Taxation for Economic Survival

The Business Transfer Tax

by David A. Hartman

The severity of the ongoing decline of U.S. manufacturing has placed our prosperity and national security in jeopardy. A principal cause of this crisis is the federal tax code, which currently imposes multiple layers of progressive taxation on U.S. goods. The result, as many economists acknowledge, is crippling: a double taxation of savings for investment and excessive marginal rates. But there is an even greater disadvantage to U.S. manufacturing: a one-sided application of free-trade policies. The object of the various free-trade agreements crafted by our government was supposedly the mutual elimination of tariffs. Tariffs were, in fact, eliminated, but all of America's trading partners replaced them with comparably high border-adjusted value-added taxes (VAT), which give selective advantage to their industries. The result is crippling: a double taxation of savings for investment and excessive marginal rates, redoubled by the additional burden of foreign value-added taxes.

America is virtually alone in the developed world in not providing the advantage of such border-adjusted taxation to her manufacturers. At an average level of 17.7 percent for member countries of the Organisation for Economic Co-operation and Development (OECD), these taxes are not only levied on goods imported from the United States but abated on goods exported to the United States, constructing barriers to U.S. competitiveness in manufacturing that are insurmountable, especially since, in today's open world economy, capital, technology and management are free to move anywhere that offers the best opportunities.

The United States has adopted a self-destructive trade policy, in part, because of our entirely laudable commitment to free enterprise and our rejection of mercantilism and colonialism. At least since World War II, American business and political leaders have viewed free trade as the basis for international peace and prosperity. In theory, the "invisible hand" of free markets—if capital, technology, and labor were free to seek their own competitive advantage—would disperse the means and fruits of free enterprise worldwide. To accomplish this economic miracle, protectionism in the form of quotas, red tape, and, most particularly, high tariffs would be progressively reduced and ultimately abandoned.

As the dominant economic and military power, the United States led the movement to dismantle trade barriers, both by setting the example and by supporting a New World Order of international trade regulation (GATT and WTO), economic cooperation (OECD), and customs unions (such as the European Union and NAFTA). According to the OECD, its members have reduced their average tariff rates from 40 percent at the end of World War II to 4 percent today. The United States' average import duty on goods is currently 1.7 percent.

The decline of tariffs masked a trend, which started in Europe, toward border-adjusted taxation in the form of value-added taxes. These taxes were levied principally on manufactured goods. The alleged purpose was to "level the playing field" by offsetting the expense of government welfare through taxation of spending on consumption. The VAT's were determined to be "indirect taxation," which the WTO permits to be rebated on exports and levied on imports. Led by France, who first adopted the VAT in 1968, European Common Market countries added the VAT over the next five years, although Germany and Italy were slower to reach the current VAT rates than were France, Belgium, and the Netherlands. The Asian countries have since joined the VAT parade. Today, the European Union 15 has an average standard VAT of 19 percent, and the average OECD standard VAT is 17.7 percent. During the 1990's, Mexico and Canada increased composite rates to 15 percent from 10 percent and 7 percent, respectively, and China adopted a 17 percent VAT in 1994.

The OECD's summary of its members' tax trends ("Revenue Statistics 1965-2002") reveals the truth:

> A fast growing revenue source has been general consumption taxes, especially the value added tax (VAT) which is now found in twenty-nine of the thirty OECD countries. In fact, the substantially increased importance of the value added tax has everywhere served to counteract the diminishing share of specific consumption taxes such as excises and custom duties.

The only one of the 30 OECD countries without border adjustments in her federal tax code is, of course, the United States.

As foreign governments have increased the VAT, they have also reduced effective corporate income taxes. In the United States, by contrast, the taxation of resident corporations' foreign income is causing the flight of corporations' headquarters to countries that exempt taxation of overseas income.

The time has come to replace the current corporate income tax with a border-adjusted and territorial tax code that really does level the economic playing field. Any effective alternative should also meet the requirements of supply-side tax reform. In other words, such a tax code should be neutral in taxing savings *versus* taxing consumption; it should reduce marginal rates and assess the tax burden equitably.

There are four principal candidates for supply-side tax reform. Only two of them, unfortunately, meet the criteria of consumption taxation and border adjustability. The most popular plan with conservatives is probably the Hall-Rabuska flat tax, which is a single-rate tax on wages and an equal-rate

David A. Hartman, a retired banker, is chairman of the board of directors of The Rockford Institute.

tax on origin-based corporate cash flow that exempts returns to capital at the personal level. As a "direct tax," however, the flat tax could not be made border-adjusted according to WTO standards and, therefore, could offer no comparable border-adjusted tax relief for U.S. manufacturers. Although it is promoted as a simple tax, political reality would subject the flat tax to a continuing redefinition of income—and, potentially, to a progressive rate schedule. Since such a plan would inevitably be stigmatized as tax relief for the rich at the expense of the majority of wage-earning taxpayers, its prospects are very dim.

