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Tax Policies to Make U. S. Exports More Competitive

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The difficulties that the United States is experiencing in reducing its balance-of-payments deficit are well known. Adding to this concern is the increasing economic integration of the member countries of the European Common Market. Together these developments are focusing a good deal of attention on policies to make American exports more competitive. Competitiveness in international, as in domestic trade, is a matter of prices, costs, availability, financing, and established trading relationships. But in the public discussion of U. S. competitiveness the factors other than prices and costs are generally neglected. And among the cost factors, wage rates, or more appropriately labor costs per unit of output, are often given exaggerated importance. Thus, the comparative advantage that the United States has in raw material and capital costs is being overlooked. For example, raw materials such as natural sulfur, molybdenum and phosphate rock have comparative advantages as the result not only of plentiful natural deposits but also of ingenious capital intensive methods of extraction. Also frequently overlooked in discussions of the competitiveness of U. S. products are the effects of different national tax structures and fiscal relationships.

The plan to integrate or harmonize indirect taxation within the European Common Market and the provisions of the General Agreement on Trade and Tariffs which limit remission of internal taxes on exports to indirect taxes, are considerations that warrent a reappraisal of the impact of internal tax policies on our international trade.

Relative Tax Burdens of the Major International Trading Nations

Country-to-country comparisons of the burden and impact of different national fiscal programs involve judgments about many variables. The total amount of taxation, the benefits derived from Government expenditures; the types of taxes and the relative reliance on the different types; tax rates, definitions of the tax bases; and permissible deductions and exemptions are all factors affecting international comparisons. Recent studies, particularly the report of the Neumark Committee on its recommendation for the harmonization of indirect taxes among the members of the European Common Market, have provided some information for judgments on these problems.

Total governmental revenues, central and local, as a per cent of a country's gross national product seems to be the best measure by which to compare the tax burden between countries.

In 1959, the taxes from all governmental units, central and local, in the major trading nations (here defined as members of the European Common Market, Britain, Japan, Canada, and the United States) averaged 28 per cent of Gross National Product. Japan had the lowest proportion, slightly less than 20 per cent, going to taxes, followed by Belgium, Canada, the United States (26.8 per cent), Italy, United Kingdom, Luxembourg, the Netherlands, France, and West Germany which had the highest proportion, slightly more than 34 per cent of GNP.

Not surprisingly, any broad classification of taxes will show that the major trading nations have tapped the same general sources of revenue. However, the proportion of the total revenue raised by each tax varies greatly from country to country. Canadian and Japanese personal taxes at 6-7 per cent of gross national product are about half as important as their counterparts in the United Kingdom, United States, and France. In West Germany and the Netherlands personal taxes, including social security taxes, are between 16-17 per cent of GNP. In the United States, because of the relatively heavy reliance on personal income and property levies, business and sales taxes in relation to GNP are significantly less important (about 1/3) than they are among its major competitors excepting Japan. And because of its limited reliance on sales taxes the United States is at a disadvantage in facing the GATT provision that indirect (sales) taxes may be rebated.

Since personal and property taxes may be assumed not to be shifted and, therefore, not to affect the prices of exports, these types of taxes will be excluded from our analysis.

Consequently, the two classes of levies of principal significance in competitive costs are business and sales taxes.

Focusing our attention on business and sales taxes, we find that the United States along with West Germany, Canada, and Japan makes the greatest use of corporate business taxes -- 4.5-6.0 per cent of GNP. These data are for 1959 and since that time the U. S. has lessened its dependence on the Federal corporate income tax slightly and a further reduction is proposed. Italy makes very limited use of this tax: in France and some other Common Market countries it ranges from 2 to 3 per cent.

Difference in reliance on sales and value-added taxes are even more striking. Here the U. S. at 5.6 per cent of GNP is well below the field -- 9 per cent in Belgium, Netherlands, Luxembourg, and Japan; 10 in Canada; 13 in West Germany; and 16 in France.

Differences in Sales and Business Taxation

Sales (indirect) taxes differ in a variety of details from country to country, but the significant economic difference has to do with the degree to which they are pyramiding or cascading. When the tax is levied on gross receipts from the sales of goods or services and is applied at each stage of production through which the goods pass, the tax previously paid becomes part of the tax base at subsequent sales of the goods, and a tax on a tax results. The turnover tax is used by all members of the European Common Market, except France.

Beginning in 1954, France has been moving from a turnover tax toward a tax on value added. The French value-added tax (TVA) is of particular importance at the present time because the Report of the Fiscal and Financial Committee of the European Common Market has not only recommended that other members shift from the turnover tax system to a value-added tax system but has also suggested a tentative time table for the changeover. The aim is to remove fiscal as well as custom frontiers between the member countries.

