Border Adjustable Tax**

Proponents of the border adjustable tax claim that it is, in effect, equivalent to a value-added tax (VAT). The border adjustable tax is not a VAT. As the Ways and Means Committee is aware, a VAT, which is based on the European model for taxes, is the equivalent of a sales tax. A VAT is applied to all imports as well as domestically produced goods and services that are consumed in-country. Unlike the border adjustable tax, a VAT is transparent on a receipt to consumers as it applies at the point of purchase, is non-discriminatory, and is permitted under the World Trade Organization (WTO). On the other hand, the border adjustable tax is built into the U.S. corporate income tax structure, discriminates against businesses that import much of their products, and exempts foreign companies that sell into the U.S. if they do not pay U.S. corporate income taxes. An example of such a company is Alibaba. Alibaba would not be subject to the border adjustable tax and thus could sell directly to U.S. consumers at a huge competitive price advantage over their U.S. competitors who would bear the burden of the border adjustable tax. **No country in the world border adjusts its corporate income tax or has in place a border adjustable tax absent a VAT as contemplated under the House Republican Tax Reform Blueprint.**

Proponents for the border adjustable tax argue that it would eliminate a mythical "Made in America" tax they believe exists under current law. The U.S. federal tax code does not currently impose any taxes on products made in America that are not also imposed on imports. American-made products exported to another country are subject to that country's consumption tax (i.e. VAT) just like products imported from other countries are subject to U.S. consumption taxes (i.e. state and local sales taxes). Additionally, U.S.-based manufacturers are subject to our corporate tax code just as foreign manufacturers are subject to their countries' corporate tax codes.

As previously discussed, WTO rules allow countries to border adjust for indirect consumption taxes such as a VAT. However, the WTO does not permit discriminatory adjustment for direct forms of taxation such as the border adjustable tax. If implemented, the border adjustable tax could trigger significant retaliation from foreign countries, which would be devastating to American manufacturers and producers, retailers, consumers, and the global economy. **At a time when there is significant uncertainty in global trade, gambling the world's largest economy on whether the border adjustable tax is WTO-compliant is dismissive of the facts and dangerous.**

Proponents of the border adjustable tax also claim that the U.S. dollar would appreciate almost immediately by 25 percent, making retailers and American consumers "whole" under the new structure over time. While textbook economic theory says this should occur, a number of factors make this virtually impossible to occur. Approximately 90 percent of international trade transactions between the U.S. and other countries are priced in U.S. dollars. To the extent these are set at fixed prices subject to contractual obligations that would require difficult negotiations, the effect of any appreciation of the dollar would be much less than otherwise expected and occur over a much longer timeframe. Many countries we import from, including China, Vietnam, India, Malaysia, and Singapore engage in either complete or some form of exchange rate management. For all countries that intervene in the market for their currency, it restricts the ability of their currencies to fully adjust to the border adjustable tax as economic theory would suggest.

While RILA members source products from around the world, retailers conduct our business in U.S. dollars. This provides business certainty because it is accepted currency for trade by all countries and doing so decreases the risk of currency fluctuations. Proponents, however, are unable to address the significant impact this would have on U.S. agricultural exports as the direct result would cause those exports to be more expensive.

The idea that an immediate 25 percent appreciation of the dollar would follow implementation of the border adjustable tax is based on a simplification of currency markets, which are in reality highly complex. Key factors in the establishment of exchange rates include: speculative behavior by currency traders as global investors divert capital into different currencies to chase investment opportunities; news about policy shifts or political events which affect investor attitudes and risk tolerance; and perceptions as to whether current exchange rates are sustainable in relation to a country's economic situation. Furthermore, according to the May 2017 Capital Economics study prepared for RILA, "[t]here are reasons to believe that movements in the dollar in particular are significantly less determined by trade flows between the United States and other countries than is the case for other currencies."

Evidence from limited studies is inconclusive on the subject of exchange rate adjustment with VAT regimes and there are also doubts about the applicability of such studies in the case of the border adjustable tax, which has not been implemented anywhere in the world. Given this shortage of evidence, it would be highly risky to implement a border adjustment tax based on the assumption that currency would adjust to make American consumers and retailers whole.

If exchange rates did adjust as border adjustable proponents promise, a rapid increase in the dollar's value would significantly reduce the value of U.S. citizens' foreign investments, including investments held by many pension funds and retirees. In addition, U.S. businesses that rely on foreign tourism would struggle because a stronger dollar would increase the cost of their products and services in the eyes of foreign customers. A stronger dollar would also increase the value of foreigners' U.S. investments, making it more difficult for U.S. firms to pay off non-dollar denominated loans. Dollar appreciation would also make it much more difficult for emerging market countries to repay dollar-denominated debt and for foreign consumers to acquire dollar-denominated commodities, potentially giving rise to unintended consequences.

Thus, currency adjustment has its own set of consequences that would negatively impact many segments of the world economy.

***

**Conclusion**

No industry supports and desires comprehensive tax reform more than the retail sector, as a driver of the U.S. economy and one that currently pays a very high effective tax rate. The retail industry is on the front lines with the U.S. consumer and undergoing rapid transformation to compete in the 21st century marketplace – the U.S. federal tax code should help foster this growth, innovation and investment, not kill it.

The border adjustable tax would disproportionately impact the retail sector because we import many products that are not able to be sourced domestically. Such a drastic new border adjustable tax would undermine the benefits of a corporate tax rate reduction, precluding the industry from realizing potential economic growth. A border adjustable tax will lead to higher prices for American families and put many retail businesses at risk.

RILA and its member companies are eager to work with Members of the Ways and Means Committee in this once in a generation effort to reform the tax code in a comprehensive manner that promotes economic growth and enhances U.S. competitiveness.

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SANMAR

May 22, 2017

The Honorable Kevin Brady
Chairman
Committee on Ways and Means
1102 Longworth House Office Building
Washington, D.C. 20515

Dear Chairman Brady:

Thank you for the opportunity to comment for the record regarding the Hearing on "Increasing U.S. Competitiveness and Preventing American Jobs from Moving Overseas."

