TAXATION OF AMERICANS WORKING ABROAD

HEARING

BEFORE THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

NINETY-FIFTH CONGRESS

SECOND SESSION

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TAXATION OF AMERICANS WORKING ABROAD

MONDAY, MAY 8, 1978

U.S. SENATE,
COMMITTEE ON FINANCE,
Washington, D.C.

The committee met, pursuant to notice, at 10:05 a.m. in room 2221, Dirksen Senate Office Building, Hon. Russell B. Long (chairman of the committee) presiding.

Present: Senators Long, Bentsen, Curtis, Dole, Packwood, and Danforth.

[The committee press release announcing this hearing follows:]

PRESS RELEASE

COMMITTEE ON FINANCE,
U.S. SENATE,
May 2, 1978.

FINANCE COMMITTEE ANNOUNCES HEARING ON TAXATION OF AMERICANS WORKING ABROAD

The Honorable Russell B. Long (D-La.), Chairman of the Committee on Finance, announced today that the Committee will hold a hearing on the taxation of Americans working abroad. The hearing will be held at 10:00 A.M. on Monday, May 8, 1978, in Room 2221, Dirksen Office Building.

The following witnesses have been scheduled to testify:

The Honorable Anthony M. Solomon, Under Secretary of the Treasury (Monetary Affairs) and Mr. Donald C. Lubick, Acting Assistant Secretary of the Treasury (Tax Policy).

The Honorable Elmer Staats, Comptroller General of the United States.

Jane G. Gravelle and Donald W. Kiefer, Congressional Research Service, Library of Congress.

George P. Shultz, President, Bechtel Corporation.

Richard M. Hammer, Price Waterhouse & Company.

Legislative Reorganization Act.—Chairman Long stated that the Legislative Reorganization Act of 1946, as amended, requires all witnesses appearing before the Committees of Congress "to file in advance written statements of their proposed testimony, and to limit their oral presentations to brief summaries of their argument."

Witnesses scheduled to testify should comply with the following rules:

(1) A copy of the statement must be filed by the close of business the day before the witness is scheduled to testify.

(2) All witnesses must include with their written statement a summary of the principal points included in the statement.

(3) The written statements must be typed on letter-size paper (not legal size) and at least 75 copies must be submitted by the close of business the day efore the witness is scheduled to testify.

(4) Witnesses are not to read their written statement to the Committee, but are to confine their ten-minute oral presentations to a summary of the points included in the statement.

(5) Not more than ten minutes will be allowed for oral presentation.

Written Testimony.—Chairman Long stated that the Committee will be pleased to receive written testimony from those persons or organizations who wish to

submit statements for the record. Statements submitted for inclusion in the record should be typewritten, not more than 25 double-spaced pages in length and mailed with five (5) copies by May 10, 1978, to Michael Stern, Staff Director, Committee on Finance, Room 2227, Dirksen Senate Office Building, Washington, D.C. 20510.

The CHAIRMAN. The hearing will come to order.

Early in February, the Finance Committee approved a further postponement of the 1976 tax changes in section 911 and a new approach to the taxation of Americans working abroad to go into effect in 1979.

Since then, the Ways and Means Committee has held hearings on this subject, the Treasury Department has made its proposals in testimony at those hearings, and the General Accounting Office and the Congressional Research Service have published reports.

Hopefully, the Senate will soon consider the Tax Treatment Extension Act of 1978, which includes these provisions.

In order that some of these issues be better understood, by myself and other members of the committee, I have scheduled this hearing today. I am sure that we will all benefit by the information that is made available to us.

We are pleased to have as our first witnesses today the Honorable Anthony M. Solomon, Under Secretary of the Treasury for Monetary Affairs and Mr. Donald C. Lubick, Acting Assistant Secretary of the Treasury for Tax Policy.

Gentlemen, we are happy to have both of you before us. We will appreciate your views on this subject.

Mr. SOLOMON. Thank you, Mr. Chairman. I will read a statement on behalf of Mr. Lubick and myself, and then we can answer your questions.

STATEMENT OF THE HONORABLE ANTHONY M. SOLOMON, UNDER SECRETARY OF THE TREASURY FOR MONETARY AFFAIRS AND DONALD C. LUBICK, ACTING ASSISTANT SECRETARY OF THE TREASURY FOR TAX POLICY

Mr. SOLOMON. I am pleased to be here today to discuss the U.S. taxation of the earned income of Americans working abroad. In particular, I would like to comment on the impact that our system of taxing Americans working abroad may have on U.S. exports.

The administration values the role of overseas Americans. It wants to assure that they are taxed fairly. At the same time, it wants to put this troubling issue to rest so that overseas Americans can continue their work free from the uncertainties of the changing tax law. This administration also recognizes that our tax policy regarding overseas Americans has important consequences for our trade interests. The administration does not believe that the present provisions of section 911, as set forth in the Tax Reform Act of 1976, adequately reflect the important considerations which must be raised in formulating our policy towards overseas Americans.

On February 23, in testimony before the House Ways and Means Committee, the administration recommended a system for taxing Americans working abroad which permits those taxpayers to deduct: (a) the amount by which reasonable housing costs abroad exceed average U.S. housing costs; (b) the cost of educating dependents

through grade 12, subject to a ceiling of $4,000 per year, plus the cost of two round trips per year between the school and the foreign residence; and (c) the cost of home-leave travel for each family member every other year.

In addition, the administration proposal would liberalize certain other provisions of the tax law affecting nonresident citizens such as the moving expense deduction and construction camp provisions. The basic approach and rationale of the administration's proposal are similar to those of the Ribicoff bill, H.R. 9251, which this committee has voted on favorably.

I would like to explain how these proposals respond to the competing interests which arise in formulating a tax policy for the foreign-earned income of overseas Americans.

The debate concerning the taxation of Americans working overseas and the various bills introduced in Congress on this subject, including the administration's proposal, reflect a fundamental policy decision: the United States chooses to tax its citizens whether they reside in the United States or overseas. The United States is the only major country that taxes wage and salary income of its nonresident citizens simply because they are citizens.

On administrative grounds, taxation of Americans on the basis of residence rather than citizenship might be easier to apply. It may also be true that nonresident citizens derive fewer benefits from Government spending than do taxpayers living in the United States. But these arguments overlook two basic precepts of our tax policy.

First, U.S. citizenship carries with it very considerable lifetime benefits and with these benefits come lifetime responsibilities.

Second, the basic determinant of tax due in our system is the ability to pay and not the extent of benefits received during any given year.

If we accept the citizenship basis of taxation—and I have heard few people criticize that fundamental principle—we are left with two principal arguments directed against the present manner in which we now tax nonresident citizens. I am sure you have heard these arguments before, and I am sure you will hear them again today. It is important that these arguments be made and heard, but it is equally important that they be placed in proper perspective.

The first argument essentially is that the tax system is insufficiently sensitive to the special conditions faced by Americans overseas. The argument is that a citizen's foreign earnings are frequently inflated to compensate him for unusually high costs of moving and living abroad. In some countries, housing which is barely adequate by U.S. standards costs several times what more comfortable housing would cost in the United States.

In non-English speaking areas, Americans may have to spend considerable amounts to obtain education for their children comparable to that available without cost at public schools in the United States. In addition, costs associated with moving abroad or returning to the United States on home leave can be substantial.

If a citizen must earn more to maintain a U.S. standard of living overseas and the United States taxes the additional earnings, then that citizen will pay more U.S. taxes than a citizen maintaining a comparable standard of living at home. In this sense, our tax laws

may place our citizens overseas in a worse position than they would have been had they remained in the United States.

The administration recognizes the validity of this equity argument, as have virtually all the sponsors of legislation relating to the taxation of Americans working abroad. But without additional facts, this argument is no more compelling than a similar case which can be made for recognizing the wide variation in living costs within the United States itself, for which no special tax treatment is provided. Living costs in the United States also vary considerably, and those who are compensated for the added cost of living in expensive areas of the United States must pay a higher percentage of their income in taxes even though they do not necessarily enjoy greater purchasing power than those with lower incomes in relatively inexpensive areas of the United States. For example, living costs in Alaska and Hawaii are substantially higher than they are in Mississippi and Alabama.

Although overseas living costs often exceed the costs of living in even the most expensive parts of the United States, equity considerations alone would not necessarily dictate that overseas Americans be treated differently from residents of the United States. But when these issues of equity are combined with the competitive realities facing many overseas Americans, special consideration seems advisable. Indeed, these competitive realities facing overseas Americans can have important consequences for our trade balance.

Unlike Americans working within the United States, Americans working overseas are often subject to higher tax burdens than persons of other nationalities in the same income bracket. Because the United States is virtually unique in taxing the earned income of its overseas citizens, Americans working in a country imposing low tax rates must pay higher taxes than citizens of other nations living in that country.

In countries imposing taxes comparable to or higher than those in the United States, Americans are not placed at a disadvantage by virtue of U.S. taxes since the local tax system acts to equalize the taxes paid by local residents, American or otherwise. As you know, Americans are permitted to credit such foreign income taxes paid against their Federal income tax liability, and, thus, are not subjected to double taxation. These points may be simply illustrated: An American and a French citizen living in New York City pay approximately the same income taxes, assuming they have comparable incomes and situations; this same relative position holds true if they move to Stockholm, Sweden, because of the fact that Swedish income taxes are higher than U.S. income taxes. But these same individuals living in Jeddah, Saudi Arabia, bear very different tax burdens. Although the American in Jeddah continues to pay U.S. income taxes, the Frenchman living in Jeddah does not pay any income taxes, either to France or to Saudi Arabia. This basic disparity supports treating the earned income of overseas Americans differently from the earned income of U.S. residents.

The consequences of this disparity for our trade balance are difficult to quantify. To the extent that overseas Americans must bear a heavier tax burden than other nationals, they either will expect higher compensation or must accept less take-home pay than others with comparable incomes. In either case, the result is to foster the replacement of Americans in overseas employment by nationals of other countries.

When overseas Americans are replaced by foreign nationals, the U.S. economy loses an employment opportunity and the remittances to the United States which normally accompany such employment. However, from a trade perspective, there can be even more important adverse effects. From my own experience in living and doing business abroad, I know that an American engineer is much more likely to specify American products, which he has used and with which he is familiar, than a French engineer who is familiar with French products. The overseas employment of an American engineer thus creates jobs in the United States. Given the falling share of the United States in world manufactures trade, and our present trade deficit, we need the exports that are created by the employment of overseas Americans.

The administration proposal does not totally eliminate the disparity in the tax treatment of overseas Americans and persons of other nationalities. The disparity is rooted in our citizenship approach to taxation. But our proposal ameliorates that disparity. By recognizing excess overseas costs in the tax law, Americans residing in countries where they will experience the most extreme tax disparity in comparison with nationals of other countries will obtain the largest tax benefits while those experiencing relatively small will receive lesser benefits. In particular, our proposal will confer a significant portion of its tax benefits on Americans working in the Middle East, where there is a considerable promise of generating U.S. exports.

Reasonable people may differ on how to resolve the competing considerations which arise in formulating tax policy in this area. We believe the administration's proposal represents a fair and practical soluton to this important problem.

Mr. Chairman, thank you and we will be happy to answer your questions.

The CHAIRMAN. You make a point—you make several good points in your statement. The one that impresses me is the fact that in areas of the Middle East and also in the developing countries, where Americans go, they are likely to specify American equipment because that is the equipment with which they are familiar. And if Americans are not to be permitted to go there, if they find it unattractive to go there, those people are going to tend to specify the other equipment because that is the stuff with which they are familiar.

I have a modest amount of familiarity, for example, with the difficulty of hooking up American electrical equipment—that is the generating equipment—with power sources of other countries. You have to have converters and one thing and another. By the time you do it, you have plugged the fool apparatus in, it might work and then again, it might not. You might not have any power coming out the other end.

I was in Iran, for example, and at that Hilton Hotel there, bearing an American name, they had American equipment and the stuff would not work. The reason it would not work was that it was hooked up to British generators and when you take English circuits and then you try to hook up American electrical equipment, the power source being to English specifications and the elevator made to American specifications, it does not work very well.

I know the little fellow who was trying to repair that Otis elevator was an Englishman, by the way. If those elevators are working the way they are supposed to work today, I would be surprised.

But, to me, the logical answer for that country was to say that you ought to go for one brand of equipment or the other. This thing of having the Russians make one thing and the Frenchmen make something else and the Japanese make something else and the Americans make something else, by the time you get around to connecting the whole fool thing up, even if all of them were working the way they were supposed to work in their countries, none of them were made to fit the other ones, with the result that when you try to convert them all over and make them all work together, they will not.

Now, the logical answer there is to go either one way or the other. Either use American specifications and American equipment or use the equipment made by some other country. Perhaps you could do it by metropolitan areas. Take Tehran and use one style of equipment there and in some other place, use somebody else's equipment, but even then you are going to have the problem of connecting up to power when you transfer from one city to another.

But would it not be just the most natural thing—in fact, about the only logical recommendation a person could make, that he would recommend that if he is going to do the work for you that he is going to use the equipment that he knows how to operate.

Mr. SOLOMON. Mr. Chairman, I have lived overseas and been in business overseas for many years. Even though it is hard to quantify, from that experience, as well as seeing the way sourcing takes place on World Bank loans, and Asian Development Bank loans, and loans of other development banks frequently the sourcing of equipment depends upon the nationality of the engineers who draw up the specs. We have seen hundreds of examples where this seems to have an impact.

There was one case brought to my attention recently where one part of a fertilizer project—I believe it was in Pakistan—was financed by the Asian Development Bank, another part of it, the same project, was financed by the World Bank. The part that was financed by the Asian Development Bank had a German engineering consulting firm draw up the specifications and the part that was done by the World Bank had an American engineering consulting firm.

The results of those contracts ended up that there was absolutely no American firms prequalified to bid on the Asian Development Bank part of the project whereas there was a substantial number of American firms prequalified to bid on the part of the project that was financed by the World Bank.

There are innumerable examples of this. It is a well known, accepted point of view among American businessmen living abroad that this is an important factor in getting business for the United States.

I think that this intangible, Mr. Chairman, is at least as important as the other argument, namely that the costs of doing business overseas for U.S. firms are increased by having to pay U.S. employees more money because of the taxation problem.

The CHAIRMAN. Senator Packwood?

Senator PACKWOOD. No questions.

The CHAIRMAN. Senator Bentsen?

Senator BENTSEN. No questions.

The CHAIRMAN. Thank you very much, Mr. Solomon.

Next, we will call the Honorable Elmer Staats, Comptroller General of the United States.

Mr. Staats, we are very happy to have you with us today. We will be delighted to hear your views on this issue.

STATEMENT OF HON. ELMER STAATS, COMPTROLLER GENERAL OF THE UNITED STATES

Mr. STAATS. Thank you very much, Mr. Chairman.

Our remarks today are based on a review which we initiated in May of last year, just a year ago, and a report which we presented to the Congress in February which was entitled: "Impact on Trade of Changes in Taxation of U.S. Citizens Employed Overseas."

The United States has taxed the overseas income of its citizens, with certain exceptions, since enactment of the Federal income tax in 1913. It is the only industrialized trading nation of the world to do so. Most countries do not tax income earned outside their borders.

Approximately 150,000 of the U.S. civilian work force of about 98 million are employed overseas. For more than 50 years, until 1976, the United States provided a substantial tax incentive to citizens employed abroad to promote U.S. exports and commercial competitiveness. The tax incentive, under the 1975 tax practices, would according to the Treasury's February estimate, have amounted to $563 million in 1977, or 75 percent of the total U.S. tax liability of overseas employees.

In 1976, two things occurred which would reduce the amount of the incentive by a total of $384 million:

The Tax Reform Act of 1976 increased the tax liability of citizens employed abroad by about $319 million.

The U.S. Tax Court reaffirmed the taxable status of some overseas allowances. The Internal Revenue Service now requires that the full value of allowances be reported, thus increasing the tax liability of citizens overseas by another $65 million.

At the time the law was amended in 1976, it was not clear what economic impact the changes would have on trade, foreign investment, and individuals. Uncertainty existed because little effort had ever been made to determine the impact or evaluate the effectiveness of this tax incentive.

We made our review to reduce the uncertainty over the impact of the tax changes, in the expectation that Congress would consider making further changes to these rules in 1978.

We attempted to determine the probable impacts on trade which could be attributable to the 1976 tax increases on Americans abroad and appraised alternative methods of granting tax relief to these taxpayers. To encourage others to conduct future analyses, we analyzed several methods of evaluating these tax incentives and identified the kinds of information that must be collected in order to predict the effects of future changes.

We gathered data on the impact of the 1976 tax changes from 145 U.S. companies which have foreign operations, 367 individuals working abroad in 11 different countries, 6 U.S. nonprofit foundations operating abroad, and 38 member firms of the Tax Executives Institute, a professional association of corporate tax executives.

The principal Government agencies which have operations overseas also gave us assessments of the impact the reduced incentives would have on private sector participation in their programs.

Of the companies surveyed, 77 percent reimburse their American employees for all or part of the additional taxes incurred as a result of living abroad. These companies will have to absorb the potential tax increase, pass the increased costs on to customers, or replace American employees with less costly local or third-country nationals. Companies that do not reimburse their American employees may lose them because of the higher tax burdens.

According to the survey:

Companies relying heavily on American employees would experience a greater impact than those that have only a few Americans in key positions. The former tend to be in the building/construction and service industries, operating in a country for a relatively short time and on a contract/project basis. For example, 300 firms employ 30,000 Americans in Saudi Arabia alone.

Companies operating where the living costs are high and/or where little or no taxes are imposed on foreigners would experience the greatest impact.

About 60 percent of the companies surveyed in the United States and 42 percent overseas currently had plans to reduce the number of American employees abroad due to the tax change. Many others were adopting a "wait and see" approach.

About 65 percent of the companies estimated their increased costs if they reimbursed employees for the tax increase. Half of these thought the amount would represent 5 percent or less of their total employee compensation costs; 70 percent thought the increases would represent 5 percent or less of their total operating costs.

Our study, together with an analysis by the Treasury of a sample of tax returns claiming overseas tax incentives in 1975, suggests that the potential tax increases will vary greatly according to income levels, employer compensation policies, and geographic locations.

Forty-five percent of the individual taxpayers responding to the study expected to return home on or before the end of their present tour because of the tax changes. About 29 percent of these were planning to return even though they expected to be reimbursed by their employers for most of the tax increase.

About 40 percent of the estimated $384 million in increased taxes will be paid by those who have adjusted gross incomes, including allowances, of more than $50,000—about 10 percent of the overseas taxpayers. The tax increase for these taxpayers would average about $10,000.

Taxpayers reporting less than $20,000 income, 53 percent of the total, would have an average tax increase of about $215.

Nearly 75 percent of those surveyed received separate cost-of-living and tax-equalization allowances and overseas premiums. The remainder consisted of the self-employed, employees of firms that either did not have tax equalization programs or provided higher salaries to offset the increase in taxes or lived in areas where the allowances did not apply.

Within the study group, average monthly housing costs were $1,025; 80 percent of those surveyed considered their housing inferior to housing they would occupy in the United States.

Americans living in the oil-producing countries of the Middle East and Africa will have the largest tax increases, averaging $6,650 per return. Americans working in those countries generally receive relatively large taxable allowances for housing, dependent education, and general living costs. They also usually have high gross annual incomes—43 percent earn in excess of $30,000 compared with 29 percent for all overseas taxpayers and 4 percent for taxpayers residing in the United States.

In certain extreme cases in extraordinarily high-cost countries, some individuals who receive large noncash allowances may have a tax liability equal to, or in excess of, their basic cash salaries.

The changes will have an unusually severe impact on U.S. firms and employees in Saudi Arabia, because of the large allowances necessitated by the high living costs and the higher salaries required to attract qualified employees to the harsh environment of this remote desert country.

For example, we found a typical employee with a wife and two schoolaged children earning $40,000 could be taxed on the basis of $131,000 gross income because of housing, education, and other allowances needed in Saudi Arabia. We were told that many U.S. employees are expected to leave Saudi Arabia because they cannot afford the high taxes or because their employers, for cost considerations, are replacing them with foreign personnel.

U.S. companies with operations overseas generally expressed the position that it is essential to maintain U.S. citizens abroad in order to promote and service U.S. products and operations. Of the permanent based companies, 26 percent indicated that they had lost American employees as a result of the tax change, while 57 percent of the companies on a contract/project basis indicated such a loss.

The companies advised us that either the increased costs or loss of U.S. citizen employees associated with the tax changes may be the cause, in part or entirely, of lost contracts and adverse effects on U.S. exports.

We obtained views of U.S. company officials and found:

A concern with the "ripple effect" on subcontractors or suppliers, should a primary company lose a contract due to higher costs associated with tax reimbursements or should Americans be replaced by other nationals who might deal with their own countries' firms rather than with U.S. firms.

Most of the headquarters' officials believed that few, if any, firms in their industries would close down operations as a result of the tax changes, but over half of the overseas officials believed that at least 5 percent of the U.S. companies would close down their overseas operations.

Over 80 percent were of the opinion that the tax changes would result in at least a 5-percent reduction of U.S. exports.

On the assumption that the tax increase would be passed along to customers, we estimated the economic impact of the reduced incentives on the U.S. gross national product, exports, and employment. The results showed a generally smaller effect than was forecast by company officials. However, the full impact of the tax increase on the U.S. economy cannot be objectively measured due to the data limitations as well as to intangible values accruing from having Americans employed abroad, especially the secondary or ripple effect.

In summary, the results of this analysis showed that the tax increase, assuming that these costs are passed along in the form of higher prices, might cost as much as 5,000 jobs in 1978, increasing to 27,000 jobs in 1981; adversely affect the gross national product, in real terms, by up to $270 million in 1978, increasing to $790 million in 1981; and adversely affect real exports by $140 million in 1978, increasing to $320 million in 1981, excluding any indirect or ripple effect.

In the 1970s, for the first time in this century, the United States was confronted with a deficit trade balance. In 1977, the deficit had climbed to $31.2 billion. In this connection it should be noted that the United States share of Saudi Arabia imports declined from 31 percent to 22 percent from 1974 to 1976, just 2 years.

This trend, together with the recognition that policy instruments for promoting U.S. exports and commercial competitiveness abroad are limited, underline the importance of adopting policies that have the greatest potential for strengthening the U.S. international economic position.

They also focus attention on the following issues:

How can Government policy and resources be used more effectively to promote U.S. exports and competitiveness abroad?

What policy instruments are available for these purposes? Which are the most cost effective? Is there an effective alternative to the subject tax incentives?

How significant are the benefits of having a large force of U.S. businessmen abroad influencing world economic affairs as well as representing the U.S. system of values and culture?

With respect to the question of further adjusting the subject tax incentive, basic options include fully taxing, partially taxing, or making tax free all allowances and foreign-earned income. If the Congress decides to grant a greater degree of tax relief, there are several ways of doing this.

In our opinion, the primary ways include adjusting the existing general exclusion, granting special deductions for extraordinary costs, or modifying available tax credits. In our report, we discussed variations within each of these options, together with the advantages and disadvantages of each.

The preferred option and degree of incentive provided must be chosen by the Congress in the light of the objectives it defines.

However, because of the seriousness of the deteriorating U.S. international economic position, the relatively few policy instruments now available for promoting U.S. exports and commercial competitiveness abroad, we recommend continuing section 911-type incentives at least until more effective policy instruments are identified and implemented.

Our concern is based upon a fundamental belief that, to maintain and build upon the competitive position of the United States, it is essential for a large force of U.S. citizens to be maintained abroad to promote and service U.S. products and operations.

The Congressional Research Service recently made an analysis of the section 911 tax incentive. They concluded that the incentive is contrary to the principles of both tax neutrality and tax equity and dismissed the adverse impact on trade because its relationship is indirect and uncertain. The CRS study addresses itself primarily to the equity question, while we believe the overriding issue to be trade and export promotion. Moreover, we believe our in-depth study provides concrete evidence of the direct relationship of the tax incentive to maintaining and enhancing U.S. exports.

It may be that alternative policy instruments can be devised which are more cost effective. To date, such alternatives have not been found. Until such alternatives are found, we believe that a convincing case exists for continuing to use a section 911-type incentive. If Congress continues this incentive, we recommend that the Department of the Treasury, in consultation with the Department of Commerce, be required to:

Evaluate periodically the effectiveness of the tax incentive program in achieving these objectives.

Compare this tax incentive with other policy instruments, such as trade fairs, trade exhibits, and domestic international sales corporations, that are designed to achieve similar objectives.

Report the results of its evaluation regularly to the Congress.

Mr. Chairman, I have prepared here a brief tabulation of the various instruments the U.S. Government now employs for promoting exports, together with the amount in the budget for each of those items. They seem to me relevant, and I would like your permission to put it into the record along with my statement.

The CHAIRMAN. By all means.

[The following was subsequently supplied for the record:]

INSTRUMENTS FOR PROMOTING EXPORTS

Credit Programs

Program	Description	Amount
Export-Import Bank	Stimulation of exports primarily by extension of loans to foreign buyers to purchase U.S. goods, and by extension of credit insurance and guarantees against commercial risks and political uncertainties.	$899,000,000 Est. FY1977* Outlays
Commodity Credit Corporation	P.L. 480-I program - Extends loans to foreign purchasers of agricultural commodities at interest rates substantially lower than commercial ones and with maturities ranging up to 40 years.	$799,000,000 Est. FY1977*** Shipments
	Short-Term Export Credit Sales program - Extends loans to foreign purchasers of agricultural exports determined to be in surplus.	$1,000,000,000 Est. FY1977* Obligations

Export-Import Bank authorizations:

	FY1977**
Loan authorizations	$1,221,000,000
Guarantee authorizations	$1,021,000,000
Insurance authorizations	$3,358,000,000
Total authorizations	$5,600,000,000

*The Budget of the United States Government Fiscal Year 1978 - Appendix
**Export-Import Bank of the United States 1977 Annual Report
***Department of Agriculture Budget Justification for P.L. 480 January 1978

27-727-78—2

Promotion Programs

Department	Program	Amount
Department of Commerce	International trade development - Encourages and assists U.S. businesses to export by (1) conducting market research and overseas trade promotion events (trade fairs, trade centers, trade missions, etc.), (2) assisting U.S. companies to compete for foreign capital projects and product purchases, and (3) providing U.S. industry with overseas sales leads.	$20,070,000 Est. FY1977*
	East-West trade - Expands the U.S. trade with the U.S.S.R., Eastern Europe, the People's Republic of China, and other countries with centrally planned economies.	$ 4,219,000 Est. FY1977*
Department of Agriculture	Foreign market development - Administers programs concerned with the development of long-term foreign markets for agricultural products of the Unites States.	$22,718,000 Est. FY1977*
	Agricultural Attaches - Assists in the development of markets abroad for U.S. agricultural commodities.	$10,250,000 Est. FY1977*
Department of State	Various commercial programs - Includes salaries, expenses, and support spending (e.g., travel and transportation, commercial libraries, representation, contract services, training programs for commercial specialists, etc.)	$13,800,000 Est. FY1976**

*The Budget of the United States Government Fiscal Year 1978 - Appendix
**Commerce and State Departments Export Promotion Programs - Hearings before a Subcommittee of the Committee on Government Operations House of Representatives - March 22 and 23, 1977

Tax Incentive Programs

Program	Description	Estimated cost
Domestic International Sales Corporations (DISC)	Increases exports by allowing companies to defer part of their tax liability on DISC export sales.	$945,000,000 FY1977* Estimated tax revenue foregone
Western Hemisphere Trading Corporations (WHTC)	Reduces tax rates for domestic corporations all of whose business is done in the Western Hemisphere. (Note: Phased out by the Tax Reform Act of 1976)	$35,000,000 FY1977* Estimated tax revenue foregone
Deferral of income of Controlled Foreign Corporations (CFC)	Defers taxes on income of CFC's until repatriated to parent U.S. taxpayers (Primarily to promote U.S. foreign investment)	$570,000,000 FY1977* Estimated tax revenue foregone
Exclusion of income earned abroad by U.S. citizens	Allows U.S. citizens abroad to exclude an amount of foreign earned income from their taxable income	$180,000,000 FY1977** Estimated tax revenue foregone

*Tax Expenditures: Compendium of Background Material on Individual Provisions - Committee on the Budget United States Senate - March 17, 1976

**Taxation of Americans Working Overseas - Revenue Aspects of Recent Lgislative Changes and Proposals - February, 1978

Programs with other Objectives

Program	Description	Amount
Foreign Assistance - to the extent that programs are tied to the purchase of U.S. goods	Primary examples: Security supporting assistance	$1,457,000,000 Est. FY1977* Outlays
	Functional development assistance	$688,000,000 Est. FY1977* Outlays
	International development assistance	$78,000,000 Est. FY1977* Outlays
Overseas Private Investment Corporation	Encourages participation of U.S. private capital and skills in the economic and social development of less developed countries (Note: New insurance for 15 months ending 9-30-77 was $750,000,000, promoting investments of $332,000,000)	-$35,000,000 Est. FY1977* Outlays
Foreign Military Sales	Credit program for sales of military equipment - Estimated FY1977 long-term credit agreements of $2,022,000,000 (Value of foreign military sales agreements in FY1977 estimated at $8,770,000,000)**	$740,000,000 Est. FY1977* Obligations

*The Budget of the United States Government Fiscal Year 1978 - Appendix

**Congressional Presentation Document: Security Assistance Program, Volume 1, FY1978

The CHAIRMAN. I am most impressed with your statement. This tax consideration ought to be considered in the context of the other things that we do to promote American policy objectives around the world.

How much do you suppose we are spending on foreign aid of one sort or another, if you include the various things that we are doing to help people develop their industries and everything that you could think of that would go under the name of foreign aid of one type or another?

Mr. STAATS. I do not have the figure offhand, but in many cases, we have built up industries through our foreign assistance program which are now in direct competition with the United States. Now, those programs all had valuable foreign policy effects as their objectives, but it seems to me, Mr. Chairman, that it is relevant to point out that we have authorized large programs in our Export-Import Bank to try to encourage exports. The Commodity Credit Corporation has programs adding up to almost $2 billion. The Foreign Military Sales have as their objective, partly, to deal with our balance-of-payments problem. We have the AID program that you mentioned. We have the Overseas Private Investment Corporation. And then we have a number of other tax incentives which are to serve that purpose also.

The CHAIRMAN. Well, I wish you would just give us, for the record, an estimate of how much that runs into, just including all the different things that you might include on one basis or the other.[1] For example, I do not know how you would include Export-Import loans, but I would think that to the extent we insure loans, or the extent to which we make loans on more favorable terms than would be available within the United States, that that should be considered.

And the thought that occurs to me, first, in helping to overcome our disastrous balance-of-payments deficit, which I do not think we can stand indefinitely, we need to keep people overseas who help to take American services and equipment abroad.

And then, second, in terms of our foreign policy objectives, I do not know of anything that tends to help us more than to have Americans working side by side with nationals of other countries in those countries abroad. It is one thing for someone who is an American tourist to go over there and lord it over everybody and take the view that everything we do is right and everything that the other people do is wrong. I have seen some of that, and that does not help us.

But the kind of Americans that get right side by side with people and show them how to operate a piece of American equipment and how to hook it up and how to make it work, I would think just has to be a great asset to our country.

Now, I have known both kinds of people, but my impression was the kind of people that I have had the privilege to work with, that work side by side with foreign workers, that they are a big asset to us.

Mr. STAATS. All of the evidence that we have developed in this review, in 11 countries, and we have the views of our embassies also on a broader basis than that, Mr. Chairman, support what you have said.

Now, this is a difficult thing to measure in dollars and cents terms, but nevertheless, there is no question about it in our mind that it is very important to have American business people who are dealing with

[1] See p. 12.

the business people and with the government of these countries. If we lost that, we would be losing a very valuable asset.

The CHAIRMAN. Now, in terms of saying what it takes to provide an adequate incentive and to have the Americans overseas, if you try to shave it down so that you are squeezing it down to the last penny, is it not likely that oftentimes you are shaving it so close that the American just does not go. Either the employee does not want to go, or the company, looking at what it would cost them, would prefer to hire somebody else from England or Sweden or Italy or somewhere else rather than hire the American to do the job.

Mr. STAATS. I agree.

The CHAIRMAN. Mr. Packwood?

Senator PACKWOOD. Are the things that you say about the taxation of individuals and its relation to the encouragement of exports and U.S. influence overseas also applicable to corporate taxation?

Mr. STAATS. We did not really focus on the corporate taxation question, Senator. We are focusing here, really, on the changes that were made in the 1976 tax legislation.

Senator PACKWOOD. I am aware of that. I was curious in your personal opinion whether the same arguments ought to apply to the taxation of corporations?

Mr. STAATS. I would welcome the comments of any of my colleagues here. I really had not given much thought to that question.

Senator PACKWOOD. If they have any comments, I would appreciate them.

Mr. JANTSCHER. Well, we did focus solely on the effects of the tax increase on the presence of individual Americans. We did not look at the presence of American business.

Senator PACKWOOD. Excuse me. I did not hear you.

Mr. JANTSCHER. We focused only on the effect that the change in the tax laws would have on the presence of Americans abroad. To the extent that the change in the tax rules that apply to American corporations might affect the presence of Americans abroad, our conclusions would carry over.

Mr. STAATS. To the extent that it meant that the corporations would close down their offices, or it might mean that they would be less competitive, to the point where they, in the future, may have to close down, then they do have a direct correlation. I can see that one.

Senator PACKWOOD. Thank you.

The CHAIRMAN. Senator Bentsen?

Senator BENTSEN. Mr. Chairman, I am impressed with the depth of the study and its objectivity and pragmatism. I had a Venezuelan businessman in my office a couple of days ago, and I am not talking about a U.S. businessman; a Venezuelan businessman. He was talking about buying American equipment and, in turn, trying to hire Americans to operate it and he said he would get them down to Venezuela—he was talking about a salary of $55,000—and said the man would agree and then he would say, but I want to get out here and look at housing and education for my kids, and that type of thing.

He said repeatedly after a week of study he would come back and say, I am sorry, I just cannot take it for the costs that I will incur and the taxes I would pay. And he said he would return to the United States.

And he said he had been through repeated numbers of these situations where he would try to hire an American citizen.

I cannot help but believe that, particularly in contracting firms where we have American engineers abroad, they are going to buy the kind of equipment that they understand, they know and they have confidence in—American equipment, generally.

In turn, if our contractors have to hire a German engineer, French engineer, Italian engineer, he is going to buy those kinds of things for the job with which he has familiarity.

I think it is terribly important for our exports and for our domestic production and the rippling effect that you refer to here, that we do what we can to encourage the hiring of these Americans overseas. I could not help but be impressed by the numbers you gave me when you talk about someone in Saudi Arabia earning $40,000 a year that with the allowances that he needs for housing and education and the other allowances in Saudi Arabia, that you would tax him on a base income of $131,000 a year.

I have seen some of the photographs of some of the housing in some of these countries and the price tags they put on it, and I can understand the problem that that fellow faces and why it is difficult to recruit him and keep him over there.

Thank you very much, Mr. Chairman.

The CHAIRMAN. Senator Danforth?

Senator DANFORTH. No questions.

The CHAIRMAN. Senator Curtis?

Senator CURTIS. I have just glanced at this testimony and I would like to ask Mr. Solomon——

The CHAIRMAN. Mr. Solomon has left.

Senator CURTIS. I will just ask this question for the record, and maybe Mr. Solomon and his staff could answer it.

He recommended certain provisions and guidelines that would remedy the situation, and I wondered how that worked out from the standpoint of the revenue as compared to just repealing what we did in 1976.

Mr. STAATS. Senator Curtis, we are making various calculations on different proposals and we will make all of these available. If there are additional laws that we have not looked at, we would be happy to do that.

We have the capability now, in working with the Treasury Department, of analyzing the tax effect of any of these alternative proposals.

Mr. Chairman, we have prepared a detailed statement of comments on the Treasury proposal. We did this initially for the House Ways and Means Committee and it occurred to us that this might be useful to you in analyzing the administration's proposal.

[The following was subsequently supplied for the record:]

GENERAL ACCOUNTING OFFICE COMMENTS ON THE ADMINISTRATION'S PROPOSAL FOR SECTION 911

The Administration's proposal to revise taxation of Americans working outside the United States was described in testimony before the House Committee on Ways and Means on February 23, 1978, by Mr. Donald C. Lubick, Acting Assistant Secretary of the Treasury for Tax Policy. That proposal advocated changes in tax rules to overcome certain problems and promote fairness. It would replace the existing Section 911 exclusion with a new Section 221 that would provide special deductions related to certain excessive costs overseas. It would also

liberalize tax rules under certain other sections of the Internal Revenue Code for the benefit of overseas taxpayers.

The proposed Section 221 would permit overseas taxpayers to deduct certain expenses not normally deductible by domestic taxpayers—education, home leave transportation, and a portion of housing costs. It would not, however, provide a deduction for higher general costs of living, and it would not provide a specific tax incentive for Americans to work overseas.

The proposal would require Treasury to prepare a detailed report to Congress every two years describing the revenue costs and economic effects of Sections 221 and 912.

The General Accounting Office believes that for the United States to remain competitive in overseas markets it is essential to maintain a large force of U.S. citizens abroad to promote and service U.S. products and operations. GAO believes that serious consideration should be given to continuing Section 911-type incentives at least until more effective policy instruments to promote exports and commercial competitiveness abroad are identified and implemented.

