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Congressional Testimony

Testimony before Joint Economic Committee

Comments on the 2003 Economic Report of the President

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Mr. Chairman and members of the Committee, thank you for the opportunity to testify on the 2003 Economic Report of the President. My name is Daniel Mitchell. I am a Senior Fellow at the Heritage Foundation, though the views expressed here are my own and should not be construed as representing the position of The Heritage Foundation. The recently released Economic Report of the President covers a number of important issues. I would like to focus on two of them – taxes and international economic growth.

The tax policy discussion in Chapter 5 ("Tax Policy for a Growing Economy") is a very important contribution to the public policy debate. The chapter addresses a number of key issues, including the need to dramatically improve distributional analysis. The Economic Report explains how a growing economy enables people to climb the income ladder. Indeed, it includes very useful data showing the tremendous income mobility that already exists in America and makes a compelling argument that a more market-based tax code will facilitate even greater upward mobility.

Most importantly, the chapter focuses on how good tax policy can encourage better economic performance. The CEA estimates that fundamental tax reform can increase GDP by six percent. This additional growth occurs because:

- Lower tax rates encourage more work and entrepreneurship. Reducing marginal tax rates lowers the price of productive behavior. People have a greater incentive to earn income.

- Neutral tax treatment of savings and investment increases capital formation. Ending the multiple layers of tax on income that is saved and invested will boost the nation's capital stock and thereby increase productivity and wages.

- Elimination of tax preferences means decisions will be based on economic factors, not tax-minimization strategies. Resources therefore will be allocated on the basis of growth-maximization.

- Simplicity will free up resources for more productive uses. Some of our nation's most productive people will be able to concentrate on wealth creation instead of complying with a tax code that defies comprehension.

Drawing on the analysis in the Economic Report, I would like to focus on four issues:

Should America shift to a consumption-base tax system? Chapter 5 asks whether America should shift to a consumption-base tax. This does not necessarily mean a value-added tax or national retail sales tax. It also can mean a flat tax or USA tax (the old Nunn-Dominici proposal). A consumption-base tax is any system that only taxes economic activity one-time. A flat tax, for instance, taxes economic activity only one time – and presumably at one low rate – when income is earned. A national retail sales tax, by contrast, taxes economic activity only one time – and at one low rate – when income is spent. These kinds of tax systems differ from the "comprehensive income" base of the current tax code, which taxes some forms of income more than one time and also taxes both changes in wealth and transfers of wealth.

If we want more economic growth, the answer to the question of whether we want a consumption-base tax code is yes.

Should there be double-taxation of income that is saved and invested? In some sense, this is just a different way of asking whether we want a consumption-base tax system. Chapter 5 examines different aspects of this issue. It shows how dividend reform eliminates the double-tax on corporate equity investment. It explains how front-ended IRAs and back-ended IRAs are ways to protect savings from double taxation. This part of the Economic Report is important because it explains why there should be neutrality between current consumption and future consumption. And since saving and investment is the same thing as future consumption, this means that discriminatory taxes on capital should be abolished.

The accompany chart illustrates how the current tax system can impose as many as four layers of tax on income that is saved and invested (See Graph 1 on page 6). This is why the answer to the question of whether it is right to double-tax income that is saved and invested is no.

Should businesses "expense" new investment or "depreciate" that investment? Another important issue raised in Chapter 5 is the appropriate tax treatment of investment expenditures by business. Under current law, businesses are not allowed to fully deduct (or "expense") investment costs. Instead, they often must "depreciate" these expenditures, deducting only a fraction of the cost each year for a specified number of years – even though the full cost is incurred the year the investment takes place. In other words, the tax code treats a portion of business investment the same way the tax code treats profit.

If we want a rational tax code – one that defines taxable income as the difference between total revenues and total costs, companies should be allowed to "expense" their new investments.

Should "worldwide" taxation be replaced by "territorial" taxation? Finally, the Economic Report also asks whether companies should be taxed on income they earn in other nations. This is an important question since it has the effect of significantly undermining the competitiveness of U.S.-based firms – particularly since the United States now has the fourth-highest corporate tax rate in the developed world. To cite an example, a Dutch-chartered company operating in Ireland only has to pay the 12.5 percent Irish corporate income tax on any profits. An American-chartered company competing in Ireland against that Dutch company, by contrast, has to pay the 12.5 percent Irish tax and the 35 percent U.S. corporate tax. Even if the U.S.-based company can take full advantage of America's complicated foreign tax credit system, it still faces a tax burden that is three times higher than its overseas competitor. No wonder some companies are inverting to places with better tax law such as Bermuda and the Cayman Islands.

If lawmakers want American-based companies to successfully compete in the global economy, they should shift to "territorial taxation," the common-sense notion of only taxing income earned inside national borders.