SanMar is a family-owned business and has been in business for over 47 years. With 4,000 employees across eight states including Texas, Washington, Nevada, Arizona, Ohio, Minnesota, New Jersey, and Florida, we take pride in our strong history of providing stable and steady employment. Most of our 50,000 customers are American small businesses who rely on SanMar's excellent customer service and competitive pricing in order to successfully run their businesses. We are active participants in our communities and take pride in giving back. We believe in making a difference to our customers, employees and to our nation.

We applaud your efforts to meet the challenge of permanent and comprehensive tax reform. The House Blueprint for Tax Reform includes a proposal for "border adjustments" which would prohibit companies from deducting their costs of goods sold which would, in effect, constitute a 20% or 25% tax, depending on the structure of the business, on all imports into the United States.

SanMar, as an "S" corporation, presently pays an effective tax rate of 39.5% on its earnings in addition to state B&O taxes and import duties. Our reading of the House Blueprint suggests our effective tax rate would surge past earnings, necessitating substantial price increases on our products. We are glad to meet and discuss this analysis.

The BAT would have an immediate, devastating and long-lasting impact on SanMar's 4,000 employees and its 50,000 partner businesses in the United States. If this new tax becomes reality, it will significantly impact SanMar and lead to increases in prices for our customers. Not only will this affect the products we sell, this tax will drive up the price of food, cars, gas, produce, electronics and thousands of other imported goods. Because our industry is so heavily dependent on imports and will be for the foreseeable future, the impact of border adjustability would be immediate, devastating and long-lasting.

It has been suggested that implementation of border adjustability may lead to an immediate appreciation of the dollar in the 20% to 25% range, which would then offset the adverse effects on importers by reducing the cost of their imported goods. We looked at internal data from the past few years where the dollar appreciated approximately 25% and such gains on imports were largely not realized. Like most importers, SanMar contracts for and buys its imports in dollars

**Corporate:** 22833 SE Black Nugget Road, Suite 130 | Issaquah, WA 98029 | **Phone:** 206.727.3200 | **Fax:** 206.727.3203
**Sales:** **Phone:** 800.426.6399 | **Fax:** 800.828.0554 | **www.sanmar.com**
CINCINNATI DALLAS JACKSONVILLE MINNEAPOLIS NEW JERSEY PHOENIX RENO SEATTLE

which largely mitigates currency risk in routine supply chain transactions. As such, even if border adjustability were to have such a profound and quick impact on the dollar in the $4.4 trillion-per-day currency market, which seems unlikely given the unpredictable and difficult to forecast nature of the foreign-exchange market, SanMar would still be disadvantaged by way of its dollar-based supply contracts and it is unrealistic to think we can force our suppliers, many of whom we have worked with for decades, to restructure agreements which would put them at such a financial disadvantage.

While we do not want to take anything away from Made in USA products or the industries that produce goods in America, the manufacturing and labor base of the apparel industry, like many others, is largely absent from this country and has been for decades. It is impractical and unrealistic to assume that such a large, across-the-board punitive tax on imports will somehow bring garment factories and their workers back to the United States.

The reality is that this tax will disrupt global business, cause job losses at American companies relying on imports and lead to significant increases in prices on a wide variety of consumer goods. For a typical reseller in our industry, more than 95% of their current apparel offerings would be subject to substantial price increases. Absent significant changes or elimination of this proposal altogether, our industry will be asked to fund tax reform that will be enjoyed by others.

We have never lobbied Washington on any issue before now. We are compelled now to make our voice heard against the BAT proposal, because it threatens to put us out of business. We ask that you remove this provision as tax reform deliberations proceed. We would welcome any opportunity to testify as a witness in a future Committee hearing on this subject. In addition, we are pleased to meet with Members of the Committee to discuss with specificity our concerns.

Thank you for your consideration.

Sincerely,

/s/

Jeremy Lott
President

CC:
Representative Richard Neal, Ranking Member, Committee on Ways and Means
All Members of the House Committee on Ways & Means
Senator Orrin Hatch, Chairman, Committee on Finance
Senator Ron Wyden, Ranking Member, Committee on Finance
All Members of the Senate Committee on Finance

SLADE GORTON & CO., INC.
*"America's Original Seafood Family"*

May 22, 2017

The Honorable Kevin Brady
Chairman
House Committee on Ways and Means
1102 Longworth House Office Building
Washington, DC 20515

The Honorable Richard Neal
Ranking Member
House Committee on Ways and Means
1139E Longworth House Office Building
Washington, DC 20515

Dear Chairman Brady and Ranking Member Neal:

I am writing today to express concerns regarding the proposed Border Adjustment Tax (BAT) that is a subject of the hearing to discuss "Increasing U.S Competitiveness and Preventing American Jobs from Moving Overseas" on May 23, 2017.

My name is Kim Gorton and I am President and CEO of Slade Gorton & Co., Inc. Our company is a third generation family business. We are one of America's largest distributors and manufacturers of fresh, frozen and premium value-added seafood products. We process, develop, and manage fresh and frozen seafood programs for some of our nation's largest retailers, distributors and chain restaurants. All in all, we provide over 200 million seafood meals to Americans every year from our operations in Massachusetts, Florida, California, Washington, and Illinois.

Slade Gorton & Co., Inc. is proud to sell over 100 species of seafood to our customers at a variety of price points. Our products are sourced from both American and International waters, for the pure reason that several species that our customers crave cannot be produced domestically to meet the demand. We need to go elsewhere to feed Americans growing appetite for seafood. It simply has to be caught where it swims.

The proposed BAT will hinder our company, not help it--or the people we employ. By eliminating the deduction on imported goods, the BAT will force use to raise our prices in order to keep the company open. These higher prices will be felt in the pockets of the consumers we feed. At a time when the Federal Government is asking for Americans to consume more seafood, we are making it harder for working families to afford it. It is estimated that Americans will be forced to pay $1700 more a year for things like groceries, clothing, shoes, gas, prescription drugs, etc.—solely because of the BAT's impact on retail prices.

The seafood industry is not an insular one—it is by necessity highly globalized. In fact, over 500,000 U.S. jobs stem from imported seafood: shipping, longshoremen, processors, logistics, distributors, cold storage facilities, etc. That raw imported material is the life blood of jobs, which in turn support families.