The tax on value added is levied on the gross receipts of a business, minus the cost of materials and supplies purchased from any other business. Payroll is not a deduction; therefore, the value added by labor is included in the tax base. The tax can apply to services as well as manufacturing and distribution of goods.

If there are no exceptions or exemptions and a single rate schedule, the value-added tax is the equivalent of a retail sales tax of the all-inclusive type where capital goods and services as well as consumer goods are in the base. In a form limited to manufactures it resembles a manufacturer's sales tax without pyramiding. Or in its pure form, the value-added tax also comes close to being a flat rate tax on all forms of income. In the national income accounts, depreciation, indirect business taxes and business transfer payments, as well as purchases of materials and supplies are deducted from gross receipts to obtain a net value added at factor costs. If value added for all types of business activity were summed, it would equal national income less the wages and salaries paid by governments. Consequently, a uniformly applied value-added tax is similar to a proportional income tax, except that the tax is collected before the distribution of income, rather than afterwards.

The value-added tax in France, however, is not in this all-inclusive form. It applies only to manufacturing and most services. Manufacturers pay a higher rate than service industries. Agriculture, some services (generally utilities), some goods like bread and dairy products are exempt from the tax. Wholesale and retail trade are not subject to the value-added tax but are subject to a local turnover tax. Thus the French indirect tax system, at present, is a combination of a turnover tax and a value-added tax. It is planned, however, to put the local turnover tax on a value-added basis also. Computation of the French TVA encourages its forward shifting. The tax is computed on gross receipts and then the tax previously paid is deducted.

The excise taxes are still a third form of sales taxation. The excise taxes, such as the Federal manufacturer's excises in this country and the purchase taxes in Britain, are levied on specific goods, usually as a per cent of the value of the goods. All countries have sumptuary excises on tobacco and alcoholic beverages. In addition, all the countries have excises on petroleum products which are frequently earmarked, as in the United States, for the construction or maintenance of the highway system.

The final general form of sales taxation is a retail sales tax, such as occurs in Sweden and State and local government units in the

United States. One of the major differences in retail sales taxation is that in other countries the tax is frequently uniform throughout the country and collected by the central government. The proceeds are then redistributed to meet the costs of local government units.

Direct taxation of business generally takes four major forms: (1) a tax on income, usually as a percentage of profit; (2) a tax related to payroll to finance social security programs; (3) a tax on the value of property[1/]; and (4) business licensing levies, which are of minor importance in the United States but are a relevant part of the revenue system in some of the European Common Market countries.

In most cases the taxes on profits and the taxes on property are the most important. Not only do the rates of profit taxation vary but the definition of taxable profit is unique to each country. A good deal of the difference revolves around the definition and timing of depreciation. The definition of property tax base ranges from assessed valuation of all real and personal property, which is the most common in the United States, to net worth or some fraction of tangible assets.

GATT Agreements

The differences in the form of internal business taxation, particularly the variation in the degree of reliance on direct business versus sales taxation, has special significance for exports. The General Agreement on Trade and Tariffs (GATT) permits exemption or rebate of indirect (sales) taxes for exported products, but not exemption or rebate of direct business taxes. The Agreement also permits governments to levy charges

1/ National accounts record this as an indirect tax.

on imports to equalize the indirect (sales) tax burden on comparable domestic and imported goods but a levy to equalize the internal direct business tax burden is not permitted.

All of the major trading countries exempt or rebate the sales taxes on exported goods. Where the tax is levied only at one stage of production, like the U. S. manufacturing excise taxes, the process of exemption is relatively simple. Retail sales taxes levied by a governmental unit other than the central government are only marginally involved. For example, retail sales taxes are ordinarily included in the price of those goods and services purchased by foreign tourists. Some countries attempt to treat their tourists more openhandedly; France exempts all purchases made with foreign currency travelers checks.

When the sales tax is not levied at a single stage of production, internal sales of goods destined for export are exempt from the tax where practicable. However, it is frequently difficult, if not impossible, to determine in the early stages of production whether a particular sale will eventually be embodied in an export. Consequently, those countries with pyramiding turnover or value-added types of sales tax have rebates of taxes previously paid on exported goods. These rebates are frequently rough estimates of the previously paid taxes and there is some suspicion that the amount of the rebate is larger than the previously paid taxes, thus providing a partially hidden subsidy to exports. There is also a suspicion that the import equalization levies tend to over-compensate and thus discriminate against imports. However, abuse of the export rebates and import levies is not excessive except for specific countries and occasionally specific goods.