GAO endorses the Administration proposal as a means of relieving a part of the excessive costs of living and working overseas. It is noted, however, that the proposal does not include a deduction related to general costs of living and does not provide a specific incentive for Americans to work overseas. Therefore, if Congress decides it is appropriate to provide relief for all elements of excessive living costs overseas and to provide an incentive as well, additional provisions are necessary.

The Administration cited difficulty of administration as one reason for not proposing a general cost of living deduction. Should the Congress decide that such a deduction is appropriate and that some incentive should be provided as well, GAO suggests that provisions for these could be combined in a manner that would help to simplify administration. An exclusion similar to that now contained in Section 911 could be provided, but with a provision to adjust the appropriate basic exclusion (intended incentive) according to the relative cost of living in each area or country. The adjustment should be made for each tax year and could be based on State Department cost of living indexes.

The proposal for periodic reports to Congress on the revenue costs and economic effects of the tax changes is generally in conformance with a recommendation in our report, "Impact on Trade of Changes in Taxation of U.S. Citizens Employed Overseas," (ID-78-13, February 21, 1978). GAO suggests that Congress identify in legislation the specific purposes to be served by whatever deductions and incentives are provided so that Treasury can evaluate accomplishment of these purposes. GAO also suggests that the reports be required by legislation and that the Secretary of the Treasury be required to consult with appropriate Congressional Committees and the Secretary of Commerce to determine what specific information should be developed and included in the report.

Comments on specific elements of the Administration's proposal follow.

HOUSING DEDUCTION

The Administration proposes to allow a deduction for housing expenses in excess of 20 percent of the taxpayer's earned income (presumably only foreign source earned income) net of actual housing costs and the allowable deductions for education and home-leave travel. The figure of 20 percent was chosen because a recent Bureau of Labor Statistics study disclosed that an average American family in the United States spends approximately one-sixth of its income on housing, or 20 percent of its income net of housing expenses.

Comments

We agree that the unusually high cost of American-style housing in many foreign locations warrants a special deduction for housing costs abroad. The basic approach embodied in the proposal—that of allowing a deduction for the part of housing expenses in excess of a specified fraction of the taxpayer's income—seems sound to us.

The Treasury Department states that no ceiling should be placed on the amount of the deduction for housing expenses, except that the housing should be "reasonable." We understand why the Treasury Department is reluctant to recommend a ceiling on the deduction. Housing costs vary widely around the world and a ceiling that is generous in one area might be inadequate in another. But we believe that the alternative of restricting the deduction to the costs of "reasonable" housing (in excess of 20 percent of the taxpayer's income net of hous-

ing expenses) is even less satisfactory. Taxpayer's and tax collectors are bound to differ occasionally over what is reasonable housing and what is not and their disagreements will sometimes have to be settled in court. In the end the Service will devise its own definition of what is reasonable housing and what is not, presumably based on the prevailing level of housing costs in each overseas location, and a ceiling will effectively be established by regulation rather than by law. We believe it would be preferable for Congress to enact a ceiling in law.

A ceiling on the housing deduction would also serve another purpose. Its absence would encourage Americans abroad to spend more on housing than they would otherwise do, to the detriment of the U.S. balance of payments, since a part of every extra dollar devoted to housing would effectively be paid for by the U.S. Government—more than half of every dollar, in the case of taxpayers in the highest marginal rate bracket.

There are a number of ways to establish a limit on the housing deduction in order to prevent abuses as well as to avoid promoting an abnormally large expenditure on housing. One way would be to enact a fixed dollar limit on the maximum housing deduction, possibly a limit that varies from country to country or from region to region around the world. The ceiling might be set equal to some multiple of the U.S. Department of State housing allowance for the country or area or it might be established independently of that index. The merit of this approach is its administrative simplicity. Another way would be to enact a variable ceiling that is expressed as a fraction of a taxpayer's income. The ceiling would differ from country to country or region to region to reflect the actual level of living costs in the country or region. Such a variable ceiling would entail more effort to establish and keep up to date than a ceiling expressed as a fixed number of dollars, but presumably would be fairer for any given amount of revenue loss because it would grant a larger deduction to families with larger incomes.

EDUCATION DEDUCTION

A deduction would be allowed for expenditures for tuition, books, and room and board at school of up to $4,000 per dependent child enrolled in grades 1 through 12. Also deductible would be expenditures for two economy-class round trip airline tickets per year between the school and the taxpayer's foreign residence for college students and for students enrolled in primary and secondary schools in cases "where boarding schools are necessary."

Comments

We agree that an education deduction is appropriate and do not disagree with the Treasury's approach. However, we do see some possible problems and suggest some refinements.

Treasury's explanation of the provision states that the travel deduction would be allowed for pre-college students only in cases 'where boarding schools are necessary." No such statement is made about the "room and board" provision. If the IRS is going to appraise the adequacy of local schools for purposes of allowing the transportation deduction, they may as well do so for the room and board deduction also. If the wish is to minimize the audit task, the travel expenditures should be allowed on the same basis as the room and board.

In Canada and perhaps some other English-speaking countries, there are local, free, English-language schools comparable to the U.S. public schools. For persons located in these areas, schooling involves no necessary additional expenses. We suggest that consideration be given to excluding American residents of Canada, at least, from this provision or even disallowing the deduction in any area where IRS determines a local free school system exists that offers instruction comparable to that offered in the United States.

The adequacy of the $4,000 ceiling may need to be reconsidered from time to time. Congress may wish to instruct the Treasury Department to include in its periodic evaluation of these provisions a recommendation for appropriate adjustments in the ceiling to take account of inflation and changes in exchange rates.

HOME-LEAVE TRAVEL

The Administration proposes a deduction for one economy round trip fare every other year for each member of the taxpayer's family between a foreign post and the taxpayer's residence in the United States.

Comments

GAO endorses this proposal but suggests the deduction be allowed only for trips actually taken. In addition, GAO suggests that the deduction be limited to

the cost of economy fare between the foreign post and the nearest U.S. port of entry in the contiguous United States in order to more nearly approximate the situation of domestic taxpayers.

COST OF LIVING

The Administration does not propose a special deduction for costs of living because

Measurement of a deduction would cause very substantial administrative burdens, lead to demands for more relief, and add unwarranted complexity to the tax laws.

It would be unfair to domestic taxpayers who also face wide variations in costs of living without tax relief.

Comments

GAO agrees that determination of an appropriate cost of living deduction would be a very complex and difficult task. The formula for such a deduction would have to take into account a wide range of variances in area living costs and individual income levels. If the deduction were to be based on cost of living indexes, it would have to be limited to the portion of income used for expenses covered by the indexes to avoid double deduction for costs deductible under other provisions (housing, education, home leave transportation). State Department cost of living indexes for foreign areas would have limited applicability for use in determining deductions. These indexes primarily cover areas where Government employees are located and therefore omit many areas, particularly non-urban areas, where private Americans may work. In addition, there are questions whether the goods and services included in the indexes are directly comparable to those involved in a typical life style in the United States.

GAO recognizes that there are wide variations in costs of living within the United States. Those variations, however, are not so extreme as the variations that may be encountered in some areas overseas. While a deduction for overseas variations may be regarded as unfair to domestic taxpayers, the principle of allowing a deduction for excessive costs of this nature does not differ from the principal behind allowing deductions for excessive costs of housing, education, and home leave transportation. Rather, it is a question of degree.

In summary, it is for Congress to decide whether overseas taxpayers should be relieved from tax due to excessive costs of living and whether such relief warrants the complex and difficult administrative effort that would be required. If administrative difficulty is the main objection, it could be overcome by giving up a degree of precision. One option would be an exclusion similar to that of Section 911, but with a provision to periodically adjust the amount for each area or country based on the relative cost of living for each location.

OTHER CHANGES

The Administration's proposal would—

Reduce the qualifications criteria for special benefits to physical presence in foreign countries for 334 days during the taxable year.

Not disallow a credit for foreign taxes attributable to amounts that may be deducted under Section 221; however the new deductions would reduce the U.S. tax on foreign source income, thereby reducing the overall foreign tax credit limitation (Section 904).

Broaden the conditions under which housing and meals furnished by the employer overseas can be excluded from income under Section 119.

Increase the time limitation and amount of excludable temporary living costs for taxpayers moving to, from, or between foreign countries (Section 217).

Extend, by up to four years, the period for reinvestment of proceeds realized on the sale of a principal residence (Section 1034) for persons working overseas who are eligible for the benefits of Sections 221 or 912.

Comments

The General Accounting Office has no objection to the above proposals that would liberalize tax rules for Americans working and living abroad.

Mr. STAATS. In brief, I guess our conclusion is that the administration proposal moves in the right direction, but we do not think it goes far enough. It does not go far enough in the sense that it does not take into account the higher general cost of living, and this is not a complex

matter to determine because those surveys are made currently now by the State Department. So it would be a matter of adjusting, on a country by country basis, some amount to take into account the higher cost of living.

We would encourage the Congress also to consider positive incentives to get Americans overseas. So we would go along with the Treasury proposal except for those two points and we do not think that the Treasury proposal goes really far enough.

The CHAIRMAN. When I look at this problem, it reminds me a little bit of what a man on the Louisiana Mineral Board told me one time about people who were coming in and bidding on leases down there. Some fellow came several times and bid on leases. He was always unsuccessful, always went home empty handed however.

So finally he came in and bid on one, and they opened the bids. Well, he had bid about 30 percent more than anybody else, so he had bid about $10 million above the next bid. He had bid $10 million more than anyone to get that lease, and he was sick about it.

Well, this old fellow working for the mineral board who tells the story, he said,

> Well, I have seen you around here for the last 3 years. How many leases did you take home with you?

He said;

> None.

The fellow with the board said:

> Well, let's look at it this way. You bought yourself a lease, you paid a good price, but this time you took the lease home. Now, if you had kept doing it the way you were doing it before, where you were afraid you would have a penny on top of the table over the other guy's bid, afraid to bid a dollar or two more, you still would not have had a lease. Everything your company was spending sending you here would have been wasted. This time, you went home with a lease in your pocket, so you ought to be satisfied.

Well, if we try to shave this thing so close that the people have to go shopping around and by the time they get through shopping and the man talks to his wife and his relatives and his friends and they look at all of the different problems that they have to contend with, they finally conclude that they would just as soon not take the job. If you shave it that close, you are giving your competitor a tremendous advantage because he is not putting a tax on those people at all.

Generally speaking, the people who are competing with the Americans in these same areas are not taxing their citizens on what they make doing business in these countries are they?

Mr. STAATS. That is correct, Mr. Chairman.

The CHAIRMAN. So you have more than one standard to look at. One is what would a person pay if he were doing business here in the United States. Well, I do not know of anybody—there are very few countries that an American is going to prefer to live in compared to the United States.

Then the other standard is to see what the relative considerations are for your competition: (A) They have a lower standard of living in their country than we have in ours, and (B) when they go outside the country, they do not pay the same taxes that an American pays when he leaves his country.

I think, in comparing the policy objectives, if you simply do not want Americans to go, sure, you can fix it so they are at a competitive disadvantage. But it makes me wonder why you want to do that if it is to our advantage to have them there.

You think it is to our advantage, I take it, Mr. Statts?

Mr. STAATS. Yes, indeed.

The CHAIRMAN. Thank you very much, gentlemen.

Mr. STAATS. Thank you.

The CHAIRMAN. Next we will call Ms. Jane Gravelle and Mr. Donald Kiefer, Congressional Research Service, Library of Congress.

We are pleased to have you, Ms. Gravelle and Mr. Kiefer.

STATEMENTS OF JANE G. GRAVELLE AND DONALD W. KIEFER, CONGRESSIONAL RESEARCH SERVICE OF THE LIBRARY OF CONGRESS

Dr. KIEFER. Thank you very much, Mr. Chairman. In the interests of time, I will abbreviate our statement slightly and I would request that the entire statement appear in the record. We also have submitted a copy of our recent study on this issue for the record, Mr. Chairman.

I am Donald Kiefer and I am accompanied by Jane Gravelle. We are both specialists in taxation in the Economics Division of the Congressional Research Service of the Library of Congress. We thank you for the invitation to appear before you today to present the results of our study, released on April 20 of this year, entitled "U.S. Taxation of Citizens Working in Other Countries, an Economic Analysis." [1]

The approach of our study was to analyze the taxation of overseas American workers within the most general conceptual framework possible. To accomplish this, we chose to employ the so-called principles or canons of taxation which have been developed over the years to offer guidance in developing and evaluating tax policy. These principles include concepts such as simplicity, neutrality, equity, that taxation should be structured to be consistent with the attainment of other economic goals and, of course, should raise the necessary revenue for the operation of government.

The two tax principles which seem to be the most revelant to the analysis of the taxation of overseas Americans are the principles of tax neutrality and tax equity.

The principle of tax neutrality would recommend taxing overseas workers in such a way that the U.S. tax system provides neither an inducement nor a discouragement to U.S. workers in deciding whether to accept employment abroad and to U.S. employers in deciding whether to employ American workers abroad.

If costs of living abroad are extremely high compared to the United States, the combination of cost-of-living reimbursement for foreign employees and the progressive rate structure of the U.S. tax system suggests a tax adjustment based on the principle of tax neutrality.

The neutrality concept would require that if, in the absence of tax considerations, it would cost, say, 50 percent more to employ a U.S. worker in a given foreign location than in the United States, then

[1] See appendix on p. 106.

this relative cost differential should also exist when taxes are considered. If the tax structure reduces the differential, it would provide an incentive to foreign employment. If the tax structure increases the differential, it would discourage working abroad.

If no adjustment were made to the tax liabilities of foreign workers in high-cost areas, the progressive rate structure of the income tax would increase the cost differential and thus discourage employment in such areas. This is because the higher wages paid by the employer to the foreign worker to compensate for the higher living costs become part of taxable income, and this taxable income will be taxed at higher marginal tax rates under the progressive tax rate structure.

Given this consideration, how should an adjustment for foreign living costs be structured to achieve locational neutrality?

Clearly, the adjustment should not be a full deduction of the amount equal to compensation for the higher living costs because such a deduction would make the foreign worker better off than the domestic worker. Under a strictly neutral tax system, if the cost of living in a foreign location is 50 percent higher than in the United States, an American citizen who moves to that locality and receives a 50 percent higher salary would also pay a 50 percent higher U.S. income tax.

This system would preserve the relative before-tax costs of the United States versus the foreign location. Thus, a location in which living costs are 50 percent higher, ignoring inome taxes, would also be 50 perent more expensive when taxes are considered.

The principle of tax neutrality would also require that the tax adjustment should be made for only the cost of living in excess of the highest cost locale in the United States because otherwise the tax code would have nonneutral locational effects, in that it would provide incentives to accept jobs in foreign locations compared to high-cost domestic locations.

By this strict interpretation of tax neutrality, all of the present alternative tax treatments of U.S. citizens living abroad are nonneutral. Our study examined the prior and present versions of section 911, the administration proposal, H.R. 9251, and a hypotheticl policy of allowing no tax adjustment for overseas workers.

Example calculations show that, with the exception of the effects of present section 911 on upper-income taxpayers in higher cost of living foreign locations, all of the alternative policies yield lower U.S. tax liabilities for overseas Americans than would a neutral tax adjustment.

Of the five alternative policies examined, disallowing any tax adjustment for foreign taxpayers appears to most closely approximate the tax neutrality result overall, although the present section 911 produces results closer to the tax neutrality standard in higher cost foreign locations.

The second principle of taxation employed in our study is that of tax equity. There are two aspects of tax equity which are usually considered: horizontal equity, or the equal treatment of equals; and vertical equity, which is concerned with how the tax burden is distributed across income classes.

In general, the points presented above concerning tax neutrality also pertain to the principle of tax equity.

Specifically, a provision allowing deduction of living costs in excess of average costs in the United States rather than a high-cost locale would be inequitable to the large number of Americans who live in areas in the United States where the cost of living is higher than the average. As a hypothetical example of this inequity, a tax adjustment which allowed a deduction of foreign living costs which exceed average living costs in the United States would allow deductions in excess of $5,000 for U.S. citizens working in Hon Kong and Tehran, but would provide no deductions to taxpayers in New York or Boston, even though the costs of living in these four cities are nearly identical.

With regard to vertical equity considerations, because citizens working abroad have comparatively high incomes, tax provisions benefiting them tend to reduce the overall progressivity of the U.S. income tax structure.

In our report, the alternative tax treatments for overseas Americans are also evaluated in terms of achieving other economic goals, specifically in terms of their impact on foreign trade and employment.

First, it must be observed that the relationship between U.S. tax treatment of citizens working in other countries and the quantities of U.S. exports is both indirect and uncertain. Since foreign investment and production by U.S. multinationals is, in many cases, a substitute for domestic production and exporting to the foreign markets, it seems ironic that subsidizing foreign operations should be perceived as stimulating U.S. exports.

The argument has been made that foreign operation by U.S. multinationals expands their foreign sales and, because their foreign production uses U.S.-produced inputs, thereby expands U.S. exports. Whether this effect outweighs the effect of foreign production substituting for U.S.-produced exports is unknown and cannot be assumed without supporting evidence.

However, even if there were a direct relationship between tax treatment of citizens working abroad and exports, a tax subsidy would not have a permanent effect on the balance of payments because, under a system of flexible exchange rates, international currency price adjustments would render ineffective policies which attempt to have a long-term impact on a nation's balance of payments.

With regard to employment and unemployment policy goals, tax subsidies to overseas Americans cannot contribute to solving the fundamental macroeconomic causes of either cyclical or structural unemployment problems. Even if preferential tax treatment for Americans working in other countries creates jobs in the export industries, under a system of flexible exchange rates, this policy will likely accelerate the decline of import competing industries and lead to less employment in those sectors.

A recent study by the General Accounting Office, which we heard about a moment ago in the statement of Mr. Staats, performed an econometric analysis to estimate the maximum impact on U.S. trade and employment which could be anticipated from the 1976 changes in section 911 and calculated that the impacts would be very small. The calculated impacts, as a matter of fact, are less than 1 percent in each case.

An argument which has been made and used to support a preferential tax treatment of Americans working abroad, and which is related

to both the effects on trade and employment and to tax neutrality, is the issue of competitiveness. U.S. firms operating abroad maintain that increasing U.S. taxes on their employees will increase their wage costs, thus forcing their prices up and reducing their competitiveness.

Similarly, U.S. citizens working in other countries claim that higher U.S. taxes will make them less competitive in the foreign job market than foregn nationals who are not taxed by their home countries.

The argument that reduction of tax benefits for overseas Americans would lead to a small reduction in U.S. business activities abroad is correct and is viewed by firms as reducing their competitiveness. Similarly, the argument that increased taxation of Americans working abroad would tend to lead to a substitution of foreign for U.S. employees, a substitution which has been occurring for several years for other reasons, is also correct and is viewed by U.S. employees as a reduced ability to compete.

The implications of these arguments must be considered carefully, however. The goal of structuring the U.S. tax system to maximize the competitiveness of all U.S. workers and companies does not provide very useful guidance in either designing or evaluating tax policy. An obvious way to achieve this goal would be to reduce all taxes to zero.

However, since the continued operation of Government does require some tax revenue, the question becomes how to raise the required revenue and, at the same time, cause minimum disturbances in the free market operation of the private sector of the economy.

As emphasized in our report, this is precisely the goal of tax neutrality: to structure the tax system so that it does not cause distortions in economic decisions unless some clear national purpose is served by such nonneutralities.

As indicated in the analysis above, there is no clear evidence that artificially encouraging Americans to work abroad through the tax code serves as identifiable national economic purpose. Therefore, whatever benefits result from the increased competitiveness of American firms and citizens in foreign locations, appear to be at the expense of other Americans through more inequitable taxes and through less efficient allocations of economic resources.

I would be happy to answer your questions.

The CHAIRMAN. It is my impression that the way the countries competing with us are doing business is that they are charging their citizens little or no taxes on what they earn doing business in a foreign country. Is that in accord with your understanding, or not?

Dr. KIEFER. Yes, that is correct, Senator.

The CHAIRMAN. Well, then, while it is nice to think if the American worker was working here in the United States he would pay this amount of taxes, if you are trying to compete in a foreign country and the other fellow over there is paying no tax to his home country, and our Nation is insisting on collecting a very heavy tax, does not that put the American at a disadvantage?

Dr. KIEFER. Yes, it does put the American at a disadvantage. What it boils down to is that the United States can structure its tax system and its tax treatment of overseas Americans to accomplish one of two goals. One goal is to attempt to have a neutral impact on the allocation of U.S. resources of employees and investment. The other goal is to match the competitive posture of citizens of other countries.

So long as other countries do not tax their expatriate employees, then we are faced with that policy dilemma. The best that the United States can hope for in that situation is attempting to have a neutral impact on the resource allocation of its own employees with regard to their decisions to work at home or work abroad.

But it is true, as we indicate in our statement and in our report, that if we follow a strictly neutral approach, it will put our expatriate employees at a competitive disadvantage.

The CHAIRMAN. It would seem to me that, just from my limited lights at all of this, as though it could be compared to a boxing match. In this country, we want to go by the Marquis of Queensbury rules as they were subsequently amended to take care of Jack Dempsey—where you cannot use the rabbit punch—and later on amended to take care of someone else. Take the rule they imposed on Jack Dempsey: that you cannot stand over the man when he gets up off the floor; you have to go to a neutral corner. Then you send your man abroad and he is going to be forced to fight by the old London prize ring rules when you can hit a man below the belt and you can stand over him or hit him behind the head or about anywhere else.

Well, to some of us, it would seem fair that if our fellow is going to go into the ring against their man that they ought to both be fighting by the same rulebook and if that were the case, our man might stand a chance. But if they are going to be fighting by the law of tooth and nail and our fellow is bound by the modern sophistication that requires him to wear heavy cushioned gloves and not to hit a great number of places where the other man can hit him, does that not put the American at a very great disadvantage?

Dr. KIEFER. Well, Senator Long, our approach was to try to analyze this issue from the most general and objective standards that we could devise, and we wanted to look at the incentives that the tax code builds into locational decisions.

The neutrality concept is an appealing one because if a tax system has neutral impacts on locational and investment decisions, it can be shown and it is generally accepted that that will maximize the output and the production of the U.S. economy and will result in the most efficient allocation of U.S. resources.

That characteristic of a neutral impact on the economy is true, regardless of the tax policies of other countries.

Now, it is true that if the other countries of the world do not tax their expatriate employees, that our expatriate employees operate at a disadvantage, and I think that is probably the central issue that has been discussed on this issue. It is the competitive disadvantage that our expatriate employees, and companies, to some extent, suffer because of the policies of other countries, versus an attempt to structure tax policy to have a neutral impact on allocation of U.S. resources.

The CHAIRMAN. Well, another way of looking at the neutrality would be that our people who are competing in a third country ought to have the same chance that the other people, nationals, have competing in that third country. If you do it that way, that is an entirely different kind of neutrality than you are talking about here, is it not?

Dr. KIEFER. That is correct. That concept of neutrality is called capital import neutrality as opposed to capital export neutrality, and that would put U.S. expatriates in a situation where they were competing on the same basis as expatriate employees of other countries.

It does, however, when you look at the allocation of U.S. resources, lead to a somewhat larger allocation of U.S. resources to foreign production and employment than would be consistent with the most efficient allocation of U.S. resources.

The CHAIRMAN. Thank you very much.

Senator Packwood?

Senator PACKWOOD. I am curious about the one-word difference between your statement now and the statement on page 57 of your report. On page 57 of your report, you say:

There is no clear evidence that artificially encouraging Americans to work abroad through the tax code serves any identifiable national purpose.

In your statement today, you say:

There is no clear evidence that artificially encouraging Americans to work abroad thorugh the tax code serves any identifiable national economic purpose.

Is there any reason that you chose to add the word "economic" to your statement?

Dr. KIEFER. Yes, Senator, there is. In our preparation for our appearance before the committee today, we naturally sought the review of several people of the statement that we were making, and it was pointed out to us that the scope of our study really is limited to economic factors, and the factors that Senator Long brought up earlier in questioning, I believe, Mr. Solomon about foreign policy implications of U.S. employees abroad are not considered in our study.

So we thought it best to limit the statement in our summary to national economic purposes.

Senator PACKWOOD. Well, now, you have done studies on this subject, the two of you, for a number of years. Do you think there is any justifiable, identifiable national purpose in encouraging Americans to work abroad?

Dr. KIEFER. Well, I think that is beyond the scope of our capabilities to respond, Senator. We are economists and we try to limit our conclusions to the economic impacts. There may indeed be foreign policy implications or defense or other implications that are beyond the scope of our expertise.

Senator PACKWOOD. If Congress were to make the determination that it is in our interests to have Americans working abroad, one of the major factors we should then consider is how foreign countries tax their expatriate employees.

Dr. KIEFER. Well, it seems to me that evaluating the method that foreign countries use in taxing their expatriate employees is largely an economic question. If we decide that it is in our national interest to encourage U.S. employees to work abroad beyond the levels that would naturally occur without some tax inducement, remembering all the time that we are not talking about employees working abroad versus not working abroad, we are talking about a level of employment abroad which would occur in the absence of tax inducements versus the level that would occur with tax inducements——

Senator PACKWOOD. Yes, but you said you were not going to make that judgment. You are strictly giving us an economic judgment.

Dr. KIEFER. That is correct.

Senator PACKWOOD. My question is, if Congress or the executive branch decides that we want people to work overseas, would the

method by which foreign countries tax their expatriate employees be a significant factor to consider?

Dr. KIEFER. It seems to me that if we wanted to encourage employees to work overseas, then the relevant question would be, what is the most efficient way for the United States to encourage their employees to work overseas, and that could be through a tax system, or it could be through another system. We would probably want to look at the method that other countries use in encouraging their employees.

Senator PACKWOOD. All right.

If we have reached the conclusion that we want to encourage employees to work overseas for our own identifiable national interests, looking at the tax system is one method of doing it?

Dr. KIEFER. Yes, that is certainly correct.

Senator PACKWOOD. And would you say the same thing as to the encouragement of businesses overseas?

Dr. KIEFER. Yes, that is correct.

I think the contribution that our approach brings to the evaluation is that we are trying to identify what a neutral policy would be so that in structuring a tax incentive, if the Congress decides that there is an identifiable national purpose for doing so, at least we would have a basis for measurement of how strong that inducement is.

Senator PACKWOOD. On page 6 of your statement, you say:

> Since foreign investment and production by use of multinationals is, in many cases, a substitute for domestic production and exporting in the foreign markets, it seems ironic that substituting foreign operations should be perceived as stimulating U.S. exports.

If we were to close down our overseas operations, what percentage could we serve by exports from this country that is now being served by overseas production?

Dr. KIEFER. I do not think we actually have a figure on that.

Senator PACKWOOD. Well, then, how can you make that statement?

Dr. KIEFER. Well, there are, of course, examples one can point to where foreign production has served as a substitute for exports. What we are saying is that we do not know what direction the net impact is? And I do not think anyone does.

The GAO study makes the same statement, that it is not clear what is the net impact of foreign production on U.S. exports.

Senator PACKWOOD. You mean overseas operations might actually encourage our exports?

Dr. KIEFER. They may, yes.

Senator PACKWOOD. But your statement is that it serves as a substitute for domestic production in exporting to foreign markets.

Dr. KIEFER. What we are saying is that some foreign operations serve as a substitute and others serve to expand exports, and we do not know the net direction of those two effects.

Senator PACKWOOD. And yet you have never done a study that has any idea as to what the net direction might be?

Dr. KIEFER. We have not done one, and I have not seen anyone else who has been able to successfully pin down that evaluation.

Senator PACKWOOD. All right.

Is it fair to say, then that in any study you have done, including studies on deferral of foreign source income, you are unable to reach any conclusion as to whether the tax system, if it encourages these

companies to operate overseas, has any effect on U.S. exports one way or the other?

Dr. KIEFER. Well, that is not entirely fair. The effect we are talking about here is the direct impact as to whether, in the first round effects, if you will, it expands or reduces U.S. exports.

There is also the secondary effect which must be looked at, which is the effect on flexible exchange rates and the overall trade posture of the United States. And what we have shown here is that even if we assume that all of the impact of these tax provisions is positive on exports, the net effect after we consider all of the economic adjustments will be very small or negligible.

Senator PACKWOOD. I want you to go back through the evidence that you have for the statement that foreign investment and production by U.S. multinationals is, in many cases, a substitute for domestic production and exporting to foreign markets. What is the basis for that statement?

Dr. KIEFER. Well, I think there are several examples that could be pointed to, but also there is much that has been written in economic literature which assesses the decisions of a company to produce either in the United States or abroad for foreign markets. To the extent that a decision based on economic factors, or tax considerations, is made to produce abroad for a foreign market rather than domestically for a foreign market, that would serve as a substitute for U.S. production and exporting.

Senator PACKWOOD. And you think our present tax code encourages companies to go abroad that would not otherwise go abroad?

Dr. KIEFER. Not necessarily. There are characteristics of our tax code which do have that impact. There are other characteristics which, in fact, discourage companies to go abroad.

Senator PACKWOOD. Which parts of our tax code have that effect?

Dr. KIEFER. Well, if we are talking about the corporate level now rather than at the individual level, the deferral of U.S. tax liabilities in low-tax countries would be an encouragement to go abroad. There are other characteristics, for example, the fact that the investment tax credit and accelerated depreciation range can only be taken on domestic equipment, is a discouragement to go abroad. And those affect company decisions differently depending on whether they are thinking about investing in a high-tax foreign country or a low-tax foreign country.

Senator PACKWOOD. So if we wanted to achieve, in your words, tax neutrality, we should extend accelerated depreciation and the investment tax credit to companies operating overseas?

Dr. KIEFER. That would be one method of achieving tax neutrality on that side, as well as eliminating tax deferral. There are other ways to achieve that result; yes.

Senator PACKWOOD. But if you are going to be perfectly neutral, there would be no incentive to go overseas. You do say, however, that as far as individuals are concerned, a factor to be considered is the way foreign countries tax their expatriate workers?

Dr. KIEFER. That was on your premise that the Congress had determined that there was a reason to want to encourage U.S. citizens to go abroad; yes.

Senator PACKWOOD. Well, now, you recommend in many of the reports that you have done that deferral should be eliminated?

Dr. KIEFER. That is not entirely correct. The CRS does not have the power to recommend to Congress. What we can do is assess economic impacts, and we have in one our studies that you have seen, indicated that it does not look like deferral has a positive economic impact on U.S. trade or employment.

Senator PACKWOOD. Can you tell me two or three other studies that come to that same conclusion?

Dr. KIEFER. I think there are several others that come to that conclusion.

Senator PACKWOOD. Can you give them, for the record?

Dr. KIEFER. Yes; we could provide them for the record.

Senator PACKWOOD. I mean do you know them now.

Dr. KIEFER. The U.S. Treasury has come to the same conclusion and their recommendation is that deferral be eliminated. There are studies——

Senator PACKWOOD. Which Treasury, and which study?

Dr. KIEFER. The present Treasury in, among others, the documents issued to support the President's tax proposals in his state of the Union address this year.

There is also a study by Peggy Musgrave which was published in a committee print, I believe, of the Senate Committee on Foreign Relations.

Senator PACKWOOD. Is that the study done in about 1974 or 1975?

Dr. KIEFER. I think that is approximately correct.

Senator PACKWOOD. I have no other questions, Mr. Chairman.

The CHAIRMAN. Senator Danforth?

Senator DANFORTH. The principle of neutrality that you talked about, from the standpoint of the employee, how would that be applied? From the employee's standpoint, if he is going overseas to live in a country with a very high cost of living, to make it worth his while at all to go over there, he is going to have to be compensated. He is going to have to be made whole, correct?

Dr. KIEFER. Yes.

Senator DANFORTH. So, in making the employee whole from his standpoint, does not constitute a violation of neutrality, does it? Or does it?

Dr. KIEFER. No; certainly not. That is largely the basis of the neutrality concept; we would expect that an employee in accepting a foreign job would require to be kept whole, as you say, in accepting that position.

Senator DANFORTH. So, then, to maintain the concept of neutrality for the employee, there are a couple of ways to do it, right?

Dr. KIEFER. That is correct.

Senator DANFORTH. And one would be to allow the employer to pay the employee the differential between the cost of living in the United States and the cost of living in the foreign country and then let the employee deduct that difference?

Dr. KIEFER. Yes; that is correct. The concept of strict neutrality that we are employing in our study is one that would preserve the neutrality at both the employee and the employer level, and the adjustment process that you are suggesting would preserve the neutrality at the employee level in making his decision as to whether to accept a foreign job. There would be no tax inducement.

It is at the employer level that a nonneutrality would develop in the——

Senator DANFORTH. A nonneutrality would?

Dr. KIEFER. I am sorry?

Senator DANFORTH. It is at the employer level that nonneutrality would develop by letting the employee deduct the differential?

Dr. KIEFER. Right.

Senator DANFORTH. And to preserve neutrality for the employer, your approach would be what?

Dr. KIEFER. Well, the strict definition of neutrality that we are employing is that for an employer, if in the absence of taxation, totally ignoring any impact of taxes on an employee, if a given foreign location is, say, 50 percent more expensive to employ that individual, then when we consider the impact of taxation on that decision, that location should still be 50 percent more expensive. If it is less than 50 percent more expensive, if it is, say, 40 percent or 30 percent more expensive, then to that extent there is somewhat of an inducement, a more favorable treatment of that location.

It turns out that the way to accomplish this strict neutrality at both the employee and employer level is precisely the same as indexing the tax system. In other words, if we were to index the U.S. tax system by moving the tax brackets up and by moving the personal exemptions amounts up and the standard deduction or the zero bracket amount up by the percent of inflation of United States versus that foreign location, that is precisely the same mechanism that we used in our study as the definition of strict neutrality.

That mechanism will preserve the before and after tax cost differential, so that if a foreign location is 50 percent more expensive ignoring taxes, it will also be 50 percent more expensive considering taxes. If you allow the employee to deduct the total cost differential that his employer provides, the tax system will have neutral effects with regard to the employee, but if you examine the cost difference, the differential will be reduced at the employer level.

Rather than it costing 50 percent more to locate the employee in a foreign location, it may cost 35 percent more or 30 percent more.

Senator DANFORTH. So how, specifically, would you carry it out if you were to apply the strict principle of neutrality?

Dr. KIEFER. There are two ways that one could do it. The specific method that we use in our study, merely because it seems to be simpler than the other, is that an employee, when computing his taxes each year, would make a cost of living indexing calculation. The Treasury Department would specify an adjustment based on the cost of living differential, and that adjustment would be multiplied by the adjusted gross income and the amount of itemized deductions of the employee to calculate an equivalent U.S. adjusted gross income. The employee would calculate his taxes based upon that equivalent U.S. adjusted gross income and then there would be a contrary adjustment which multiplies the tax amount up to his actual adjusted gross income in the foreign location.

That adjustment is set out on page 20 of our study, and it accomplishes the same thing as indexing the U.S. tax system to each separate cost-of-living differential appropriate to each foreign location.

Now, I would hasten to add that we do not include that in our study as a proposal. It is merely our standard of evaluation and what a tax structure would look like if it did accomplish this strict definition of neutrality.

Senator DANFORTH. Now, the difference between that kind of an approach and the approach of allowing the deduction for the difference between the cost of living here and the cost of living in the foreign country, the difference would be felt by the employer, not the employee, is that the idea?

Dr. KIEFER. Well, presumably that is where the difference would be felt. I think the GAO survey indicated that not all employers do fully reimburse their employees for cost-of-living differentials, but in the case in which the employer does fully reimburse the employee for cost-of-living differentials, which I think has become the prototype in this discussion, what you state is correct, that the employee would be treated in a neutral fashion. It would be the employer who would receive some relative cost reduction.

Senator DANFORTH. So then the real question is, if the cost of living is compensated for by the employer, what portion of that additional compensation should, in effect, be borne by the Treasury, is that the issue?

Dr. KIEFER. That seems to be the real question.

Senator DANFORTH. It is or is not your view that that question relates to business decisions?

Dr. KIEFER. Well, it is our view that it does relate to business decisions. Presumably what we are talking about on the business side of this issue is locational decisions in terms of businesses deciding between alternative locations of where to conduct their economic activities, and in making that decision, certain locations are going to be more expensive than others by certain amounts and the question is, how does the tax code affect those decisions?

If the tax code changes those relationships and the relative costs of those alternative locations, then presumably those changes have an impact on locational decisions, so yes.

Senator DANFORTH. Thank you.

The CHAIRMAN. Senator Curtis?

Senator CURTIS. No questions.

The CHAIRMAN. Senator Dole?

Senator DOLE. I have not had a chance to read the entire evaluation, but did your study include the taxation of Government employees, living abroad, section 912?

Dr. KIEFER. No, Senator Dole. That was outside the scope of our review.

Senator DOLE. There is a different treatment, as I understand it.

Dr. KIEFER. There is a very different treatment, yes.

Senator DOLE. Do you see any need for treating workers living overseas in the private sector one way and those workers living overseas in the Federal sector treated another way?

Dr. KIEFER. Well, we did not review that question in our study, but presumable a neutral tax treatment would be neutral with regard to Government employees and private employees. There does not seem to be any difference in those characteristics.