The BAT will cause our company's prices to go up and/or reduce the variety of fish we bring in. Either way, that means lower sales for the company, which would mean we would have to cut our workforce. Congress' actions will have the perverse impact of us having to let people go instead of expanding our business and growing the economy. Please reconsider the Border Adjustment Tax.

Sincerely,

Kim Gorton
President and CEO

*225 Southampton Street, Boston, MA 02118-2715, Tel. 617-442-5800 Fax 617-442-9090*

◆

To: House Ways and Means Committee
From: Southern California Local Bead Store Association
Re: Border Adjustment Tax
Date: 5/21/2017

Beads? That's right! Beads have been used for religious and monetary purposes for thousands of years. Can you think of any business that has been around that long?

The Association For Creative Industries (AFCI) is the premier trade association for the global creative arts products industries. Their members include the manufacturers, retailers, distributors, designers, educators, digital content providers, professional makers and DIYers, and other creative professionals that comprise the $40 billion+ creative arts industries, which the bead industry is a part of.

We are specifically representing the Southern California Local Bead Store Association. This local association is made up of the following companies:

A Place to Bead – (Christina Rizzo – Owner) 2566 Mission Street, San Marino, CA 91108
A Rolling Stone – (Rena Chapman – Owner) 320 Citrus Ave, Redlands, CA 92373
Bead Gallery – (Julie Gioia – Owner) 5519 Mission Rd, Ste C, Bonsall, CA 92003
Beadahs – (Ermie and Shannon Leonard – Owner) 203 Arizona Blvd, Santa Monica, CA 90401
Bead It! – (Janet Beck – Owner) 13460 Central Ave #E, Chino, CA 91710
Beads and More – (Julia Armfield – Owner) 4150 Mission Blvd, Ste 111, San Diego, CA 92109
Beadology – (Iris Osumi and Erin Demotte – Owner) 16085 Goldenwest St, Huntington Beach, CA 92647
Bead Station – (Jill Cremer – Owner) 27601 Forbes, Laguna Niguel, CA 92677
Brea Bead Works – (Wendy and Scott Remmers – Owner) 1033 E. Imperial Hwy E6, Brea, CA 92821
Dancing Bear Indian Trader - (Svea Komori – Owner) 1313 Simpson Way Escondido, CA 92029
Garden of Beaden – (Irene Sanchez – Owner) 313 N. 2nd Ave, Upland, CA 91786
Jewel City – (Art Agekian – Owner) 201 Magnolia Blvd #118, Burbank, CA 91502
Katherine's Beads and Supplies – (Gracie Lovett – Owner) 12210 Michigan St. Ste G, Grand Terrance, CA 91052
Monica's Quilt and Bead Association (Monica Gonzales – Owner) 77-780 Country Club– Palm Desert, CA 92211
Ocean Sky Beads (Dee and Rod Layden – Owner) – 630-A Grand Ave, Carlsbad, CA 92008
Oskadusa Beads – (Lauren McChrie – Owner) 243 N. Highway 101, Solana Beach, CA 92075
Ruby Tuesday Bead Company – (Connie Haywood – Owner) 1786 Clark Ave, Long Beach, CA 90815
The Bouncing Bead – (Joleen Brims – Owner) 8876 La Mesa, La Mesa, CA 91942

Basically the bead industry imports 90% of our goods. Bead suppliers who support the thousands of bead stores in the US produce, or buy, their goods from Pakistan, India, Japan, Czech Republic, Mexico, South America, and Africa.

The retail brick and mortar bead store business has seen as many as 2400 stores but is estimated to have lost 40% of the retail stores in the last five years due to the cost of doing business. This is on par with all other craft and hobby stores.

There are several issues with the Border Adjustment Tax we want to address. Revenues at the Federal level must increase by 20% to cover the increased costs that will be passed on to the consumers. It is stated that the UBS Securities analyst estimated that average prices in the U.S. could rise by 8 percent. The citizens LOSE again. The proposed Border Adjustment Tax is harmful, not to even mention how complicated the details are to understand and would force:

- Businesses to raise prices on over 80-90% of their products. The consumer will LOSE; the businesses will LOSE, because the consumer spending which is already tight will decline.
- The oversea vendors LOSE because they will suffer due to the slowdown in purchasing from the US bead industry slowdown. This means US businesses will LOSE even more so when they can't supply the goods because those oversea vendors are closing their businesses due to low demand.

The bead industry holds the largest gathering of bead vendors in the world in Tucson, Arizona at the end of January, beginning of February each year. Thousands of vendors from all over take part in over 35 plus shows over the city. They use spaces in hotels, convention centers, free standing large tents, and if the industry slows down due to BAT, it would create a loss of tens of millions of dollar for the vendors and the city of Tucson, Arizona and the loss of jobs.

There are hundreds and hundreds of bead shows that take part across the US every year and the goods sold at these shows come from overseas suppliers. Once again BAT will increase the cost of goods, forcing the price to go up, which means customer spending will decline. That means revenues from these shows will disappear when the shows no longer exist, the job loss from these shows will raise, the cities that gain tax money and other revenues from these shows will dry up.

BAT has been described by many "as the most complex provision on the table" and an "a vast hidden sales tax" that will hurt the bead industry. We haven't even addressed the internet sellers or even the jewelry designers who are selling at craft shows, selling to galleries, etc, all the way up to named high end jewelry designers. An organization like the JCK can address the high end designers and jewelry store issues about their industry which represented over $70 billion in US sales last year. BAT will simply make companies raise their prices to cover the additional cost BAT costs. Then add the new minimum wage that states are putting on business owners, the health care program is in limbo about the future cost for businesses and that creates a huge hurdle for companies to stay in business.

I know some industries don't depend on imports as much as the bead industry, but the BAT will drastically be a financial gains killer for our industry. This new tax will jeopardize the loss of jobs and stores fronts in our industry, not to mention overseas job loss in the industry. We don't need job lose, we need consumption of goods. Any additional tax will lower the amount customers have to spend.

In understanding this tax proposal, if passed, it will have a tough road ahead. The way BAT is outlined now could discriminate against imports in favor of the same type of domestic goods and will probably face a challenge by the WTO.

A perfect goal to achieve would be a well-balanced comprehensive tax reform – one that our organization and industry would understand. Why put more of burden on the retail sector of the US economy that has been hurt due to other additional costs.