Japan is the only one of the major trading countries which provides rebate of direct business taxes on exports. Trading companies are allowed to deduct 1 per cent and manufacturing companies 3 per cent of the proceeds from their export contracts from their taxable income. The maximum amount deductible cannot exceed 80 per cent of the income arising from such exports. Japan has agreed with GATT to eliminate this provision of their corporate tax law by March 1964. In addition to Japan, Australia, Columbia, India, Ireland, and Uruguay have some remission of direct taxes on exports.

<u>Other Tax Incentives for Exports</u>

Common to all the countries discussed here, exporters are permitted drawback of customs duties on material used in exports. Exporters are allowed to reclaim import duties paid on raw materials and parts which are contained in finished goods exported.

Other types of export incentives include accelerated depreciation allowances for exports (France and Japan), the establishment of special tax free reserves against losses from exports (Japan and Norway), and over-expensing of promotion costs (Australia and New Zealand).

<u>Tax Policies to Increase the Competitiveness of American Exports</u>

A. Incidence of Direct and Indirect Taxes.

The GATT agreements accept the classical economic theory of incidence of direct and indirect business taxation. This position is that corporate net income taxes are not shifted forward as increased prices but are absorbed by the factors of production--that is shifted backward. The theory is that the suppliers or manufacturers are always attempting to maximize profits and have, therefore, already moved to the scale of output which equates marginal cost and marginal revenue. Since imposition of a profits tax could not change the output at which profits are maximized it follows that a net income tax would not affect the price.

The classical theory of incidence of sales taxes considers such taxes a wedge between the cost of production and the sales price. Indirect taxes are passed forward as a net addition to the price of the product.

The classical theory applied to international trade would conclude that the country relying more heavily on indirect (sales) taxation would tend to have higher prices than the country relying more heavily on direct (net income) taxation. If the classical theory of incidence of direct and indirect taxes is accepted, then the country which relies more on direct taxation could undersell the country relying more on indirect taxation in the short-run. Equalizing this short-run advantage is a rationale for permitting rebates of indirect taxes. However, no allowance is made for the long run adjustments implicit in classical theory. The country which relies more heavily on direct taxation may be earning a lower return to capital as a consequence of backward shifting. It cannot equalize the return to capital by selling a larger quantity because it loses its price advantage when indirect taxes are rebated. The reduced return to capital discourages investment. Restriction in the return to capital may reduce the capital stock or slow its growth. The resulting distortion in the economic allocation of resources may lead to increased cost of production and ultimately raise prices. To the extent that prices are ultimately increased in the country relying more heavily on direct taxation, direct taxes are shifted forward.

Businessmen generally come to approximately the same conclusion by a more direct route. They argue that prices are set to cover average cost plus an allowance for net profit. Under these conditions, the profits tax becomes a cost element and is passed forward as increased prices, just like indirect taxes.

Most recent studies of incidence have emphasized that the long-run incidence for both the direct and indirect business taxes depends on the elasticities of demand and supply for the product. If the demand for the product is completely inelastic (that is the same quantity will be sold regardless of price) any business tax, direct or indirect, will be passed on as an increase in price. If the tax is fully passed on as an increase in price, the secondary incidence is a reduced level of real private consumption, which may or may not be compensated for by a rise in real public consumption, depending on how the proceeds of the tax are used. On the other hand, if the demand for the product is completely elastic (at a given price any quantity can be sold, but at a higher price, nothing can be sold), then none of the tax can be passed forward as an increase in prices and the burden of the tax must be absorbed by the factors of production. In reality, demand for various products is rarely at one extreme or the other. And therefore the amount of forward shifting of either direct or indirect taxes varies from one product to another.

The differential treatment of direct and indirect taxes on exports has implications for tax policies aimed at encouraging American exports. If one accepts the view that direct as well as indirect taxes are to some degree passed forward as increased prices, then the current practice of remitting only indirect taxes tends to favor countries which rely more heavily on indirect rather than direct business taxation. The price of the exported product is reduced by the amount of the rebated indirect tax. Whereas, that portion of the price of the product which reflects direct taxation is not rebated. Everything else being equal, the nation having a larger proportion of direct taxes on business would have higher international prices for its goods. Or there would be lower prices on exported goods, than those sold domestically, thus reducing the return from exported goods compared to goods sold domestically.

The United States does have relatively higher direct business taxes for which no allowance is permitted in international trade. Leaving aside for the moment the provisions of the GATT agreements, two possible changes in tax policy could increase the competitiveness of American exports; permitting some form of rebate of direct business taxes for exports; or changing the tax structure so as to increase the proportion of indirect relative to direct business taxes. Both policies raise additional problems.