Senator DOLE. That would not change anything that you have stated?

Dr. KIEFER. No.

Senator DOLE. I know under the old law, there was a flat exclusion on earned income from the taxpayer's gross income. One of the chief hopes of the administration is to simplify returns and tax laws. It seems, in some of the section 911 proposals, we might be going in the other direction. There would be a lot of bookkeeping by the employee and the employer.

That is a matter not covered in your study.

Dr. KIEFER. Well, the goals of tax policy that we specified at the first of our study are frequently incapable of all being achieved simultaneously. Simplification is one of the goals that we speak about a lot and sometimes do not accomplish as much as we would like to.

Senator DOLE. About every 4 years.

Dr. KIEFER. That is right.

But it turns out that it is possible to achieve something closer to tax neutrality in a way that is not all that complicated. Certainly, if only one adjustment were required to a tax liability, it would be simpler than separate adjustments for separate categories of expenses or remuneration.

So, in that sense, the neutrality standard that we have employed in our study is not really a complication. It may, in fact, be a simplification.

Senator DOLE. Thank you, Mr. Chairman.

Thank you.

The CHAIRMAN. Thank you very much, Mr. Kiefer.

[The prepared statement of Mr. Kiefer follows:]

STATEMENT OF DONALD W. KIEFER AND JANE G. GRAVELLE, THE LIBRARY OF CONGRESS, CONGRESSIONAL RESEARCH SERVICE

Mr. Chairman and members of the committee, I am Donald Kiefer and I am accompanied by Jane Gravelle; we are both specialists in taxation in the Economics Division of the Congressional Research Service of the Library of Congress. We thank you for the invitation to appear before you today to present the results of our study released on April 20, 1978, entitled "U.S. Taxation of Citizens Working in Other Countries: An Economic Analysis."

The approach of our study was to analyze the taxation of overseas American workers within the most general conceptual framework possible. To accomplish this we chose to employ the so-called principles or canons of taxation which have been developed over the years to offer guidance in developing and evaluating tax policy.

These principles include concepts such as: simplicity—the tax system should be simple to administer and simple for taxpayers to understand and comply with; neutrality—the tax system should cause minimum interferences in the economy; and equity—the tax structure should raise revenue on a fair and equitable basis. In addition to these objectives, the tax system should operate in a manner consistent with attainment of other economic goals, and, of course, should raise the necessary revenue for the operation of government.

The two taxation principles which seem to be the most relevant to the analysis of the taxation of overseas Americans are the principles of tax neutrality and tax equity.

TAX NEUTRALITY

The principle of tax neutrality would recommend taxing overseas workers in such a way that the U.S. tax system provides neither an inducement nor a discouragement to U.S. workers in deciding whether to accept employment abroad and to U.S. employers in deciding whether to employ American workers abroad.

If costs of living abroad are extremely high compared to the U.S., the combination of cost of living reimbursement for foreign employees and the progressive tax rate structure of the U.S. tax system suggests a tax adjustment based on the

principle of tax neutrality. The neutrality concept would require that if, in the absence of tax consideration, it would cost, say 50 percent more to employ a U.S. worker in a given foreign location than in the U.S., then this relative cost differential should also exist when taxes are considered. If the tax structure reduces the differential it would provide an incentive to foreign employment; if the tax structure increases the differential, it would discourage working abroad. If no adjustment were made to the tax liabilities of foreign workers in high cost areas, the progressive rate structure of the income tax would increase the cost differential, and thus discourage employment in such areas. This is because the higher wages paid by the employer to the foreign worker to compensate for the higher living costs become part of taxable income, and this taxable income will be taxed at higher marginal tax rates under the progressive tax rate structure.

Given this consideration, how should an adjustment for foreign living costs be structured to achieve *locational neutrality?* Clearly the adjustment should not be a full deduction of an amount equal to the compensation for higher living costs, because such a deduction would make the foreign worker better off than the domestic worker. For example, consider a domestic worker who accepts a job in a high cost foreign location and is exactly compensated by his employer for the higher foreign cost of living; in other words, his foreign real income is precisely the same as his domestic income. If the worker is allowed to deduct his cost of living adjustment in the foreign location, his effective tax rate will be reduced and he will have a higher real after tax income in the foreign location than he had in his domestic situation. However, the tax neutrality principle requires that the real tax burden of the worker in the foreign location be the same as it was in the domestic location.

Under a strictly neutral tax system, if the cost of living in a foreign location is 50 percent higher than in the United States, an American citizen who moves to that locality and receives a 50 percent higher salary would also pay a 50 percent higher U.S. income tax. Thus, for example, a U.S. citizen who pays 25 percent of his income in Federal income taxes would still pay 25 percent of income in U.S. income taxes if he accepted a foreign job with cost of living compensation. This system would preserve the relative before tax costs of United States versus foreign locations; thus, a location in which living costs are 50 percent higher, ignoring taxes, would also be 50 percent more expensive when taxes are considered. The principle of tax neutrality would also require that the tax adjustment should be made only for the cost of living in excess of the highest cost locale in the United States because otherwise the tax code would have nonneutral locational effects, in that it would provide incentives to accept jobs in foreign locations compared to high cost domestic locations.

By this strict interpretation of tax neutrality, all of the present alternative tax treatments of U.S. citizens living abroad are non-neutral. Our study examined the prior and present versions of section 911, the Administration proposal, H.R. 9251, and a hypothetical policy of allowing no tax adjustment for overseas workers. Example calculations show that, with the exception of the effects of present section 911 on upper income taxpayers in higher cost of living foreign locations, all of the alternative policies yield lower U.S. tax liabilities for overseas Americans than would a neutral tax adjustment. Of the five alternative policies examined, disallowing any tax adjustment for foreign taxpayers appears to most closely approximate the tax neutrality result overall, although the present section 911 produces results closer to the tax neutrality standard in higher cost foreign locations.

TAX EQUITY

The second principle of taxation employed in our study is that of tax equity. There are two aspects of tax equity which are usually considered: horizontal equity, or the equal treatment of those in equal circumstances (generally defined as those with equal incomes), and vertical equity, which is concerned with how the tax burden is distributed across income classes. In general, the points presented above regarding tax neutrality also pertain to the consideration of tax equity. Thus, to avoid discriminating among taxpayers with equal abilities to pay taxes, any cost of living adjustment for citizens working abroad would have to be based on the highest cost locale within the United States, and the amount of the deduction should be subjected to the appropriate effective tax rate. Specifically, a provision allowing deduction of living costs in excess of average costs in the United States would be inequitable to the large number of Americans who live in areas or cities within the United States where the cost of living is higher

than the average As a hypothetical example of this inequity, a tax adjustment which allowed a deduction of foreign living costs which exceed average living costs in the United States would allow deductions in excess of $5,000 for U.S. citizens working in Hong Kong and Tehran, Iran, but would provide no deductions to taxpayers in New York or Boston, even though the costs of living in these four cities are nearly identical. With regard to vertical equity considerations, because citizens working abroad have comparatively high incomes, tax provisions benefitting them tend to reduce the overall progressivity of the U.S. income tax structure.

EFFECTS ON TRADE AND EMPLOYMENT

In our report, the alternative tax treatments for overseas Americans are also evaluated in terms of achieving other economic goals, specifically in terms of their impact on foreign trade and employment. First, it must be observed that the relationship between U.S. tax treatment of citizens working in other countries and the quantity of U.S. exports is both indirect and uncertain. Since foreign investment and production by U.S. multinationals is in many cases a substitute for domestic production and exporting to the foreign markets, it seems ironic that subsidizing foreign operations should be perceived as stimulating U.S. exports. The argument has been made that foreign operation by U.S. multinationals expands their foreign sales and, because their foreign production uses U.S. produced inputs, thereby expands U.S. exports. Whether this effect outweighs the effect of foreign production substituting for U.S. produced exports is unknown and cannot be assumed without supporting evidence.

However, even if there were a direct relationship between tax treatment of citizens working abroad and exports, a tax subsidy would not have a permanent effect on the balance of payments because, under a system of flexible exchange rates, international currency price adjustments will render ineffective policies which attempt to have a *long-term* impact on a nation's balance of payments. With regard to employment and unemployment policy goals, tax subsidies for overseas Americans cannot contribute directly to solving the fundamental macroeconomic causes of either cyclical or structural unemployment problems. Even if preferential tax treatment for Americans working in other countries creates jobs in the export industries, under a system of flexible exchange rates this policy will likely accelerate the decline of import competing industries and lead to less employment in those sectors.

A recent study by the General Accounting Office performed an econometric analysis to estimate the maximum impact on U.S. trade and employment which could be anticipated from the 1976 changes in section 911 and calculated that the impacts would be very small.[1]

An argument which has been used in support of preferential tax treatment of Americans working abroad, and which is related both to the effects on trade and employment and to tax neutrality, is the issue of competitiveness. U.S. firms operating abroad maintain that increasing U.S. taxes on their employees will increase their wage costs, thus forcing their prices up and reducing their competitiveness. Similarly, U.S. citizens working in other countries claim that higher U.S. taxes will make them less competitive in the foreign job market with foreign nationals who are not taxed by their home countries.

The argument that reduction of tax benefits for overseas Americans would lead to a small reduction in U.S. business activities abroad is correct, and is viewed by firms as reducing their "competitiveness." Similarly, the argument that increased taxation of Americans working abroad would tend to lead to a substitution of foreign for U.S. employees (a substitution which has been occurring for years for other reasons) is also correct—and viewed by U.S. employees as a reduced ability to compete. The implications of these arguments must be considered carefully, however.

The goal of structuring the U.S. tax system to maximize the competitiveness of all U.S. workers and companies does not provide very useful guidance in either designing or evaluating tax policy. An obvious way to achieve this goal would be to reduce all taxes to zero. However, since the continued operation of government does require some tax revenue the question is how to raise the required revenue and at the same time cause minimum disturbances in the free market operation of the private sector of the economy. As emphasized in our report, this

[1] Impact on Trade of Changes in Taxation of Citizens Employed Overseas, Report to the Congress by the Comptroller General of the United States, February 2, 1978. See esp. chapter 3.

is precisely the goal of tax neutrality—to structure the tax system so it does not cause distortions in economic decisions unless some clear national purpose is served by such non-neutralities. As indicated in the analysis above, there is no clear evidence that artificially encouraging Americans to work abroad through the tax code serves an identifiable national economic purpose. Therefore, whatever benefits result from increased "competitiveness" of American firms and citizens in foreign locations appear to be at the expense of other Americans—through more inequitable taxes and through less efficient allocation of economic resources.

The CHAIRMAN. Next we will call George P. Shultz, president of Bechtel Corp.

Mr. Shultz, we remember you from your years around Washington. I think it might be useful for the record if you would recount all of the positions you served in here in Washington during the past 12 years or so.

STATEMENT OF GEORGE P. SHULTZ, PRESIDENT, BECHTEL CORP.

Mr. SHULTZ. Well, first of all, Mr. Chairman, let me say I am very pleased to have a chance to appear before this committee again. In the past I have spent many hours and had a certain amount of argument here and a certain amount of agreement here and I have always enjoyed the chances to appear.

My full-time jobs in Washington were first, in 1955 and 1956 as a member of the staff—the label was senior staff economist—at the President's Counsel of Economic Advisers. Arthur Burns was the chairman at that time.

The next full-time job I had in the Government was beginning in 1969 as Secretary of Labor, and then in June of 1970 I became the Director of the Office of Management and Budget which was newly created and based essentially on the Budget Bureau at that time.

In June 1972, I became Secretary of the Treasury. I served in that capacity for about 2 years. I resigned in May of 1974.

And, when you are Secretary of Treasury you get involved with all of the international lending agencies, with the IMF and a lot of other activities.

The CHAIRMAN. Well, you have been on both sides of this issue, both on the collecting end and I now take it you are on the putting up end.

Mr. SHULTZ. Yes, sir.

The CHAIRMAN. Insofar as your views have changed since you left Washington, it might be useful if you would give us, for the record, some indication of it, now that you are in the so-called real world where you are paying for those of us who live on the fat of the land up here who provide you with taxation, bureaucracy, and whatever helpful services we can provide in one respect or the other. We will appreciate and welcome your testimony and hope we can give you the same thoughtful consideration you gave other taxpayers when they came before the Treasury.

Mr. SHULTZ. Thank you, Mr. Chairman.

Well, Mr. Chairman, I have a statement, as you know, and if I may, I would like to file it for the record rather than read it. It is fairly lengthy, and also many of the points that are made in it have been made very well in the statement by Secretary Solomon, and I think especially in the comments made by Mr. Staats, and particularly in your ques-

tions on the Library of Congress study you have brought out many of these same points.

Also, I would say that I appear here on behalf of my company, Bechtel, and also Fluor, Dresser and Pullman-Kellogg.

In addition, the Tax Fairness Committee and the National Constructors Association have endorsed my statement.

Let me say first, Mr. Chairman, speaking from the standpoint of the Bechtel Corp., it is a company that has had a long history of work internationally, going back to the late 1930's. We have projects active now in about 23 countries and this overseas business represents about one-third of our total business.

So, in the course of my job, I do travel around the world a little and visit our jobs and talk to our people who are there. And the first comment that I would like to highlight from my testimony has to do with what you learn when you go around and talk to people who are working in all of these overseas locations, and I bring out the following points.

First of all, they are patriotic Americans and they are doing good work. It is well appreciated. The work is of high quality.

Second, they are generating exports because, as you and others brought out here, they design things to U.S. specifications; they know the situation here; they order here, so they are generating exports.

Third, they are very good ambassadors for our country because they are doers. They are actually involved in building something that the people there want and that will be of service to them, and in the process of doing that, they train people who are often unskilled to do useful things, to do carpentry work, plumbing work, and so forth. So in a very fundamental sense, they are good ambassadors.

And finally, they feel harassed and they feel uncertain and they feel left out by their own Government because when you go and talk to them, the first question they ask you is "what am I supposed to put down on my tax return? What is going to happen on this section 911?"

"Was I crazy to come over here in the first place? Am I going to get thrown in jail? I cannot possibly pay the taxes the IRS people around here are telling me I have to pay."

And there are people from our Government going around to these folks and saying, in effect, "I am going to get you. I am going to get you for being overseas." It breaks your heart, because they are doing good work.

So I think a little perspective of what life is like over there and the way the Government appears to them is instructive.

The second point I would like to make, Mr. Chairman, is this, and although I am here repeating things that have been said, an awful lot of the discussion on this issue of taxing the earnings of Americans overseas misses the main point, and I do think the Library of Congress study that was being discussed here is the latest illustration.

In saying this, I believe I am saying exactly the same thing as Secretary Solomon said, and as Mr. Staats said. The point that it misses is exactly how competitive things are overseas. If you want to get business, you have to be competitive.

So I would say the following things. First of all, these international markets are intensely competitive. People from all over the world are trying to get that business, and they are darned good.

The second point I would make, and I know this from my direct observation and experience, and you can see it, of course, in the record; but the second thing is that we can compete head-to-head with anybody if our Government will give us a chance. But if you insist—and I thought your boxing analogy here earlier was very good—if you insist on tying both hands behind our back and then send us over there to compete, we are going to get our head knocked off.

We have to have a chance, and if we have an equal chance with the people from other countries, we can compete, and we have proven it.

Third, I would say, as has been brought out here, and there is just no question about it, that the combination of the change in section 911 in the 1976 act plus the new approach the IRS has been taking to the treatment of these provisions is absolutely pricing Americans out of the market.

I think Mr. Staats brought out the example that was referred to by the GAO study of the married person in Riyad with the $40,000 income paying a $52,000 tax.

Now, you are going to come home under those circumstances. Or, if it is felt by the American firm necessary to keep that person there and you compensate him for the taxes that he is paying, then you pay the tax on the tax, and then you pay the tax on the tax on the tax, and so forth. The roll up here is gigantic and then if you try to bill a client for that, you could get thrown out on your ear.

So we are being priced out of the market by the way the tax system is being applied to Americans overseas.

And then finally, I believe that there is absolutely no question that the presence of Americans overseas helps our exports.

One of the companies that I participated with in working on this Fluor Corp., was building a refinery in a country in the Middle East at about the same time an Italian firm was building a very similar facility. They compared the amount of U.S. exports to the Italian job with the amount of U.S. exports to the Fluor job.

In the case of Fluor, 40 percent of the value of the construction put in place came directly from the United States as exports. In the case of the Italians, 7 percent.

So there is a dramatic illustration.

I was discussing this with a friend of mine named Ben Powell, an executive at Brown & Root, which also has a lot of work overseas, and he gave me another example. I asked him to write it down, and he did. I will just read it, if I may, because I think, again, it is pretty dramatic evidence on this point.

He says:

In 1976, I visited Bahrain in the Arabian Gulf and saw two large construction jobs. One project was that of Brown & Root at its fabrication yard, constructing oil production facilities and offshore platforms on which they were to be erected in the Arabian Gulf.

With American management in charge there was approximately $14 million of construction equipment on this job site, all of which was provided new in the United States except for one blast-shot recovery system purchased from Great Britain and one automatic plate burning machine from Japan, with these foreign purchases totaling $265,000 out of the total of $14 million.

So there is $14 million of new construction equipment over there, working on the American job.

The second project right alongside of it was the construction for approximately $340 million for a new ship drydock and repaid yard by a South Korean contractor with Korean management. All the construction equipment required for this project, whose value is estimated to exceed $50 million was manufactured in Korea, Japan, or Europe, and not one item was manufactured in the United States.

So the picture is really dramatic. And I think that it is true that the presence of Americans overseas does stimulate our exports. You can see it in those examples.

A third general point that I would like to make—and I see your light is on, Mr. Chairman, and I will speed this up——

The CHAIRMAN. Your time is not up.

Mr. SHULTZ. There have been quite a number of revenue estimates made about what it would cost the Government if, let us say, you went back to the old section 911 and to the IRS interpretations prior to the time the change was made. They vary, but at any rate, there are numbers ranging from $300 million to $500 million, in that general area, of Treasury loss. And much of the worry about doing what I believe should be done comes from this discussion of revenue losses.

Now, I believe that these revenue loss estimates are simply wrong. They are wrong because of the way they are made—and I do not blame the Treasury; they are the basic ones who do it—but what they have to do is they take the income base that is overseas before the change is made and then they say, okay, let us assume that the tax rates are changed and apply it to that same base and then we will see what difference is cranked up.

Obviously, what that assumes is that the income base is not affected by the tax change. Now, that is ridiculous. We know the base is going to be affected by the tax change. We know that the fellow Mr. Staats researched is not going to stay there. There is no way he is going to stay there.

So I think that the calculation is wrong. First, because the income base overseas will change. It will diminish tremendously. In our own company, since the 1976 revision was made, we have gone from 57 percent American expatriates in our nonmanual role overseas to 48 percent now.

So the overseas role is going to change.

Second, there is a tremendous amount of "mainland" support for overseas work based on calculations. We estimate, in our company that for every nonmanual person we have on a job overseas we have 1.77 people employed in support of that project here in the United States. So you have all of that employment that will have to find someplace else to work if overseas work stops.

Third is the point about the exports being generated, and it is going to affect the income base for the exports that do not come from the United States. They will come from Italy, they will come from Japan and so on and so on, instead of the United States, so somebody is going to have to make something else.

In the meantime, there is not going to be any income there.

Fourth, you lose all of the jobs involved in processing the exports—the people who drive the trucks, run the railroads, work on the docks, and so on, who are involved in this whole process.

So I think the assumption that you can change the taxes and nothing else changes and then you make a calculation based on that is just wrong.

My guess is that, if the course that now seems to be on the track is allowed to become final and take effect, the Treasury will lose more money than if it went the other way. I just feel that in my bones; I do not have any econometric studies that prove that.

So I would just say finally, Mr. Chairman, that I think there is a genuine need here. I believe that Mr. Staats said it directly and clearly and the GAO study also was very extensive, that two things are needed.

First of all, we have to do something about housing allowances, education allowances, cost-of-living allowances, home-leave allowances, they are not that complicated to do, that keep a person whole as a result of going and working overseas.

Second, we have to provide an income exclusion off the top as in the old section 911 so that we can be competitive with our competitors from other countries. That is not to say that these people would not pay any taxes; by no means. But that they have some break there so that we have a chance to compete on reasonably equal terms, and then we can compete and we can export and we can do the job for this country.

But our business firms, if you tie our hands behind our backs, are going to get beaten up.

Thank you, Mr. Chairman.

The CHAIRMAN. Let me just ask one or two things.

First, let's look at these countries competing with you in these places—let's take the Near East as an example. When they ship their equipment in, their governments have been financed mainly by these value-added-type taxes and, as I understand it, the way they do business, this is one thing they have succeeded in having in the General Agreement on Tariff and Trade, they are permitted to rebate at the border all of the tax burden represented by those taxes. Is that not correct?

Mr. SHULTZ. That is my understanding, Mr. Chairman.

The CHAIRMAN. All right. So if you assume that a country has a 15-percent value-added tax and that that tax is paying for social welfare programs and most of its defense programs and others, they can reduce that price by that 15 percent in selling into this third-party country. Is that right?

Mr. SHULTZ. Yes, sir.

The CHAIRMAN. All right. Now, I think that Ms. Gravelle did a study for the Library of Congress that you heard something about saying that DISC is not justified. How much does that give our people back, compared to the 15 percent that one would get back in a value-added country?

Mr. SHULTZ. I do not know the answer to that, Mr. Chairman, but the ideas are roughly similar. What the proportions work out to, I do not know. I am not familiar with the study you are talking about.

The CHAIRMAN. What I have heard from most American manufacturers is, is what the DISC gives them back is a relatively small

fraction of what these other countries get in the rebate of that value-added tax. Now, is that in accordance with what you hear from your business associates?

Mr. SHULTZ. Yes, I think that is generally right.

The CHAIRMAN. So they have that advantage in the beginning. Now, if in addition to that they are paying no taxes back home on their employees, that is an additional advantage that they have in addition to what I have just described.

Now, what is your reaction to the kind of argument that I have heard on occasion that some fellow is living over in Paris, having a big time, living it up, and that he is getting a tax break by this Government because of these provisions in section 911? How do you react to that situation, somebody in Paris or London having a big time, perhaps Rome.

Mr. SHULTZ. He had better be careful, if he is in Rome these days.

The CHAIRMAN. Or even the Riviera. I mean, you know, let's take the best case. What is your reaction to that type argument?

Mr. SHULTZ. Well, people who are living it up clipping coupons and what-not, these are not the people I am talking about. The people I am talking about are working on these jobs and producing things and doing a great service.

And it may very well be, Mr. Chairman, in dealing with this, if you do consider—and I certainly urge you to have an income exclusion—that you might want to say that as to certain metropolitan areas in Western Europe and Canada, where people who are living there are not eligible for the income exclusion. To define it that way, I think, would take care of the problem.

There are very few jet-setters who are living in Tehran or Jakarta, or similar places around the world.

I do not think that is a big item, but if it bothers people, I think it can be taken care of.

The CHAIRMAN. I have heard the statement made in testimony here that under the system of flexible exchange rates in effect that everything neutralizes itself; that, in effect, it all comes out in the wash. What is your reaction to that?

Mr. SHULTZ. Well, if you can construct a model and you let it run long enough, the flexible exchange rates, in theory, everything will come out in the wash. I think there are some questions that need to be raised about that.

No. 1, how far down do you want to drive the U.S. dollar when you have other tools in your hand? I think, myself, the scene we have before us today is most unfortunate, and too much weight is being put on the idea that we will just drive the dollar down some more and solve the problem.

It is hurting us abroad; no question about it. Not only is it an economic problem, it is a political problem.

Then, I think the second thing is that, if we are going to do it that way, there is going to be a long, drawn out and difficult transition for many people to undertake for these longrun effects to take hold. In the meantime, there will be so many spokes in the wheel that probably it will not work out as in theory. But certainly in theory, and if you let a long enough time pass, everything can be washed out. In a flexible exchange rate system, as they say, everything else is equal, which it is not.

The CHAIRMAN. That sort of makes me think of a situation where some fellow has his thumb on the scale and you say, oh, do not worry about that. The time is going to come when you are going to have your goods on the other side of the scale. When that time comes, that thumb is going to be to your advantage.

The heck of it is, when that time comes, he has his thumb on the other side of the scale, too, so that it did not work out the way you were planning.

Now, I find some difficulty understanding how this thing is supposed to work out in the long run. My impression is—and I have been around here for 30 years—these practices that discriminate against Americans keep on going. I do not expect to live long enough to see the thing turn around and head in the other direction.

It reminds me about the story I told about the man in the poker game where he says he thought he had won, but they say, "Oh, no, you do not win, this other hand is better than yours. It is a phloogie."

He says, well, why is that? I do not understand. There are not even two cards that match in that hand.

Oh, yes, but see the sign right there? It says, "A phloogie beats anything." That is a house rule.

Next round, he drew that same hand. He says, it is my turn to win. The other fellow says, "Oh, no, it is too bad. You lose."

He says, "Well, why is that?" And the other fellow says, "well, look at the sign behind you. Only one phloogie a night." That is another house rule that we play by here.

It seems to me that when the time finally turns around where we are supposed to benefit from one of these things, one of these longrun theories that somebody has, that we are likely to have the wires crossed on us again.

Senator CURTIS. Would the chairman yield right there?

Well, is it not also true that in the meantime there would be a great number of casualties and some gross unfairness on certain indivduals and companies.

Mr. SHULTZ. Well, there would certainly be a lot of rearrangement, and I do not think that there are some special advantages in being able to have your own citizens living and working abroad, which I have tried to bring out here, and which it would take, in a sense, a big change in exchange rates to offset.

Do not misunderstand me. I think that a flexible system of exchange rates is basically a good thing. But a continuously deteriorating dollar is not a good thing, and we need to do the things that in a market system of exchange rates keep our dollar as a strong currency.

The CHAIRMAN. Senator Danforth?

Senator DANFORTH. Mr. Shultz, if the entire amount of payment that an employee receives to compensate him for the increased cost of living is deductible or if it is excluded from his income taxes, he is not going to be any better off than if he had stayed in this country in the first place, is that not correct?

Mr. SHULTZ. That is the way it would seem to me.

Senator DANFORTH. It is simply compensation for the increased cost of living. It is not a windfall, right?

Mr. SHULTZ. That is exactly right.

Senator DANFORTH. And, from the standpoint of the employer, no matter how you design such a program, the employer is going to end

up having to pay more money to maintain employees abroad than if he kept the employees in this country. Is that not right?

Mr. SHULTZ. Yes, and of course, the amount depends upon the cost-of-living differentials that are found there. There may be some places where they are not extensive. so it will vary considerably.

Senator DANFORTH. Right. But say, in the Middle East, for example. It would cost, no matter how 911 were designed, it would cost the employer more to maintain employees in Saudi Arabia than it would to maintain the same employees in the United States?

Mr. SHULTZ. That is correct, and it is correct, in part, because when you send families overseas, naturally they adapt themselves to the local conditions as best they can and they should do so, but they also want to live like Americans to a reasonable degree, and they want to eat foods that they are accustomed to, to a reasonable degree, and so these things cost more money.

So there is a special cost of living there for the American or other foreigners in a given country that perhaps local people do not experience.

Senator DANFORTH. The point is, no matter how 911 is designed, the employee is going to be no better off than had he stayed in this country in the first place. The employer is going to be paying out more money than if the employee had stayed.

Mr. SHULTZ. Well, I think there are two different things here to be distinguished. One is the tax treatment of various payments made to keep the person whole and by definition their purpose is to keep the person as though he were in the United States, as to cost of living, housing, and so forth.

Then, second is the effort to provide some incentive for overseas work that puts a person competitively on the same basis as people from other countries. Now, we feel that if you are going to go and ask somebody to work in the desert and work the long hours—six 10's is a typical week there, and many people just prefer to work every day. Long, hard work. There is nothing else to do. in many cases—you cannot expect to pay the person the same thing as if he were going to live here in Washington, D.C. You have to pay him more to do that.

And so we think you have to say you are going to have an after-tax increase in your income as a result of undertaking that kind of assignment.

Senator DANFORTH. If you could measure the entire lifestyle of the person going abroad, the theory is that that person is not going to be better off had he stayed here in the first place. You are not conferring on him some windwall or bonanza, is that right?

Mr. SHULTZ. That is not a windwall or a bonanza. It is a payment for services rendered under very difficult conditions.

Senator DANFORTH. Now, with respect to this so-called principle of tax neutrality, I do not know whether that principle was put forth as a guide to judge tax policy or whether it was advocated as the principle which is desirable, but do you see any reason why tax neutrality should be a desirable principle?

It would seem to me that, in designing tax policy, rather than be neutral a strong case could be made for the Federal Government's providing positive incentives for American business to sell as much as possible.

Mr. SHULTZ. I think that is right. You could make a very strong argument, and I have tried to make it. I think one once again could say, if you were idealizing here and saying, "let us take the tax code and scrap it and then let's write a nice, simple new tax code with much, much lower tax rates and with no exemptions and so forth"—that has been advocated around various circles—then you would be applying principles of that kind.

But our tax code is so complicated because there are all sorts of things—some desirable, I think; some undesirable—that are being sought through the tax code. That seems to be the way we use it.

Senator DANFORTH. It is pretty clear, is it not, that there are other countries that are much more aggressive in developing markets and encouraging sales abroad than is the case in the United States?

Mr. SHULTZ. I think one could say practically every country is more aggressive in encouraging sales abroad than is the United States.

Senator DANFORTH. And also you indicated that, far from the ugly American idea of Americans living abroad, you believe that they have a positive role to play in affecting the image of our country and in extending the scope of America abroad in the world?

Mr. SHULTZ. I believe that. And I think particularly—you said "Americans working abroad." They are there, they are contributing, they are part of the work life of the community, they get to know people as they live and as I said, they train people to do useful things and I think, at least in our experience, when we leave, the people in the host countries are sorry to see us leave. They feel we have left something good, and we are proud of that. I think that is important for our country.

Senator DANFORTH. Thank you, Mr. Chairman.

The CHAIRMAN. Mr. Curtis?

Senator CURTIS. Dr. Shultz, I would join the chairman in welcoming you here. I think that there are few people as well qualified to speak on this subject as you are. In the interest of time, I am not going to elaborate. You have made your case very well and I agree with it.

In Nebraska, we happen to have a few good contractors doing business around the world and we have quite a number architect-engineering firms, and when they are invited or take an assignment in a foreign country, that is more or less the first step toward increasing American business and exports, and they, too, have a vital stake in this matter. Do you agree?

Mr. SHULTZ. Yes, sir, and I think that that is a very good point, because oftentimes we focus on the large company that can have a big export program and mount a sales effort abroad, and so forth. On the other hand, just that kind of architect-engineer setup that you mentioned in Nebraska tends to be as though it is a sales agent for all sorts of little companies scattered around that could not mount an export program of their own at all, but yet they are there, they are local. You know what they can do and you need something and so you order it from them. So they wind up exporting as a result of this process.

They would not know how to get to first base, otherwise.

Senator CURTIS. And when they draw their specifications they take into account such equipment and material as they know about and have had a lifetime experience in.

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You have made a strong case here. The hour is late. I will not continue the discussion, but that in no sense indicates that what you said is not very, very valuable.

The CHAIRMAN. Senator Dole?

Senator DOLE. As I understand your statement, Dr. Shultz, you support, with certain changes, what has been proposed in the Senate Finance Committee. You address those changes in your written statement.

Mr. SHULTZ. Yes. I think that the Finance Committee proposal, or what was voted out, recognizes the problem of keeping people whole. However, I do not believe it is complete, and in my statement I refer to certain areas where I think it ought to be reexamined, because I do not think it meets that objective.

In addition—and this is not in the bill at all—I think, as Mr. Staats said when he was testifying here this morning, that there needs to be some positive incentive in addition to the keeping whole. And so the old section 911, as it was written before the 1976 changes, something like that, it seems to me, belongs in the law.

That is not in your bill.

Senator DOLE. As I understand, the revenue loss under the Senate Finance Committee proposal is about $310 million, the loss under the 1975 law is $498 million, the 1976 act loss is $180 million, and the administration's bill is $254 million. There is some spread and some recognition, apparently by everyone, that the 1975 law probably should be changed. However, maybe not as much as some propose.

Mr. SHULTZ. Could I just interject something on those estimates, just to emphasize a point I made earlier? I think those estimates are demonstrably wrong, in every case, because they are based on the assumption—and I think, once again, Mr. Staats brought this out and the Treasury recognizes it; I am not stating a criticism that the Treasury is not well aware of—but they do not take into account the effects of the changes on behavior, and when behavior changes and people are no longer overseas, you do not have the tax base to tax.

So I think that those revenue loss estimates are just not correct.

Senator DOLE. What countries provide the most overseas competition for the American construction industries? What countries are the most competitive? Japan and Germany?

Mr. SHULTZ. Well, they are all competitive and it depends on the particular kind of project you are talking about. Of course, I am speaking of engineering and construction here, as distinct from manufacturing. Others could speak about that.

But there is strong competition from all of these countries—Japan, Germany, France, Italy, the United Kingdom. The Koreans are very competitive, and so on around the world. So there is a lot of competition, and we respect it.

At the same time, Senator, I repeat again that, if our Government will just give us a break, we can compete with these people. There is nothing wrong with what the Americans can do. We are desired.

But if the tax treatment makes us so expensive, we will just get priced out of the market, not because we are not any good, not because we are charging too much for our services, not because we are not competitive, but because our tax system just prices us too high. That is the root of the problem that we are talking about.

Senator DOLE. There is always a difference of opinion on what the real impact might be on jobs. I am not certain the CRS study had any reference to the job impact but I think GAO referred to the job market.

Have you tried to figure what the job impact would be on your company?

Mr. SHULTZ. Yes, sir, we can see it very clearly. We did a tabulation recently just to see what happened in our own employment overseas, proportionately. Since the 1976 Tax Act made this change and the IRS is making these changes, people are now uncertain and they do not know what is going to take place. Therefore, the proportion of our overseas nonmanual people when the act was passed was 57 percent, whereas today, it is 48 percent, and we are actively looking for individuals from other countries to take jobs. We have no other alternative.

Now, at the same time, it is suicidal to let that go too far, because we are an American firm. We are selling American know-how. We want to sell American exports. And if we say "Yes, we will do this job for you and we will have 20-percent Britishers and 20-percent Australians and 20 percent from Germany and so on and so on and we will have one American there," they will say, "That is not an American job. We might as well go and sign up with some contractors from some other countries."

Senator DOLE. I think that GAO estimated that the 1976 act might be a loss of 5,000 jobs annually in 1978, rising to 27,000 in 1982. However, the study points out that the U.S. economy generates 30,000 jobs a week. In that context, it would not be all that dramatic.

Are you familiar with the recent rulings by the U.S. Tax Court which ordered company cost-of-living allowances made taxable and the Internal Revenue Service regulations on computing the market value of overseas housing?

Mr. SHULTZ. Yes, sir. Those are causing us and our employees a tremendous amount of concern because they are proposing to tax the very things that you have to do to keep a person whole as a result of working overseas. And so, if you tax those things, you wind up with a bigger tax bill, as in Mr. Staats' example, than the man has income.

So you know that is not going to happen. The person is going to leave.

Senator DOLE. Thank you.

The CHAIRMAN. It seems to me, Mr. Shultz, if you are looking at it from the point of view of any country wanting to compete with the United States in most of these areas, going back to the end of World War II when they started rebuilding and the United States was the only one big enough and strong enough and well organized enough to move into a lot of these areas, when the other countries started to seek to compete with us in these third-party countries, we were what they had to contend with and if their governments were doing what an up and coming government would do, seeking a market for its product and business for its business people, it would do whatever it could do legally and within the rules of the game to give their exporters and their contractors and their business people abroad whatever incentive they had to provide to them to get in there in competition with the Americans.

Now, I would have to assume that they have been doing that, and that is why they are over there in the Near East and elsewhere competing with you. And it looks like we can all agree that they are giving their people tax advantages and whatever trade advantages they can, to get the business for their people.

Now, companies like yours are going to have to pay whatever it takes to get Americans to go there and apparently that is what you have been paying. It just costs a lot more to persuade Americans to go to all these less desirable places on the earth than it does to get them to work here.

But to the extent that that tax is raised beyond what it was, if you assume the competitive situation is anything like even, that really just puts you at a further disadvantage.

It is just about that simple, is it not?

Mr. SHULTZ. Yes, sir. Suppose a person goes from, let's say, Canada, to work in Egypt. He does not pay any Canadian tax on that income at all. So he is way ahead of the game. He gets a big, automatic uplift in his real income.

If another person goes from the United States and works right alongside the Canadian, he is heavily taxed. He is not only taxed on his income—what we think of normally as income—but all the things that we de to try to keep him whole, he gets taxed on them too. So it is basically an impossible situation that is being created.

The CHAIRMAN. So, as I indicated to the previous witness, this talk about tax neutrality, it amounts to the other governments doing all that can be done to help their citizens while we have people over here clobbering the Americans and trying to clobber them a little harder. That is about the way it looks from where you are sitting, I take it?

Mr. SHULTZ. That is the way it looks, no question about it. And I think another thing wrong with the idea of neutrality is that it is one thing to talk about it within the confines of competition inside the United States. Then if we say we are going outside the United States, then we are, in a sense, competing with a lot of other tax systems, and if we want to be out there, we have to recognize that fact, that reality.