Comprehensive tax reform is a worthy goal — one that my organization strongly supports. But it must be done in a way that doesn't increase the burden on American families, or unfairly handicaps certain sectors of the economy. Even the chairwoman of the Federal Reserve has cast doubt on these claims, saying it is "very uncertain" what exactly would happen. As the Beatles song goes "Come together" by having the Congress correct the wrong that has been proposed with the Border Adjustment Tax by delivering a balance in tax cuts. This can be accomplished by stopping the wasteful spending in other government programs and end the tax loopholes that special interest groups receive.

Thank you for the consideration,

Scott Remmers
President
Southern California Local Bead Store Association
1033 E. Imperial Hwy E6
Brea, CA 92821
(714) 494-3668

## How the Border Adjustment Helps Fix Business Taxation in the United States

Kyle Pomerleau
Director of Federal Projects
Tax Foundation

The problems with the current corporate income tax are well-known. The current corporate tax discourages investment, creates an incentive to finance spending with debt over equity, encourages companies to shift profits and headquarters overseas, and is overly complex.

In June 2016, the House Republicans released a tax reform plan, titled "A Better Way."[1] Part of this tax reform proposal was a fundamental restructuring of business taxation that would eliminate most if not all the current issues with the corporate income tax.

The plan would replace the corporate income tax with a 20 percent "destination-based cash-flow tax." This tax is different than the current corporate tax in four key ways:[2]

- Businesses would be able to fully expense their capital investments rather than being required to depreciate them over a number of years or decades.
- Businesses would no longer be able to deduct their net interest expense against their taxable income.
- Foreign profits would no longer be subject to domestic taxation.
- The tax would be "destination-based," meaning that the plan would make the U.S. income tax border-adjustable.

The most novel change the House GOP plan makes to the current tax code is that it applies the destination principle to the U.S. business income tax. This is done by enacting a "border adjustment." Under the plan, businesses in the United States would no longer be able to deduct the cost of purchases from abroad, or imports. At the same time, businesses would no longer be taxed on the revenue attributable to sales abroad, or exports.

By itself, the border adjustment directly addresses two major problems with the corporate income tax. First, it eliminates the ability and incentive for corporations to shift their profits out of the United States. Second, it would greatly simplify business taxation by eliminating the need for complex current-law transfer pricing rules and anti-base erosion provisions. In addition, the border adjustment would raise additional revenue over the next decade, which would help fund the transition to a cash-flow business tax. The components of the cash-flow tax (most notably, expensing) would greatly improve the incentive for companies to invest and would grow the long-run size of the U.S. economy.

### A Brief Overview of the Border Adjustment

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[1] "A Better Way, Our Vision for a Confident America: Tax," House Republicans. June 2016. https://abetterway.speaker.gov/_assets/pdf/ABetterWay-Tax-PolicyPaper.pdf

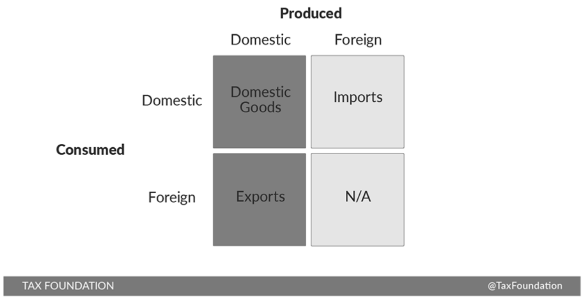
[2] Kyle Pomerleau and Steve Entin, "The House GOP's Destination-Based Cash Flow Tax, Explained," Tax Foundation. June 30, 2016. https://taxfoundation.org/house-gop-s-destination-based-cash-flow-tax-explained/

The most basic way to understand the border adjustment is to understand the change it makes to the tax base.[3]

Generally, a country has two options when setting a tax base. It can levy an origin-based tax, a tax on the production of goods and services in a country. Or, a country can levy a destination-based tax, a tax on the sale of goods and services in a country.

An origin-based tax is one that taxes goods based on where they are produced, regardless of where they are consumed. As such, an origin-based tax applies to goods produced and consumed domestically (purely domestic goods) and to goods produced in the U.S. and consumed in foreign countries (exports). In the two-by-two matrix (below), an origin-based tax is applied to the top and bottom boxes on the left.

**Origin-based Tax**



| | | | |
|---|---|---|---|
| | | **Produced** | |
| | | Domestic | Foreign |
| **Consumed** | Domestic | Domestic Goods | Imports |
| | Foreign | Exports | N/A |

TAX FOUNDATION @TaxFoundation

Generally, the current corporate income tax is an origin-based tax: the tax falls on the production of goods in the United States, regardless of where they end up.

The border adjustment switches the tax base to what is called a “destination-based” tax. A destination-based tax is one that taxes goods and services based on where they are consumed, regardless of where they are produced. In our two-by-two matrix, a destination-based tax system is levied on goods and services in the two top boxes: goods produced and sold domestically (purely domestic products) and goods produced in foreign countries and sold domestically (imports).

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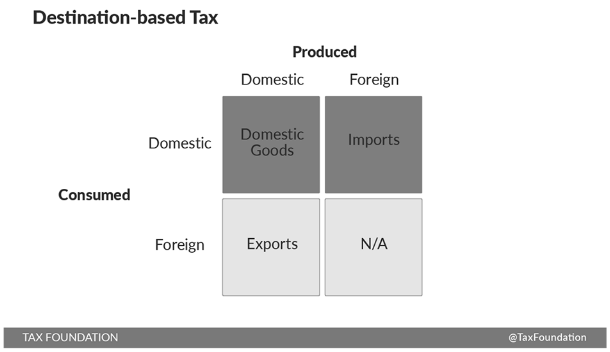
[3] Kyle Pomerleau, “Understanding the House GOP’s Border Adjustment,” Tax Foundation. February 15, 2017. https://taxfoundation.org/understanding-house-gop-border-adjustment/



**Destination-based Tax**

| | | Produced | |
|---|---|---|---|
| | | Domestic | Foreign |
| Consumed | Domestic | Domestic Goods | Imports |
| | Foreign | Exports | N/A |

TAX FOUNDATION @TaxFoundation

In the United States, the most common example of a destination-based tax is the retail sales tax. These state-level taxes are applied to all goods (and sometimes services) sold in a state, regardless of where they were produced. Goods produced in a state and exported to another state are exempt from the sales tax. (However, they may face sales tax in the state in which they are ultimately sold to a consumer.)

