Backgrounder

Published by The Heritage Foundation

No. 1779
July 15, 2004

FSC/ETI Conference Should Not Waste Opportunity for Real Tax Reform

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In 1999, the World Trade Organization (WTO) first ruled that the so-called FSC/ETI[1] tax preference for export-oriented income was an "impermissible trade subsidy." It has subsequently ruled three more times that the United States cannot tax income from exports at a lower rate than other forms of business income. As a result of the WTO rulings, the European Union is now allowed to impose additional taxes on American exports. To bring the U.S. into compliance and remove these additional taxes, both the House of Representatives and the Senate have recently approved bills (H.R. 4520 and S. 1637) to repeal the offending provision.

The FSC/ETI law is not good tax policy and should be repealed in any case. Special tax breaks for certain types of income are a form of industrial policy in which the government micromanages the economy for the benefit of politically powerful interest groups and to the detriment of the general public. The FSC/ETI provision—worth about $5 billion per year—certainly meets this criterion. The economy performs much better, and to everyone's advantage, when tax rates are low and when economic—rather than political—factors determine how people choose to work, save, and invest.

Talking Points

- Siding with the European Union, the World Trade Organization ruled that preferences for export-oriented income in the U.S. tax code are an impermissible subsidy.
- While an international bureaucracy interfering with U.S. tax law is disturbing, this ruling created an opportunity for lawmakers to move the tax code in the right direction—toward a low-rate, consumption-based, territorial system.
- Regrettably, the House of Representatives and the Senate did not choose from the most desirable options—either an across-the-board corporate rate reduction or a reduction in the double-taxation of foreign-source income.

This paper, in its entirety, can be found at:
www.heritage.org/research/taxes/bg1779.cfm

Produced by the Thomas A. Roe Institute for Economic Policy Studies

Published by The Heritage Foundation
214 Massachusetts Avenue, N.E.
Washington, DC 20002–4999
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1. Technically, the foreign sales corporation (FSC) provision was replaced by the extraterritorial income exclusion (ETI) as part of an earlier effort to comply with the WTO ruling, but because both provisions had the same impact—a lower tax rate on certain income generated by exports—the two acronyms are usually used to describe current law.

While virtually every policymaker agrees that repealing the FSC/ETI law would be appropriate, the battle in Congress has been about how to use the $50 billion of increased tax revenue that will result from eliminating the export preference. There is widespread agreement that the money should be used for business-related tax cuts, but the House and Senate have taken a long time to choose from the many competing options.

Regrettably, lawmakers have generally made bad choices. Instead of adopting policies (such as lowering the corporate tax rate or eliminating the extra layer of tax on foreign-source income) that would boost U.S. competitiveness by reforming and reducing tax rates for all firms, both the House and Senate have devoted most of the tax revenue windfall in their respective bills to special tax preferences for domestic manufacturing. This merely replaces one form of misguided industrial policy with another. Moreover, the bills also contain numerous "pork" provisions that benefit narrow interest groups. This is hardly unusual, and these provisions may be a trivial concern compared to the failure to use the FSC/ETI money in a way that will make America more prosperous. Nonetheless, they should be removed in the final legislation.

The important thing now is for the Bush Administration and the congressional leadership to give strong and clear guidance to the Senate–House conferees about the bills, because so far Congress has evidently decided to put parochial interests ahead of using the repeal of the FSC/ETI law to achieve tax reform and boost economic growth.

Rectifying a Missed Opportunity?

While the separate bills approved by the House and Senate are the bad news, the good news is that the conference committee that will reconcile the differences has an opportunity to create a much better final product. To this end, the Senate–House conferees should:

Replace Special Breaks with a General Rate Reduction. Conferees should junk the many industrial-policy tax breaks and instead reduce the corporate tax rate. This sounds like a dramatic change, but lawmakers need only expand the preferential tax rate for manufacturing companies in the House version of the legislation and make it universal for all businesses. This would turn a special tax break into an across-the-board tax rate reduction—the legislative equivalent of turning a sow's ear into a silk purse. Not only would a lower corporate tax rate be a significant policy improvement, it would be a much-needed first step toward fixing a major flaw in the tax code.

The United States currently has the second highest corporate tax rate in the world, exceeded only by Japan's. With a 35 percent federal tax rate and an average state corporate tax rate of 5 percent, America's 40 percent corporate tax rate is higher than the rate in every European nation—even socialist welfare states like France and Sweden. This creates a significant competitive disadvantage for U.S.-based companies. The FSC/ETI money would probably allow only a modest reduction in the corporate tax rate, but this would be desirable so long as policymakers see it as the beginning—with more rate reductions to be implemented as soon as possible.

Cutting the corporate tax rate would be a pro-growth tax reform. Shifting closer to territorial taxation would also be a pro-growth tax reform. However, a special tax preference for manufacturing income—as contained in both bills—would make the tax code even more complicated and could hinder economic growth.

Expand the Level of International Tax Reform in the Two Bills. The United States is in a small minority of nations that tax business income earned outside national borders. This policy of "worldwide taxation" is inconsistent with fundamental tax reform and imposes a heavy compliance burden on U.S.-based corporations. Most important, this policy undermines U.S. competitiveness, which is why territorial taxation would be preferable. Territorial taxation—the common-sense policy of taxing only income earned inside national borders—would enable U.S. companies in foreign markets to compete on a level playing field. The FSC/ETI money could be used to take a big step in that direction.

Revisit the Special Interest Provisions. The FSC/ETI legislation includes several special-interest provisions. Language in the Senate bill provides tax breaks for Oldsmobile dealers and owners of NASCAR racetracks. The House version includes tax benefits for bank directors and the producers of fishing-tackle boxes and sonar fish-finders.