The CHAIRMAN. It would seem to me that neutrality would indicate that all the nations ought to try to get together and agree on the rules of the game as to how much each will subsidize his competitor. And if we would agree to that type of thing, that would seem to me to be neutral.

But if you are going to let those people go to whatever degree they want to go to give their people an advantage, and at the same time cut back on our people, then this country may be moving in the wrong direction. While they are giving their people advantages, we are levying disadvantages on ours.

I do not see how our people can survive against this kind of competition.

Mr. SHULTZ. That is exactly the point, Mr. Chairman.

The CHAIRMAN. The only way we could survive is if we were smart and they were not smart, and I think if we engaged in that kind of intellectual arrogance, we are in for disaster.

But I can see the problem. I just hope that others can see it.

Thank you very much.

Mr. SHULTZ. Thank you, Mr. Chairman.

Senator DOLE. If I may, just one other question—there is some degree of urgency, is there not, that the Congress act quickly?

Mr. SHULTZ. There is great urgency in two senses. First of all, the people who are living overseas now must file their return by June 15. Already, people who were overseas and have come back have had to file their returns, so they are in a distressed state.

Second, there is urgency in that even leaving aside this immediate tax return problem, people are very upset. They are living in a house that is not that great, but it is extremely expensive. They are getting compensated for that, and they are saying to themselves, "What am I doing here? Am I going to get clobbered as a result of being over here and trying to do this work if these new tax laws apply?"

So they want to get that straightened out, and I do not blame them. We all do.

The CHAIRMAN. Unfortunately, Mr. Shultz, altogether too often these things tend to be decided on the basis of some movie actress or movie actor who took an apartment on the Riveria or somewhere and is living it up and enjoying a tax advantage by doing so; rather than in terms of the kind of people that you are speaking for, the kind of people that you are trying to employ, and having very difficult times trying to get them, who want to go and get out there in the field and work with a wrench or work side by side with other people in the field, to be the straw boss or do even some of the direct skilled labor on the construction jobs, and things of that sort.

In that context, I believe the Senate and the House would have an entirely different view of the situation.

Mr. SHULTZ. Well, I believe those kinds of "movie actor," "jet setter" type things can be taken care of. The numbers that we are talking about, Mr. Chairman, are not the numbers in those leagues anyway. We are not talking about millionaries here, we are talking about working people who are trying to do a job.

I was very pleased, incidentally, to see the letter that Bob Georgine, the head of the Building Trades Department of the AFL-CIO, wrote to you endorsing basically the kind of position that I was taking here, and I think that is of particular significance since I know labor has often scratched its head about some of these things affecting overseas taxation.

But Mr. Georgine has looked this one over and feels that it is in everybody's interest, and he wrote you to that effect.

The CHAIRMAN. Thank you very much.

Mr. SHULTZ. Thank you, Mr. Chairman.

[The prepared statement of Mr. Shultz follows. Oral testimony continues on p. 63.]

STATEMENT OF GEORGE P. SHULTZ, PRESIDENT, BECHTEL CORP.

Mr. Chairman and Members of the Committee, my name is George P. Shultz and I welcome the opportunity to appear once again before this distinguished Committee. I am President of the Bechtel Corporation, an international engineering and construction firm with headquarters in San Francisco. Today I am also speaking for two other such firms—Fluor Corporation of Los Angeles and Pullman-Kellogg of Houston—as well as Dresser Industries of Dallas, a major international supplier of petroleum equipment. My statement has also been endorsed by the Tax Fairness Committee and the National Constructors Association.

This hearing is especially timely for two reasons. The enactment of the 1976 legislation sharply raising U.S. income taxes on citizens and resident aliens working abroad, along with new interpretations by the courts and IRS of what con-

stitutes taxable income, has produced a strong consensus both in government and business that those changes, if allowed to stand, will have several unintended and highly undesirable effects.

Senator Ribicoff and your Committee has exercised leadership in this matter, and both are to be commended for seeking to deal with the substantive issues involved and also to once again extend the earlier Section 911 legislation to January 1, 1979—an extension that would protect those workers abroad who have to pay their 1977 taxes by June 15, 1978. As to the extension, clearly, time is running out and the earliest possible action by Congress is of the utmost importance. These taxpayers need to know where they stand.

The "long run" legislation which this Committee has been considering and which is reflected in H.R. 9251 (as adapted from Senator Ribicoff's bill, S. 2115) would substantively address the issues relating to Section 911. It is essential that permanent legislation be enacted, but I am concerned about certain aspects of that legislation which I shall come to in a moment. First, let me comment in some detail upon the substantive issues involved—issues that have clearly emerged from study and discussion during the many months which have elapsed since passage of the 1976 Tax Reform Act. In addition to discussing these issues, I will address briefly recent studies completed on Section 911. Studies done by the Treasury Department and the General Accounting Office are mentioned hereafter, while the most recent study by specialists at the Library of Congress is noted in a separate section.

My basic argument with respect to the substantive issues is as follows:

1. The U.S. tax bite makes it far more expensive to employ Americans overseas than the citizens of any other country.
2. The result is that individual Americans by the thousands are already losing out on job opportunities overseas.
3. As the presence of Americans on the job around the world declines, so the tendency to design to American standards and to order from American vendors declines. The American overseas is a "built-in" sales representative for American exports.
4. The inability to employ Americans on overseas jobs of U.S. engineering and construction firms and firms supplying equipment and services overseas, including those supplying them to the oil industry, adversely affects the ability of those firms to obtain contracts based on the appeal of American know-how. In turn, this makes a drastic difference in the country from which purchases are made for installation or for use in foreign locations.
5. The net result is a large-scale loss of American jobs
   - In overseas locations;
   - In the United States doing engineering and other home office tasks;
   - In the factories, offices, railroads, trucks, barges, docks and other locations engaged in manufacturing, sales, transportation and processing of exports.
6. The result is also bad news for our balance of trade and payments and for the value of the dollar on exchange markets. (Of course, if the dollar is driven down far enough and for long enough, accounts will eventually come into balance, but with a cost in terms of higher inflation.)
7. It is bad news also for Treasury revenues, since the income base will be significantly and adversely affected by the tax rate changes currently in prospect.

I will support these seven statements in the course of discussing key questions relating to the taxation of earnings of individual Americans living and working in other countries.

TAX FAIRNESS

I do not suggest for a moment that this nation should emulate most of our major competitors and exempt citizens working abroad from U.S. taxes. But I do believe that any such taxes should be levied and administered fairly and equitably—something that, in my judgment, is not the case under the 1976 legislation or in some IRS and court interpretations of earlier law.

Take, for example, an average Bechtel engineer working in Indonesia. Assume he would earn $27,600 ($2,300/mo.) in the U.S. Assume also that the cost of decent housing is $19,990, which is what it might well cost in Jakarta. If he receives a special housing allowance for that purpose, is it fair that he pay full taxes on the additional amount? To him, these are payments from which he receives no economic benefit; nor in my judgment does it represent tax fairness or equity. The same point can be made with respect to other allowances for costs of equalizing conditions for the person serving overseas. It must also be noted that the person or family residing overseas does not receive the same

level of government services as does the U.S. resident, especially the benefits of large scale Federal grants-in-aid to states or cities. Whether one considers the benefits of Medicare or Medicaid, revenue sharing, or any other form of Federal assistance to states and municipalities, the American serving abroad is in a situation far removed from his U.S. counterpart.

But I need not dwell on this point, for the letters, cablegrams and telephone calls that Senators have received from employees abroad have brought the story home. Clearly, unusually high foreign expenditures for housing, education, local costs of living, etc., need special treatment in the tax code.

REVENUE CONSIDERATIONS

With back-to-back Federal budget deficits projected in the $60-billion range, this Committee must be concerned about the revenue impact of changes in the tax laws. In a study of "Taxation of Americans Working Overseas" [1] released earlier this year, the Treasury seemed to conclude that a return to the pre-1976 provisions of Section 911 would "cost" the Government $318 million in revenue.

That conclusion is wrong. It is wrong because—as the Treasury is careful to point out—changes in behavior that one would reasonably expect on the part of affected taxpayers is ignored. Clearly, the static—"other things equal"—approach to estimating revenue impacts of tax changes is inappropriate, especially where reasonable assumptions can be made with respect to changes in taxpayer behavior.

When we make such assumptions with respect to the 911 issue, the conclusion is apparent that "second order" effects will be very significant. As a result, the "revenue cost" would be far less than is implied in the Treasury study.

Let me describe this more fully. If, combined with recent court decisions and IRS interpretations, the 1976 provisions affecting 911 are permitted to stand as enacted, the most obvious "second order" effect will result from the strong pressure on U.S. companies to substitute foreign for U.S. workers and technicians in overseas operations. The competition for international engineering and construction projects is intense and growing. This competition forces us to keep employee costs in line with our competitors—most of whom tax their nationals moderately or not at all. With respect to cost-plus contracts, which are widely used, the clients have in some cases insisted that additional workers we hire be nationals of these low-tax competitor countries. In addition, the tax situation may cause employees to decide on their own to return to the U.S., especially from what might be referred to as "hardship assignments." This is, I believe, already occurring, and the problem has been recognized by American labor.

As these citizens return to the U.S., the domestic labor force would increase and the problem of reducing unemployment would be greater as these citizens sought new jobs. Sooner or later they could be expected to find work, but during the interim, their taxable income would be greatly reduced, and unemployment benefit payments increased. Moreover, in order to regain employment, many of these workers might have to take lower paying jobs—still another example of extended second order effects as the impact of the tax changes "ripple" through the economy.

The argument regarding lost export earnings can also be most clearly understood if one traces this "ripple" effect. First, as noted above, there are direct U.S. taxes lost on the overseas business that U.S. firms are no longer doing. Second, also lost are U.S. tax revenues on employees based in the U.S. working for the parent companies, whose jobs are essential to the work being done abroad. Third, U.S. taxes are lost because goods and services are no longer being "pulled" from the United States suppliers of that foreign project. Fourth, U.S. taxes on income earned by all those engaged in export trade are lost, be it sales companies, transportation companies, dock workers, shipping companies, or the like.

In addition, the taxable income earned by U.S. businesses in other countries would decline as their competitiveness decreased, thus adding still another "second order" effect not considered in the Treasury study.

My conclusion is that the first order effects discussed in the Treasury study are only the beginning of a ripple that will expand throughout the U.S. economy to the second, third and even fourth order—all with significant future losses of revenue to the U.S. Treasury.

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[1] *Taxation of Americans Working Overseas*, Department of the Treasury, February 1978, p. 2.

INTERNATIONAL COMPETITIVENESS

The competitive impact of sharply increasing U.S. taxes on citizens working abroad will vary among industries and locations, but there is no question about its severity with respect to the engineering and construction industry or firms supplying equipment and services. There seems to be a widely held myth concerning "invincibility" of U.S. firms that needs to be dispelled. To be sure, U.S. expertise in the engineering and construction industry is immense and highly prized, especially in developing areas such as the Middle East. Likewise, U.S. technology in oil field and other services has historically been preeminent. Indeed, the companies that I represent here feel that, given half a chance by our own Government, we can compete around the world on a head-to-head basis with firms from other countries. But to assume that we are "the only game in town" is simply incorrect. For such business, we encounter growing, high-quality competition from companies headquartered in France, the United Kingdom, West Germany, Italy, South Korea, Japan, and elsewhere. None of these countries tax their citizens working abroad as we do.

For equipment and service contracts and construction projects, many of which are on a "cost-plus" basis, the problem is especially severe. Understandably, foreign officials and businessmen do not view what they consider to be excessive U.S. taxes as legitimate costs. And even if the contract is not "cost-plus," we must factor into our bid the higher remuneration necessary to keep U.S. workers in the area.

I have attached to my statement examples of how grossly costs can be escalated by the application of U.S. tax policies (including the effects of recent court decisions and IRS interpretations of the taxation of income) to the unusual circumstances existing in overseas work. These examples, derived from the data contained in Appendix V of the recently issued GAO report,[3] adequately exhibit that these recent policy changes are driving our citizens home. A single individual working in Saudi Arabia at an annual salary of $20,000 has had an increase in his total tax burden over 585% from what it was under the rules in effect just 2 or 3 short years ago. Such tax burden now equates to about 78% of his salary income. Nor does the married taxpayer escape—although his overall tax burden has increased about 226%—he is now expected to pay taxes totaling nearly 129% of his salary. At these rates per employee we very quickly become noncompetitive.

There is no way to translate the impact on the competitiveness of U.S. industry abroad into dollars and cents—but I assure you that the impact, present and potential, is large indeed. And this bears heavily, of course, on much broader aspects of U.S. international and domestic policy.

BROADER CONSIDERATIONS

If tax policy does in fact impair the international competitiveness of U.S. industry in world markets—and I believe it does—then it surely follows that this nation's ability to fulfill several important international and domestic goals is also impaired.

Most apparent, of course, is the problem of the balance of trade. Last year this country incurred a record deficit of $27 billion. Inevitably, with a rising money supply and rising inflation, the dollar declined in world markets, thereby increasing the cost of many of our imports and adding to domestic inflation. Foreign holdings of short-term dollar investments rose sharply. This increase will be of little concern if we move persistently and effectively to balance our international accounts, as I believe we must. But if we do not, significant liquidation of such investments somewhere down the road could prove troublesome indeed.

To me, the important point is not that the sky is falling—the economic and financial strength of this country is immense. Rather, the point is to recognize the foolishness of policies in the tax or any other area that needlessly compound our international financial problems. I submit that the existing 911 statute would do just that. I also submit—and I will come back to this with respect to legislative recommendations—that this Committee should consider ways in which our tax laws could be used, in positive fashion, to help meet these pressing problems.

Referring once again to my own experience, it is important to emphasize the extent to which U.S. goods tend to follow projects that U.S. firms plan and

[3] Report to the Congress by the Comptroller General of the United States, "Impact on Trade of Changes in Taxation of U.S. Citizens Employed Abroad," February 21, 1978.

carry out. For example, in constructing gas-gathering systems or an hydroelectric facility in a foreign country, or a host of other projects. U.S. engineers are more likely to use technology and techniques that require U.S. produced equipment and parts (and this will result in U.S. replacement parts being used throughout the life of the project). The engineers and constructors tend to become personally known and their work trusted. This leads to future contracts, as well as follow-on work, with additional positive benefits for the U.S. balance of trade.

A dramatic illustration of this U.S. export drain has been brought to my attention by Fluor Corporation and I believe it is important enough to share this factual example with you.

Of two grass-roots petroleum refinery projects for the same owner and located in the same Middle East country, one was awarded to Fluor and the other to an engineering and construction company of a third country. Fluor has been able to determine the percentage of the U.S. purchased goods and materials entering into the total costs of each of these projects. Their analysis indicates that whereas 40.2% of the constructed cost of their project is exported from the U.S., only 7.3% of the foreign competitor's shipments to the project are U.S. originated. Thus, on two similar projects for the same client in the same foreign country, imports from the United States for goods and materials acquired for inclusion in the project of the foreign firm were only 18.2% of that for the Fluor project. Is there any doubt that any competitor generally favors the goods, materials and services of his home country? In addition to this loss of export trade, there may be a loss of shipping revenue to our American flag merchant marine.

As this trend continues in the loss of overseas projects, reduction of exports of U.S. goods and materials to our projects and the inability to man our projects with the desirable U.S. personnel, Treasury revenue will continue to decline, especially when one takes into consideration the rippling effect throughout our national economy. Only by increasing our exports of men and materials can we overcome the foreign trade imbalance.

Nor does the process stop there. More exports means more domestic jobs in the U.S. This not only bolsters the standard of living of American workers at home, but augments Treasury revenues (another second-order effect) as more people are employed both at home and abroad and their taxable incomes and those of their employing companies increase.

Balance of payments aspects of the 911 problem are only part of the story. Both in terms of humanitarian concern and our own national interest, the importance of maintaining an effective U.S. "presence" abroad is of vital importance. This "presence" can be effected only in part through official government channels; there is no substitute for the role played by efficient and respected U.S. industry, especially in the developing countries. How better to generate goodwill and understanding than to bring U.S. expertise to bear on the problem of reducing poverty and increasing affluence through sound projects for increasing production of both the necessities and luxuries of life?

Much has been said and written in recent years about "good corporate citizenship" within the U.S. "Good international corporate citizenship" is only an extension of that basic theme. We should not let our tax laws hinder its maximum development.

THE GRAVELLE-KEIFER STUDY

I am personally convinced that these broad considerations, in effect, transform the 911 controversy from a relatively narrow issue of tax policy to a public policy issue of much greater ramification and importance. Again, we need not emulate our major competitors by eliminating U.S. taxes on our citizens working abroad; but neither should we permit some notion of "tax purity," however defined, to work counter to vital U.S. interests.

In this connection, Mr. Chairman, I should like to comment specifically on a recent "study" prepared by Jane G. Gravelle and Donald W. Kiefer, who are identified as "Specialists in Taxation and Fiscal Policy, Economics Division," of the Congressional Research Service of the Library of Congress.[3] This study purports to evaluate alternative 911 policies "according to the principles of tax neutrality, tax equity, and the achievement of national economic goals." I shall begin with a general comment to the effect that it is based in its entirety on a clearly erroneous assumption.

[3] "U.S. Taxation of Citizens Working in Other Countries: An Economic Analysis," by Jane Gravelle and Donald W. Kiefer, Congressional Research Service, Library of Congress, April 20, 1978.

On the final page of the study (p. 57), Gravelle and Kiefer agree that reduction of tax benefits for overseas Americans would lead to a reduction in U.S. business activities abroad, but argue that the reduction would be small. They also agree that increased taxation of Americans working abroad would tend to lead to a substitution of foreign for U.S. employees. But then they conclude:

"The standard of tax policy with respect to business and employee location decisions should be to achieve neutrality so that tax provisions do not cause distortions in location decisions unless some *clear national purpose* is served by such nonneutralities. As indicated in the analysis above, *there is no clear evidence that artificially encouraging Americans to work abroad through the tax code serves any identifiable national purpose.* Therefore, the resulting increased 'competitiveness' of American firms and citizens in foreign locations appears to be at the expense of other Americans—through higher and more inequitable taxes and through less efficient allocation of economic resources." [Emphasis added.]

Quite clearly, therefore, if it can be shown that tax incentives for U.S. citizens to live and work abroad do serve "some clear national purpose," then such incentives may be justified and the Gravelle-Kiefer study becomes almost totally extraneous.

I have in effect argued in my testimony this "clear national purpose" exists. It is in fact twofold: to help restore and maintain balance in our international accounts, and to continue the U.S. "presence" abroad that is so crucial in serving our broad goals of foreign policy. Free World security, and economic progress in both industrial and developing nations. Even more convincing to this Committee should be the official view of the Secretary of the Treasury and the strongly held view of Congress' own agency, the GAO, in favor of such incentives. As recently as April 21, 1978, Secretary Blumenthal pointed out that the laws relating to the tax liability of Americans overseas are unsatisfactory and unfair, that the net effect will be to cause Americans to leave overseas employment, and that:

"An overall reduction in American involvement in the economic development efforts of the Middle East would be severely injurious to U.S. policy objectives. Such involvement contributes positively and substantially to U.S. exports to the area, as well as to the economic development of an area of major importance."

In his recent report to the Congress on the same subject the Comptroller General of the United States stated:

"Because of the seriousness of the deteriorating U.S. international economic position, the relatively few policy instruments available for promoting U.S. exports and commercial competitiveness abroad, and uncertainties about the effectiveness of these, serious consideration should be given to continuing Section 911-type incentives of the Internal Revenue Code, at least until more effective policy instruments are identified and implemented."

These official statements make incomprehensible and Gravelle-Kiefer assumption that there is no identifiable national purpose to be served by the proposed legislation.

In any event it is the responsibility of Congress to identify any "clear national purpose" with respect to the 911 issue, and it has in fact done so. As noted in the GAO study (at page i) (but relegated to a footnote by Gravelle-Kiefer), for more than fifty years, Congress has "provided a substantial tax incentive to citizens employed abroad *to promote U.S. exports and commercial competitiveness.*" [Emphasis added.] To be sure, Congress today could change this longstanding policy, but such a step would seem highly questionable in the light of our pressing balance of payments and foreign policy problems.

I can only conclude that, in view of its basic assumption, the Gravelle-Kiefer study is useless; worse still, if its recommendations were followed, the national interest could be severely harmed. And even though the fundamental fault of denying the "clear national purpose" of 911 incentives in effect destroys the credibility of the study, there is one other important point that needs to be made.

The study purports to evaluate alternative policies according to principles of tax neutrality and tax equity. As I have already pointed out, it is not tax equity to tax citizens on payments from which they receive no economic benefit. Aside from this point, however, tax neutrality and tax equity are addressed by Gravelle-Kiefer solely in the context of United States tax policy. Ignored entirely is the fact that the Americans involved are working overseas and must compete for their jobs with nationals of other nations who are generally not taxed by their home countries. There is no tax neutrality or tax equity for an American working overseas who can be replaced by a citizen of Germany or Japan or Korea who pays no taxes to his home country. To ignore this aspect of tax neutrality

or tax equity is to do a great disservice not only to Americans working abroad, but to the American companies who compete abroad and must either employ foreigners or find themselves at a serious competitive disadvantage.

I have noted briefly in Attachment 3 many other assertions of the Gravelle-Kiefer report that are subject to serious challenge.

H.R. 9251

Mr. Chairman, I should like to comment briefly on the substantive provisions of H.R. 9251. I have already referred to the importance of postponing the effective date of new legislation until January 1, 1979. Not only would H.R. 9251 grant such an extension but it would also substantially address the 911 problem.

For some time now, the companies I speak for today, working with other interested parties, have studied the problem and various approaches to its solution. In light of these studies and our experience as an employer of Americans overseas, we should like to recommend some improvements in H.R. 9251. These improvements would include substantive changes, some technical changes, and inclusion of specific Treasury recommendations.

I am convinced that the two critical items that must receive recognition are (1) the importance of not treating as taxable income payments made to keep a person "whole" who moves overseas, and (2) the need for a genuine income exclusion that makes it possible for American business to remain in a competitive position overseas. An income exclusion which comes off of the top, i.e., reduces gross income before the tax rates are applied, is essential not only from the standpoint of tax equity, but also from the viewpoint of international competition.

To avoid treating as taxable income payments made to keep an overseas employee "whole," I recommend a change in the cost of living computation contained in H.R. 9251 that would more accurately reflect the actual cost of living problems faced by Americans living abroad. Secondly, I would hope the housing provision in H.R. 9251 could be amended to more adequately reflect the impact foreign housing costs have on U.S. employees living abroad. Thirdly, I would recommend that with regard to the allowance for education, the Committee include the cost of reasonable travel where there is no adequate local American type schooling. By so amending H.R. 9251, U.S. taxation would be more in line with the principles set forth in the earlier part of my testimony.

The Treasury Department recommended that costs of "home leave" once every two years be excluded from an employee's gross income. We agree with the Treasury recommendation but recommend that the allowance should be on an annual basis. The Treasury Department has also proposed changes in Section 119 of the International Revenue Code relating to the situation of those who live in camps. The changes recommended by the Administration should be adopted, but in addition they should be thoroughly reviewed to be sure that all legitimate camp situations are adequately covered. Further, we agree with the Treasury Department that the moving expense provision under Section 217 of the Internal Revenue Code should be liberalized.

There are two technical changes I believe should be made. The first is to eliminate some of the timing provisions, namely the so-called 510-day rule and the bonafide resident rule, so that an employee on an overseas assignment for a period of less than eighteen months can fall within the provisions of Section 911. In addition, resident aliens who accept American employment abroad should be included in the term "citizens" for purposes of Section 911, since they pay U.S. income taxes the same as citizens, but as the law is now, many are excluded from Section 911.

With these changes, it is my personal belief that the broad principles outlined in my testimony would be adequately and accurately reflected in the 911 legislation.

Legislation along the lines of H.R. 9251, together with the changes we have recommended would provide continued presence as well as equity for our taxpayers working abroad. The "revenue loss" to the Treasury would, when second-order effects are taken into account, be small; indeed, revenues could rise as sustained competitiveness of U.S. industry abroad bolsters exports, domestic jobs, and taxable income. And, of no little importance, our national "presence" in many countries around the world would be enhanced.

The General Accounting Office in its recent study (Digest, page i) states the case well. Referring to changing world economic conditions, raw materials needs, export balances, and the need for the United States to remain competitive, the report states:

"* * * it is essential to maintain a large force of U.S. citizens abroad to promote and service U.S. products and operations. Major industrial competitors of the U.S. do not tax their non-resident citizens. The United States does. This reduces U.S. competitivness in overseas markets."

CONCLUSION

Mr. Chairman, while in Federal service between 1969 and 1974, I had the privilege of working with this distinguished Committee. I am pleased to have this opportunity once again. If I can be of further assistance to this Committee in connection with this very serious national problem, I shall be happy to do so.
Thank you very much.

ATTACHMENTS 1 AND 2

ANALYSIS OF TAX IMPACT USING GAO EXAMPLES

	1975 rules	1975 rules with Tax Court changes	Tax Reform Act rules	Excess of Tax Reform Act over 1975 rules	
				Amount	Percent
SINGLE TAXPAYER					
Saudi Arabia:					
Salary	$20,000	$20,000	$20,000		
Allowances	12,458	33,210	33,210		
Foreign-earned income	32,458	53,210	53,210		
Total U.S. and foreign tax	2,281	10,077	15,628	$13,347	585.1
Taxes as percent of salary	11.4	53.8	78.1		
Japan:					
Salary	$20,000	$20,000	$20,000		
Allowances	11,121	26,850	26,850		
Foreign-earned income	31,121	46,850	46,850		
Total U.S. and foreign tax	6,501	7,324	13,990	$7,489	215.2
Taxes as percent of salary	32.5	36.6	69.9		
Mexico:					
Salary	$20,000	$20,000	$20,000		
Allowances	9,216	13,380	13,380		
Foreign-earned income	29,216	33,380	33,380		
Total U.S. and foreign tax	12,188	12,188	12,188	0	0
Taxes as percent of salary	60.9	60.9	60.9		
Hong Kong:					
Salary	$20,000	$20,000	$20,000		
Allowances	7,310	19,382	19,382		
Foreign-earned income	27,310	39,382	39,382		
Total U.S. and foreign tax	3,826	4,447	9,812	$5,986	156.5
Taxes as percent of salary	19.1	22.2	49.1		
MARRIED TAXPAYER (FILING JOINT RETURN)					
Saudi Arabia:					
Salary	$40,000	$40,000	$40,000		
Allowances	45,894	91,372	91,372		
Foreign-earned income	85,894	131,372	131,372		
Total U.S. and foreign tax	22,898	45,409	51,662	$28,764	225.6
Taxes as percent of salary	57.2	113.5	129.2		
Japan:					
Salary	$40,000	$40,000	$40,000		
Allowances	39,202	71,932	71,932		
Foreign-earned income	79,202	111,932	111,932		
Total U.S. and foreign tax	26,124	35,932	44,057	$17,933	168.6
Taxes as percent of salary	65.3	89.8	110.1		

ANALYSIS OF TAX IMPACT USING GAO EXAMPLES—Continued

	1975 rules	1975 rules with Tax Court changes	Tax Reform Act rules	Excess of Tax Reform Act over 1975 rules	
				Amount	Percent
Mexico:					
Salary	$40,000	$40,000	$40,000		
Allowances	25,964	32,600	32,600		
Foreign-earned income	65,964	72,600	72,600		
Total U.S. and foreign tax	35,167	35,167	35,167	[1] 0	0
Taxes as percent of salary	87.9	87.9	87.9		
Hong Kong:					
Salary	$40,000	$40,000	$40,000		
Allowances	23,528	53,018	53,018		
Foreign-earned income	63,528	93,018	93,018		
Total U.S. and foreign tax	11,916	25,525	33,324	$21,408	279.7
Tzxes as percent of salary	29.8	66.3	83.3		

[1] No effect as effective foreign tax rates are in excess of those in United States.

Note: All numbers for salary, allowances, foreign earned income, and total U.S. and foreign tax income are taken from app. V, beginning at p. 116, of the GAO report cited earlier.

ATTACHMENT 3

ADDITIONAL COMMENTS ON SPECIFIC PORTIONS OF THE GRAVELLE-KIEFER REPORT

(1) *Page iii*: ". . . any cost of living adjustment for citizens working abroad should be based on the highest cost locale within the U.S. . . ."

Comment: Why? The decidedly tortured reasoning that lead Gravelle-Kiefer to this conclusion is derived from their personal view that domestic "tax neutrality" and "tax equity" should be the deciding factors in the 911 issue. But the Congress has consistently viewed the provision as an incentive to promote exports and commercial competitiveness.

(2) *Page iv*: ". . . the relationship between U.S. tax treatment of citizens working in other countries and the quantity of U.S. exports is indirect and uncertain."

Comment: This statement not only flies in the face of common sense; the authors themselves in effect state the opposite on p. 57 (as noted earlier) in agreeing that reduction of tax benefits for such workers would lead to a reduction in U.S. business activities abroad.

(3) *Page iv*: "However, even if there were a direct relationship, a tax subsidy would not have a permanent effect on the balance of payments because, under a system of flexible exchange rates, international currency price adjustments will render ineffective policies which attempt to have a long-term impact on a nation's balance of payments."

Comment: Although I would yield to no one in supporting flexible over fixed exchange rates, other proponents have grossly overstated their role and impact in the real world.

First, rates may be more flexible than in the past, but they are not freely floating; countries intervene in currency markets to effect changes they believe to be in their national interest. In fact the International Monetary Fund met only recently to discuss appropriate "rules of the road" and accompanying "surveillance" to try to get away from what the press calls "dirty floats."

Second, the Gravelle-Kiefer argument—one that, unfortunately, has been used in other contexts much too frequently—assumes that price is the dominant if not only factor in international trade, when in fact a whole host of other factors intrude (e.g., financing arrangements; tariff and other barriers; custom and tradition; international political and security considerations; etc.).

Third, if experience in 1977–1978 has proved anything, it is that reliance on a shrinking dollar to balance our transactions is a dangerous policy indeed. It generates ill will abroad and more inflation at home.

(4) *Page iv*: "With regard to employment and unemployment policy goals, tax subsidies for overseas Americans do not contribute directly to solving the causes of either cyclical or structural unemployment problems."

Comment: It is estimated that one out of eight jobs in this country is export related. Therefore, the question before the Committee is whether tax incentives of the 911 type promote exports. The evidence that they do seems to me to be clear. If so, the impact on U.S. employment is obvious.

(5) *Page v*: ". . . the resulting increased 'competitiveness' of American firms and citizens in foreign locations appears to be at the expense of other Americans."

Comment: This type of tunnel vision typifies many who believe that "equity" (defined in the image of Gravelle-Kiefer) is the end-all and be-all of tax policy. If jobs are created; if adequate supplies of scarce resources (e.g., energy) are assured; if international trade expands; if our allies abroad are strengthened politically and economically by our presence and economic contributions—then any so-called "expense of other Americans" related to considerations of "tax equity" is offset many times over.

(6) *Page 2*: "The Treasury Department has estimated the revenue loss from the version of the law prior to the 1976 changes and Tax Court decisions at $563 million. The Tax Court changes reduced this amount by $65 million to $498 million. The 1976 changes reduced that loss by $318 million for a total loss of $180 million. The Senate Finance Committee bill is estimated to cost $310 million, while the Treasury proposals would involve a revenue loss of $255 million."

Comment: These figures are phony. As I emphasized in my earlier testimony, they ignore "second order" effects and therefore greatly overstate any "revenue cost" of 911-type legislation.

(7) *Pages 11–12:* "Over the years a number of principles or canons of taxation have been developed to offer guidance in developing and evaluating tax policy. . . . The two taxation principles which would seem to be the most relevant to this analysis are the principles of tax neutrality and tax equity."

Comment: I have already noted the case—and the proclivity of Congress—for another principle: incentives relating to our international position and goals. But here it is important to note an implicit assumption to the Gravelle-Kiefer analysis; namely, that such principles or canons are subscribed to and followed by our competitors in world markets. Quite the contrary; almost all other industrialized nations with which we compete tax their nationals working in other countries not at all. International tax policies should not be established on the basis of theories or "principles" that apply primarily to domestic factors.

(8) *Page 14:* ". . . it must be observed that considering costs of living in a discussion of appropriate treatment under the U.S. tax code is itself unusual. The U.S tax system is not inflation-indexed to account for rising costs of living each year, nor is the system indexed to account for variation in costs of living among areas within the United States, though such variation is considerable."

Comment: The authors are correct. They have effectively pointed to domestic inequities in the tax code. There is no reason why those inequities should be extended to workers abroad, especially when the side effects can be so damaging to the national interest.

(9) *Page 36:* "Whether residence abroad should be considered as a relevant characteristic for horizontal equity considerations is, of course, a subjective question. In general, location has not been viewed as a relevant characteristic in the United States in terms of horizontal tax equity."

Comment: Again, the question involved relates to international—not domestic—tax policies. Moreover, as noted earlier, the fact that domestically "location" has not been viewed as relevant in no way supports the case for continuation of that policy.

(10) *Page 44:* "The argument is occasionally made that individuals living abroad receive smaller benefits from U.S. Government services than those living in the United States, and therefore overseas Americans should be exempt or partially exempt from the Federal income tax. However, no one seriously argues that the U.S. Federal income tax is based on the benefits received principle of taxation."

Comment: The last statement is fundamentally correct, but misses the point The fact is that citizens working abroad fail to realize many of the benefits of their tax dollars, a rising number of which are being returned to State and local governments, colleges, etc., for direct benefit to taxpayers residing in this country.

(11) *Page 48:* "Since foreign investment and production by U.S. multinationals is in many cases a substitute for domestic production and exporting to the foreign markets, it seems ironic that subsidizing foreign operations should be perceived as stimulating U.S. exports."

Comment: This bald assertion is open to serious challenge and smacks of a desire for a type of "economic isolationism" that one would scarcely expect to find in a document published under the imprimatur of the Economics Division of the Library of Congress.

(12) *Page 49:* ". . . the relationship between U.S. tax treatment of citizens working in other countries and the quantity of U.S. exports is indirect and uncertain. The GAO report . . . suggested that a more direct relationship may exist because 'it is essential to maintain a large force of U.S. citizens abroad to promote and service U.S. products and operations'; however, there seems to be no specific evidence in the export experience of the U.S. or other countries to support this assertion (e.g., the substantial success of imported automobiles, televisions, calculators, etc., in this country has not been accompanied by an influx of foreign nationals to sell and service them)."

Comment: Bechtel can employ third-country engineers and managers, but to do so in large numbers will hardly enhance our efficiency or client regard for American expertise. In addition, the high technology exports so important to the U.S. trade position often require installation and servicing by American experts. As to the reference to our import of automobiles, television sets, and calculators, the inference is absurd—we developed those products and are more than capable of marketing and servicing them.

(13) *Page 15:* "In the case of some foreign countries whose economies are heavily dependent on the international trade sector, this concern [with the value of a country's currency] may be greater than in the United States."

Comment: Perhaps so, but it should not be. Last year, the U.S. logged $120 billion in exports; something in the order of seven million jobs are related thereto. In addition, important resources, such as energy, will have to be imported more and more in coming years, and the simple fact is that a weak currency raises their cost and boosts inflation in the U.S.

(14) *Page 53:* "The GAO study employed the Data Resources, Inc. (DRI) econometric model of the U.S. economy to estimate the effects on U.S. trade and employment of the 1976 amendments to section 911. . . . Basically, the GAO Report concludes that the impact of the tax change on U.S. exports and employment is extremely small."

Comment: It is impossible to set forth the economic impact of tax incentives for U.S. workers abroad in quantitative terms. Econometric models can be useful for a variety of purposes, but when so many intangible, unmeasurable factors (as in the case of the 911 issue) are involved, the results can be extremely misleading. In those instances, common sense must be relied upon—and common sense should tell us that the more Americans there are working and living abroad, the more business we shall do there, the higher our exports will be, and the greater the second-order effects on domestic jobs and economic growth.

ATTACHMENT 4

U.S. AND OVERSEAS EMPLOYEES TAX FAIRNESS COMMITTEE

Guy F. Atkinson Company, 10 W. Orange Avenue, S. San Francisco, Calif. Badger America, Inc., One Broadway, Cambridge, Mass. Bechtel Corporation, 50 Beale Street, San Francisco, Calif. Henry C. Beck Company, 4600 1st National Bank Building, Dallas, Tex. Louis Berger International, 100 Halsted Street, East Orange, N.J. Black & Veatch International, P.O. Box 8405, Kansas City, Mo. Blount Brothers, P.O. Box 949, Montgomery, Ala. C. F. Braun & Company, 1000 South Fremont, Alhambra, Calif. Brown & Root, 1730 Rhode Island, NW., Washington, D.C. Camp, Dresser & McKee, One Center Plaza, Boston, Mass. Caterpillar Tractor Co., Peoria, Ill. CH2M Hill International, 200 S. W. Market Street, Portland, Oreg. Crawford & Russell, Inc., 733 Canal Street, Stamford, Conn. D'Appolonia Consulting Eng., Inc., 10 Duff Road, Pittsburgh, Pa. DeLeuw Cather Int'l., Inc., 165 West Wacker Drive, Chicago, Ill.