The specific mechanism by which the House GOP has proposed applying the border adjustment would be to eliminate the deduction for purchases from overseas, effectively applying the tax to imports, and to exclude revenue from the sale of goods and services overseas, effectively removing any tax on exports. It is worth noting that a destination-based tax is not the same as a tariff.[4] As the diagram above shows, a destination-based tax falls on all domestic consumption, whether it is produced in the United States or produced in a foreign country. While a destination-based tax applies to imports, it also falls on domestically produced goods as well. By contrast, a tariff applies only to imports, creating a higher price for traded goods relative to domestic goods. While destination-based taxes are neutral, tariffs are not.

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[4] A long line of academic literature has found that border adjustments are trade-neutral. See: European Coal and Steel Community, High Authority, "Report on the problems raised by the different turnover tax systems within the Common Market" (Tinbergen Report) (European Coal and Steel Community, High Authority, 1953).
Shibata, Hirofumi, "The theory of economic unions: A comparative analysis of customs unions, free trade areas, and tax unions," in Carl S. Shoup ed., *Fiscal Harmonization in Common Markets, Vol. l: Theory* (New York: Columbia University Press, 1967), 145-264.
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Alan Auerbach, "The Future of Fundamental Tax Reform," *The American Economic Review*. May 1997.

### The Border Adjustment Eliminates the Ability for Corporations to Shift Their Profits Overseas

Fundamentally, corporate income taxes are prone to base erosion and profit shifting because they are levied on a base that is extremely hard to measure in today's globalized world: domestic production.[5]

The location of production can be extremely difficult to figure out.[6] This is because production processes stretch across numerous jurisdictions and include not only physical processes, but also intangible ones that are difficult to price. Take, for example, the production of the movie *Star Wars: The Force Awakens*. The movie used intellectual property (IP) located in the United States; actors from the United Kingdom and the United States; and special effects developed in San Francisco, Singapore, London, and Vancouver. The movie was shot in the UAE, the U.K., Iceland, and Ireland, and tickets for the movie were sold throughout the world.

Companies with multinational production processes take deductions and report revenues throughout the world to allocate their profits. As such, it is very hard to determine exactly how much profit should be taxed in a given country. This leaves room for companies to take advantage of the complexity of cross-border pricing to allocate revenues and costs in tax jurisdictions in a way that can limit their worldwide tax liability. Specifically, companies face incentives to realize revenue in low-tax jurisdictions and incur costs in high-tax jurisdictions.

With the border adjustment, the transactions that allow a reduction in tax liability through profit shifting are eliminated. Since the cost of imports cannot be deducted, it doesn't matter what a company charges its affiliates; it cannot deduct its import costs and thus cannot change its domestic tax liability. Likewise, exports are excluded from taxable income, so a company charging its affiliates $1 or $1 billion for an export has no bearing on its U.S. tax liability.

In fact, the incentives would go the other way under this tax system. Profit shifting would not change a company's U.S. tax liability, but it would still change its foreign tax liability. As such, companies would have an incentive to locate profits in the United States. These profits would not be taxed in a foreign jurisdiction, and would only be taxed in the United States to the extent of a company's U.S. sales. This could have a slight positive economic benefit to the extent that companies shift real activity to the United States along with their profits.

### The Border Adjustment Greatly Simplifies International Taxation

The inability of firms to shift profits out of the United States would also mean that large portions of the U.S. tax code that deal with international taxation could be eliminated. The border adjustment would eliminate the need for complex anti-base erosion provisions such as Subpart F, which currently attempts to prevent companies from using highly mobile income to avoid U.S. taxation.

One common goal of tax reform is to move from the U.S.'s current worldwide tax system to a territorial tax system. A territorial tax system, which exempts foreign-source income from domestic taxation, is

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[5] Although there is debate over the degree of profit shifting being done by multinational corporations, there is unanimous agreement that profit shifting occurs on a regular basis. See: Cederwall, Eric, "Making Sense of Profit Shifting," Tax Foundation. May 26, 2015. https://taxfoundation.org/making-sense-profit-shifting-halftime-report-part-1

[6] Kyle Pomerleau, "How a Destination-based Tax System Reduces Tax Avoidance," Tax Foundation. April 4, 2017. https://taxfoundation.org/destination-based-tax-system-reduces-tax-avoidance

superior to current law, which requires corporations to pay tax on their worldwide profits. Moving to a territorial system would eliminate the incentives for corporations to shift their headquarters out of the United States.

However, territorial tax systems do suffer from base erosion concerns. Under a pure territorial system, companies that successfully shift profits out of the U.S. and repatriate those profits tax-free can reduce their U.S. tax burden. This is why the vast majority of developed countries that have moved to territorial tax systems have also enacted limits on their territorial tax systems and have kept strict rules to prevent companies from avoiding domestic tax liability. The goal of the Organisation for Economic Cooperation and Development's (OECD) Base Erosion Profit Shifting (BEPS) initiative is to help countries prevent profit shifting under their origin-based corporate income taxes.

In 2016, 29 of the 35 member nations of the OECD had territorial tax systems that exempted between 95 and 100 percent of foreign profits from domestic tax liability.[7] Of these 29 countries, 17 placed limitations on their territorial tax system by either requiring the foreign profits to face some minimum tax rate, or by limiting the countries in which the territorial treatment applies. For example, Greece only exempts the profits of multinational firms if those profits are earned in EU member states.