Another less popular plan is the Consumed Income Tax (CIT), which taxes all income once and only at the personal level, after investment savings have been exempted. This, too, qualifies as a "direct tax," making it ineligible for border adjustment. Although the CIT has the advantage of taxing all income the same and of encouraging investment, it is also susceptible to political tinkering that could reintroduce progressive taxation and higher marginal rates.

Closer to the mark is the Fair Tax, which is a flat-rate retail-sales tax (RST) that replaces all federal taxation, including social-insurance taxes, and gives rebates on the tax on the equivalent of poverty-level income. It is an indirect consumption tax, and, as such, qualifies by WTO standards for border adjustment.

The preferable alternative is the Business Transfer Tax (BTT), a subtraction method value-added tax based on the difference between revenues and purchased goods and services for all enterprises and employers. The BTT would exempt fixed investment and exports, but it would apply to imports, and it would credit an employer for social-insurance taxes paid. Both the RST and the BTT would offer rebates that could be used to remit taxes on "necessities."

The RST and the BTT are both consumption taxes, but there are significant differences because of the different tax bases that underlie the plans. Theoretically, the RST has as its base all personal consumption expenditures; experience with state retail sales taxes, however, shows that it is very difficult politically to impose taxes directly on "necessities." A large portion of consumption—housing, healthcare, food, legal fees, and even hair care—are exempt from state retail taxes, and the same humanitarian zeal might afflict the RST. Even without exempting necessities, the RST would have a smaller potential base. It would require a higher rate than the BTT, which would provide an incentive for tax evasion. Were an RST to replace *all* federal taxation (as the Fair Tax proposes), then it would either have a smaller base than the proposed BTT, or it would have to introduce a companion measure that would tax payroll and the consumption expenditures of government and not-for-profits.

This leaves the Business Transfer Tax as the most viable proposal on the table. What are its advantages? Apart from the fact that it can be made border adjustable, the BTT would establish a tax base that includes all commerce and employers, eventually reaching even employment and purchases in the government sector and employment in the ballooning not-for-profit sector. Although aimed at consumption, the BTT, by collecting from employers rather than from consumers, would offer little justification for allowing exemption, but it would also provide equitable rebates to offset spending on necessities. Such rebates would serve as replacement for exemptions, deductions, and credits, and, if the BTT were adopted as a single flat tax, all taxation of income could be eliminated.

How should a Business Transfer Tax be implemented on a revenue-neutral basis, replacing current taxation in order of priority? First, the corporate income tax would be replaced by a 5.5-percent BTT. Next, the BTT would be raised to 10 percent, enabling the personal income tax to be flattened to a 14-percent single rate. Finally, the entire tax code (apart from personal FICA taxes) would be replaced by a 20-percent BTT. If the socialists insisted on maintaining a "progressive" code, a somewhat lower BTT rate could be adopted, supplemented by a modest upper-income tax. This is not recommended, but this is not a perfect world.

Following this plan would mean an equitable, neutral, transparent, and politically feasible supply-side and border-adjusted reform of the federal tax code. It would dramatically reduce our perennial trade deficits on manufactured goods and provide optimal growth for *all* sectors of the U.S. economy. It would level the playing field for U.S. corporations in general, and manufacturing in particular, and for U.S. blue-collar workers, whose earnings have been increasingly depressed over the past three decades. It would mean a return to a more equitable sharing in the growth and prosperity of the U.S. economy—not only for those in manufacturing but for all sectors of the U.S. economy.

Our representatives in Congress should consider the U.S. taxpayers' definition of "fair taxation." A *Readers' Digest* poll addressed the question "What is the highest rate of taxes Americans should pay regardless of income level?" A statistically sound sample of Americans answered: 25 percent. The BTT meets this criterion.

Some politicians and experts continue to deny that there is a manufacturing crisis and to oppose a U.S. value-added based tax. This obfuscation of the real reasons for declining blue-collar incomes serves the interests only of the few who currently profit abroad at the expense of all other Americans' prospects for the future. c

The second sentence of the second paragraph of Mr. Hartman's article "What Manufacturing Crisis?" (November 2004) should read: "From June 1998 to January 2004, 3.5 million workers lost their jobs—a decline of 19.7 percent." The editors regret the error.

Vengeance Is Mine, Says the Lord, 1943
by Leo Yankevich

in memory of the German and Russian soldiers buried together in mass graves during the battle of Stalingrad

If but the sun had burned less brightly
upon the faces of the dead
He saw heaped high that winter day
inside a pit dug in a field,
one could say who was good, who bad,
who was a sinner, who a saint,
but those He saw were saved in death
and share one grave beneath His land.