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Chicago, Ill. C. E. Lummus Company, 1515 Broad Street, Bloomfield, N.J. Arthur G. McKee & Co., 6200 Oak Tree Boulevard, Independence, Ohio. Boyle Engineering Corp., Post Office Box 3030, Newport Beach, Calif.

Morrison-Knudsen Co., Inc., P.O. Box 7808, Boise, Idaho. Pacific Architects & Engrs, Inc., 1800 M Street, NW., Washington, D.C. The Ralph M. Parsons Co., 100 West Walnut Street, Pasadena, Calif. Procon Incorporated, 30 UOP Plaza, Des Plaines, Ill. Pullman-Kellogg Company, 1300 Three Greenway Plaza E., Houston, Tex. Raymond International Inc., P.O. Box 22718, Houston, Tex. Sverdrup Corporation, 800 North 12th Boulevard, St. Louis, Mo. Stone & Webster Eng. Corp., 245 Summer Street, Boston, Mass. M. M. Sundt Construction Co., 4101 E. Irvington, Tucson, Ariz. Teleconsult, Inc., 2555 M Street, NW., Washington, D.C. Tippetts-Abbett-McCarthy-Stratton, 345 Park Avenue, New York, N.Y. Vollmer Associates, Inc., 62 Fifth Avenue, New York, N.Y. Wilson-Murrow, P.O. Box 28, Salina, Kans. Woodward-Clyde Consultants, 600 Montgomery Street, San Francisco, Calif.

Attachment 5

National Constructors Association

ENGINEERS-BUILDERS, OIL REFINERS, CHEMICAL PLANTS, STEEL MILLS, POWER PLANTS, OTHER INDUSTRIAL FACILITIES

1978 Directory

1101 15th Street, NW., Suite 1000
Washington, D.C. 20005
(202) 466-8880

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Robert M. Gants, Vice President—Government Relations
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Noel C. Borck, Ass't Vice President—Labor Relations
Jennie Mackey, Office Manager
James D. Lawlor, Director—Legal Research
David J. Burch, Administrative Assistant

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Koppers Company, Inc., Engineering & Construction Division, Koppers Building, Pittsburgh, Pa. 15219, 412-227-2000.
Leonard Construction Company, Corporate Square Office Pk., P.O. Box 14547, St. Louis, Missouri 63178, 314-694-1000.
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Edward Pavlini, Vice President, Research-Cottrell, Inc.
Richard E. Johnson, Senior Vice President, Wright-Schuchart-Harbor.

The CHAIRMAN. Next, we will hear from Mr. Richard M. Hammer of Price Waterhouse & Co.

STATEMENT OF RICHARD M. HAMMER, PRICE WATERHOUSE & CO.

Mr. HAMMER. Thank you very much, Mr. Chairman and members of your committee. I am absolutely delighted to appear here in my capacity as a representative of Price Waterhouse & Co., an international accounting firm with offices in 90 countries around the globe.

Our clients include multinational corporations employing U.S. citizens in virtually all places in the world. As part of our clients' service, we prepare tax returns for U.S. citizens working abroad.

For 1977, for example, we are preparing approximately 6,000 U.S. tax returns worldwide and we employ 60 U.S. tax professionals in overseas offices to handle this load, and this is in addition to our U.S.-based tax staff.

We also assist the employers, our corporate clients, in determining excess tax reimbursements. Accordingly my statement to the committee is submitted in my capacity as a concerned professional engaging in practice in this area and not, as such, specifically representing any company, any organization or any group of companies.

First, and referring to Senator Dole's question, the last question that he asked of Mr. Shultz, we strongly urge Congress to take prompt action to enact the Tax Treatment Extension Act of 1978, H.R. 9251, in order to postpone for 2 years, at the very least, the 1976 Tax Reform Act changes and the earned income exclusion rules.

In my view, this action is needed almost immediately to enable U.S. citizens abroad to properly file their 1977 returns by the extended due date of June 15, 1978. The fact, as Mr. Shultz indicated, taxpayers who may have returned during 1977 or prior to April 15, 1978, have already had their filing deadline to face, and have either had to file for an extension of time to file until June 15 or face the filing of an amended return.

We are fast approaching June 15 and our offices around the world are delaying completion of the returns in the expectation that H.R. 9251 will be enacted. They are reluctant to repeat last year's fiasco, I might say, of filing returns under existing law, which was subsequently amended.

In addition, many taxpayers have not, as yet, received their refunds on their 1976 amended returns.

Second, we urge Congress to consider favorably, at the very least, an amalgam of the proposals of H.R. 9251 and those of the administration to allow U.S. citizens working abroad to exclude allowances for excess living costs which are noncompensatory in nature and are, in substance, additional business expenses relating to the foreign assignment—and this does not even approach the question of an incentive.

We believe that this action on your part is necessary in order to give fair and equitable tax treatment to U.S. employees working abroad, their employers and mainly, in order to preserve, as has been brought out here this morning, the competitiveness and effectiveness of U.S. citizens abroad.

I think Mr. Shultz' comments were very well taken on that point.

My statement is based on a premise contained in the GAO report. This report stated that in order to prevent a continuing deterioration of the U.S. international position, and to maintain the international

competitiveness of U.S. multinational corporations, it is essential to retain a large force of U.S. citizens abroad to promote and service U.S. products and operations.

We agree with this conclusion, because it has been our experience in servicing multinationals that U.S. businesses have a need to send U.S. citizens abroad to insure that the business of the foreign subsidiary is conducted in accordance with U.S. standards and techniques.

U.S. citizens are needed to promote the export of U.S.-produced goods and U.S. technicians are needed to install, service, and maintain exported products and, in fact, to seek out technology developed abroad for application in their operations.

The United States, as has also been brought out here this morning, is virtually unique in that it taxes its citizens regardless of residence with the allowance of a foreign tax credit to reduce the incidence of double taxation. Thus, U.S. citizens working abroad are at disadvantages vis-a-vis their foreign counterparts, because a U.S. citizen has to pay taxes to two jurisdictions.

The U.S. employer, in order to insure the employee abroad a net disposable income equal to that which it would apply had he remained at home, must reimburse the U.S. citizen for his excess U.S. and foreign tax costs, as well as excess living costs, as has been brought out here this morning.

As we see it from our perspective, the results of extra costs of sending U.S. citizens abroad could be these. U.S. employers attempt to staff posts with foreign nationals, thereby reducing job opportunities for U.S. citizens.

Second, where U.S. citizens must be employed, the additional costs are bound to increase the costs of U.S. products and services which are especially severe for labor-intensive industries such as the construction industries, which I believe came out in Mr. Shultz's remarks. This, of course, has its adverse impact on the competitiveness of U.S. business.

Third, foreign national employees tend to purchase foreign-made rather than U.S.-made goods, and this has its adverse impact on the U.S. export performance.

U.S. business today is, indeed, facing stronger competition from multinationals from other countries and, as is well known here, the United States has a severe balance-of-payments problem. Under these circumstances, I believe it would be in the national interest to increase the earned income exclusion in one fashion or another.

Instead, in 1976, the Tax Reform Act went the other way and reduced this exclusion.

I think it has been alleged that U.S. citizens abroad receive a tax advantage over their U.S.-based counterparts. This, in fact, was the sum and substance of the Congressional Research Service study.

However, the U.S. citizen abroad is not only being taxed on his compensation but also on the value of allowances received to cover the additional costs of maintaining a Western-style standard of living. All of these allowances are taxable compensation to the employee, although they only enable him to live as he would have lived in the States, and I think this point was brought out by Senator Danforth's line of questioning earlier.

Obviously, in our view, there is something wrong with a tax law which does not recognize the noncompensatory nature of these excess

cost allowances. It is true that there are differences of living costs within the United States, as has been pointed out. However, the differences cannot be compared, in our experience, with those in the Middle East, Japan, and other developing countries.

In effect, the earned income exclusion of section 911 has been the only recognition of the fact of this double taxation and alleviation of additional living costs, and its reduction absolutely comes at the wrong time. It comes at a time when U.S. citizens are being sent to more distant, less developed, and consequently more expensive locations.

Various studies, as you know, have been made attempting to determine the additional tax costs of the 1976 act on the U.S. economy. The GAO report concedes that the full impact on the U.S. economy of the tax increases levied on U.S. citizens abroad cannot be objectively measured at this time due to data limitations as well as to the intangible values accruing to having Americans abroad, and I think that was also brought out by Mr. Shultz.

We seriously question, ourselves, whether it is possible to draw firm conclusions from a study based on the facts available and the assumptions that have to be made, but we worry if we did something adverse to having U.S. citizens abroad that the impact might be undoubtedly adverse.

The CRS conclusions on the impact of these taxes on the U.S. economy are based on data in the GAO report, for the most part. The study attempts to evaluate the various methods of taxing U.S. citizens abroad on abstract standards of domestic tax neutrality, which unfortunately leads away from the practical reality from the concept of international tax neutrality and could obviously result in legislation of unworkable complexity and administrative burdens.

The study criticizes, for example, the concept of a deduction of cost-of-living allowances at the taxpayer's marginal tax rate. Instead, it suggests that neutrality requires the deduction be allowed at the taxpayer's average, or effective rate.

Now, this would require the employer to give an allowance in excess of the actual additional living costs to compensate for the additional tax thereon, thus, in effect, creating additional tax revenue for the Treasury and additional costs to the employer.

This, I believe, conflicts with the stated aim of neutrality.

The CRS study of tax neutrality focuses strictly on a comparison of the U.S. worker in the United States of America versus the U.S. worker abroad. I think, as was brought out in the last line of questioning, in international trade it is more realistic to compare the treatment of a U.S. enterprise and its employees with the treatment of a foreign enterprise and its employees by the foreign country.

For example, a U.S. citizen employed by a U.S. construction operation or contractor in Saudi Arabia remains fully subjected to U.S. tax on his income and allowances. On the other hand, the employees of a U.K. competitor, or any other country, who are sent to Saudi Arabia are exempt from taxation in their country of citizenship, their domicile.

Since there are no personal income taxes in Saudi Arabia, the foreign national pays no taxes while in Saudi, which makes it easier to find people to accept this type of an assignment and reduces the cost to the employer.

In conclusion, then—as I see the gong just went—let me summarize. We urge you to take immediate action to enact the Tax Treatment Extension Act of 1978, particularly in regard to the extension of the filing date or the extension of the 1976 rules effective date until at least 1979.

We also urge you to favor the proposals to provide a fairer and more equitable basis of taxing U.S. citizens working abroad.

With my statement, I have attached a chapter from a book recently published by the Financial Executive Research Foundation, of which I am co-author with two of my partners. It is entitled "Accounting for the Multinational Corporation." The chapter in question deals with the entire subject of expatriate compensation of U.S. employees.

I have also attached a copy of a resolution of the 1974 Congress of the International Fiscal Association on the Taxation of Temporary Residents.

Again, let me express my appreciation for the opportunity to appear before you.

The CHAIRMAN. Your thought is that if you want to pursue the concept of tax neutrality, you ought to think in terms of who it is that the American worker is competing with rather than who it is that he is not competing with; and apparently this Library of Congress study made by Mr. Kiefer and Ms. Gravelle, apparently proceeds on the theory that the American worker overseas is competing with the guy who preferred not to go overseas. Actually, his competitor is that West German or that Englishman or that Italian or that Japanese or that Canadian who did prefer to go overseas. That is who he is competing with over there.

Mr. HAMMER. That is correct, Senator Long. In fact, there are two concepts of neutrality, and I think this was brought out by Mr. Kiefer's comments.

One is the so-called domestic neutrality—they have different terms for it—which compares the U.S. worker with a foreign worker. The other is the concept of international neutrality where you compare the facts in the country where the operation takes place.

Again, as you just said, comparing the U.S. worker in Saudi Arabia with the British worker in Saudi Arabia working for a British firm. And, in international trade, in my view, that is the sounder concept of neutrality to apply if we are to remain competitive.

The CHAIRMAN. Well, if you follow that concept, if we played a football game with the Canadians, that concept of neutrality would require that they have 12 men on that football field while we have 11, because on the theory that if you were playing an American team, you would be playing a team with 11 men.

But since you are playing a Canadian team, they usually have 12 men out there, and that indicates that they would be permitted to have an extra man on the team.

Mr. HAMMER. Same problem in baseball. You have designated hitters in the American League and not in the National.

The CHAIRMAN. When they play the World Series, they play by one rulebook.

Mr. HAMMER. By having a double base.

The CHAIRMAN. Right. Thank you.

Senator Dole?

Senator DOLE. I have no questions. I feel that you do not like the 1976 changes.

Mr. HAMMER. Well, in the sense of its restrictive applications on U.S. citizens abroad, I think it went much too far.

Senator DOLE. You agree that there should be some change?

Mr. HAMMER. Absolutely. If I went the way I really think we ought to go, I would say once an American leaves a country and is no longer a resident, he probably should not be taxable other than on U.S. source income. I think the Philippines is the only country besides us that taxes nationals abroad, and only because the Philippines adopted, after World War II, the U.S. tax law, and still maintain it.

But no other country taxes, to my knowledge, citizens abroad, when they are residing abroad, other than on domestically produced income.

The CHAIRMAN. Thank you very much.

Mr. HAMMER. Thank you, sir.

[The prepared statement of Mr. Hammer follows. Oral testimony continues on p. 84.]

STATEMENT OF RICHARD M. HAMMER, PARTNER, PRICE WATERHOUSE & CO.

My name is Richard M. Hammer. I am a partner at Price Waterhouse & Co. I am appearing before this Committee as a representative of Price Waterhouse & Co., an international accounting firm having offices in 90 countries. Our clients include many multinational corporations employing U.S. citizens in all parts of the world. As part of our services to our clients, we prepare tax returns for U.S. citizens working abroad. For 1977 we are preparing approximately 6,000 U.S. tax returns worldwide and we employ 60 U.S. tax professionals in overseas offices for this purpose, in addition to U.S.-based staff. We also assist the employers, our corporate clients, in determining the excess tax reimbursements. This statement is submitted in our capacity as concerned professionals engaged in an international tax and accounting practice and, as such, we do not specifically represent the interests of any company, organization or group of companies.

Need for congressional action

Based on our experience in this area, we strongly urge Congress to take prompt action to pass the Tax Treatment Extension Act of 1978 (HR 9251) in order to postpone for 2 years the 1976 changes in the earned income exclusion. This action is needed immediately to enable U.S. citizens abroad to file their 1977 tax returns by June 15, 1978. In fact, taxpayers who returned from an overseas assignment during 1977 were due to file in April 1978 and had to file for extensions or eventually face the filing of an amended return. We are now fast approaching the June 15 deadline and our offices around the world are delaying the completion of returns in the expectation that HR 9251 will be enacted. They are reluctant to repeat last year's experience of filing returns under existing law, which was subsequently amended, because many taxpayers have still not received refunds on their amended returns.

Second, we urge Congress to consider favorably the proposals of HR 9251 and those of the Administration to allow U.S. citizens working abroad to exclude allowances for excess living costs which are noncompensatory in nature and are in substance additional business expenses of temporary foreign assignments.

We believe that such action on your part is necessary, in order to give fair and equitable tax treatment to U.S. employees working abroad and in order to preserve the competitiveness and effectiveness of U.S. business abroad.

Need for U.S. citizens to work abroad

Our statement is based on the premise contained in the Report to the Congress by the Comptroller General dated February 21, 1978 (GAO Report). This report concluded that in order to prevent a continuing deterioration of the U.S. international economic position and to maintain the international competitiveness of U.S. multinational companies, *"it is essential to maintain a large force of U.S. citizens abroad to promote and service U.S. products and operations."*

We agree with this conclusion because it has been our experience that U.S.-owned business needs to send U.S. citizens abroad to ensure that the business of foreign subsidiaries is conducted in accordance with U.S. standards and techniques. U.S. citizens are needed to promote the export of U.S. produced goods and U.S. technicians are needed to install, service and maintain exported products, and to seek out technology developed abroad.

The U.S. tax system penalizes U.S. business abroad

The U.S. is almost unique in that it taxes its citizens regardless of residency, allowing a foreign tax credit to reduce double taxation. Thus the U.S. citizen working abroad is at a disadvantage vis-a-vis his foreign counterpart because he has to pay taxes in two jurisdictions. The U.S. employer, in order to assure the employee abroad of net disposable income equal to that in the U.S., must reimburse the U.S. citizen for his excess U.S. and foreign tax costs as well as living costs.

The results of the extra costs of sending U.S. citizens abroad are:

U.S. employers try to staff foreign posts with foreign nationals, reducing job opportunities for U.S. citizens;

Where U.S. citizens must be employed, the additional costs increase the costs of U.S. products and services, which are especially severe for labor-intensive industries, such as the construction industry, limiting the competitiveness of U.S. business;

Foreign national employees tend to purchase foreign-made rather than U.S.-made goods, adversely affecting U.S. exports.

The earned income exclusion is not an "incentive"

U.S. business is facing stronger competition from abroad and the U.S. now has a severe balance of payments deficit. Under these circumstances it would be in the national interest to *increase* the earned income exclusion. Instead, the Tax Reform Act of 1976 reduced the earned income exclusion.

It has been said that the U.S. citizen abroad is receiving a tax advantage over his U.S.-based counterpart. However, the U.S. citizen working abroad is not only being taxed on his compensation but also on the value of allowances received to cover additional costs of western-style living. All these allowances are taxable compensation to the employee, although they only enable him to live as he would have lived in the States. Obviously, there is something very wrong with a tax law which does not recognize the noncompensatory nature of these allowances. It is true that there are differences in living costs within the U.S. However, the differences cannot be compared with those in the Middle East and Japan and developing countries.

In effect, the earned income exclusion has been the only recognition of this fact and its reduction comes at the wrong time—that is, when U.S. citizes are being sent to more distant, less developed and consequently more expensive locations.

Theoretical studies versus equity for taxpayers

Theoretical studies have been made, attempting to determine the impact of the additional tax costs of the 1976 changes on the U.S. economy. The GAO Report concluded that the added tax costs should not materially affect jobs, exports and the balance of payments. This study sought to determine the impact of the taxation of 150,000 U.S. citizens abroad on the whole U.S. economy. The GAO Report concedes that the full impact on the U.S. economy of the increases on U.S. citizens abroad "cannot be objectively measured at this time due to data limitations as well as to intangible values accruing from having Americans abroad." We also seriously question whether it is possible to draw firm conclusions from a study based on the facts available and the assumptions that had to be made.

The Congressional Research Service (CRS) conclusions on the impact of these taxes on the U.S. economy are also based on the GAO Report. This study attempts to evaluate the various methods of taxing U.S. citizens abroad on abstract standards of tax neutrality, which leads away from practical reality and could result in legislation of unworkable complexity.

The study objects to the deduction of cost-of-living allowances being allowed at the taxpayer's marginal tax rate. Instead, it suggests that neutrality requires the deduction to be allowed at the average or effective rate. This requires the employer to give an allowance in excess of the actual additional living costs to make up for the additional tax thereon and this in effect creates additional tax revenue for the Treasury and an additional cost to the employer. This conflicts with the stated aim of achieving neutrality.

The CRS concept of tax neutrality focuses strictly on a comparison of the U.S. worker in the U.S., versus the U.S. worker abroad. In international trade it is more realistic to compare the treatment of a U.S. enterprise and its employees with a foreign enterprise and its employees. For example, a U.S. citizen employed by a U.S. contractor in Saudi Arabia remains subject to U.S. tax on income and

allowances. The U.K. competitor's (and also the German, Italian, French and Japanese competitors') employees who are sent to Saudi Arabia are exempt from taxation in their country of citizenship. Since there is no personal income tax in Saudi Arabia, the foreign national pays no taxes while in Saudi Arabia, which makes it easier to find people to accept such an assignment and reduces the costs of the contract to the employer. In this situation the tax factor is not neutral as between the U.S. and the foreign contractor. Even the pre-1976 provisions of Section 911 did not achieve complete neutrality as between U.S. employees and their foreign counterparts. However, it avoided some of the inequities in a broad, practical manner, because the exclusion made up to some extent for the fact that excess housing and living allowances are taxable.

The CRS study is overly concerned with achieving a theoretical equality of treatment and is excessively anxious to avoid even minor variations from its concept of neutrality between U.S. and foreign based citizens. For example, the study expresses concern that if a housing allowance is given in addition to a cost-of-living allowance (the H.R. 9251 proposal), the taxpayer could have an unintended benefit or a "double dip" in those countries where housing costs are higher than in the U.S. but other living costs are lower. In our experience, high housing costs and high living costs usually go together and this is in practice unlikely to result in a substantial windfall for many taxpayers. The possibility of such a windfall hardly warrants the criticism of the proposed legislation.

The CRS study also criticizes the use of average U.S. cost-of-living standards as a basis for determining deductible excess living costs and recommends that the highest U.S. costs be used, such as Anchorage or Honolulu, in order to favor foreign-based over U.S.-based workers. We question whether it is realistic to treat all U.S. citizens working overseas as if they come from Anchorage or Honolulu. The use of an average U.S. living cost basis would seem to be more fair to more taxpayers. We therefore question whether the CRS study is realistic in its approach and we believe the HR 9251 proposal would lead to a more equitable result.

The CRS study concludes that there is no national economic need to override these concepts of tax neutrality. However, we maintain that in view of U.S. unemployment levels the tax law should not make it more difficult for U.S. workers to take jobs abroad.

We believe that the taxation of a class of U.S. taxpayers should not be based on purely macroeconomic or theoretical considerations. U.S. taxpayers are entitled to fair and equitable treatment regardless of such considerations. Furthermore, the loss of *any* foreign contracts of jobs is serious for the U.S. economy, even if the numbers projected are not significant when compared with the GNP. Before making changes in the tax law, such as those contained in the 1976 Tax Reform Act, due consideration should be given to the practical consequences for business and equity for the citizen.

We therefore urge you to take prompt action to enact the Tax Treatment Extension Act of 1978 and to consider favorably the proposals to provide fair and equitable taxation of U.S. citizens working abroad.

Attached for your information is an extract from a recently published book entitled *Accounting for the Multinational Corporation*, of which I am a co-author. The book was published by the Financial Executives Research Foundation. As noted in the introduction to the book, endorsement by the Board and Trustees of the Financial Executives Institute should not be assumed.

Also attached is a copy of the Resolution of the 1974 Congress of the International Fiscal Association on the taxation of temporary residents.

ATTACHMENT I

CHAPTER 34—EXPATRIATE COMPENSATION

CONTENTS

Expatriate Compensation Plans
1. Current trends in expatriate compensation
2. Foreign tax approaches to expatriates
3. U.S. approach to expatriate taxation
4. The present problem
5. An illustration of the problem
Mechanics of the earned income exclusion
1. Conditions for exclusion
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3. Limitations of the system
4. An illustration of the effects of the Tax Reform Act of 1976
Current alternatives and costs
1. Objectives of expatriate compensation plans
2. Laissez-faire approach
3. Ad hoc approach
4. Tax protection
5. Tax equalization
Trends for the future
Bibliography

Extract from:
Accounting for the Multinational Corporation
by George C. Watt, Richard M. Hammer and Marianne Burge
(partners at Price Waterhouse & Co.)
Published by:
Financial Executive Research Foundation, 1977.

EXPATRIATE COMPENSATION PLANS

1. Current trends in expatriate compensation

Compensation plans for U.S. employees assigned abroad consume considerable administrative time for U.S. corporations operating internationally and the direct costs of sending employees overseas have in many cases become significant. The responsibility for the administration of these plans rest with the personnel departments. However, the tax aspects of employee taxation have become an important element of the total compensation package because employers are adopting various policies of reimbursing their employees for excess taxes paid on foreign assignments. Furthermore, employers have become more concerned with their image abroad and are anxious to ensure that their representatives abroad comply with local tax laws.

Local taxation levels also affect the attractiveness of various locations abroad and thus influence personal decisions of employees, particularly of senior executives, as to where to locate. In particular, the location of regional headquarters or liaison offices in an area such as Europe is usually heavily influenced by the taxation of the executive in charge. Locations such as the United Kingdom, Belgium, the Netherlands and France are popular countries because the personal tax levels are reasonable or they offer special incentives for foreigners. On the other hand, locations such as Germany are less popular with U.S. citizens (although some Japanese companies have located there) because of the high levels of personal taxation. The location of a headquarters office in a certain country quite often leads to the location of a physical plant in the same country, probably because management becomes familiar with conditions there. Thus, quite important decisions from a corporate standpoint can be influenced by employees' decisions which, in turn, are based in part on personal taxation.

Traditionally, in order to persuade a man to uproot himself and his family from his home base (be it the U.S.A., the United Kingdom or other capital exporting country) and serve in corporate outposts, it has been understood that a monetary incentive must be given. In the first place, the expatriate must be enabled through various allowances to live in the sort of conditions to which he is accustomed at home, to educate his children as he would at home and in many ways to uphold the corporate prestige by living as well as his counterpart in the host country. He must also be given an incentive payment to compensate for the upheaval of living away from home. It is also an incentive to, and traditional for, assignees abroad to try to accumulate savings while on foreign assignment, which is generally only possible if the continued taxation level at the home base and at the foreign location are reasonable.

2. Foreign approaches to expatriate taxation

Before describing the U.S. tax problems, the approaches of some other major industrial nations do not tax their citizens when they reside outside their country of nationality. Based partly on practical enforcement problems and as an encouragement to expand the nation's wealth by expansion abroad, countries such as the United Kingdom, France, the Netherlands, Belgium. Spain, Germany, Canada and most others do not impose an income tax on the foreign earnings of their nonresident citizens. Furthermore, nonresidents do not use the country's social services to the same extent as residents. The venturesome U.K. engineer has a clear and obvious incentive to accept an assignment in a foreign location

such as Saudi Arabia, because he can thus escape for a few years from his high home base income tax and pay the lower level of tax in the developing area.

3. U.S. approach to expatriate taxation

The U.S. approach has been to tax U.S. citizens on worldwide income regardless of source. Double taxation on foreign income, as in the case of U.S. corporations, is avoided or reduced by the foreign tax credit. However, until 1962, U.S. citizens resident abroad were allowed to exclude from their U.S. tax base *all* earnings for services performed outside the U.S., under Section 911 of the U.S. Internal Revenue Code. Many U.S. citizens working abroad were not even required to file U.S. tax returns if they had little other income. They were thus in virtually the same position as nationals of other countries.

In 1962 with the introduction of a limited "worldwide income" approach to corporate taxation, the "earned income exclusion" was limited to $20,000 per annum for the first three years of foreign assignment and to $35,000 thereafter. In 1964 the $35,000 exclusion was reduced to $25,000. In 1976 the earned income exclusion was reduced to $15,000 and other restrictions were imposed. These are discussed further in this chapter. The retention of a limited exclusion of $15,000 was in fact a "victory" for the taxpayer, since it had been proposed to phase out the exclusion altogether. The effective date for the reduction was postponed from 1976 to 1977, as discussed later in this Chapter.

The approach taken in 1962 resulted in the filing of tax returns by U.S. citizens abroad, for the first time in many cases. However, the $20,000 and $25,000 exclusions for earned income plus the foreign tax credit still kept U.S. taxes low for most U.S. expatriates. Their foreign taxes were, with some exceptions, also maintained at acceptable levels through tax incentives granted by foreign governments and tax planning.

Thus, the U.S. multinational in the sixties often adopted, as an incentive, a simple expatriate compensation policy of high compensation. U.S. citizens working in foreign locations generally appeared to be better paid than employees of host country companies because U.S. salary levels were in any event about double those in Europe. On top of this they were given cost-of-living and other allowances and left to take care of their taxes on their own. Many employers did not want to get involved in personal tax matters. This approach has come to be known as "laissez faire."

Corporate procedures in the payment of expatriate compensation in the past often involved the use of split payrolls. Under this method the U.S. parent company would pay, say, one half of the salary in U.S. dollars into a U.S. bank account. The other half would be paid in foreign currency either by the U.S. corporation or by the local subsidiary.

There are several advantages to the employee of being paid in this way. The U.S. dollar funds could be used to meet the expatriate's U.S. expenses of maintaining his home or schooling of children remaining in the U.S. and for savings. It also could enable the employee to remain within the U.S. parent company's pension plan. The split payroll saved the expatriate from exchange losses and restrictions in converging part of his salary from soft currencies. In one major country at least, the United Kingdom, any salary paid by the foreign employer was taxable only if brought ("remitted") into the U.K. On the corporate level, the U.S. corporation would claim a tax deduction for the compensation paid in the U.S., if appropriate.

In recent years the split payroll has lost some of these advantages. For example, since 1974 it is preferable for the entire compensation of an employee assigned to the U.K. to be paid from the U.S., since this is a requirement for the expatriate to receive the 50 percent exclusion for U.K. tax available for "foreign emoluments."

In this situation the U.S. employer assigns the employee to the U.K. affiliate and charges the U.K. affiliate for the compensation. The intercompany charge is required under the U.S. Section 482, which is discussed in Chapter 32. On the other hand, it is often difficult to obtain a tax deduction for intercompany charges in the other country, and in many cases expatriates are being paid by affiliates in the host countries.

If the expatriate employee remains on the U.S. parent company's payroll, the U.S. corporation continues to apply wage withholding to any compensation in excess of the earned income exclusion. Wage withholding applies not only to compensation but also to the various allowances, other than reimbursed business expenses. These amounts appear on the employee's form W-2, which is filed with his U.S. tax return.

4. The present problems

The present problems for U.S. employers arise from a combination of factors. Inflation has caused sharp increases in salaries worldwide. As a result, a U.S. salary is no longer substantially above European executive salary scales. With inflation, the $15,000 exclusion (subject to various restrictions) no longer serves to eliminate most of an expatriate's income from the U.S. tax base. The Internal Revenue Service's restrictive treatment of "moving" expenses and personal deductions have further limited the amount of the earned income exclusion and the foreign tax credit, as discussed below. The tax returns filed by U.S. citizens working abroad have also become more complex as a result of IRS audit procedures.

Foreign income tax rates have increased over the years in many countries and enforcement efforts are much keener now in countries such as the United Kingdom, Japan, Brazil, and France which have widely differing concepts of taxation of individuals. The tax authorities in countries with which the U.S. has an income tax treaty can ask the U.S. authorities to provide a copy of the individual's U.S. tax return if they feel that all his income has not been reported. Foreign social security taxes on individuals are becoming a significant cost in many European countries, such as Belgium, the Netherlands, and Italy. Tax incentives available to foreigners with technical skills are gradually being withdrawn or limited as for example in Australia and Belgium.

5. An illustration of the problem (assuming no changes in the 1976 tax reform act)

Table 1 illustrates the tax problem in a typical situation of a U.S. citizen, married with two children who earned $40,000 in the U.S. and is transferred abroad at a salary of $50,000 (base salary $40,000 plus allowances $10,000). This figure includes all allowances for cost-of-living, education and overseas differential, home leave, housing, all of which are subject to U.S. tax and generally also to foreign tax. The table shows at Column A the U.S. federal taxes he is at present paying at home on $40,000 and the U.S. tax he will pay on $50,000 after deducting the $15,000 earned income exclusion at Column B. The table then shows at Column C the foreign income taxes due in a number of countries and Columns D and E show the combined U.S. foreign taxes after foreign tax credits, based on a simple teechnique of deeducting 35/50 of the foreign tax from U.S. tax. The reason for this restriction on the foreign tax credit, which was imposed by the 1976 Tax Reform Act, is discussed later in this chapter.

TABLE 1.—TABLE OF U.S. AND FOREGIN TAXES ON U.S. CITIZEN ABROAD [1] (ASSUMING NO CHANGES IN THE 1976 TAX REFORM ACT)

	U.S. tax [2] on $40,000	U.S. tax [3] on $50,000–$15,000 exclusion	Foreign tax on $50,000	(B minus C)—U.S. tax after foreign tax credit and $15,000 exclusion	(D plus D)—combined U.S and foreign tax on $50,000–$15,000 exclusion
	A	B	C	D	E
United States	10,000	11,000			
Australia [4]			21,000		21,000
Belgium [5]			8,000	[6] 5,000	13,000
Brazil			17,000		17,000
Canada			19,000		19,000
France [7]			11,000	[6] 3,000	14,000
Germany			16,000		16,000
Japan [4]			17,000		17,000
Kuwait				11,000	11,000
Netherlands [5]			14,000	[6] 1,000	15,000
United Kingdom [6] [7]			9,000	[6] 5,000	14,000

[1] The above table assumes the U.S. citizen is married with 2 children. It is extracted from the Price Waterhouse Information Guide: "Individual Taxes in 80 Countries, January 1975".

[2] Excludes State taxes.

[3] Excludes State taxes and assumes U.S. citizen abroad.

[4] Takes into consideration deductions for housing benefits.

[5] Assumes maximum exclusion for foreigners.

[6] The foreign tax available for foreign tax credit has been reduced by an amount allocated to "excluded" income; in this case a reduction of 15/50 of foreign tax in column C has been assumed, pending the issue of clarifying regulations or enactment of the Technical Corrections Act of 1977.

[7] Income for foreign services is excludable but is not taken into consideration in this figure.

Note: This table does not show the U.S. and foreign tax in the year in which the employee receives a reimbursement for excess taxes. It thus does not show the effects of "pyramiding."

The table shows that at the levels selected under the present U.S. tax system, the U.S. expatriate would pay higher foreign taxes than U.S. taxes except for those countries which have special tax treatment of foreigners, i.e. Belgium, France, the U.K. and Kuwait. In several jurisdictions (Australia and Canada) his spendable income on a gross of $50,000 would be about $30,000, the same amount as he would retain on a gross of $40,000 if he stayed in the U.S. It also shows that the lowest tax jurisdictions of the countries selected in Europe are Belgium, the United Kingdom and France, which accounts in part for their popularity as a headquarters location. It shows that even after the reduction in the earned income exclusion in 1976, foreign taxes would still be higher in many foreign locations. It certainly illustrates the present and potential expense of providing overseas incentives and cost-of-living allowances for assignments in developed countries, incentives which at most locations virtually disappeared because of additional personal income taxes under the assumptions on which the table was based.

In determining an appropriate after-tax disposable income for an employee assigned abroad at least two elements are taken into consideration. The compensation package would be based on a comparison of the following factors in the foreign country with those in the home country:

1. High individual income taxes, high costs of living.
2. High individual income taxes, low cost of living.
3. Low individual income taxes, high cost of living.
4. Low individual income taxes, low cost of living.

For the sake of simplicity the differences in cost of living between the foreign countries and the U.S. have not been taken into consideration in the table. Allowances of $10,000 are assumed for all countries.

The table is referred to in later sections of this chapter, in illustrating tax reimbursement methods currently being used. The following section describes in greater detail the mechanism of the earned income exclusion.

MECHANICS OF THE EARNED INCOME EXCLUSION

1. Conditions for exclusion

The Tax Reform Act of 1976 reduced the previous exclusions of $20,000 and $25,000 to $15,000 and introduced several changes which substantially reduced the tax savings from the remaining $15,000 exclusion. In response to an uproar of protests from affected taxpayers, in particular objecting to the fact that the changes were effective retroactively to the beginning of 1976, the effective date was postponed by legislative action from 1976 to 1977. A further one-year postponement to 1978 has been proposed in the Tax Treatment Extension Act (H.R. 9251). The following discussion and Table I assume that there will be no change in the Tax Reform Act. However, it is entirely possible that Section 911 will be repealed and replaced by deductions for certain overseas allowances, as proposed in the Ribicoff Bill, S. 2115, discussed in a later section of this chapter.

Section 911 of the Internal Revenue Code now provides for an exclusion from income of $15,000 annually for a citizen working abroad who meets one of two conditions. The exclusion remains at $20,000 for employees of charitable organizations working abroad. The U.S. citizen must either qualify as a *bona fide* resident of a foreign country or countries for an uninterrupted period which includes an entire taxable (calendar) year, or he must be physically present in a foreign country or countries for at least 510 days out of a consecutive period of 18 months. Under the *bona fide* residence rule prior to 1977, the exclusion increased to $25,000 after three years, but did not increase for an individual who only met the 510-day requirement. To qualify as a *bona fide* resident of a country, the U.S. citizen must not claim to be a nonresident in his tax return filed in that other country. However, this rule is broadly interpreted and an employee could claim to be not domiciled in a country where domicile in part governs the level of taxation as long as he admits to being a resident of that country.

The exclusion starts from the time of departure and the annual figure is prorated to a daily rate of approximately $41. Thus, although one of the conditions of the exclusion is *bona fide* residence abroad for a period *including* an entire taxable year, the exclusion applies to the entire period of *bona fide* residence. For example, if the employee leaves the U.S. on November 1, 1975 and returns to the U.S. on January 15, 1977, the exclusion would apply from November 1, 1975 through January 15, 1977, because he was a *bona fide* foreign resident for calendar year 1976. However, if he had returned on December 1, 1976, he could not have been eligible for the exclusion. *Bona fide* residence status is not affected by tem-

porary visits back to the U.S., although such visits could affect the amount of income eligible for exclusion, as discussed below. However, days spent in the U.S. are material in determining whether an employee is eligible under the alternative 510-day requirement, because for this purpose days within and without the U.S. must be counted.