In addition, 20 of the 39 nations with territorial tax systems have what are called "Controlled Foreign Corporations Rules" or CFC Rules. CFC rules are intended to prevent corporations from shifting their pre-tax profits from a high-tax country to a low-tax country by using highly liquid forms of income. If a foreign entity or subsidiary is deemed "controlled," these regulations may subject the foreign corporation's passive income (rent, royalties, interest) and sometimes active income to the tax rate of the home country of the subsidiary's parent corporation. In the U.S., these are called Subpart F rules.[8]

Only four nations have enacted territorial tax systems without any official international tax rules. However, these countries typically apply general anti-abuse rules to international transactions.[9] It is also worth noting that even countries with low and competitive corporate tax rates have anti-abuse rules. For example, the United Kingdom has a competitive tax rate of 20 percent, but still applies complex CFC rules that attempt to tax profits that are believed to have been diverted from the United Kingdom to low-tax jurisdictions. In addition, the UK recently introduced a "diverted profits tax," or the "Google Tax," to further prevent profit shifting. In other words, a low corporate income tax rate would not automatically solve all concerns about profit shifting.[9]

| **Country** | **Corporate Tax Rate** | **Territorial (Participation Exemption)*** | **Limitations on Territorial Treatment of Foreign Profits** | **CFC Rules** |
|---|---|---|---|---|
| Australia | 30.0% | 100% | None | Yes |
| Austria | 25.0% | 100% | 15 Percent Minimum Taxation Condition | No |
| Belgium | 34.0% | 95% | Taxation Condition | No |
| Canada | 26.7% | 100% | Treaty Countries Only | Yes |
| Chile | 24.0% | No | N/A | Yes |
| Czech Republic | 19.0% | 100% | EU Member States | No |

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[7] PwC Worldwide Tax Summaries, Corporate Taxes 2016/2017

[8] Kyle Pomerleau, "International Tax Competitiveness Index 2016," Tax Foundation. September 2017. https://taxfoundation.org/publications/international-tax-competitiveness-index/

[9] PwC Worldwide Tax Summaries, Corporate Taxes 2016/2017.

| | | | | |
|---|---|---|---|---|
| Denmark | 22.0% | 100% | None | Yes |
| Estonia | 20.0% | 100% | Taxation Condition | Yes |
| Finland | 20.0% | 100% | 10 Percent Taxation Condition and EU Member States | Yes |
| France | 34.4% | 95% | Non-Blacklist Countries | Yes |
| Germany | 30.2% | 95% | None | Yes |
| Greece | 29.0% | 100% | EU Member States | Yes |
| Hungary | 19.0% | 100% | None | Yes |
| Iceland | 20.0% | 100% | None | Yes |
| Ireland | 12.5% | No | EU Member States | No |
| Israel | 25.0% | No | N/A | Yes |
| Italy | 31.3% | 95% | Non-Blacklist Countries | Yes |
| Japan | 30.0% | 95% | None | Yes |
| Korea | 24.2% | No | N/A | Yes |
| Latvia | 15.0% | 100% | None | No |
| Luxembourg | 29.2% | 100% | 10.5 Percent Taxation Condition | No |
| Mexico | 30.0% | No | N/A | Yes |
| Netherlands | 25.0% | 100% | None | No |
| New Zealand | 28.0% | 100% | None | Yes |
| Norway | 25.0% | 97% | Taxation Condition or EEA Member Countries | Yes |
| Poland | 19.0% | 100% | EU and EEA Member States and Switzerland | Yes |
| Portugal | 29.5% | 100% | Non-Blacklist Countries and Taxation Condition | Yes |
| Slovak Republic | 22.0% | 100% | None | No |
| Slovenia | 17.0% | 95% | EU Member and White-List Countries and Taxation Condition | No |
| Spain | 25.0% | 100% | Countries with Similar Tax to Spanish Corporate Income Tax | Yes |
| Sweden | 22.0% | 100% | None | Yes |
| Switzerland | 21.2% | 100% | None | No |
| Turkey | 20.0% | 100% | Taxation Condition | Yes |
| United Kingdom | 20.0% | 100% | None | Yes |
| United States | 38.9% | No | N/A | Yes |

A border adjustment would make these complex anti-abuse rules unnecessary by essentially eliminating cross-border transactions from the business tax. Under a border adjustment, the United States could move to a territorial tax system without having to enact any new anti-abuse rules. In fact, the U.S. could even eliminate current base-erosion rules such as "Subpart F" and transfer pricing rules. Eliminating these rules could potentially reduce compliance costs significantly and generally improve the tax code. The Tax Foundation found that if the U.S. replaced our current international tax regulations with the border adjustment, it would give the U.S. the second best international tax regime among OECD member nations.[10]

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[10] Kyle Pomerleau, "Grading the House GOP Blueprint with the International Tax Competitiveness," Tax Foundation. February 14, 2017. https://taxfoundation.org/grading-house-gop-blueprint-international-tax-competitiveness-index/

Impact of the Blueprint on U.S. International Index Ranking, by Category

| | Current Law | Blueprint |
|---|---|---|
| Corporate Income Tax | 35th | 4th |
| Consumption Taxes | 4th | 4th |
| Property Taxes | 30th | 21st |
| Income Taxes | 25th | 18th |
| **International Tax System** | **34th** | **2nd** |
| Combined Ranking | 31st | 3rd |
| Source: Tax Foundation | | |

**The Border Adjustment Raises Revenue to Transition to a More Efficient Cash-Flow Tax**

Besides the direct improvements the border adjustment makes to the tax code, it is an important component of the proposed tax reform because it raises revenue to help fund the transition to cash-flow business taxation, which would have a significant, positive impact on the long-run size of the U.S economy. Without the border adjustment, lawmakers would either need to make the tax reform temporary, scale back the size of the rate cuts in the tax plan, or abandon the cash-flow model in reform. Any of these approaches would have significant downsides.

Using the Tax Foundation’s Taxes and Growth Model, we isolated the effect of the business portion o the House GOP Blueprint. We estimate that converting the 35 percent corporate income tax into a 20 percent destination-based cash-flow tax (DBCFT) would grow the long-run size of GDP by 5.8 percent: other words, it would add roughly another 0.6 percent of GDP growth per year over the next decade (Table 2).