One item of particular concern in the House version is a $9.6 billion tobacco bailout. Washington currently props up tobacco prices by allowing only quota holders to grow tobacco. Often, these quota holders rent out the quota to farmers at considerable profit. The House proposal would eliminate the tobacco quotas and allow anyone to grow tobacco, while compensating growers and quota holders $9.6 billion for the lost value of their quotas.

While eliminating these over-regulatory quotas would lower prices, encourage exports, and help farmers, adding a $9.6 billion bailout raises several issues. First, can taxpayers afford such an expensive bailout and would this become a permanent tobacco subsidy as soon as prices inevitably fall? Second, because quotas were never guaranteed to be permanent, it is unclear why quota holders are "entitled" to compensation—especially for what some would consider an unfair preference in the first place. Much of this money would also go to large agribusinesses and there is no guarantee that quotas would not return later. Lawmakers should more closely examine these and all special-interest spending provisions in the two bills.

Rating the House and Senate Tax Provisions

Some specific tax provisions in the House and Senate bills are good and are worth keeping. Others are terrible for taxpayers and the economy and should be jettisoned and the revenue saved should be devoted to general corporate tax reduction.

- **Special break for domestic manufacturing income.** Both bills have gimmicks that benefit certain types of manufacturing income. Ideally, neither version will become law, but the Senate version is far worse than the House version. Instead of a tax rate reduction, the Senate bill creates a complicated new deduction. Moreover, it contains an odd provision that limits the deduction for U.S. companies that successfully compete in global markets. The House bill is more palatable because it contains a rate reduction (albeit discriminatory) that presumably could be expanded at some point to apply to all companies.
- **International reform.** Both bills have largely similar incremental reforms of America's anti-competitive worldwide tax system. These should be retained and ideally expanded.
- **Repatriation.** Both bills have provisions allowing globally active U.S. companies to bring overseas profits back to America without paying a 35 percent tax penalty. Although this provision is temporary and designed solely to attract capital to the American economy, it is quite likely that this temporary provision (in some sense, a form of retroactive territorial taxation) will help lawmakers understand that worldwide taxation should be permanently eliminated.
- **Sales tax deduction.** The House version recreates the option of a federal deduction for state sales tax payments. This would facilitate bigger government at the state level and create another interest group against tax reform. This provision should be dropped. State income and property taxes can already be deducted, so there is a perverse inequity in current law, but this injustice is best addressed by eliminating all state tax deductibility and using the resulting revenue to lower tax rates.
- **Economic substance doctrine.** The Senate bill "codifies" a bizarre provision that enables the Internal Revenue Service (IRS) to penalize businesses for transactions that the agency determines were tax motivated. The economic substance doctrine is offensive, and enshrining it in law would be abusive. For instance, if this doctrine applied to personal income taxes, an IRS bureaucrat could second guess a homeowner and, after deciding that the home was purchased for tax purposes, disallow the mortgage interest deduction and fine the taxpaying homeowner. This is essentially how the economic substance doctrine applies to busi-

nesses. Defenders say codification is needed to stop tax shelter abuses, but the real answer is to junk the corporate tax and replace it with a consumption-based, cash-flow tax, such as the business portion of a flat tax. In any event, codification of the economic substance doctrine should be dropped.

- **Corporate inversion.** The House bill has some discriminatory provisions against companies that re-charter in jurisdictions with better tax laws (a practice called "inversion"). The Senate bill, however, is far worse. It would treat foreign companies as if they were U.S. companies, creating a dangerous precedent that foreign governments might then use against America. All anti-inversion provisions should be dropped.
- **Expatriation.** Both bills contain punitive provisions that would increase exit taxes on taxpayers who emigrate and are somehow deemed to be leaving the U.S. for tax reasons. Any form of exit tax is objectionable. These provisions should be dropped.
- **Section 911.** Unlike almost every other government in the world, the United States taxes citizens who live and work overseas. This is an anti-competitive form of double taxation, and the Senate bill would make the law even worse by including housing in the definition of income that the IRS can double-tax.
- **Tax "extenders."** Both bills have provisions that would "extend" temporary tax breaks for things like research and development costs, work opportunity tax credits, and teacher expenses. Most of these provisions are bad tax policy and should be dropped.
- **Energy tax provisions.** The Senate version has a host of special tax breaks for the production and use of special forms of energy. These forms of industrial policy should be dropped from the final bill.
- **S-corporations.** The Senate bill would extend the preferential tax treatment for manufacturing to S-corporations. The House bill has a number of important reforms that would ease the regulatory burdens that make it difficult for investors to utilize a Subchapter S corporate structure (which is desirable since there is no double-taxation of profits, as occurs with traditional corporate structures). For instance, the House bill increases the number of investors that can participate in a Subchapter S corporation and treats family members as one shareholder. These provisions should be kept.
- **Special interest pork.** Both bills have an unsightly amalgamation of narrow tax provisions. A few of these provisions are defensible but most are special-interest tax breaks. In an ideal world, these provisions would be dropped. At the very least, limiting the amount of revenue used for these purposes would be a good idea.

Conclusion

Tax policy should not be based on which industry has the best lobbyists or which interest group donates the most money. The tax code should be designed to collect the necessary revenue (ideally a very limited amount) in a manner that imposes the least amount of economic damage. A single-rate, consumption-based territorial regime such as the flat tax is an example of such a system.

If tax proposals are judged against that ideal, the House and Senate FSC/ETI bills earn poor grades. Lawmakers had opportunities to enact across-the-board rate reductions and international tax reform. However, they made little progress on either front.

While the two bills may be better than the current law, that is only because they would repeal the FSC/ETI provisions. Unless the conference committee produces a significantly different bill, the final legislation will be a huge missed opportunity to improve the tax code and foster economic growth.

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