Only income earned outside the U.S. is excludable and the employee must keep a record of the number of days he spends in the U.S. For example, if the employee earns $15,000 per annum and spends 30 working days in the U.S. during the taxable year, the salary earned during those 30 days would be considered U.S. earned income and would not be eligible for the exclusion. In this case approximately $1,200 would be U.S. earnings and the exclusion would be restricted to $15,000 less $1,200. However, if the employee earned, say $50,000 his foreign earned income would still be over $15,000 even after deducting the salary for 30 U.S. working days.

To claim the exclusion the employee must file a special form 2555, which shows all his salary and allowances and provides a worksheet for computing the exclusion. The remaining taxable amount is carried to the form 1040. If his wife is employed, she can claim a separate exclusion for her foreign earned income.

Two limitations on the amount and value of the exclusion were introduced by the 1976 Tax Reform Act.

Foreign earned income which is received outside the country in which the services are rendered is not eligible for exclusion if one of the purposes of receiving such income outside that country is to avoid local income tax. The fact that the country in which the income is earned (services rendered) does not tax amounts received outside is to be viewed as a strong indication of a tax avoidance purpose. No indication is given in the statute how the exclusion would be limited, where at least $15,000 is received in the country of service. For example, if an employee is paid $25,000 by the U.S. parent company and $25,000 by a foreign subsidiary, it would appear that, regardless of the motive for the "split payroll," $15,000 is available for exclusion. The exclusion is limited if the income is received outside the country in which it is earned (i.e., where the services are rendered) which is not necessarily the country in which the employee is resident. This restriction could thus have an adverse and perhaps unintended impact on employees who are resident in one foreign country but travel extensively in other countries.

The taxable income remaining after application of the earned income exclusion is subject to tax at the higher graduated rates which would have been applicable if that earned income had not been excluded. This is known in some tax systems as "exemption with progression."

This computation is illustrated as follows:

Taxable income	$30,000
Add excluded income	15,000
Total	45,000
Tax on $45,000	14,560
Less tax on $15,000 excluded income	3,010
U.S. tax before foreign tax credit	11,550

Under the Tax Reform Act, taxpayers qualifying for the earned income exclusion can elect not to claim it. An election not to claim the exclusion for any taxable year is binding for subsequent years and can be changed only with Internal Revenue Service consent. Table 2 illustrates a situation in which it is preferable not to claim the exclusion and to reduce taxes by the foreign tax credit only, as discussed below.

2. The foreign tax credit

As in the case of a U.S. corporation, a U.S. citizen is required to file a U.S. tax return (form 1040) regardless of where his income was earned and must in addition file form 2555 to claim the earned income exclusion.

He is entitled to claim a deduction or credit for foreign income taxes. The credit is usually more advantageous. The credit, which is claimed on form 1116, is allowed against U.S. tax on *foreign* source income only. In the case of earnings this means income for services rendered outside the U.S. For example, if an employee earns $50,000 on a foreign assignment, $15,000 would be excluded, leaving $35,000 of foreign source income still subject to U.S. tax in addition to any earnings in the U.S. and other taxable income. The U.S. tax on that foreign source income could be reduced by foreign income taxes paid or accrued, as shown in the table above. Even a cash-basis taxpayer has the choice of crediting foreign taxes on the cash or accrual basis.

To determine the maximum amount of foreign tax credit which can be allowed for a given year, the following formula is used:

$$\frac{\text{Foreign source taxable income}}{\text{Total taxable income}} \times \text{U.S. tax on total income}$$

The credit for any year is limited to the lower of the actual foreign taxes (plus carryovers and carrybacks) or the amount arrived at under the above formula.

Creditable taxes comprise foreign national and local income taxes and include social security taxes when these are based on income. No credit is allowed for other taxes such as value-added taxes.

Under the Tax Reform Act of 1976, foreign income taxes paid or accrued which are attributable to excluded earned income are neither creditable nor deductible. The Act does not make it clear whether the foreign taxes to be excluded from credit are the actual taxes paid on the first $15,000 or whether a formula approach should be used to allocate a portion of foreign taxes. The amount of non-creditable foreign tax might be computed by the following formula:

$$\frac{\text{Excluded foreign earned income}}{\text{Total foreign earned income}} \times \text{Foregn income tax on earned income}$$

However, under proposed legislation, the Technical Corrections Act of 1977 (H.R. 6715), the amount of non-creditable foreign tax would be computed by the following formula:

$$\frac{\text{U.S. tax on excluded income}}{\text{Sum of the tax on excluded income plus the foreign tax credit limitation for the year}} \times \text{Forign income taxes}$$

Under the new law it is not possible for the employee to claim the standard deduction and the foreign tax credit. In the past, deductions had to be itemized if the foreign tax credit was claimed.

Any foreign tax in excess of the U.S. tax on the foreign earnings is available for credit against the U.S. tax on other foreign source income. Any other foreign tax unused in the year is available as excess (unused) foreign tax credit remaining, which may be carried back for two years or forward for five. Since foreign source income is earned at any time when an employee makes a business trip abroad, these excess foreign tax credits can be carried back or forward to years when the expatriate is based in the U.S., even though his foreign business visits do not make him taxable abroad.

3. Limitations of the system

There are a number of features of the earned income exclusion and the foreign tax credit which have been applied by the Internal Revenue Service in such a way as to reduce their effectiveness in minimizing U.S. taxes.

Foreign tax credit

One issue is in the foreign tax credit area. The foreign tax credit is limited to the lower of the actual foreign tax or the U.S. tax attributable to foreign source taxable income. For example, foreign source *taxable* income is arrived at by deducting from foreign source gross income any deductions which are directly attributable to the foreign income as well as a proportion of other itemized deductions, which are allocated between U.S. source and foreign source income on the basis of gross income from each source. The effect of requiring that itemized deduction reduce proportionately foreign source gross income to arrive at foreign source taxable income is that the amount of foreign source income is thereby reduced and thus the U.S. tax ascribed to that income (the limitation) is thereby also reduced. Similar problems are described for corporations in Chapter 27.

Moving expenses

Another area of difficulty concerns moving expenses. There is a general tax provision that no expense directly incurred for or related to the production of tax-exempt income is deductible. Since up to $15,000 of foreign earned income may be exempt from U.S. tax, no expenses attributable to earning that income would be tax deductible. If only a portion of the income is exempt, then only a portion of the expense is disallowed. For example, if an employee earns $50,000 and $15,000 is excluded, then 15,000/50,000 or 30 percent of the expense would be disallowed.

This concept has been applied to the treatment of moving expenses and reimbursements. Moving expense reimbursements must now be included in an employee's gross income, and any deductible expenses deducted therefrom. The Internal Revenue Service has taken the position, supported by the courts, that a portion of deductible moving expenses must be allocated to exempt earnings and thus disallowed in the same way as business expenses. The disallowance is based on the following formula:

$$\frac{\text{Foreign earned income which is not exempt}}{\text{Total foreign earned income}} \times \text{Moving expenses} = \text{Amount deductible as moving expenses}$$

This interpretation has the effect of disallowing some of the moving expense deduction and penaliezs employees who are moved to distant locations or who are moved frequently on foreign assignment. For this reason many employers gross up the reimbursements to cover the additional amount of U.S. tax due, (plus the tax on the tax!), since there is no reason to penalize an employee for incurring moving expenses on his employer's behalf. The effect of this IRS approach is that U.S. employers must generally pay considerably more than the actual moving costs when transferring an employee abroad, although the extra costs are deductible for U.S. corporate tax purposes.

Further technical questions arise on the source of the moving expense reimbursement, which is important in determining the earned income exclusion and the foreign tax credit. If the moving expense reimbursement is treated as foreign source income, the impact will be mitigated through the absorption of other excess foreign tax credits on the income represented by the reimbursement. On the other hand, by treating the reimbursement as U.S. source income the related expenses would be fully deductible as U.S. expenses and not pro-rated against foreign source income. The general rule adopted in Revenue Ruling 75-84 is to treat the moving expense reimbursement and deduction as foreign source on the outward move and as U.S. source on the return move. These seem to be difficulties and technicalities which should not be found in an expense item which so clearly confers no benefit on the employee. Similar difficulties are encountered by employees who move at corporate expense between two locations in the United States. Moving expenses in these situations should simply be a corporate expense for tax purposes.

4. An illustration of the effects of the Tax Reform Act 1976 (assuming no changes)

Table 2 which follows compares the additional tax costs imposed on U.S. citizens working abroad by the 1976 Tax Reform Act.

TABLE 2.—EFFECT OF 1976 TAX REFORM ACT ON U.S. CITIZENS WORKING ABROAD (ASSUMING NO CHANGE IN THE 1976 TAX REFORM ACT)

Assumptions:
1. U.S. citizen married with 2 children.
2. Total salary and allowances: $50,000.
3. U.S. investment income: $1,000.
4. Itemized deductions: Nil.
5. Foreign income tax is:
   A. $17,000.
   B. $9,000.
   C. 0.
6. Credit for personal exemptions ignored.

	1975—prior law	New law 1976	
		Exclusion	No exclusion
1. Salary and allowances	$50,000	$50,000	$50,000
2. Less exclusion	20,000	15,000	0
3. Earned income after exclusion	30,000	35,000	50,000
4. U.S. investment income	1,000	1,000	1,000
5. Adjusted gross income	31,000	36,000	51,000
6. Itemized or standard deduction	0	[1] (2,800)	[1] (2,800)
7. Personal exemptions	(3,000)	(3,000)	(3,000)
8. Taxable income	28,000	30,200	45,200
9. U.S. tax before credit	7,100	[2] 11,650	14,660
		A	
10. Foreign tax paid	17,000	17,000	17,000
11. Foreign tax available	17,000	[3] 11,900	17,000
12. U.S. tax before credit	7,100	11,650	14,660
13. Foreign tax credit [4]	6,870	11,326	14,372
14. Net U.S. tax due	230	324	288
15. Excess foreign tax credit (line 11–13)	10,130	574	2,628
		B	
10. Foreign tax paid	9,000	9,000	9,000
11. Foreign tax available	9,000	[3] 6,300	9,000
12. U.S. tax before credit	7,100	11,650	14,660
13. Foreign tax credit [4]	6,870	6,300	9,000
14. Net U.S. tax due	230	5,350	5,660
15. Excess foreign tax credit (line 11–13)	2,130	0	0
		C	
10. Foreign tax paid	0	0	0
11. Foreign tax available	0	0	0
12. U.S. tax before credit	7,100	11,650	14,660
13. Foreign tax credit	0	0	0
14. Net U.S. tax due	7,100	11,650	14,660

[1] The standard deduction can now be taken even when the foreign tax credit is claimed.

[2] Computation of U.S. tax before foreign tax credit:

Taxable income	$30,200
Add excluded income	15,000
Total	45,200
Tax on $45,200	14,660
Less tax on $15,000	3,010
U.S. tax before credit	11,650

[3] Foreign tax available for credit:

Foreign earned income after exemption divided by total foreign earned income times foreign tax on earned income.

(A) 35,000÷50,000 times 17,000 equal $11,900.

(B) 35,000÷50,000 times 9,000 equals $6,300.

However, under proposed legislation, the Tecnhical Corrections Act of 1977 (H.R. 6715), the amount of noncreditable foreign tax would be computed by the following formula:

U.S. tax on excluded income divided by sum of the tax on excluded income plus the foreign tax credit limitation for the year times foreign income taxes.

[4] Limitation on foreign tax credit allowable:

Foreign source taxable income divided by total taxable income (before exemptions) times U.S. tax.

The conclusions of this illustration were not materially changed by the Tax Reduction and Simplification Act of 1977.

The results under A and B illustrate the need to make two computations to determine whether it might be preferable to elect not to claim the earned income exclusion. Where foreign taxes are relatively high (example A), the election may reduce U.S. tax due and increase excess foreign tax credits. Where foreign taxes are relatively low (example C), the exclusion is still beneficial. The general increase in U.S. tax before credit is a result of the reduction in the exclusion and application of exemption with progression in applying the tax rates. The U.S. tax on the U.S. investment income is also increased because of exemption with progression.

CURRENT ALTERNATIVES AND COSTS

1. Objectives of expatriate compensation plans

In an effort to overcome the difficulties in providing monetary incentives for employees to move abroad and not have them substantially penalized by taxation, multinational companies have developed more or less sophisticated arrangements to deal with this matter, thus becoming involved in the personal tax affairs of their employees around the world. Several approaches are described below, the most widespread at present being "tax equalization" in various versions. It is considered by most multinationals that tax equalization meets most of the following objectives for a good plan:

(a) The plan must be fair to both the company and the expatriate and be easily understood by the expatriate;

(b) The plan must treat employees equally regardless of their geographic location;

(c) The plan must be structured so as to facilitate overseas transfers from the United States and transfers between two overseas posts; and

(d) The plan must be reasonable when compared with current practices being followed by other major companies.

2. Laissez faire approach

Under this approach, the employer pays his employee a base salary and the usual allowances and leaves the employee responsible for paying his U.S. and foreign taxes. This was the approach used by most U.S. companies in the fifties and early sixties, which involved the simple technique of highly compensating the employees and letting them fend for themselves as regards taxes. This approach is still followed by many foreign-based multinationals, partly because their employees are not subject to taxes in the home country. It is also a practical arrangement for employees working in undeveloped parts of the world where they pay little or no income taxes. It is also satisfactory in cases where the employees' tax treatment in the foreign country is part of the contract between the U.S. employer and the foreign government where the project is located. This is the case with many engineering projects in remote parts of the world.

However, it has proved to be unsatisfactory in the majority of situations and in particular when employees are assigned to high tax locations. It also results in lack of flexibility in moving employees around the world, since they will tend to want to stay in countries with the lowest tax rates, all other things being equal.

3. Ad hoc approach

Under the *ad hoc* approach the employer deals with each expatriate employee's compensation and tax problems on an individual basis. Any reimbursements of excessive taxes would depend on the location and other personal factors. This method is suitable when only a small number of employees are on international assignments. To some extent even more standardized methods require some *ad hoc* approaches for certain employees, for example, a very senior executive being sent to a very high-tax country. However, if large numbers of employees are sent overseas, the *ad hoc* approach is unsatisfactory and can result in internal difficulties among employees as well as administrative problems. As multinationals sent more U.S. employees overseas, they abandoned the *ad hoc* approach and moved toward one of the two methods described below.

4. Tax protection

Under a tax protection policy, the employer reimburses the employee for the excess of his actual foreign and U.S. taxes on his compensation over the tax which he would have paid if he had remained in the U.S. This latter tax is known

as the "hypothetical tax" and is discussed further below. The employee is thus protected from paying higher taxes on a foreign assignment than he would have incurred if he had remained in the U.S. If the taxes on foreign assignment are lower than the hypothetical tax, the employee reaps the benefit.

The technique can be illustrated roughly by looking back at Table 1 in an earlier section of this chapter. Column A shows the U.S. tax which the employee would have paid on his base salary of $40,000 if he had remained in the U.S. It is intended to be a base figure of his net after-tax disposable income had he remained at home ($40,000—tax $10,000=$30,000). This is essentially the manner in which a hypothetical tax is computed. The example in the table is typical in that it excludes State and City income taxes. Most hypothetical tax calculations do not include these local taxes, although some employers are moving in the direction of including local taxes by reference to the locality in which the head office is situated. Only employee compensation is normally included and private income is excluded from the hypothetical tax calculation. Again, some employers are beginning to consider including noncompany income in these calculations.

Under a tax protection plan, a comparison would be made of (1) the tax shown in Column A ($10,000) in Table 1, which is the hypothetical tax, and (2) Column E, which is the total U.S. and foreign tax, after the earned income exclusion and foreign tax credit have been allowed. The Column E tax figures are based on a total compensation of $50,000 including base salary and overseas allowances. The objective is to increase the employee's net after tax disposable income by $10,000 by reimbursing him an overseas allowance of $10,000, plus the additional taxes that the $10,000 will attract. The employee is reimbursed any excess of Column E over Column A taxes in Table 1.

Under the tax protection method, the excess, if any, of actual over hypothetical tax is determined on the basis of a claim filed by the employee at the time of his tax payments or some time after the end of the year to which the taxes relate. As under all reimbursement plans, the tax reimbursement constitutes taxable income for both U.S. and foreign tax purposes. This is one of the major disadvantages of all tax reimbursement plans. It can easily be seen from the second column in Table 3 that the pyramid effects of the payment of tax on tax and the corporation reimbursing the employee for the additional tax can finally become astronomical. This has been a particular problem in Australia, Japan, Canada and Germany and certain Scandinavian countries which have high progressive rates of tax. In some cases the employee might need to borrow from a bank to meet tax payments and to repay these loans subsequently out of salary or bonus payments on return from the foreign assignment.

The steps in the procedure, based on figures in the table for Australia, are summarized in Table 3 below. The first column illustrates the principles and shows the result in the first year abroad, assuming the tax reimbursement is paid to the employee in the following year.

TABLE 3.—TAX PROTECTION

	Year 1 no "pyramid"	Year 2 "pyramid" effect
EMPLOYEE		
Step I—Calculate hypothetical tax:		
Base salary	$40,000	$40,000
Hypothetical U.S. tax (col. A)	10,000	10,000
Net aftertax disposable income	30,000	30,000
Step II—Calculate foreign tax:		
Base salary	40,000	40,000
Allowances	10,000	10,000
Tax reimbursement, which is paid following the yearend	0	11,000
Total compensation	50,000	61,000
Australian tax (col. C, year 1)	21,000	28,000
Step III—Calculate actual U.S. Tax:		
Total compensation (step II)	50,000	61,000
U.S. tax after earned income exclusion (col. B, year 1)	11,000	16,000
Less foreign tax credit	11,000	16,000
Net U.S. tax (col. D, year 1)	0	0

TABLE 3.—TAX PROTECTION—Continued

	Year 1 no "pyramid"	Year 2 "pyramid" effect
Step IV—Calculate total actual U.S. and foreign tax:		
U.S. tax (step III)	0	0
Foreign tax (step II)	21,000	28,000
Total actual U.S. and foreign tax (col. E, year 1)	21,000	28,000
Step V—Caluclate tax reimbursement:		
Total actual U.S. and foreign taxes (step IV)	21,000	28,000
Less hypothetical tax (step I, col. A)	10,000	10,000
Tax reimbursement	11,000	18,000
Step VI—Calculate employee's aftertax disposable income:		
Base salary and allowances	50,000	50,000
Tax reimbursement (step V)	11,000	18,000
Total compensation	61,000	68,000
Less taxes paid by employee	21,000	28,000
Aftertax disposable income (an increase of $10,000)	40,000	40,000
EMPLOYER		
Calculate employers aftertax cost:		
Step I—U.S. taxes employee:		
Compensation paid by U.S. employer	40,000	
Tax deduction at U.S. corporate tax rate at 48 percent	19,200	
Aftertax cost	20,800	
Step II—Foreign based employee:		
Compensation paid by Australian employer	61,000	68,000
Tax deduction at Australian corporate tax rate of 47.5 percent	28,975	32,300
Aftertax cost	32,025	35,700

The conclusions in this illustration were not materially changed by the Tax Reduction and Simplification Act of 1977.

Tax protection is still used by some multinationals. Since the employee is allowed to keep the difference if his actual tax is lower than the hypothetical tax, there is again a tendency for him to want to remain in low tax countries, thus restricting flexibility of movement. Further, there is an incentive for the employee to seek ways of reducing his local taxes which the company may consider undesirable. The cost of such a plan to the employer is also greater than a full equalization plan, under which an employee is not allowed to keep the difference in a lower tax country.

5. Tax equalization

Under a full tax equalization plan the employee's gross earnings are adjusted so that, in effect, his net after-tax income is what it would have been if he had remained in the U.S., plus the incentive payment to move abroad. Using Table 1 again, the hypothetical tax on the base salary of $40,000 in Column A is $10,000. As under the protection plan, the employer reimburses the employee for the excess of the actual U.S. and foreign taxes over the hypothetical tax. But if the hypothetical tax is higher than the actual tax, the benefit inures to the employer rather than the employee.

Although this philosophy could cause complaints by employees who are assigned to low tax areas where indirect taxes are high (e.g., France and Italy), this method (and variations thereof) are now being used by most international employers of expatriate personnel.

The technique for achieving tax equalization is to compute the hypothetical tax and to deduct it from the employee's base salary. Thus the employee's taxable income both for U.S. and foreign tax purposes is reduced by the hypothetical tax, whereas under a tax protection plan the hypothetical tax does not reduce taxable income. Overseas allowances are then added to the base salary reduced by the hypothetical tax to arrive at after-tax disposable income (Step VI in Table 4). The employer then reimburses the employee for *all* and only the actual taxes he is estimated to incur, compared to reimbursing him for only the estimated additional taxes, if any, under the tax protection plan.

TABLE 4.—TAX EQUALIZATION

	Year 1 no "pyramid"	Year 2 "pyramid" effect
EMPLOYEE		
Step I—Calculate hypothetical tax:		
Base salary	$40,000	$40,000
Hypothetical U.S. tax (col. A, table I)	10,000	10,000
Net aftertax disposable income	30,000	30,000
Step II—Calculate foreign tax:		
Base salary	40,000	40,000
Less hypothetical tax	10,000	10,000
Total	30,000	30,000
Allowances	10,000	10,000
Tax reimbursement, which is paid following the yearend	0	14,000
Total compensation	40,000	54,000
Australian tax (not shown in table I)	14,000	24,000
Step III—Calculate actual U.S. tax:		
Total compensation (step II)	40,000	54,000
U.S. tax after earned income exclusion (not shown in table)	7,000	13,000
Less foreign tax credit	7,000	13,000
Net U.S. tax (col. D)	0	0
Step IV—Calculate total actual U.S. and foreign tax:		
U.S. tax (step III)	0	0
Foreign tax (step II)	14,000	24,000
Total actual U.S. and foreign tax	14,000	24,000
Step V—Calculate tax reimbursement:		
(a) Hypothetical tax (step I)	10,000	10,000
(b) Total actual U.S. and foreign tax (step IV)	14,000	24,000
Total reimbursement	14,000	24,000
Tax payment by employee	14,000	24,000
Difference retained by employer if (b) above is less than (a) above	0	0
Step VI—Calculate employee's aftertax disposal income:		
Base salary	40,000	40,000
Less hypothetical tax withheld	10,000	10,000
Total	30,000	30,000
Allowances (excluding tax reimbursement)	10,000	10,000
Aftertax disposable income	40,000	40,000
EMPLOYER		
Calculate employer's aftertax cost:		
Step I—U.S. based employee:		
Compensation paid by U.S. employer	40,000	
Tax deduction at U.S. corporate tax rate at 48 percent	19,200	
Aftertax cost	20,800	
Step II—Foreign based employee:		
Compensation paid by Australian employer	40,000	54,000
Tax deduction at Australian corporate tax rate of 47.5 percent	19,000	25,650
Aftertax cost	21,000	28,350

Under a tax equalization plan, the calculations would be made in somewhat the same way as under the tax protection steps shown in Table 3. In cases where the actual U.S. and foreign taxes are higher than the hypothetical tax, the resulting after-tax disposable income of the employee would normally be the same under either method. However, the tax cost of the employer would be lower under the tax equalization plan because the hypothetical tax reduces foreign taxable income. The procedures would be different because the hypothetical tax is withheld from the employee's salary during the year and retained by the employer who reimburses the employee for *all* taxes paid by the employee in the prior year. If the actual U.S. and foreign taxes are lower, the employee does not keep the difference which results in a saving for the employer compared to the tax protection plan.

The objective is to add $10,000 to the employee's disposable income under a tax equalization plan as illustrated above for Australia.

The after tax costs to the employer are $21,000 in year 1 and $28,350 in year 2 under a tax equalization plan. This compares with $32,025 and $35,700 under the tax protection plan in Table 3. The difference is due to the fact that under the tax equalization plan the employer has withheld the hypothetical tax, which thus does not form part of the employee's taxable income for U.S. or foreign tax purposes. Under both plans the employee usually receives, after his return to the U.S., his final year's tax reimbursement which is included in his income.

Table 4 has shown an important advantage of tax equalization over tax protection. Although the term "withheld" is used, it should be noted that the hypothetical tax is not a withholding tax. It is merely a part of the salary which is not paid to the employee and is not treated as such either for U.S. or foreign tax purposes. It does not appear on the employee's W–2 and is not a deductible item for the employer. (The actual tax reimbursement in the following year, however, constitutes taxable compensation.) If the employee's disposable income lags because his foreign tax payments all come before the additional (tax) compensation is received in the following year, he may have to obtain a loan. In some equalization plans the employee is also required to give the employer the benefits of any tax savings resulting from the use of excess foreign tax credit carrybacks and carryforwards, discussed in an earlier section of this chapter.

The disadvantages of the tax equalization method and the many variations thereof are the complexities and consequent difficulties in making the plan understood and accepted by employees. The computational complexities are not fully illustrated in the above examples. One of the major difficulties is, as mentioned above, the pyramid effect of paying tax on the reimbursement in both the U.S. and abroad. If the tax reimbursement is to make the employee whole, the tax on the tax reimbursement must also be computed for each country. This is not only complex but costly. The above example assumes that the reimbursement is made in the year following the earning of the income. Under some equalization plans the reimbursement is included in current year's income. U.S. and foreign taxes are computed by means of simultaneous equations to maintain the objective currently of giving the employee an incentive of $10,000 after taxes.

Thus, the employer has become more and more involved with the personal tax affairs of his employees and personnel departments have become more involved in U.S. and foreign taxes. As a result of these complexities, many employers have had to engage outside professional help to assist the employees with preparing their U.S. and foreign tax returns and completing their tax equalization claims while they reside abroad. The calculations are often programmed for computer applications.

Regardless of the complexity, these plans meet most of the basic objectives described at the beginning of this chapter and are an area of activity and cost which is being assumed by more and more multinational companies.

Trends for the Future

One of the two topics discussed at the 1974 Congress of the International Fiscal Association (IFA) was the taxation of employees on temporary transfer abroad. In the handbook prepared by reporters from some twenty countries, the local tax practices are described in detail. In most countries the cost-of-living and housing allowances are subject to local tax, even though the expatriate is forced by the shortness of his sojourn into a high-cost housing market, and thus does not really derive a personal benefit from the entire amount of such allowances. Another difficulty is the steepness of the tax rates in some countries, reflecting local salary levels and social philosophies. It was recognized by the IFA Congress that something should be done to alleviate this situation, as evidenced by the resolution which was adopted.

In the U.S. there is continuing discussion of how the income and allowances of U.S. citizens working abroad should be taxed. The Tax Reform Act of 1976 resulted in the view of business in too heavy a burden of taxation, borne in most cases by U.S. employers. On the other hand, some in Washington would like to see Section 911 repealed in its entirety. However, it is recognized that a major U.S. tax problem arises from the taxation of allowances. In 1977 Senator Abraham Ribicoff introduced legislation in the Senate to establish a system of replacing the fixed-level exclusion with a series of deductions for reimbursed excess costs of overseas housing, cost-of-living and education. Thus it may be that U.S. citizens working abroad may in the future pay full U.S. taxes on all their earnings, reduced only by reimbursements of certain excess living costs.

THE 28TH CONGRESS MEXICO-CITY 1974

II. TAX PROBLEMS RESULTING FROM THE TEMPORARY ACTIVITY ABROAD OF EMPLOYEES OF ENTERPRISES WITH INTERNATIONAL OPERATIONS

Resolution

The Congress notes that employees of firms engaged in international operations are more and more often being sent abroad on temporary assignment to a branch or subsidiary of their employer;

That temporary assignments abroad require the expatriate to adapt himself to new living conditions which pose problems in particular as regards the spouse and the children's education;

That the expatriate is moreover frequently concerned to make sure that he will be able to return to his previous employment at the end of his mission abroad and he therefore expects to keep the fringe benefits connected with his employment by the company making the transfer and to keep the accommodation that was previously at his disposal;

That temporary assignments abroad thus give rise to extraordinary expenses which are entirely justified for the employee as well as for the enterprise employing him;

That the principle of equal tax treatment required both the avoidance of unjustified disparities in the taxation of expatriates and also their effective taxation in accordance with the tax laws to which they are subject.

Consequently after having studied and discussed the national reports and the general report submitted to it on the position of temporary expatriates (excluding salaried employees on assignments of short duration):

The Congress: for the expatriate's country of temporary residence

Expresses the opinion that without derogation from the principle of equal tax treatment it is in the interest of sound taxation to recognise the special position of temporary expatriates.

Considers in this regard that it is equitable, conformably with the principles of the national tax laws concerned, to concede—either the deduction of additional expenses such as housing, the childrens' education or home leave—or national deductions or partial exemptions for income derived from abroad intended to take account of additional expenses incurred by the temporary expatriate.

Recommends in particular that the temporary expatriate as well as his local employer be authorized to deduct from his taxable income contributions paid to governmental and private insurance schemes of which the expatriate remains a member in his country of origin, at least on the same terms as if the contributions were paid to local institutions;

For the expatriate's country of origin

Asks that more attention be paid to the temporary nature of the stay abroad, either by exempting the expatriate from tax, or by subjecting him to tax but taking account of his additional expenses and of the taxes which he is required to pay in the country where he is working, even if his spouse and children remain resident in his country of origin or if he retains accommodation there;

For both countries

Invites the competent authorities, a tax treaty permitting, to cooperate with a view to avoiding abuse by exchanging the information at their disposal within the framework of the administrative co-operation provided for;

Calls the attention of the authorities concerned to the excessive tax burden which can result from the death of a temporary expatriate, by reason of the levying of succession duties in both countries, and therefore invites the countries to take temporary expatriates into account when concluding tax treaties bearing on succession duties.

In addition the Congress suggests that the United Nations Ad Hoc Group of Experts on Tax Conventions between Developed and Developing Countries and the OECD examine the possibility of establishing directives which would permit the countries party to a tax convention, by way of an additional protocol, to provide for the case of temporary expatriates by coordinating taxation in the expatriate's country of origin and the country of his temporary residence and by determining the information to be exchanged for the avoidance of abuse;

As concerns developing countries

Notes with interest the proposal made by certain participants from Latin America that the expatriate's country of origin should exempt him from tax or grant him a tax credit even if he has enjoyed tax concessions provided as incentives for development in the country of temporary residence and invites the nations concerned to study thee possibility of putting this proposal into effect.

The CHAIRMAN. I have a request here from Mr. Robert Best who would like to speak to this issue. I believe he represents some people who are Americans abroad.

Why do you not identify yourself for the record, Mr. Best.

Mr. BEST. Mr. Chairman, I do appreciate this opportunity. It was an informal request and I apologize for the lateness of the request.

STATEMENT OF ROBERT BEST ON BEHALF OF THE AMERICAN LEAGUE FOR INTERNATIONAL SECURITY ASSISTANCE, INC.

Mr. BEST. I am Robert A. Best, vice president of the American League for International Security Assistance, Inc. I speak on behalf of some 31 companies and 3 unions, all of whom are committed to the concept of a positive national export policy, which they earnestly believe is in the national economic interest of the United States and would create jobs in the private sector. A list of our membership is attached.

We feel that the United States is in deep trouble internationally. We are hemorrhaging from massive trade deficits which are causing a depreciation of the dollar abroad and also resulting in increased inflationary pressures at home, and these things are not unrelated.

If these deficits continue for very much longer, I fear that the situation with regard to our economy will seriously deteriorate, because oil will then be pegged on a different set of currencies and the United States will find itself more or less alone in a competitive world.

There are two false hypotheses that I have heard time and time again, which I would like to address myself to. One is that flexible exchange rates, in and of themselves, are going to solve the U.S. trade problem. I think that is a canard. I think it has been proved wrong. We have had flexible exchange rates of one sort or another since 1971—dirty floats, clean floats, or what have you, and what has happened is that the countries whose currencies have appreciated; namely the Japanese and the Germans, have had increasingly larger surpluses and the countries whose currencies have depreciated, despite all economic theory to the contrary, have increasing deficits.

So the facts belie the hypotheses that simply relying on flexible exchange rates, as this country seems to have based its policies, is going to somehow get the United States out of this continuous balance of trade problem.

And, in that respect, Mr. Chairman, I just want to read one sentence of an article on Japan. This is an article that appeared just 1 month ago.

Despite the massive appreciation, 32 percent, of the Japanese currency over the American dollar over the past 15 months and the announced government policies to somehow curtail exports, shipments of Japanese merchandise to overseas markets may actually expand between 5 and 10 percent this year.

Now, here is a country—Japan—which has an appreciating currency and appreciating trade situation.

The second, canard is that if it were not for our oil imports the United States would not have a trade problem. I do not think that is a policy. I think that is a prescription for disaster.

The fact is, we do import oil. We are going to import oil for many years. I see nothing on the horizon that is going to change that or the pricing policies of the cartel.

However, in contrast to our benign neglect policies or even negative policy we overlook the fact that West Germany and Japan import actually more oil in relation to their economies than the United States and somehow, they have huge surpluses despite appreciating currencies. The reason is that they are committed to a bold, positive export policy.

The German trade policy is so positive that, with regard to West Germany's trade with OPEC nations, they showed last year a surplus of $800 million despite a huge import bill into West Germany. Overall they had a trade surplus of $18 billion, and in manufactured goods it was about $45 billion.

Now, this gets us down to the question of 911 and the need for a positive national export policy. I believe that this is the only country in the industrialized world without a positive export policy. Everything we do, however noble the objective, unwittingly, I feel, discourages American business from competing in the world marketplace.

All of the obstacles that this country throws at our exporters were documented at some length in a recent Business Week article which I would like be asked be included in the record after my comments. I think it will show you in comparison with what other countries are doing, the disadvantage that the American companies have including 911 as an obstacle, is having a devastating effect on our competitive situation.

Mr. Chairman, this committee has worked long and hard on resolving the 911 issue. I think you have struck a happy medium and with some small changes in the approach that the committee has taken, I think the issue can be resolved finally for the long term.

There are many, and probably some in my group, that would like to see much more generous benefits, but I really think that it is urgent to get a long term solution because of all the factors that were mentioned by previous witnesses. And if the Senate bill can be somewhat simplified, and perhaps some election included in it, I think that the essence of a solution is there.

Now, Mr. Chairman, I would like to address myself briefly to the CRS study. I have nothing personal against the authors of the study; I have great respect for the institution. However, I have seen over the course of the years, both while I was working for this committee and the private sector, so-called independent objective analysis by the Library which defy economic rationale. I have seen analysis that deregulation of prices is not going to result in increased production, that somehow eliminating DISC is not going to cause the loss of one job in the United States, the same thing with deferral.

I have seen analysis which would indicate that there is no price elasticity in investment decisions. If the price of oil were $2 a barrel, the American companies would do just as much to look for that oil as if it were $12 a barrel. Absolute economic nonsense, in my view.

I have great respect, as I have indicated, for Don Kiefer. He is a fine man, a former staff aide to Senator Hartke, and I am sure he believed

that the Hartke-Burke bill, which his Senator cosponsored, was in the interests of the United States, that simply eliminating the foreign tax credit, the foreign deferral, imposing massive import barriers in the United States, virtually having a fortress America economic policy, was going to somehow in this world of international competition, create a full employment situation.

I just do not see that it would have worked that way, and I do not believe in the assumptions. I know that words like "tax neutrality" and "tax equity" have a nice ring to them, just like "tax reform" has a nice ring. It sounds like motherhood.

But one man's neutrality and one man's equity is another man's misery. My concept of neutrality and equity in this kind of situation is to allow American firms to compete on an equal basis with the Germans, the British, the French, the Japanese and all of the other countries whose companies are going after the business.

Unless we do that, we are going to find ourselves increasingly behind the 8-ball and the same kind of thing can be said for estimates on revenue gains and revenue losses. When you think something is a loophole, you assume no feedback. When you think something is equitable or neutral, you assume a huge feedback.

I can recall, in the investment tax credit situation when this committee was considering the 1969 act, the administration, including the Honorable George Shultz, said that eliminating the investment tax credit would save the United States $7 billion or some such figure.

Well, so the committee assumed that here we can save $7 billion; it is a great reform. So we eliminated the investment tax credit and as a result, the United States got into a massive depression—or at least, recession. We did not save $7 billion. We probably cost the economy $20 billion and the Treasury.

So in 1971, the investment tax credit which 2 years before was costing the Treasury $7 billion was somehow a great thing to restore and would gain the Treasury $7 billion. So we restored it.

That experience taught me a lesson about what tax revenue estimates were all about and I think the committees of the Congress have to apply a commonsense rule about investment decisions and corporate planning when incentives are eliminated. In this regard, if the American companies are going to have to employ foreign nationals abroad to run their businesses, those foreign nationals are going to the source on foreign supplies. They are not going to buy American products.

Secretary Solomon said this, George Shultz said this. It is commonsense. Can you measure it? I do not think you can measure it, but I think you have to apply a commonsense rule.

So, in conclusion Mr. Chairman—and the buzzer rang—I would respectfully urge the committee to try to get the issue resolved with some improvements in the Ribicoff approach, but in sufficient time to meet this June 15 deadline, which is, as you well recognize, pressing against these taxpayers.

Thank you very much.

The CHAIRMAN. It seem to me that we have heard everybody's point of view and that is good. We need to hear all the points of view and all the theories. But we have had some awfully erroneous suggestions back in the past. For example, there are some who have thought that the smart thing was to rely upon the foreign oil because

foreigners could produce it cheaper than we could produce it. Some of us back at that time were saying that just because they could produce it cheaper does not mean they will sell it cheaper, if they ever get us at their mercy. And so the theory that free foreign trade would solve the whole thing prevailed against the advocacy of some of those who said we ought to try and defend and save an American industry capable of producing our energy requirements.