B. Export Tax Credit.

The export tax credit proposal immediately raised the problem of how the credit is computed and who gets to take it. If the business which makes the actual foreign sale is permitted the credit, it might be rebated not only its own taxes but the taxes paid by the producers at prior stages of production depending on how the credit was determined. Tracing the amounts of direct taxes paid at each stage of production on goods finally exported would at best be difficult if not impossible. There are very few American products manufactured primarily for export and exemption of goods destined eventually for export from direct taxation doesn't improve the problem of redistributing the tax rebate. However, after a period of aging, trade practices would tend to result in some sharing of the benefits of the rebate.

There would also be the usual problems tax administrators worry about. An allocation of profits would have to be made between goods sold domestically and goods sold internationally and the tax credit would encourage some companies to alter their operations, treating the rebate as a challenge to their tax avoidance ingenuity. It is doubtful, however, that any of the possibilities of exploiting loopholes would be worth viewing with alarum considering the approximate character of tax determination.

Obviously steps to treat direct and indirect taxes similarly would have to be preceded by renegotiation of the GATT agreements. Clearly the area of greatest importance for the U. S. is the corporate income tax and it might be desirable to focus attention on this one tax. Approaching the problem by alternatively eliminating all indirect tax rebates, would be too disruptive of present practices. French export prices, for example, would rise by nearly 20 per cent, if that were done.

C. Changing the American Tax Structure.

Another way to increase the competitiveness of our exports by tax policies would be to increase the amount of indirect (sales) and decrease the amount of direct (income) business taxes. In other words, lower the corporate profits tax rate and institute, say, a national value added tax. Putting the matter this way raises the question of what sort of internal tax system is desirable and whether policies which would improve the competitiveness of our exports might not result in undesirable internal tax policies--the same question raised by the dilemma of monetary policy.

One major argument for not tampering with the present tax structure is that inequities produced by the structure have already been worked out through shifts in relative prices for goods and services and in relative returns to the factors of production. Shifting to greater reliance on sales taxation in the place of corporate income taxation would, at a minimum, cause some disturbance in the relative domestic price structure. There are possibilities for windfall losses and to the extent that corporations are not now fully exploiting semi-monopolistic positions, possibilities for windfall gains. But in any event views on the relative advantages of sales, value added, or corporate income taxes are firmly held on domestic grounds of neutrality, equity and political practicality. It is doubtful that the priorities of international competitiveness can compete with these domestic goals. One country, Sweden, has substituted increased indirect taxation for direct taxation and is relying on expenditures policy to maintain equity in the fiscal system. England has been discussing the desirability of such substitution, although there has been no official sponsorship of such a proposal.

In summary, the United States would enhance competitiveness of its exports if its business tax system were overhauled with the objective of eliminating from the price of its export products any element of tax cost beyond benefit levies (user taxes, local utility type charges, and some small part of the property tax). However, the GATT convention with respect to incidence stands in the way of the simplest solution to the problem--i.e., remitting taxes on corporate profits and miscellaneous business levies, thereby putting these taxes on a parity with sales and value-added taxes. And it is hardly likely that domestic considerations implicit in the present U. S. tax system will be submerged while the system is revised to take advantage of existing GATT rules as might be done by the substitution of personal income or sales taxes for business levies.

What seems to be called for is a less doctrinaire approach in the GATT posture to the problem of incidence--a systematic study of the forward shifting on a product-by-product basis where the elasticities of demand can be approximately evaluated. From this body of knowledge a more realistic program for rebating taxes on exported products should emerge.

Government Revenues as a Per Cent of Gross National Product
central and local governments combined

1959

	Total	Direct Taxes		Property	Indirect	Total Business Taxes Other than Property
		Personal 1/	Corporate 2/			
United States	26.8 (23.7e)*	12.9 (10.6e)*	4.8 (4.0e)*	3.5	5.6	10.4
West Germany	34.3	16.6	3.2	1.1	13.4	16.6
France	33.4	13.6	2.5	1.2	16.1	17.6
Belgium	24.4	12.3	2.1	.8	9.2	11.3
Netherlands	30.0	16.9	3.0	.8	9.3	12.3
Italy	28.5	N.A.	N.A.	.8	N.A.	N.A.
Luxembourg	29.1	15.8	3.7	1.0	8.6	12.3
United Kingdom	28.8	11.3	4.1	1.1	12.3	16.4
Japan	19.8	5.8	4.1	1.3	8.6	12.7
Canada	25.0	7.2	4.5	3.3	10.3	14.5

1/ Includes contributions to social security.
2/ Does not include business franchise taxes or the German Trade Tax.
* If new tax proposal were fully effective.
Data in table were difficult to put on a comparable basis. Small differences in percentages are probably not too significant.
N.A. Not available.