Last but not least, I would like to comment briefly on Chapter 6 ("A Pro Growth Agenda for the Global Economy"). This chapter makes a number of useful observations on the importance of free trade, price stability, deregulation, low tax rates, frugal government, property rights, and the rule-of-law to economic development. It highlights White House efforts to improve economic growth in other nations, including trade expansion and a shift in foreign aid programs so that government-to-government transfer programs are less likely to subsidize bad economic policy.

But this section fails to address a critical issue – and that is the war that international bureaucracies are waging against fiscal competition. High-tax nations resent the flow of jobs and capital to low-tax nations. But rather than lower tax rates and reform bloated welfare states (Ireland is a rare exception), these uncompetitive nations are using international bureaucracies such as the Organization for Economic Cooperation and Development, the European Union, and the United Nations to pursue tax harmonization policies.

More specifically, high-tax nations want to tax income earned in low-tax nations if the factors of production that created that income originally came from a high-tax jurisdiction. This is why the international bureaucracies are so interested in destroying financial privacy laws and promoting the unlimited collection and automatic sharing of confidential financial information on nonresident investors. Simply stated, high-tax nations need a global network of tax police if they want to tax flight capital (and perhaps even emigrant labor income).

This type of policy would have a very adverse impact on economic development and individual freedom. It would mean that a developing nation – or even a developed nation – would not be able to use pro-growth fiscal policy to attract the factors of production. Why would a French taxpayer shift economic activity – either labor or capital – to a lower-tax jurisdiction, after all, if the French government had the ability to impose oppressive French tax rates on any resulting income?

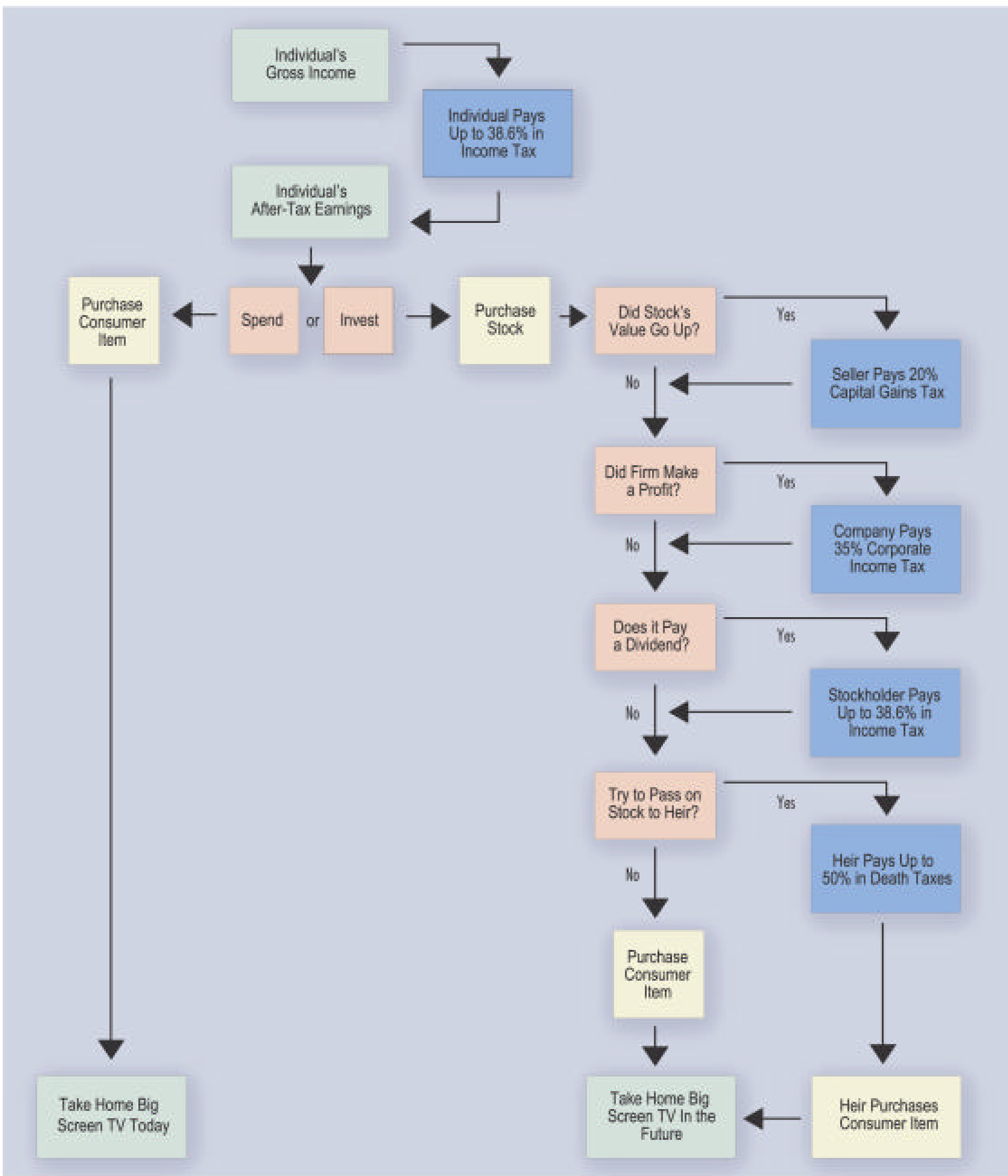
Global information sharing (this phrase is a misnomer since the information flows only one way – from the low-tax nation to the high-tax nation), enforced by international bureaucracies, would destroy fiscal competition. This would be akin to creating a tax cartel – an OPEC for politicians. This would be tragic since the last 20 years have demonstrated that tax competition is a liberalizing force in the world economy. Almost every nation in the world lowered tax rates in response to the Thatcher and Reagan tax rate reductions. Oftentimes, this did not happen because politicians wanted to lower tax rates. Instead, tax rates were reduced because governments knew that jobs and capital would flee to more hospitable jurisdictions unless fiscal policy became more responsible.