They did not think the Arabs could make it work. Well, they did make it work. Now, it looks like we will be lucky if we are able to get back on our feet between now and the year 2000 so far as our energy problem is concerned.

Then, trying to solve the energy problem, some of them say, well now look, if you just put more money into it, if you drill twice as many wells, you will get twice as much oil. So then others came up with the theory, no, spending more money will not get more energy. And then we scratched our heads and tried to figure what was that based on?

Well, that theory was based on the assumption that you had only 2,000 drilling rigs and that you would have them all active at a price of $1.75 for gas.

Now, my understanding is that they did not even put in the computer the 300 rigs in the process of being built when they came up with that thoughtful theory. Nor did they put in the fact that we could build 1,000 rigs a year and, over a 2- or 3-year period, we could double the number of drilling rigs we had operating.

Even there, I think, they are still proceeding under the theory that if you spend more money, you will not get more energy. We have apparently moved from a prejudice to a conclusion to support the prejudice.

Now, here again, we see this theory that there is no advantage in trying to do something to help our people against our competition—those nations which adopt the theory that their people should pay little or no taxes beyond what they pay to the overseas government when they work in a foreign place.

Now, at some point I suppose there may be a turning in all of this. But do you buy the theory that the whole thing can be worked out by letting the dollar go slap-dab to zero and on that basis that somehow it will all turn around and move it in the other direction?

Mr. Best. No; I think that is a prescription for having the United States being bought up by foreigners. Once I testified before the House committee and the distinguished chairman said, we should just run the printing presses and give them depreciated dollars, not realizing that they take those depreciated dollars and buy up all of the industry in this country and half of the real estate.

I do not see the economic logic of arguing for a weak currency.

The Chairman. Well, I have not had the economic courses that you have had, Mr. Best, or the courses that Mr. Kiefer here has had, or that George Shultz has had. I have not been favored with all of that. But in discussing this problem with a banker who seemed to know something about international finance he said, in trying to explain it all to me, what has been happening, it is a result of some fine liberal thinking that free trade is the ideal. The idea is we should not do anything to help our people compete with the other fellow.

Then he pointed out that given our present situation, if it were a

problem involving two corporations, it would be an ideal situation for a merger. The one who is losing everything he has got, which is us, ought to be taken over by the guy who is making money hand over fist.

So we ought to merge with Saudi Arabia somewhere, with them being the acquiring party and us being the selling party. And that, to me, is something that I could understand.

In other words, if you have an operation that is making a lot of money and the other fellow has one that is losing a lot of money, you ought to be taking him over. But if you are the one who is losing a lot of money, he ought to be taking you over.

Now, I regret to say with respect to this theory that we should not worry, if the dollar goes down to zero or below zero, it is going to all correct itself, I have not quite learned that much economics. You will have to pardon me for not understanding that part of it.

Thank you very much.

Mr. BEST. Thank you, Mr. Chairman.

[The material submitted by Mr. Best follows:]

AMERICAN LEAGUE FOR INTERNATIONAL SECURITY ASSISTANCE, INC.

ALISA Membership

COMPANIES

Aerojet General Corp.
American Hoist and Derrick Co.
AM General Corp.
AVCO Corp.
The Boeing Co.
Control Data Corp./Commercial Credit Co.
Emerson Electric Co.
FMC Corp.
Garrett Corp.
General Dynamics Corp.
Goodyear Aerospace Corp.
Hazeltine Corp.
Hughes Aircraft Co.
Lear Siegler, Inc.
Lockheed Corp.
LTV Corp.
Martin Marietta Aerospace
NAPCO Industries, Inc.
Northrop Corp.
Pneumo Corp.
Raytheon Co.
Rockwell International
Rohr Industries, Inc.
The Singer Co.
Sundstrand Corp.
Teledyne, Inc.
TRW, Inc.
United Technologies Corp.
Westinghouse Electric Corp.

UNIONS

International Brotherhood of Teamsters, Chauffeurs, Warehousemen and Helpers, AFL-CIO.

United Brotherhood of Carpenters and Joiners of America, AFL-CIO.

Marine Engineers' Beneficial Association, AFL-CIO.

[From Business Week, Apr. 10, 1978]

THE RELUCTANT EXPORTER—TRADITIONAL U.S. ATTITUDES AND ANTIEXPORT POLICIES

The U.S. is the world's biggest, and most indifferent, exporter. Last year, American industries and farms shipped $120 billion worth of goods—from soybeans and blue jeans to machine tools, computers, and aircraft—to foreign customers, compared with $118 billion for Germany and $81 billion for Japan. But U.S. imports—of oil, autos, TV sets, and thousands of other products—soared to $147 billion and opened up a yawning $27 billion trade deficit (chart). Meanwhile, the export-minded Germans and Japanese piled up fat surpluses of $18 billion and $10 billion respectively, partly by stepping up sales to the U.S.

The unprecedented shortfall in the U.S. trade account, which is likely to be repeated this year, signals a dangerous erosion in the ability of U.S. industry

to compete in world markets. That deterioration is not due to traditional business factors: costs of labor and capital, or productivity. In those respects U.S. companies are now competitive. The real problems lie in the attitude of many corporate managers that exports are marginal business, and in the antiexport policy of Congress and successive Administrations, which have paid lip service to promoting exports while actually inhibiting them with laws and regulations. The U.S. is a reluctant exporter.

One immediate result is the dollar's headlong plunge. It stems, in large part, from the huge outflow of unwanted dollars as U.S. payments for imports outstrip U.S. income from exports.

The quick and easy diagnosis is that oil imports are to blame. Last year the U.S. bought $45 billion worth of oil from abroad. President Carter insists that if Congress would only pass his energy bill, the problems of the dollar would evaporate. But economists, such as Rimmer de Vries of Morgan Guaranty Trust Co., insist that solving the energy problem is only part of what is needed to put the dollar on a sound basis. The other requirement is a national export policy. Says de Vries: "I think we have a negative policy on exports. We sometimes discourage agricultural exports because of domestic price pressures; we discourage military exports for political reasons; we discourage trade with eastern Europe, and we have the problem of Arab boycott legislation."

The thinking on trade in many U.S. companies and in government is a hold-over from the days when the U.S. had little need of export markets. But today, to pay for the oil it imports, the U.S. must find takers for tens of billions of dollars worth of additional products abroad.

Until it does, the U.S. is likely to be a major obstacle to worldwide economic recovery. Indeed, the current turbulence and uncertainty in international money markets threatens to abort the slow recovery of the global economy from the longest and deepest recession since World War II. And within the U.S., the falling dollar, by making imported goods more expensive, is adding fuel to inflation.

Longer term, the U.S. failure to earn its way in international markets is costing the nation hundreds of thousands of jobs, millions of dollars of corporate profits, and billions of dollars of added business activity that expanded exports would generate for industries and communities throughout the country. The consequence is likely to be lower economic growth and, ultimately, a slower rise in living standards.

A DEEP-ROOTED DISINTEREST

The response of labor unions, Congress, and many industries to deteriorating U.S. trade competitiveness has been to demand restrictions on imports rather than stepped-up efforts to boost sales of U.S. products abroad. "There is no concern at all about exports," says Senator Adlai E. Stevenson (D-Ill.), who is trying to stir interest in the issue by conducting extensive hearings before the Senate Banking Committee's subcommittee on international finance. "The objective of the Humphrey-Hawkins bill is jobs, and it has been estimated that each $1 billion of exports creates 40,000 jobs," he adds, referring to the Administration's proposed legislation to spur employment. "But Humphrey-Hawkins has something in it for everybody, except exports, and that demonstrates our indifference to this sector." Stevenson's comments are echoed by an executive in Brazil of a major U.S. capital goods exporter. "For American companies, there is no reward for exporting, nor any penalty for failing to export," he says.

Such widespread U.S. disinterest in exports—despite the success of individual U.S. companies in foreign markets (table, page 65)—is nothing new. The American colonies exported timber, tobacco, and cotton to Britain to pay for manufactured goods, and Yankee ship captains later traded products of New England's budding industries on a small scale as far away as China. But the emergence of a continent-sized internal market in the 19th century turned the attention of U.S. manufacturers inward. Unlike the Germans and Japanese, most American companies do not need to export to achieve economies of scale.

Following World War II, U.S. companies did participate in the rebuilding of Europe primarily by exporting. But as country after country regained its strength, many U.S. companies built manufacturing plants and marketing operations abroad to serve local markets. U.S. multinationals spread management skills, capital, and technology rather than U.S.-made products around the world. The exception was Japan, where restrictions kept out most multinationals as well as many U.S. exports.

For nearly 20 years the economics of overseas production, compared with high costs at home, compelled U.S. companies to continue building plants abroad,

rather than export, to serve foreign markets. But many of the factors that made that practice desirable no longer exist. For example, the increase in unit labor costs in the U.S. from 1974 to 1976 was the second-lowest of the major industrial countries. (It was bettered only by the rate in West Germany.) The U.S. increase in hourly compensation over the same two years was also the second best. (West Germany again had the best record.) What is still lacking is the determination to export.

Frank A. Weil, Assistant Secretary of Commerce for domestic and international business, estimates that 20,000 U.S. companies export, but another 20,000 that could successfully sell in foreign markets are not doing so. The resulting asymmetry in U.S. trade relations with the rest of the world is typified by the auto industry. Detroit designs big cars for the U.S. market and exports very few; Europeans and Japanese build smaller cars for world markets, and last year they shipped 2 million to the U.S.

THE PROBLEM OF OIL IMPORTS

There are also shorter-term causes of the current lag in U.S. exports. In part, the trade gap reflects the slow economic recovery in Europe and Japan at a time when the U.S. is at the peak of its business expansion. The result is a strengthening demand in the U.S. for foreign products and weak demand in those countries for U.S. goods. Eventual reversal of the cycles should sharply improve the trade balance, as happened in 1975 when the U.S. ran up a record $11 billion surplus.

A more fundamental problem is soaring oil imports (chart). In itself, the huge bill for foreign oil reflects a leveling-off of domestic supplies rather than a loss of U.S. trade competitiveness.

In contrast, official doctrine among Administration policymakers, at least up to now, has held that the trade gap would automatically be closed by an economic revival abroad and by depreciation of the dollar under the system of floating exchange rates. The cheaper dollar should achieve this, in theory, by giving American goods a price advantage in world markets and making foreign products more expensive in the U.S.

To some extent, this is happening. John A. Armbruster, general manager for Asian operations of J. I. Case Co., a subsidiary of Tenneco Inc., for example, expects to sell more construction equipment in South Korea and Taiwan this year against Japanese competition because of the depreciating dollar. George F. Newman, assistant treasurer of Hewlett-Packard Co., a Palo Alto (Calif.) maker of computers and instruments, sees growing signs that the company's price cuts in foreign markets, as the dollar declines, are helping to increase exports sales.

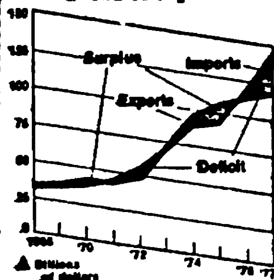
Price, of course, is only one factor—along with quality, delivery, service, and credit terms—in world market competition. Numerous nonprice barriers, ranging from foreign governments' "buy local" rules to the European Community's "variable levies" on farm imports, also nullify the impact of currency changes on trade in many products.

MULTINATIONALS' STAKE

Moreover, an increasing share of U.S. exports—anywhere from 25% to 50%—is now made up of intracompany shipments of materials, components, and finished products by parent companies of U.S. multinational concerns to thousands of their own affiliates abroad. The multinationals' huge financial stake in overseas production, as well as foreign government pressures against worker layoffs, inhibits any moves to cut back foreign output and replace it with stepped-up exports from the U.S., even if they are cheaper. Thus, the structure of international trade is moving further and further from the classical model of unimpeded commerce based strictly on "comparative advantages." Eventually, the large reverse flow of foreign multinational investment that is now moving into the U.S. should help narrow the U.S. trade gap by substituting U.S.-made products for imports of everything from Volkswagens to Japanese TV sets.

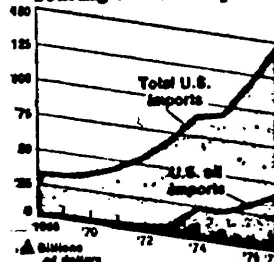
On the export side of the trade ledger, though, U.S. companies that already have well-established export networks are the only ones in position to make aggressive use of the new price competitiveness of American products in order to sell more abroad. Unfortunately, many U.S. companies turned away from exports in the 1960s when the dollar was overvalued. More recently, they have been deterred from making costly investments in overseas sales and service organizations by a rash of laws, executive actions, and court rulings that impede exports (table, page 57). Unless a more favorable business environment is created for U.S. exporters, they will continue to lose world market shares to foreign rivals, regard-

U.S. imports are racing ahead of exports...



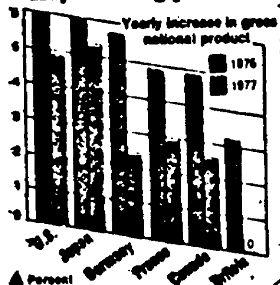
Data: Commerce Dept.

...partly because of soaring oil consumption...



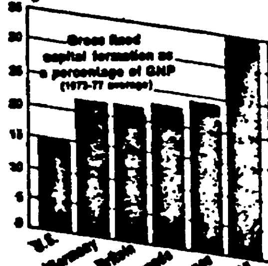
Data: Commerce Dept.

...and slow growth of major trading partners



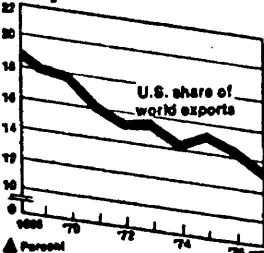
Data: Organization for Economic Cooperation & Development, government agencies

The U.S. must step up productive investment...



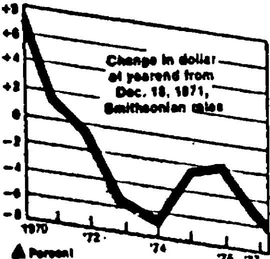
Data: Organization for Economic Cooperation & Development, government agencies

...to regain shrinking export market shares...



Data: Commerce Dept., International Monetary Fund

...and halt the dollar's steep decline



Data: Morgan Guaranty Trust Co. (Yearend figures are average for the last full work week of the year. Changes are trade-weighted against a group of 15 currencies)

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less of business cycles and the cheapening dollar. Says David C. Garfield, vice-chairman of Ingersoll-Rand Co., which annually exports more than $400 million worth of heavy machinery and equipment: "It doesn't make much difference what you are willing to sell for if you are unable to represent your product, service it, and get it into customers' hands."

WASHINGTON'S FEEBLE—AND CONTRADICTORY—EXPORT POLICIES

"We need a national export policy that assesses continually the impact on trade of whatever we do," says Frank A. Weil, Assistant Commerce Secretary for domestic and international business. "Right now, not only do we not have any plus programs for exports, we have a lot of negatives."

In recent years, Presidents and congressmen have given lower priority to exports than to such issues as tax reform, nuclear proliferation, corporate corruption, the Arab boycott of Israel antitrust enforcement, human rights, the environment, and rivalry with Communism. Even the Export-Import Bank, the oldest and probably the most effective government aid to exporters, increasingly has been hobbled by restrictions on its lending that reflect public concern over other issues, regardless of the impact on trade.

Now there are a few indications of more action by the Carter Administration to boost U.S. exports. Within a few weeks, the President is expected to name an interagency task force to start drafting a national export strategy.

MOORE'S MOVES

So far, the main push has been to try to increase demand for U.S. products abroad by prodding the governments of Germany and Japan to stimulate their economies and thus draw in more U.S. goods. On the supply side of the export ledger, the Administration's biggest move has been to ask Congress for a record $15 billion increase over the next five years in the loan ceiling of the Export-Import Bank, which finances exports of the capital goods that are the country's greatest strength in foreign trade.

Even before Congress acts, John L. Moore, Ex-Im's new chairman, is moving to make the agency more competitive with such rival foreign export-finance agencies as Germany's Hermes, France's Coface, and Japan's Export-Import Bank. "I have been traveling to the financial centers of the country," Moore says, "to tell the board chairmen of the multinational companies that do most of our exporting that the falling dollar is making exports from this country price-competitive, and that I intend to do everything I can, within the restrictions Congress has put on this institution, to make them credit-competitive."

To achieve that, Moore has shaved interest rates on Ex-Im loans to as low as 7½% from 8% or more and has increased Ex-Im's share of financing export transactions from a standard 45% in the past to 85% in some cases now. He even went to 100% for a proposed $16 million sale of gas turbines to Malaysia by United Technologies Corp. But despite such support, a Japanese company won the sale with a government-backed 4%, 20-year loan.

Faced with that kind of competition, Moore concedes that even if Congress grants the new funds, Ex-Im still will not fully match its foreign rivals. Ex-Im is hampered by the necessity of getting congressional approval for every loan over $60 million. And to add to the tangle of restrictions, environmental groups are asking Congress and the courts to require Ex-Im to assess the environmental impact on foreign countries of the exports it finances.

Apart from the request for more funds for Ex-Im, though, the Administration has done little to spur exports directly. Despite inflation, the Office of Management & Budget has kept a low $20 million ceiling on the Commerce Dept's export promotion programs in recent years.

Assistant Secretary Weil, who runs such programs, proposes a number of additional steps to "enrich the environment in which exports take place." For example, he suggests making Ex-Im credits automatic for small exporters, as do the French and British export-financing agencies, provided the exporters' local banks help with the total financing. And he proposes a computerized system to match inquiries from potential foreign buyers with information on products available in the U.S., which present reporting by Commerce and U.S. embassies abroad cannot do.

ADDED OBSTACLES

But Weil until recently has been a lone voice calling for a hard-hitting national export policy. The Administration, as part of its tax reform program, proposes to abolish tax incentives for exporters, who are allowed to defer part of their corporate taxes on profits from exports that are channeled through domestic international sales corporations (DISCs). Such sheltered profits, which must be invested in export-related activities, now total $11 billion. But offsetting the loss of tax revenue to the Treasury, businessmen claim, DISCs have also generated more taxable corporate income by giving a boost to exports. Another Administration proposal—to end the deferral of U.S. taxes on profits of foreign subsidiaries—would hit hardest at operations in developing countries, businessmen say, including export sales subsidiaries. Congress, heeding such complaints, may rebuff the Administration on both proposals.

HOW THE U.S. GOVERNMENT HELPS—AND HINDERS—EXPORTS

Aids	How they work	The outlook
Export-Import Bank	Finances aircraft, nuclear plants, other big-ticket items.	Congress will approve $15,000,000,000 increase in lending to $40,000,000,000.
Domestic International Sales Corporations.	U.S. companies use 10,000 DISC tax shelters to aid exports.	Congress will probably reject proposal to phase out DISC's.
Commerce Department export promotion programs.	Help small and new exporters to enter foreign markets.	May be expanded following earlier budget holddown.
"Tokyo round" trade negotiations	Administration hopes to bargain down foreign barriers to U.S. goods.	Rising protectionism threatens the talks.
U.S. pressure on Germans and Japanese to spur their economies.	Recovery abroad would stimulate U.S. exports.	Germany resists. Japan set buying mission to the United States, but its economy lags.
Join United States-Japan Trade Facilitation Committee.	Acts on complaints by U.S. companies against Japanese nontariff barriers.	Hurdels cleared for GE, Procter & Gamble, others. More cases pending.

Obstacles	How they work	The outlook
Anti-Arab boycott rules	U.S. exporters must forgo Arab contracts that bar Israel made goods.	Stiff additional curbs take effect in June.
Reduction of income tax advantage for Americans abroad.	Raises cost of keeping U.S. sales and service personnel overseas.	Congress is likely to restore some exemptions.
Trade Act of 1974	Bars Exim credit to most Communist countries.	Congress is expected to restore credits to Hungary.
Foreign Corrupt Practices Act of 1977	Imposes jail terms and fines for overseas payoffs by U.S. companies.	No change expected. European and Japanese competitors unaffected.
Antitrust laws	Prevent U.S. companies from bidding jointly on major foreign projects.	No change expected.
Restrictions on sale and financing of nuclear plants.	Designed to halt the spread of nuclear weapons.	No change expected. Europeans are replacing U.S. suppliers.
Human rights legislation	Exim denies credits to rights violators. Loans withheld from South Africa, Uruguay, Chile.	No change expected. Not imposed by other trading nations.
Proposed environmental restrictions	Exim would be required to assess impact of U.S. exports on foreign countries.	Pending in Congress, administration, and courts. Procedures could be long and costly.
U.S. trade embargoes	Ban exports to Cuba, Vietnam, Rhodesia, other countries.	Talks on easing ties with Havana slowed by Cuban intervention in Africa.
Strategic controls	Restrict exports with potential military uses to Communist bloc.	U.S. enforces more strictly than allies. Curbs under review.
Proposal to end U.S. tax deferral on multinationals' operations abroad.	Would mainly affect U.S. plants and export sales subsidiaries in developing countries.	No change expected.

Another tax reform provision that has been delayed would boost personal income taxes on Americans abroad. Enacted by Congress in 1976, it has not yet been put into effect and will probably be modified. If not, businessmen warn, it will force U.S. companies to bring back most American personnel, including engineers and managers who promote the use of U.S. equipment in overseas plants and construction projects.

Still another U.S. government-imposed obstacle to exports, in the eyes of many businessmen, are antitrust rules that prevent them from teaming up to bid on

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major foreign projects against government-backed European and Japanese consortiums. Thus, in Brazil, General Electric Co. and Westinghouse Electric Corp. are vying independently for pieces of a $450 million generator and turbine contract, the biggest ever, for the Itaipu dam. But a huge European group led by Germany's Siemens and Switzerland's Brown-Boveri is expected to win most of the order.

LOSING A TRACTOR ORDER

This month, Deere & Co., which has sold agricultural tractors to Iraq in the past, ran into an export barrier embodied in legislation that prohibits U.S. companies from certifying in contracts with Arab countries that the products to be sold are not made in Israel. Deere has no plants in Israel. Nonetheless, Deere had to withdraw from bidding on an $18 million order for 1,500 tractors to Iraq because of the language in the proposed contract. The company said such an order could have provided 20,000 man-days of work in its U.S. plants. Deere Chairman William A. Hewitt wrote Illinois and Iowa congressmen, complaining that the U.S. counter-boycott "hurts American trade but does not seem to us to meet any important Israeli need."

Charles H. Weaver, an executive vice-president of Westinghouse, is outspoken, too, about restrictions on nuclear exports. "We haven't sold a nuclear plant overseas for two years, largely because of our government policies," he says. "Either the buyer can't be sure of our policies, or he disagrees directly with President Carter's no-reprocessing demands, or he won't go along with our inspection procedures and bilateral agreements."

Sums up George F. Newman, assistant treasurer of Hewlett-Packard Co., of Palo Alto, Calif., which exported more than $330 million worth of computers and other equipment last year. "As a general rule, it seems to be getting more and more difficult to export."

"MADE IN U.S.A." MEANS LITTLE TO THE MULTINATIONALS

Just 1% of U.S. companies—mostly the big multinationals—account for an estimated 85% of all U.S. exports. Thus, the international production and marketing strategies of the globe-girdling companies are crucial to U.S. export performance. But their basic aim is to maximize worldwide profits, without regard to source of product or national boundaries. U.S. multinational managers have no business reason, therefore, for preferring to export American-made products rather than producing the same goods in foreign plants.

"I am conscious of the trade deficit and the value of the dollar," says Charles H. Weaver, executive vice-president for corporate world relations of Westinghouse Electric Corp., which operates 55 plants overseas and exported $800 million worth of products from the U.S. last year. "We do everything we can to make the situation better and pray for Washington to stop putting up distractions. One of the things we can do is sell aggressively overseas—either by exporting or building a plant."

This same basic option is deeply embedded in the approach of other multinational corporations to world markets. For many, in fact, a big share of exports is made up of intracompany transfers of components and products within the same corporate group. As a result, several major companies had difficulty in supplying *Business Week* with data for its ranking of the top U.S. exporters (table, page 65). International Business Machines Corp. failed to provide a figure for its exports from the U.S., and General Motors Corp. flatly refused to do so.

FOREIGN GOVERNMENT PRESSURE

The blurring of the distinction between exports from the U.S. and local production, in the marketing decisions of multinational managers, is having an increasing impact on U.S. trade. Foreign governments, eager to improve their own trade balances, are wielding an array of carrots and sticks to get multinational companies to produce more locally and to export to the rest of the world. In Brazil, for example, 62 of the 100 biggest exporters last year were multinationals, spurred by a combination of official export requirements and subsidies.

Ford Motor Co.'s Philco subsidiary in Brazil exported $131 million worth of products, many of them radios for U.S. cars, and imported only $66 million worth, giving it the best corporate trade balance of any company in Brazil. And under the Brazilian government's policy of promoting the inflow of technology to replace imports with local production, France's Technip won a contract last year to build

a big ethylene cracker at a new petrochemical complex in the south over rival bids by two U.S. engineering companies, Lummus Co. and Stone & Webster Inc. "Only the French met our conditions for transferring technology," says a Brazilian government petrochemical planner.

Several deals now in the works in Brazil illustrate how General Electric Co., the biggest U.S. exporter, meshes exports from the U.S. with those from its producing subsidiaries around the world. GE's International Sales Group, a headquarters team, operates as an in-house trading company with the objective of promoting exports from any GE manufacturing affiliate around the world, not just from U.S. plants. Most GE operating units pay a basic fee to support the ISG, which has offices in 70-odd cities in the U.S. and abroad, and the ISG also gets a commission from the operating units on sales that it negotiates.

Under one such deal, GE do Brasil will sell $3.5 million worth of refrigerators to the Middle East this year. The ISG is also trying to sell $20 million worth of Brazilian-made locomotives to Mozambique. GE do Brasil, which has exported locomotives to other African countries and Latin America, is seeking Brazilian government financing for the sale. If the deal falls through, GE will try to sell locomotives to Mozambique from its Erie (Pa.) plant instead. But if GE do Brasil gets the contract, the only benefit to the U.S. trade balance will come from exports of the 30% of U.S.-made components that go into the Brazilian engines.

CONCENTRATING IN THE UNITED STATES

But for another product, numerical control systems, GE in recent years has concentrated all manufacturing and export sales within the U.S. Until 1972, GE had also made such equipment in Italy and in Britain, in cooperation with Hawker Siddeley Group Ltd. "We were building a complex system that had to be reliable," says Werner Rieben, GE's Frankfurt-based European sales manager for industrial controls. "In fact, reliability is all that counted." Rather than make heavy investments in expensive inspection machinery in three plants, GE shifted all production to its plant in Richmond, Va., even though 40% of the company's $50 million annual sales of numerical controls go to Europe.

To do this, GE had to adapt its product to the needs of foreign markets—a costly requirement that deters many U.S. exporters. It has developed a numerical control system that is usable in both metric and English measures, and it also designed the machines to operate despite the wide differences in voltage among European countries.

For U.S. auto companies, the emphasis on big-car production for the home market and production overseas for the rest of the world has shrunk exports to a tiny 4% of U.S. production for GM, and even less for Ford. Last year, not counting shipments to Canada under the U.S.-Canadian automotive free trade agreement, GM exported 204,000 assembled cars and knockdowns outside North America—less than it did it 1929. Nevertheless, says Richard R. Jensen, executive vice-president for overseas operations, GM's exports are "big business." He adds: "And it will get bigger. The organizational structure is in place, and as fast as people appreciate North American cars, we ought to be able to increase these sales."

To achieve this, according to Richard McGill, director of marketing for overseas operations, GM has been appointing more overseas dealers in recent years. (Possibly the biggest, worldwide, is Kuwait dealer Jusaf Alghanim & Sons, which sold 20,000 Chevrolets, Cadillacs, Oldsmobiles, and Pontiacs last year.) "There is a lot of room out there for both exporting and manufacturing," McGill says, although there is no sign, so far, that GM is preparing a major export push. But Ford, which has bigger overseas production capacity than GM, has virtually no interest in exports from the U.S. "We've got a tremendous product line in Europe, and we've got English products going to Asia," says a spokesman. Any thought of exporting in quantity from the U.S., he adds, "just doesn't figure."

LANDING SOVIET ORDERS

While major U.S. companies have developed worldwide options for "sourcing" their products, many smaller concerns are successfully winning foreign market shares strictly by exporting from U.S. plants. Of course, companies with a distinct technological edge, such as GCA Corp., of Bedford, Mass., are best able to do this. GCA manufactures semiconductor equipment, and last year customers outside the U.S. and Canada accounted for more than one-third of total sales of $52 million. James E. Gallagher, senior vice-president for operations,

cites one shortcoming of many U.S. exporters. "They are not willing, or have not been willing in the past, to make a commitment to service their products," he says. GCA, for its part, makes almost a fetish of service overseas. In Europe, it maintains a backup inventory of critical spare parts, available 24 hours a day, and it has trained local representatives to service its products. "Every foreigner is afraid you will go out of business or won't have spare parts or won't get there in time," he says. "One of the worst things that can happen is to have a customer get nervous and tear the equipment apart."

On a still smaller scale, Alox Corp., a Niagara Falls (N.Y.) producer of corrosion inhibitors and lubricating oils, has based much of its expansion on export sales, which have risen to 40% of total output in recent years. In turn, tax-deferred profits from exports that the company accumulates in a domestic international sales corporation have helped to finance two plant enlargements, following abandonment of earlier plans to put a plant in Holland. "The expansion has really been based on the growth of our business in Europe," says Chairman Clarence A. Weltman.

And in Cleveland, a medium-sized capital goods maker has pursued a deliberate strategy of export-led growth. Until 1971, Cleveland Crane & Engineering Div. of Akron-based McNeil Corp. was a strictly domestic manufacturer of materials handling systems, mostly for the steel industry. As a result, says President Karl A. Pamer, it was faced with sluggish sales prospects in a slow-growing market, and it was also exposed to fluctuations of the capital investment cycle.

To offset that, Pamer six years ago adopted a multi-pronged export strategy. He decided to seek sales in the world's biggest market areas, including the Soviet bloc, despite apparent political obstacles. As part of the strategy, Cleveland Crane began to offer complete turnkey systems by farming out some of the manufacturing. Pamer also decided that Cleveland Crane itself would do the expanded engineering required by turnkey projects, since engineering is more profitable than manufacturing.

The strategy, partly as a result of sizable contracts in the Soviet Union, has helped push Cleveland Crane's sales up from $17 million to between $40 million and $45 million last year, Pamer says, although McNeil does not break out exact figures.

Pamer began making sa' s trips to the Soviet Union in 1971 but took two years to land contracts for installations at Russia's huge Kama truck plant. Later, Pamer says, the supplier-customer rapport he had established with the Soviets helped him get payment in cash for materials handling systems at the Cheboksary tractor plant after the U.S. cut off Export-Import Bank credits to the Russians. The Soviet contracts have been a major factor in pushing Cleveland Crane's exports from zero to an average 20% to 25% of total revenues. Now, following a trip to China a year ago, Pamer expects to return with other Cleveland Crane executives in July. After that meeting, Pamer says, he might not hear from the Chinese for another two years, but the payoff, if it comes, is likely to be a big contract.

Like other successful U.S. exporters, particularly of capital goods, Pamer emphasizes that willingness to invest management time as well as money is the key. "The average American company will shy away from putting enough capital in front of an export sale," he says. "Sales trips and application engineering can be very expensive," he adds. "But you need fore front money—along with tremendous persistence."

Ingersoll-Rand's Secret of Success

"You can't do business out of an empty wagon," says William L. Wearly, chairman of Ingersoll-Rand Co., a maker of equipment for mining, construction, oil and gas production, and industrial use. "In the export field, you have to have your service organization over there, and at least the standard products on the shelf."

For Ingersoll-Rand, based in Woodcliff Lake, New Jersey, having products "on the shelf" overseas means stocking foreign warehouses with items such as compressors and compactors carrying price tags up to $50,000 and water-well drillers that sell for as much as $200,000 apiece. Last year the company exported $408 million worth of goods out of total worldwide sales of $2.1 billion—a 20% export ratio that is high for an American company.

I-R's foreign marketing strategy is shaped by the necessity of investing heavily in foreign sales and service organizations to support exports from the U.S. as well as production abroad, which accounted for an additional $366 million in 1977 sales. In France, for example, I-R's subsidiary has 405 employees, many of them specialists, selling and servicing its products even though the company does no manufacturing there.

Costly receivables.—"We need about $1 of assets overseas for every $1 of sales," Wearly says. "And the big money we tie up is in inventories and accounts receivable." Thus, of I-R's total assets of $723 million outside the U.S. last year, inventories and receivables accounted for $561 million, or nearly 80%. The receivables, in particular, are what boost the cost of exporting compared with domestic sales for I-R as well as for other U.S. capital goods makers. In Europe and in foreign countries elsewhere, explains David C. Garfield, I-R's vice-chairman, customers take three to nine months to pay, compared with six to eight weeks in the U.S. That is one of the asymmetries in international trade that favor the flow of foreign goods into the U.S. market while making it more costly for U.S. companies to export.

Garfield is chairman of the Special Committee for U.S. Exports, a group of 1,200 companies that is lobbying to retain the domestic international sales corporations (DISCs) that the Carter Administration proposes to phase out. I-R has $47.7 million of tax-deferred earnings accumulated in its DISC, invested entirely in export inventories and receivables. If the DISC were abolished, Garfield says, "we would have to cut inventories and receivables so the money would be available to pay American taxes." He adds: "It would be clearly counterproductive."

Complex management.—Establishment of the DISC system in 1971, and the initial dollar devaluation under the Smithsonian Agreement, coincided with a push by Wearly to boost I-R's exports, which had fallen to 45% of the company's total foreign sales. Exports jumped from $131 million in 1971 to $436 million in 1976—which represented 56% of total foreign sales—before dropping somewhat last year under the impact of the economic slowdown abroad. In I-R's corporate setup, an international executive vice-president plans the sourcing of production from U.S. plants, with authority that cuts across the responsibilities of three other executive vice-presidents who are in charge of standard products, engineered products, and components, respectively. "This is a complex thing to administer," says Wearly. "You have two different managements and many countries to deal with."

Part of I-R's export success Wearly attributes to the use of foreign producing subsidiaries, which make a limited number of products locally, as the "cutting edge" for larger exports from the U.S. For example, I-R has had a manufacturing plant in South Africa since 1894, but 80% of the goods it sells there are made in the U.S. "You need a presence, the customers want to see that you are there," he says. "It gives the customers a sense of permanence."

Appendix A

Charts Comparing Export Incentives Offered by the U.S. and Foreign Countries

Chart I. Description of Tax Incentives for Exports.
Chart II. Description of Nontax Incentives for Exports.

Note.—Prepared in 1975 and 1976 from various sources including counsel and accountants in some countries and published sources in all. Since published sources cannot be fully current, there may be some changes not recorded.

TAX INCENTIVES FOR EXPORTS

	Austria	Portugal	Australia	New Zealand	Japan	Canada
Taxation of foreign branch income	Fully taxed at usual rate (progressive rates from 30 to 55 percent). Deduction for foreign taxes paid. Foreign tax credit upon application.	Exemption of 3/8 of income (effective tax rate of 17.4 percent).	Exempt except if has not been taxed abroad (tax rates from 47.5 to 50 percent).	Fully taxed at usual rate (tax rates are from 20 to 45 percent). Foreign tax credit.	Taxable at usual rate (effective tax rate of 52 percent). Favorable foreign tax credit system.	Fully taxable at usual rate (46 percent). Foreign tax credit.
Taxation of foreign subsidiaries.	None. No subpart F income equivalent.	None. No subpart F income equivalent.	None. No subpart F income equivalent.	None. No subpart F income equivalent.	None. No subpart F income equivalent.	Yes, but under conditions less stringent than under subpart F income.
Deductibility of foreign branch losses.	Fully deductible	Fully deductible	Fully deductible	Fully deductible	Fully deductible	Fully deductible.
Taxation of foreign source dividends.	Exempt if at least 25 percent control.	Excempt if at least 25 percent control. One-third taxable in other cases.	Exempt in practice	Exempt	Fully taxed at usual rate. Direct and deemed paid foreign tax credit.	Exempt when foreign subsidiary is controlled (50 percent). Partial exemption from 1976. Foreign tax credit.
Special deferrals of taxable domestic income.	Investment reserves	None		None	Income may be deferred for: overseas market development; overseas investment losses; foreign exchange losses.	None.
Specific export tax incentives.	10 percent writeoff with respect to acquisition of shares in certain foreign entities. Custom free zones.	None	Deductions and rebates for export market development expenses.	Deduction of 150 percent of the cost of export relzted expenditures. Deduction of an amount related to increased export sales.	Reserves for overseas market development—deduction of overseas investments; reserves for foreign exchange losses; special deductions for certain overseas transactions.	None.
Intercompany pricing rules					Favorable treatment for exporting companies.	
Border tax adjustments (VAT).	VAT (rate 16 percent) zero rate on exports.	None	None	None	None	None.
Tax incentives indirectly benefiting exports.	Accelerated depreciation or tax-exempt investment reserve.[1]	Reduced tax rate or exemption from taxation for introduction of new products or processes. Accelerated depreciation.	None		None	Tax reduction for manufacturing income. Accelerated depreciation.[1] Investment tax credit.