Table 2. Revenue Impact of the House GOP's Destination-Based Cash-Flow Tax

| | **Revenue (2017-2026)** | **Long-run GDP Impact** |
|---|---:|---:|
| Full Expensing of Capital Investments | -$2,472 | 4.3% |
| Territorial Tax System | -$171 | 0.0% |
| Reduce Corporate Rate to 20 percent | -$1,251 | 1.5% |
| 25 percent Pass-Through Rate | -$678 | 0.3% |
| | | |
| **Total Tax Cuts** | **-$4,572** | **6.1%** |
| | | |
| Eliminate Interest Deduction | $1,141 | -0.2% |
| Border Adjustment | $1,244 | 0.0% |
| Eliminate Business Deductions and Credits | $735 | -0.1% |
| Enact Deemed Repatriation | $185 | 0.0% |
| | | |
| **Total Base Broadeners** | **$3,305** | **-0.3%** |
| | | |
| **Total Static** | **-$1,267** | |
| **Total Static without Border Adjustment** | **-$2,511** | |

| | | |
|---|---|---|
| | | |
| **Additional Revenue from Economic Growth*** | **$1,589** | |
| | | |
| **Total Dynamic** | **$322** | **5.8%** |
| **Total Dynamic without Border Adjustment** | **-$922** | **5.8%** |
| Source: Tax Foundation Taxes and Growth Model, March 2017 | | |
| *Assumes broader base from individual income tax reform in GOP Blueprint | | |

The two components of the DBCFT that contribute the most to growth are full expensing of capital investments (4.3 percent over the long run) and the 20 percent corporate income tax rate (1.5 percent over the long run). However, these two components, combined with moving to a territorial tax system and a special lower rate on pass-through businesses, would reduce revenue by $4.5 trillion over the next decade. Even accounting for the additional dynamic revenue of $1.5 trillion, these tax cuts would reduce revenue by $3 trillion over the next decade.

The GOP's business reform offsets the cost of these tax cuts with four base changes that raises $3.3 trillion over the next decade. The largest of these is the border adjustment, which would raise $1.2 trillion, followed by the elimination of the deduction for net interest expense ($1.1 trillion), the eliminations of most business credits and deductions ($735 billion), and deemed repatriation ($185 billion).

In total, the DBCFT would reduce federal revenue by $1.2 trillion over the next decade. However, accounting for the higher output over the next decade and the broader tax base, the DBCFT would end up raising revenue by $322 billion over the same period. This means that the case could be made that the business provisions are roughly revenue-neutral and could comply with the Byrd Rule in a reconciliation package.

Without the border adjustment, the static cost would increase from $1.2 trillion to $2.5 trillion over the next decade and the dynamic estimate would go from raising $322 billion to losing $922 billion without changing the plan's impact on the long-run economy. The plan would no longer be close to revenue-neutral on either a static or a dynamic basis. The plan would no longer comply with the Byrd Rule and would likely need to be temporary if passed through reconciliation. This would significantly mute the potential growth from the reform and could introduce uncertainty into the business community.

To avoid making tax reform temporary without the border adjustment, the plan could be brought closer to revenue neutrality by scaling down the size of the tax cut. One option would be to raise the corporate tax rate from 20 percent to 28 percent. However, with a much higher corporate rate and no border adjustment, the plan would reintroduce concerns about base erosion and profit shifting and necessitate reintroducing complex international tax regulations. The plan would also not generate as much growth.

Alternatively, the plan could keep the rate close to 20 percent, but abandon the move to a cash-flow tax base by not moving to full expensing or eliminating the deduction for net interest expense. While this would bring the revenue numbers more in line with the original plan, it would significantly reduce the growth from the tax reform. As mentioned previously, full expensing, by itself, would grow long-run GDP by 4.3 percent, which is more than half of the total GDP impact of the business tax reform. Again, since it eliminated the border adjustment, this option would necessitate reintroduction of international tax regulations.

**Conclusion**

The House GOP's tax reform proposal would replace the current 35 percent corporate income tax with a 20 percent "destination-based cash-flow tax." Part of this tax would be the "border adjustment," which would apply the tax to all goods and services sold in the United States. The border adjustment would be an elegant way to eliminate base erosion and profit shifting by multinational corporations. It would also allow for the elimination of complex anti-base erosion provisions, which would improve the competitiveness of the U.S. tax code. It would also raise revenue over the budget window, which helps fund the transition to a cash-flow tax, which we estimate would boost the long-run size of the economy by 5.8 percent.

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TEXAS AUTO 290

May 22, 2017

The Honorable Kevin Brady
Chairman
Committee on Ways and Means
1102 Longworth House Office Building
Washington, DC 20515

The Honorable Peter Roskam
Chairman
Committee on Ways and Means
Subcommittee on Tax Policy
1102 Longworth House Office Building
Washington, DC 20515

Dear Chairman Brady and Chairman Roskam:

My name is Tony Noun and I live in Montgomery, Texas. Chairman Brady is my Congressman. I immigrated to the U.S. back in 1986 from Lebanon with nothing but my wife and the clothes on my back seeking the freedom and opportunity that President Reagan said defined America.

31 years later, I'm the epitome of the "American dream." I own several small businesses including a car dealership and an automobile repair facility that specializes in high-end foreign cars. Several years ago, I founded the United Republicans of Texas because I wanted to help preserve the American dream for future generations and defend the freedoms that define our great nation.

I fully support reforming our tax system, but I am vehemently opposed to the inclusion of a Border Adjustment Tax as a part of that reform. We don't need a new 20% tax that will hurt my business, hurt my customers, and damage our economy. Instead, we need to cut the size and scope of government.

Kevin Brady is my friend and I, as well as United Republicans of Texas, have strongly supported him in his past elections. I want tax reform to succeed, but the Border Adjustment Tax is a non-starter for me and for tens of thousands of Congressman Brady's constituents.

I am here in Washington, D.C. today because I want to urge Kevin Brady and the members of the Ways & Means Committee to start paying more attention to those who live, work and vote in their districts and less attention to Speaker Ryan who doesn't know me, doesn't understand my business, and who, unfortunately, seems to have forgotten the lessons of the last election.