The Council of Economic Advisers did not address this issue, though it is important to note that the Bush Administration generally has been critical of the tax harmonization schemes being advocated by the OECD, EU, and UN. Defeating these schemes is important, not only because fiscal competition helps promote pro-growth policy around the world, but also because tax harmonization schemes are a direct threat to American interests. The United States is the single largest repository of international capital flows (See Graph 2 on page 7). Any efforts to hinder those global flows – particularly schemes to cripple investor privacy – will limit capital flows to our nation and therefore harm our economy and financial markets.

Thank you for this opportunity. I would be happy to answer any questions.

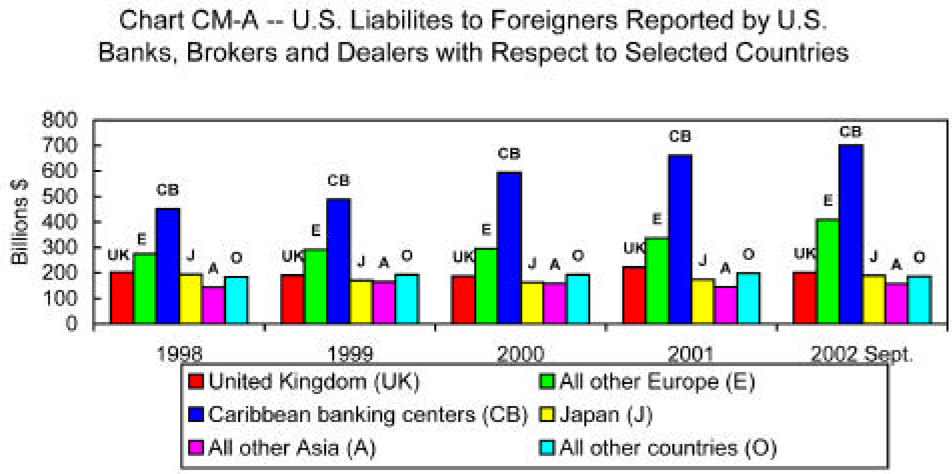
Graph 1

Up to Four Layers of Tax on Income that is Saved and Invested: Tax Code Punishes Capital Formation, Makes America Poorer



Source: IPI Policy Report #171, *Tax Reform: The Key to Preserving Privacy and Competition in a Global Economy* by Dan Mitchell, Ph. D.

Graph 2



(In millions of dollars. Source: Treasury International Capital Reporting System)

Country	1998	1999	2000	2001	2002 Sept.
United Kingdom..................	202,280	190,706	187,145	222,321	200,964
All other Europe..................	274,354	290,632	294,716	336,485	408,711
Caribbean banking ctrs\1 \2	451,575	487,601	593,499	661,835	700,261
Japan..	193,202	170,614	162,449	174,067	189,620
All other Asia........................	143,224	165,229	158,524	143,475	157,576
Subtotal..................................	1,264,635	1,304,782	1,396,333	1,538,183	1,657,132
All other countries.............	184,327	192,495	192,856	197,792	186,186
Grand total........................	1,448,962	1,497,277	1,589,189	1,735,975	1,843,318

\1 Includes Bahamas, Bermuda, British West Indies, Netherlands Antilles, and Panama.

\2 Beginning January 2001, Cayman Islands replaced British West Indies in reporting format.

In the first three-quarters of 2002, U.S. banking liabilities increased $107 billion. In 2001, banking liabilities increased $147 billion.

U.S. banking liabilities to foreigners, excluding long-term securities, are concentrated in international financial centers. The data on this page show that nearly one-half of U.S. banking liabilities currently is reported opposite the United Kingdom and the banking centers in the Caribbean. Foreigners domiciled in the rest of Europe and in Asia hold an additional 40 percent.

U.S. banking liabilities in the mid-1990s went through a growth spurt. The annual growth rate between 1993 and 1997 averaged 10 percent. From 1998 to 2000, growth slowed to about 5 percent per year, more in line with the 1989 through 1992 period. Last year, growth increased to almost 9 percent.

Source: http://www.ustreas.gov/tic/exhibita.pdf

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