Sincerely,

**Texas Auto 290**
**Address:** 52186 US 290, Hempstead TX | **Phone:** 979.921.9144 | **Website:** www.texasauto290.com

[redacted]
Owner of Texas Auto 290
Hempstead, TX

cc: The Honorable Richard Neal
Ranking Member
Committee on Ways and Means
1102 Longworth House Office Building
Washington, DC 20515

The Honorable Lloyd Doggett
Ranking Member
Committee on Ways and Means
Subcommittee on Tax Policy
1102 Longworth House Office Building
Washington, DC 20515

# Written Testimony

**Mark J. Nuzzaco**
**Vice President, Government Affairs**

**NPES The Association for Suppliers of Printing, Publishing and Converting Technologies**

**Submitted to the**

**Committee on Ways and Means**
**United States House of Representatives**

**For the Record of the Hearing of**
**May 23, 2017**

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## Testimony Summary

I. **NPES Urges Pro-Growth Tax Reform**

II. **NPES and the Printing, Imagining and Mailing Industries**

III. **Full Expensing is Critical to Capital Investment and Economic Growth and Must be Included in any Tax Reform Plan**

IV. **NPES Stands Ready to Continue to Work with Congress and the Administration to Achieve the Vital Goal of Pro-Growth Tax Reform**

The Association for Suppliers of
Printing, Publishing and Converting Technologies
1899 Preston White Drive • Reston, Virginia 20191-4367 • 703/264-7200 • Fax: 703/620-0994
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## I. NPES Urges Pro-Growth Tax Reform

NPES The Association for Suppliers of Printing, Publishing and Converting Technologies urges pro-growth tax reform as essential to a more robust economy and sustained economic security, and in particular commends Speaker of the House Paul Ryan, House Ways and Means Committee Chairman Kevin Brady, and Tax Policy Subcommittee Chairman Peter Roskam for their leadership in bringing forth ***The Better Way Tax Reform Blueprint***, which is designed to promote efficiency and economic growth by simplifying and making permanent tax laws that will facilitate business planning and investment for the future, while reducing costs of tax compliance.

## II. NPES and the Printing, Imagining and Mailing Industries

NPES The Association for Suppliers of Printing, Publishing and Converting Technologies is a U.S. national trade association with over 660 member companies that are engaged in the manufacture and importing for sale or distribution machinery, equipment, systems, software and supplies used for design, assembly, production and distribution of information by companies in the printing, imaging and mailing industries. Combined, these industries account for over $1.4 trillion in commerce annually, and over 7.5 million jobs. Collectively, they comprise one of the largest industrial sectors in the country. Moreover, they are found in every community in America.

Notwithstanding the ongoing shift to electronic communication, the ubiquitous printing, imaging and mailing industries are still vital manufacturing employers that play a critical role in the Nation's communication and commerce. And while these industries include some very large companies, they are also very much small business oriented.

## III. Full Expensing is Critical to Capital Investment and Economic Growth and Must be Included in any Tax Reform Plan

Full expensing must be the first building block of pro-growth tax reform. Expensing is a timing issues that does not decrease tax revenue. Weakening full Expensing in exchange for other corporate tax reforms must be avoided. The synergy of combining it with a corporate rate cut would be even more powerful.

NPES cannot express strongly enough its support for inclusion of full Expensing in whatever tax reform plan emerge from this Committee, Congress and is signed into law by the President. As noted by the Tax Foundation's analysis of ***The Better Way Tax Reform Blueprint***, Expensing is unequivocally the single most powerful, and therefore vital, component to a tax reform plan that will increase sorely lacking capital investment, add the most growth to the economy, and bring back well-paying jobs, which in turn will result in rising wages and increased tax revenue. Full expensing is the correct method of accounting for the service price of job-producing capital investment, and NPES urges that it be a permanent part of a comprehensively reformed tax code.

In addition to Expensing, NPES also supports other elements of the Better Way Tax Reform Blueprint, including: a corporate rate cut for all business entities - however they are legally organized- and repeal of the Death Tax, the latter being especially important to smaller family owned businesses.

## IV. NPES Stands Ready to Continue to Work with Congress and the Administration to Achieve the Vital Goal of Pro-Growth Tax Reform

In conclusion, NPES is grateful for the opportunity to contribute to the ongoing tax reform dialogue, and urges that the proven economic power of Expensing and the vital job creating role of smaller businesses in the economy are fully factored into comprehensive tax reform. To that end, NPES stands ready to continue to work with this Committee, Congress and the Administration to achieve the vital goal of tax reform that promotes efficiency, business planning certainty, economic growth, and the well-paying jobs that come from it.

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UNITED STATES FASHION INDUSTRY ASSOCIATION

**Written Testimony for the Record**

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

Increasing U.S. Competitiveness and Preventing American Jobs from Moving Overseas:
*How Border Adjustment and Other Policies Will*
*Boost Jobs, Investment, and Growth in the U.S.*

1100 Longworth House Office Building
May 23, 2017

The United States Fashion Industry Association (USFIA) appreciates the opportunity to submit comments for the record of the House Ways & Means Committee hearing on corporate tax reform, including the border adjustment tax proposal.

USFIA members include fashion brands, retailers, importers, and wholesalers based in the United States and doing business globally. These companies rely on complex global supply chains, and indeed, global trade, to make their apparel, footwear, and accessories for American consumers and create high-quality jobs in the United States, including jobs in design, logistics, sourcing, marketing, and retail.

On behalf of our members, we urge the House Ways & Means Committee to not include a border adjustment tax in any tax reform proposal, because such a tax would have a major, negative impact on our member companies as well as on consumers. Without a doubt, the border adjustment tax would lead to price increases for consumers on everyday necessities—including items like baby clothing and back-to-school necessities—which are already taxed at rates as high as 32 percent due to the outdated tariff system. According to estimates, the border adjustment tax would cause the cost of everyday essential products, including clothing, to increase by as much as $1,700.

In addition, the border adjustment tax will not bring manufacturing jobs back to America; on the contrary, this tax would lead to a loss of high-quality jobs in the United States, as companies like fashion brands and retailers would be forced to downsize or close due to the significant loss of revenue under the proposal. Today, the retail industry, including the fashion industry, supports 42 million jobs—or 1 in 4 jobs in the United States. The border adjustment tax will cause these numbers to plummet.

We encourage you to listen to the testimony from the many retailers, including fashion retailers, who will be negatively affected by a border adjustment tax, and more importantly, we encourage you to develop a tax proposal that would spur economic growth and innovation, not raise prices for consumers and disregard high-quality American jobs in our sector.

Please let us know if the United States Fashion Industry Association (USFIA) can provide additional information as you finalize the tax reform proposal.