	Belgium	France	Germany	Italy	Luxembourg	Netherlands
Taxation of foreign branch income.	¼ the usual rate (48 percent).	Exempt[3] (corporate tax rate is 50 percent).	Normal tax rate (51 percent) plus foreign tax credit or, in certain cases, imposition of a flat 25 percent tax rate.	Taxed at usual rate (35 percent). Foreign tax credit.	Exemption on 50 percent of income (progressive tax rate from 20 to 40 percent). Foreign taxes deductible.	Taxed at usual rate. Favorable foreign tax credit system.
Taxation of foreign subsidiaries.	None. No subpart F income equivalent.	None except if election is made. No subpart F income equivalent.	Yes, but under conditions less stringent than the U.S. subpart F provision.	None. No subpart F income equivalent.	None. No subpart F inocme equivalent.	None .No subpart F income equivalent.
Deductibility of foreign branch losses.	Fully deductible even though foreign income is exempt under tax treaty.	Not deductible[3]	Fully deductible even though foreign income is exempt under tax treaty.[4]	Fully deductible		Fully deductible.
Taxation of foreign source dividends.	Permanent participation (held for more than 1 year); 95 percent exclusion plus 5 percent tax credit. Non permanent participation: 15 percent tax credit.	95 percent exclusion if French company owns 10 percent or more of the stock.	Fully taxed at usual rate. Foreign tax credit and deemed paid foreign tax credit under certain circumstances.	Fully taxed at usual rate. Foreign tax credit.	50 percent exclusion if at least 25 percent control. Total exemption for holding companies. Foreign taxes deductible.	Exempt in majority of cases.
Special deferrals of taxable domestic income.	None	Income may be deferred for—losses of certain foreign business—cost of investment in certain business in LDC's—export credit extended to foreign buyer.	Income may be deferred for—losses of foreign branches whose income is tax exempt—losses of foreign subsidiaries—profits realized upon an exchange of property for stock of a foreign corporation.		None	None.
Specific export tax incentives.	None	Joint export programs—Election to compute income on a worldwide basis—All special deferrals—Exclusion from the "inflation levy".	None		None	Tax credit for withholding tax on interest and royalties paid by residents in certain nontreaty LDC's.
Intercompany pricing rules.	Will provide assurances on allocation in certain cases. Historically generous to exporters.	As a general rule, not enforced against exporters.	Usually enforced although relaxation may be granted in special circumstances.			Usually enforced but special agreement used. May be negotiated with the tax authorities.
Border Tax adjustments (VAT).	VAT (18 percent rate) up to 25 percent for luxury items. Zero rate on exports.	VAT (20 percent rate) up to 33 percent for luxury items. Zero rate on exports.	VAT (11 percent rate). Zero rate on exports.	VAT (12 percent up to 30 percent for luxury items). Zero rate on exports.	VAT (rate 10 percent). Zero rate on exports.	VAT (16 percent rate). Zero rate on exports.
Tax incentives indirectly benefiting exports.	Accelerated depreciation; exemption from real estate tax; reduced income tax rate on certain reinvested profits.[5]	Accelerated depreciation; exemption from local business tax; reduction of registration taxes.[5]	Accelerated depreciation; reduction of corporate tax rate and VAT rates.[5]	Tax exemption or reduction for financial or government-owned companies.[5]	Investment credit from 3 to 9 percent of cost of certain capital assets.	Accelerated depreciation[5] Investment tax credit from 8 to 16 percent of cost of certain capital assets.

TAX INCENTIVES FOR EXPORTS—CONTINUED

	U.K.	Ireland	Denmark	Norway	Sweden	United States
Taxation of foreign branch income.	Taxable at usual rate (52 percent). Foreign tax credit.	Taxable at usual rate. (Average rate 50 percent). Deduction for foreign taxes paid.	Taxed at half the usual rate (½ of 37 percent). Foreign tax credit.	Exemption on 50 percent of income (rate is 25.5 percent).	Taxed at usual rate (effective income tax rate is 54 percent). Foreign tax credit.	Fully taxable at usual rate (48 percent). Foreign tax credit.
Taxation of foreign subsidiaries.	None. No subpart F income equivalent.	None. No subpart F income equivalent.	None. No subpart F income equivalent.	None. No subpart F income equivalent.	None. No subpart F income equivalent.	Yes, under subpart F provisions.
Deductibility of foreign branch losses.	Fully deductible. Deductible against foreign source business income only when carried over to following years.	Fully deductible	Fully deductible		Fully deductible	Fully deductible.
Taxation of foreign source dividends.	Fully taxed at usual rate. Direct and deemed paid foreign tax credit.	Fully taxed at usual rate	Fully taxed at usual rate. Deemed paid foreign tax credit.	Half-exempt if at least 95 percent control.	Fully taxed at usual rate. Foreign tax credit.	Fully taxed at usual rate. Direct and deemed paid foreign tax credit.
Special deferrals of taxable domestic income.	None		None	Tax free reserves deductible.		About 25 percent of taxable income may be deferred under the DISC provisions.
Specific export tax incentives.	Deduction of business entertainment expenses connected with export activities.	Exemption from corporate taxes on profits attributable to exports of goods produced in Ireland.		Tax free reserves deductible.	Additional deduction for interest charged on export credit.	None, aside from DISC.
Intercompany pricing rules.	Not actively used				Not actively used	Strictly enforced, including against export industry. Important cases against exporters pending.
Border tax adjustments (VAT).	VAT (8 percent rate up to 25 percent for luxury items). Zero rate on exports.	VAT (19.5 percent up to 36.5 percent for luxury items). Zero rate on exports.	VAT (15 percent rate). Zero rate on exports.	VAT (20 percent rate). Zero rate on exports.	None	None at Federal level.
Tax incentives indirectly benefiting exports.	Favorable rates of depreciation.[1]	Acclerated depreciation[1]	Tax-free investment reserves constituted by 20 percent of annual profits. Dissolved after 10 years.[1]	Accelerated depreciation. Tax-free reserves deductible.[1]	Acclerated depreciation[1]	Accelerated depreciation. Investment tax credit (10 percent).

[1] Most of the tax incentives are granted in connection with industrial and regional development.

[2] Foreign branch income is taxable at usual rate if the French company elects to be taxed on a worldwide or consolidated basis.

[3] Losses of foreign branches are deductible when the domestic company elects to be taxed on a worldwide or consolidated basis.

[4] When the income has not been taxed abroad, the amount deducted for foreign losses must be put back into income after a number of years.

[5] Most of the tax incentives are granted in connection with industrial and regional development.

NONTAX INCENTIVES FOR EXPORTS

	Austria	Portugal	Australia	New Zealand	Japan	Canada
Nontax incentives indirectly benefiting exports.	Investment allowances [1]		None			Cash grants.[1]
Financing assistance	Guarantees for medium-term credits. Rate of interest is 7 percent.				Direct loans for medium-term sales. Long-term credits at preferential rates (from 7.5 to 8.75 percent). Financing of contract value from 48 to 64 percent. Mixed credits.	
Insurance assistance					Are insured: production risks; commercial risks; political risks; currency fluctuations; loss of foreign investment. Risks are covered from 60 to 80 percent.	

	Belgium	France	Germany	Italy	Luxembourg	Netherlands
Nontax incentives indirectly benefiting exports.	Interest subsidies. Investment subsidies.[2]	Grants. Investment subsidies.[2]	Grants [2]	Capital grants. Long- and medium-term loans by specialized government institutions.[2]	Grants. Loans. Guarantees [2]	Investment subsidies. Interest subsidies.[2]
Financing assistance	Discount at low rates. Interest rebates on export credit. Subsidized medium term export financing. Average rate borne by exporters is 9 percent. Financing of up to 90 percent of contract value.	Discount at low rates. Long-term loans at 7.5-percent rate, to both suppliers or buyers. Financing of up to 100 percent of contract value. Mixed credits.	Discount at low rates. Guarantees. Long-term credits to both suppliers or buyers. Preferential rates of 10 percent. Financing of up to 80 percent of contract value. Mixed credits.	Discount at low rates. Interest subsidies. Long-term loans at 8.95-percent rate to both suppliers and buyers. Financing of up to 100 percent of contract value.		Discount at low rates. Guarantees. Subsidized medium- and long-term export credits. Average interest rate borne by exporters is 9.5 percent. Financing of up to 90 percent of contract value.
Insurance assistance	Are insured: Commercial risks; political risks; currency fluctuations. Risks covered from 80 to 100 percent.	Are insured: Production risks; commercial risks; political risks; currency fluctuations; market development; exhibition expenses; inflation risks. Risks are covered from 80 to 100 percent.	Are insured: Production risks; commercial risks; political risks; currency fluctuations; inflation risks. Risks are covered from 80 to 100 percent.	Are insured: Commercial risks; political risks; currency fluctuations; inflation risks. Risks are 90-percent covered.		Are insured: Commercial risks; political risks; currency fluctuations. Insurance usually covers from 75 to 100 percent of the risks.

NONTAX INCENTIVES FOR EXPORTS—CONTINUED

	U.K.	Ireland	Denmark	Norway	Sweden	United States
Nontax incentives indirectly benefiting exports.	Grants. Investment subsidies. Interest subsidies.[1] Employment subsidies.[3]	Investment allowances. Training grants. Loan guarantees.[1]	Loans. Cash grants[1]		Investment allowances Loan guarantees.[1]	None, except limited agricultural subsidies.
Financing assistance	Guarantees. Interest rate subsidies. Portofolio refinancing. Support granted on a supplier and buyer basis. Interest rate borne by borrowers: 7.8 percent. Financing of up to 100 percent of contract value. Mixed credits.	Guarantees. Medium-term loans at preferential rates (8 percent). Financing of up to 80 percent of contract value.	Guarantees. Financing of up to 90 percent of contract value. Interest rate is 8.5 percent after 1st year.		Medium-and long-term financing at 2 or 3 percent above discount rate. Financing of up to 100 percent of contract value.	Discount at medium rates Guarantees. Long-term export credit financing at interest rates from 8.25 to 9.5 percent. No mixed credits. Financing of 30 to 55 percent of contract value.
Insurance assistance	Are insured: commercial risks; political risks; production risks; inflation risks; currency fluctuations. Performance bonds. Risks are covered up to 100 percent.	Are insured: Production risks; commercial risks; political risks; currency fluctuations. Risks are covered up to 100 percent.	Are insured: Commercial risks; political risks; currency fluctuations. Risks are covered from 65 to 90 percent.		Are insured: Commercial risks; political risks; currency fluctuations; inflation risks. Risks are covered up to 90 percent.	Are insured: Commercial risks; exhibition expenses; political risks. Risks are covered up to 95 percent.

[1] Most of the nontax incentives are granted in connection with industrial and regional development.
[2] Most of the nontax incentives are granted in connection with industrial and regional development. In Belgium, interest subsidies are granted for the purpose of investment throughout the country and not only in depressed areas.
[3] Granted in order to encourage employers to retain employees.

[From the Journal of Commerce, Apr. 5, 1978]

DESPITE ANNOUNCED POLICY JAPANESE EXPORT EXPANSION SEEN

TOKYO.—Despite the massive appreciation (32.1 percent) of the Japanese currency against the American dollar over the past 15 months and an announced government policy to somehow curtail exports, shipments of Japanese merchandise to overseas markets may actually expand by between 5 and 10 percent this year.

This is the belief of a growing number of private Japanese economists who point to the strong cost competitiveness of the country's manufactured products and the continued sluggish demand in Japan's domestic market.

This view appeared Tuesday to be supported by a joint announcement of the finance ministry and the Bank of Japan which said that an official indicator revealed that the nation's exports are increasing sharply.

HISTORIC HIGH

In the joint statement, the ministry and the central bank explained that export letters of credit received last month reached an all-time historic high of approximately $6.6 billion at the current exchange rate. This is a jump of 8 percent compared with March of 1977.

Even after applying seasonal adjustments, it was disclosed, the figure for March represented a climb of 6 percent over the previous month. Exports on a letter of credit basis usually are a dependable barometer of trends for several months ahead.

Among the individual items which showed particularly heavy gains in March letters of credit, according to the announcement, were automobiles—up a massive 77 percent for the United States market alone—and general machinery.

Examining the letters of credit, officials of the ministry and the bank discovered that exports to the U.S. and the countries of Asia in March expanded by 21 percent in the case of the former and 13 percent in the latter.

The announcement said that, in dollar terms, March export from Japan on a letter of credit basis totaled $624 billion. This was an increase of 30.6 percent when compared with the same figures for the same month last year.

NO SURPRISE

It came as no surprise, therefore, when Japanese banking officials spoke out in favor of governmental emergency restraints on future exports if such shipments continue to climb. The bankers are worried that as long as Japanese exports expand there will be no way to prevent the yen from rising in value against the American dollar.

A number of prominent Japanese banking executives feel that the nation's exporters are hurrying up their shipments to foreign markets in anticipation of further drastic appreciation of Japan's currency against the dollar.

Although there has been some increase in the dollar-quoted export prices of Japanese products in recent months, the newly announced pricetags usually remain considerably under the extent of yen appreciation.

Many of Japan's exporting corporations have managed this by slashing profit margins and forcing financially hard-pressed sub-contractors to lower their delivery prices.

Also playing an important part in this process, quite obviously, is the recent improvement in the conditions surrounding Japan's export industries. Interest burdens of the companies involved have been reduced as a result of the steady slashes in the official discount rate—now the lowest in Japan's history—the unusually stable trend in the nation's wholesale prices, and the slowing down of wage increases in recent years.

PRODUCTION COSTS

All these factors combined doubtless have worked to hold the costs of production for Japan's manufacturing industries comparatively low. This is especially true of the country's technology-intensive industries, such as automobile manufacturing and the electric and electronics fields.

It should be pointed out as well that each sharp appreciation of the yen the cost of imported fuels, raw materials and other items necessary for manufacturing have fallen at least to some degree.

As a result of the general situation, however, many Japanese manufactured products are believed to be exported on more favorable terms than when sold on the country's own domestic market. It is believed, for example, that these include passenger cars, small trucks, motorcycles, citizen band radios, tape recorders, stereo equipment, color television receivers and microwave ovens.

MORE EXPORTS URGED

The president of a giant Japanese trading firm urged the United States Tuesday to step up efforts "to export more to Japan" to correct the giant trade imbalance between the two countries.

Yoshizo Ikeda, president of Mitsui and Co. and head of a recent import promotion mission to the United States, said at a luncheon at the Japanese National Press Club:

"We now have pitched the ball and it's your (America's) turn to hit it."

Mr. Ikeda said many American businessmen tend to look at the Japanese market "in the short-term perspective.

"Many of them come to Japan and if they see no immediate profits, they simply pull out in a few years, blaming their failure on tariff barriers."

The 92-member mission headed by Mr. Ikeda concluded $1.95 billion worth of import contracts during its tour of the United States March 2–17.

Mr. Ikeda said massive crude oil imports are a major cause of the U.S. trade deficit, which reached a monthly record of $4.52 billion in February.

He said recent U.S. corporate charges of dumping Japanese products on U.S. markets were unreasonable and that Japanese goods like color television sets, automobiles and watches are popular in the United States "simply because they are efficient and competitive."

[From the Washington Post, Apr. 5, 1978]

VYING WITH "FRANCE, INC."

(Rowland Evans and Robert Novak)

Eastern Airlines plans to sign the purchase agreement this week for 23 European wide-bodied airliners, a deal that not only delivers another stunning blow to the American dollar but also raises serious questions of U.S. industrial survival in the world of subsidized foreign exports.

The A300 airbus is an excellent plane, but that's not why Eastern is buying it. Airbus Industrie, a Western European combine, made an offer that Eastern Chairman Frank Bormann could not refuse. The price was right because Airbus Industrie is subsidized by the French government, one of its principal owners.

Although the Europeans cannot match the Americans in cost-efficient production of commercial airliners, they are spoon-fed government funds to compete in the world market. In the case of the Eastern Airlines deal, the French taxpayer enables planes to be sold far below cost. What makes that dangerous for the United States—and the dollar—is its threat to aerospace exports, one of the last places where Uncle Sam still keeps his head above water in international trade.

This is not the ancient conflict between free trade and protectionism. Rather, the model of Japan, Inc., is being duplicated in Western Europe (France, Inc., in the airbus deal). Here is a neomercantilist system against which American companies are helpless playing by Adam Smith's rules.

Typically, this overpowering problem has not been addressed at policymaking levels of the Carter administration. But almost by accident, it is coming to the attention of worried congressmen. A warning signal was sounded at a House Banking subcommittee hearing March 17 by J. B. L. Pierce, treasurer of the Boeing Company: "We can compete with Airbus and the other European aircraft manufacturers on cost and technical merits, but we cannot compete with the national treasuries of France and Germany and other European countries."

Rep. Jim Leach of Iowa, a 35-year-old freshman Republican with no aerospace interests in his district, took notice. That very day, Leach wrote the subcommittee chairman, Rep. Stephen Neal of North Carolina, urging a close look at Eastern's French connection: "We could be witnessing the emergence of a kind of international trade warfare that has nothing to do with economic competition, but rather with the skill of individual governments to establish reverse trade barriers."

Leach, Neal and other congressmen want to see the fine print of the Eastern deal—a closely guarded secret up to this point. Apart from details, however, the subsidy for each A300 in the Eastern package is estimated at $10 million.

The French subsidy system is revealed by a 1976 French parliamentary report. The government "loan" of $366 million covers half of airbus production, with repayment indefinitely halted at $2.5 million, or 0.7 percent. The report vigorously argues that France's aircraft industry "must be supported by the government."

While Boeing fired the warning signal on Capitol Hill, Lockheed Corporation faces more immediate damage. Eastern's new A300s will replace Lockheed L1011 jetliners, which will then go on the used-plane market. But the airbus also competes with the Boeing 747 and the McDonnell-Douglas DC10. Those three companies can and do offer subsidy plums to buyers, but cannot afford the French government's juicy level.

Those A300s for Eastern are just the beginning. Similar subsidized deals with Allegheny and PSA (Pacific Southwest Airlines) are in the talking stage. What's more, airbus sales to U.S. carriers are the breakthrough for cutthroat competition against the Americans, with Japan the next target. "The Europeans are pulling out all the stops to win sales in Japan," Aerospace Daily reported last week. "Aside from normal commercial representation, the governments involved are applying strong pressure on the Japanese government."

The stakes are high. Last year's U.S. aerospace exports totaled $7.6 billion against $732 million in imports. For commercial aircraft, the export surplus was $2.5 billion in 1977 (down from $3.1 billion in 1976). Considering the record U.S. trade deficit and its ruinous effect on the dollar, that bulge in commercial aircraft is one the United States cannot afford to surrender.

Unlike textiles, electronics or even steel, this is not a case of foreign productivity and ingenuity outstripping the sluggish Yankees. The Americans can still make jetliners more efficiently than anybody else. The difference is France, Inc., aligned against three private American producers.

While the French emulate the Japanese hard-sell subsidies, U.S. policymakers are occupied in loftier pursuits. At the middle level, officials here say they want to study the Eastern transaction more closely before doing anything rash. But the role of Adam Smith does not fit the hard world of neomercantilists, threatening to cloud a rare American bright spot in world economics.

The CHAIRMAN. The committee is recessed subject to the call of the Chair.

(Thereupon, at 12:50 p.m., the committee recessed to reconvene subject to the call of the Chair.)

APPENDIX A

U.S. TAXATION OF CITIZENS WORKING IN OTHER COUNTRIES: AN ECONOMIC ANALYSIS

Summary

The combination of changes to section 911 of the Internal Revenue Code in the Tax Reform Act of 1976 and a recent Tax Court ruling that certain cost of living allowances are fully taxable has increased the U.S. tax liabilities of some citizens working abroad, and in some cases by substantial amounts. The resulting controversy has led to the delayed implementation of the section 911 revisions, and both the Senate Finance Committee and the Treasury have proposed changing the tax provision affecting foreign Americans from an income exclusion to a cost of living adjustment. This study evaluates the alternative policies according to the principles of tax neutrality, tax equity, and the achievement of national economic goals.

The principle of tax neutrality would recommend taxing overseas workers in such a way that the U.S. tax system provides neither an inducement nor a discouragement to U.S. workers in deciding whether to accept employment abroad and to U.S. employers in deciding whether to employ American workers abroad. This principle requires a tax adjustment for Americans working in foreign locations with very high living costs because of the progressive rate structure of the U.S. tax system. However, to achieve neutrality the tax adjustment for

overseas workers should not be a deduction equal to the foreign cost of living differential, because such a provision would make a foreign worker better off than a domestic worker. The tax neutrality concept requires that a foreign worker's compensation for higher living costs should be taxed at the effective tax rate which would apply to the worker ignoring the cost of living compensation. Furthermore, the adjustment should be made only for the cost of living in excess of the highest cost locale in the United States.

By this standard all of the present alternative tax treatments of U.S. citizens living abroad are nonneutral. The prior and present versions of section 911 are nonneutral because they provide flat across-the-board allowances to foreign taxpayers which are unrelated to foreign cost of living differentials. The Senate Finance Committee proposal (H.R. 9251) is also nonneutral because it provides a separate tax adjustment for housing costs rather than a single cost of living adjustment, allows outright deductions of cost of living allowances rather than applying the appropriate effective tax rate to the allowance amount, bases the allowances on the average cost of living in the U.S. rather than on the highest cost of living locale, and also bases the allowances on an assumed salary of $22,000 rather than on actual salary. The Administration's proposal is also nonneutral because it would make no general cost of living adjustment, and its allowances

for housing costs and travel would not be based on the highest cost U.S. locale, nor would they be subject to the appropriate effective tax rate of the taxpayer. Example calculations show that, with the exception of the present section 911 with regard to upper income taxpayers in higher cost of living foreign locations, all of the alternative policies yield lower U.S. tax liabilities for overseas Americans than would a neutral tax adjustment. Of the five alternative policies examined, disallowing any tax adjustment for foreign taxpayers appears to most closely approximate the tax neutrality result overall, although the present section 911 produces results closer to the tax neutrality standard in higher cost foreign locations.

There are two aspects of tax equity which are usually considered: horizontal equity, or the equal treatment of those in equal circumstances (generally defined as those with equal incomes), and vertical equity, which is concerned with how the tax burden is distributed across income classes. In general, the points regarding tax neutrality also pertain to the consideration of tax equity. Thus, to avoid discriminating among taxpayers with equal abilities to pay taxes, any cost of living adjustment for citizens working abroad should be based on the highest cost locale within the U.S., and the amount of the deduction should be subjected to the appropriate effective tax rate. Specifically, a provision allowing deduction of living costs in excess of average

costs in the U.S. would be unfair to the large number of Americans who live in areas or cities within the U.S. where the cost of living is higher than the average. Example calculations and data illustrate the degree of this inequity with regard to a general cost of living allowance, and also with regard to specific allowances for housing costs and travel. With regard to vertical equity considerations, because citizens working abroad have comparatively high incomes, tax provisions benefitting them tend to reduce the progressivity of the U.S. income tax structure.

The alternative tax treatments for overseas Americans are also evaluated in terms of achieving other economic goals, specifically in terms of their impact on foreign trade and employment. First, it must be observed that the relationship between U.S. tax treatment of citizens working in other countries and the quantity of U.S. exports is indirect and uncertain. However, even if there were a direct relationship, a tax subsidy would not have a permanent effect on the balance of payments because, under a system of flexible exchange rates, international currency price adjustments will render innefective policies which attempt to have a long-term impact on a nation's balance of payments. With regard to employment and unemployment policy goals, tax subsidies for overseas Americans do not contribute directly to solving the causes of either cyclical or structural unemployment

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problems. Even if preferential tax treatment for Americans working in other countries creates jobs in the export industries, under a system of flexible exchange rates this policy will likely accelerate the decline of import competing industries and lead to less employment in those sectors. A recent study by the General Accounting Office performed an econometric analysis to estimate the maximum impact on U.S. trade and employment which could be anticipated from the 1976 changes in section 911 and calculated that the impacts would be very small.

An additional argument which has been used in support of section 911 is the impact of U.S. taxes on the foreign "competitiveness" of U.S. industries and workers. However, the standard of tax policy with respect to business and employee location decisions should be to achieve neutrality so that tax provisions do not cause distortions in location decisions unless some clear national purpose is served by such nonneutralities. As indicated in the analysis, there is no clear evidence that artificially encouraging Americans to work abroad through the tax code serves any identifiable national purpose. Therefore, the resulting increased "competitiveness" of American firms and citizens in foreign locations appears to be at the expense of other Americans.

U.S. TAXATION OF CITIZENS WORKING IN OTHER COUNTRIES: AN ECONOMIC ANALYSIS

I. Introduction

The Tax Reform Act of 1976 amended section 911 of the Internal Revenue Code to reduce the benefits from allowing certain exclusions of income earned abroad under the Federal individual income tax. In addition, the Tax Court has ruled that certain allowances paid by employers on behalf of employees working abroad, which heretofore had been excluded from income by some employees, were subject to taxation. These allowances generally relate to housing, education and travel. The combination of these changes increased the tax liabilities of some Americans working abroad, and in some cases by substantial amounts.

As a result of this effect, considerable controversy has been generated over the issue of the tax treatment of U.S. citizens working abroad. Americans working abroad and their employers have argued that more liberal tax treatment is justified because of high costs of living abroad, particularly for housing, and because of the potential effect of the tax changes on U.S. foreign trade and investment. Proposals have been made to return to the pre-1976 version of the law; in fact, the implementation of the 1976 changes has already been delayed for one year and may be delayed again. Other proposals have been made to restructure the allowance from an income exclusion to a cost of living adjustment, a change which would alter the level of benefits and the distribution

across different groups of taxpayers. This type of proposal has been adopted in the Senate Finance Committee and a similar, although more limited, proposal has been made by the Treasury Department.

Others propose that the present version of the law, reflecting the 1976 changes, be retained, or that no provision at all be made for lower taxation of Americans abroad. These proposals reflect the view that reduced taxation of Americans abroad is unfair to taxpayers living in the United States and that the provision is a nonneutral tax adjustment.

The Treasury Department has estimated the revenue loss from the version of the law prior to the 1976 changes and Tax Court decisions at $563 million. The Tax Court changes reduced this amount by $65 million to $498 million. The 1976 changes reduced that loss by $318 million for a total loss of $180 million. The Senate Finance Committee bill is estimated to cost $310 million, while the Treasury proposals would involve a revenue loss of $255 million.[1/] Therefore. in aggregate revenue loss terms, the prior law is the most liberal, followed by the Senate Finance Committee proposal, the Treasury Department proposal and the present law, which is the most restrictive.

In response to the legislative issues, the General Accounting Office prepared a report which focused on the impact of the tax changes

1/ Estimates provided to CRS by the Office of Tax Analysis, U.S. Department of the Treasury. All of these revenue loss figures are compared to full taxation of foreign income and imputed in-kind income.

on U.S. trade, [1] and the Treasury Department has prepared an extensive statistical study of the current and proposed revisions of the law. [2] The present study, while relying in part on the GAO and Treasury studies, is more general in nature and focuses on evaluation of the alternative policies according to the basic principles of tax policy: neutrality, equity, and achievement of national economic goals.

1/ General Accounting Office, Impact on Trade of Changes in Taxation of U.S. Citizens Employed Overseas, February 21, 1978. Hereafter referred to as the GAO Report.

2/ U.S. Department of the Treasury, Taxation of Americans Working Overseas, Revenue Aspect of Recent Legislative Changes and Proposals, February, 1978.

II. Past and Present Law and Current Proposals

There are four spe fic tax alternatives which must be considered in an evaluation of U.S. taxation of Americans working in other countries. Section 911, "Earned Income From Sources Without the United States," is the relevant section of the Internal Revenue Code. This section was amended substantially by the Tax Reform Act of 1976; thus, the first two tax provisions which necessitate consideration are section 911 prior to the Tax Reform Act of 1976, and the present section 911. The 1976 amendments to section 911 generated considerable controversy because they resulted in higher tax bills for many overseas Americans. Because of the controversy, implementation of the new section 911 was delayed until January 1, 1977 (the 1976 Tax Reform Act would have made the change effective January 1, 1976) and may be delayed further. Also, alternative tax treatments of Americans working abroad have been proposed. The two most prominent alternative proposals are the Senate Finance Committee proposal which the Committee amended into H.R. 9251 and generally follows the form of S. 2115, introduced by Senator Ribicoff, and secondly the Administration proposal, presented by Donald Lubick, Acting Assistant Secretary of Treasury for Tax Policy, to the Ways and Means Committee on February 23, 1978. These four alternative tax treatments of U.S. citizens living in other countries are described below.

A. Prior section 911:[1/]

U.S. citizens are generally taxed by the United States on their worldwide income with the allowance of a foreign tax credit for foreign taxes paid. However, for years prior to 1977, U.S. citizens (other than employees of the U.S. Government) who were working abroad could exclude up to $20,000 of income earned during a period in which they were present in a foreign country for 17 out of 18 months or during a period in which they were bona fide residents of a foreign country (sec. 911). In the case of individuals who had been bona fide residents of foreign countries for three years or more, the exclusion was increased to $25,000 of earned income. Further income tax savings could be obtained where foreign taxes were paid on the excluded income because those taxes could be credited against the U.S. tax on any foreign income above the $20,000 (or $25,000) limits.

Under prior law individuals claiming the standard deduction were not entitled to claim the foreign tax credit.

B. Present section 911:

The Tax Reform Act of 1976 generally reduces the earned income exclusion for individuals working abroad to $15,000 per year. However,

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1/ The descriptions of the provisions, except for the Administration proposal, are taken, mostly verbatim, from Proposals for Taxation of Americans Working Overseas, Prepared for Use by the House Ways and Means Committee at Hearings on Feburary 23-24, 1978, by the Staff of the Joint Committee on Taxation.

the Act retained a $20,000 exclusion for employees of charitable organizations. In addition, the Act made three modifications in the computation of the exclusion.

First, the Act provided that any individual entitled to the earned income exclusion is not to be allowed a foreign tax credit with respect to foreign taxes allocable to the excluded income.

Second, the Act provided that any additional income derived by individuals beyond the income eligible for the earned income exclusion is subject to U.S. tax at the higher rate brackets which would apply if no exclusion were allowed.

Third, the Act made ineligible for the exclusion any income earned abroad which is received outside the country in which earned if one of the purposes of receiving such income outside of the country is to avoid tax in that country.

In addition to the changes made in the computation of the exclusion, the Act provided an election for an individual not to have the earned income exclusion apply. The election is binding for all subsequent years and may be revoked only with the consent of the Internal Revenue Service.

Finally, the Act provided that individuals taking the standard deduction are to be allowed the foreign tax credit.

Under the 1976 Act as originally enacted, the changes in the taxation of Americans working abroad would have become effective for

taxable years beginning in 1976. However, implementation of the new section 911 in the 1976 Act was delayed for one year by the Tax Reduction and Simplification Act of 1977. Implementation of the provision would be further delayed by enactment of H.R. 9251, the Tax Treatment Extension Act. This bill is presently pending in the Senate. The House version of the bill would delay effectiveness of the new section 911 for an additional year, until January 1, 1978. The Senate Finance Committee version of the bill would extend the application of the prior section 911 until January 1, 1979, and then would change the nature of the allowances for Americans working abroad to a series of deductions for "excess" living costs as described below.

C. Senate Finance Committee Proposal:

H.R. 9251 (the Tax Treatment Extension Act) was amended by the Senate Finance Committee to revise the treatment of income earned abroad. Special itemized deductions for excess foreign living costs would be provided in three areas: cost of living, housing, and education. The deductions would be adjustments to gross income and thus would be allowed in addition to the standard deduction. The deductions would generally be allowed only to the extent that the employer pays directly or provides reimbursement for the employee's excess cost-of-living, housing, and education expenses. In addition, employees would be required to file with their returns an employer certification attesting to the fact that the reimbursements are in addition to normal compensation.

Specifically, the bill would allow special deductions as follows:

Cost of living.--The cost-of-living deduction would be limited to amounts set forth in tables prepared by the IRS showing the excess of the cost of living (excluding housing and education) in the particular foreign place over the average cost of living in the U.S. for families of various sizes with an income of $22,000, which will be adjusted for inflation.

Housing.--The excess housing costs deduction would be limited to the excess of the amount expended on housing in the foreign place over an amount representing the housing cost the individual typically would have incurred if he were working in the U.S. For this purpose, typical U.S. housing costs are considered to be an amount equal to one-sixth of the individual's base salary (earned income less excess housing, cost of living, and educational costs).

Educational expenses.--The deduction for reimbursed educational expenses would cover the cost of tuition, fees, books, and local transportation for elementary and secondary education of dependent childrent at local American-type schools. Reimbursed expenses for room and board would be allowed in situations where no local American-type schools are available.

Charitable employees and employees furnished lodging.--The principal exception to these rules involves employees of charitable organizations, employees who reside in camps because of their employment, and employees who would qualify under section 119 for exclusion of

employer-supplied housing (the special deductions are available only if an election is made not to claim the sec. 119 exclusion). These employees are required to deduct, in lieu of their actual reimbursed excess foreign living costs, an amount equal to the average deductions claimed for cost of living, housing, and education by all other taxpayers in that foreign place for the previous year (the educational deduction is limited to the amount actually expended). Appropriate average deduction tables would be issued by the IRS.

Self-employed and employees of foreign businesses.--Special rules are also provided for self-employed individuals and employees of foreign businesses (other than U.S. controlled foreign corporations). Because employer reimbursements are either not possible or not meaningful in these situations, the deductions are not limited to employer reimbursements but rather to the average amount deducted by employees of U.S. companies for the foreign place for the previous year.

D. Administration Proposal:

The Administration proposal would allow Americans working abroad three special deductions for costs associated with housing, education, and home travel. The total amount of the deductions would be limited to the amount of earned income from foreign sources. The deduction for housing costs would be nearly identical to the housing deduction under the Senate Finance Committee proposal. The educational expense

deduction would also be similar under the Administration proposal to that in the Finance Committee bill, except that the amount of the deduction would be limited to $4,000 per student per year, and the Administration proposal would allow deduction for two round trips per year between the school and the foreign residence. The transportation deduction, but not the deduction for other educational costs, would also be available for college students.

The Administration proposal would not allow an adjustment for general costs of living. However, it would allow a deduction for one economy round trip fare every other year for each member of the taxpayer's family between a foreign post and the taxpayer's residence, or last place of residence, in the United States.

The Administration's proposal also includes changes in Internal Revenue Code sections 119 (employer furnished meals or lodging), 217 (moving expenses), and 1034 (sale or exchange of residence) to adapt these provisions to the special circumstances of overseas Americans. These changes, primarily affecting the eligibility criteria for the tax benefits under these sections, are not analyzed in this study.

III. Evaluation in Terms of Tax Neutrality and Equity

Over the years a number of principles or canons of taxation have been developed to offer guidance in developing and evaluating tax policy. As with all such guiding principles, they are primarily ethical and subjective in nature; they cannot be proved or disproved, but they seem to have wide a priori appeal.[1/] These principles include concepts such as the tax system should be simple to administer, simple for taxpayers to understand and comply with, should cause minimum interferences in the economy, should raise revenue on an equitable basis, should operate in a manner consistent with attainment of other goals, for example, maximizing employment, and real incomes and minimizing inflation, and, of course, in addition to these other objectives the tax structure should raise the necessary revenue for the operation of government. One of the difficulties of policy making is that it is frequently impossible to satisfy all of these principles simultaneously. For example, a tax provision designed to be the most equitable may be very complicated, necessitating some compromise between the competing objectives. Nonetheless, the various principles serve as useful abstract goals in

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1/ The principles are, of course, subject to differing interpretation and application with regard to specific issues. See, for example, Karegeorgas, Dionisios, Taxation of Foreign Firms: Discriminative and Allocative Effects, Public Finance Quarterly, Vol. 1, No. 3, July 1973, pp. 239-265, which disagrees with the standard application of the neutrality principle in taxation of foreign corporate income.

designing and evaluating tax policy, and they may be employed in the study of the taxation of citizens living abroad.

The two taxation principles which would seem to be the most relevant to this analysis are the principles of tax neutrality and tax equity. The principle of tax neutrality maintains that the tax system should be structured to minimize unintended economic effects. Any tax, of course, will reduce after tax income and thereby affect economic activity, but tax neutrality counsels avoidance of unintended changes in relative prices which would induce substitution of one economic activity for another.[1/] The principle of tax equity, of course, prescribes that the tax system should be fair both horizontally (that is, treating people in equal circumstances equally) and vertically (i.e., achieving appropriate relative treatment of those in different circumstances). Obviously, the concept of horizontal equity provides a more objective (although not _entirely_ objective) criteria for judgment; regarding vertical equity, objective analysis can measure impacts but usually cannot offer judgments.

1/ Of course, some tax provisions, such as the investment tax credit, are _intended_ to change relative prices and induce economic substitutions, in this case to stimulate higher investment in qualifying assets.

A. Tax Neutrality

1. The Principle:

The principle of tax neutrality would recommend taxing overseas workers in such a way that the U.S. tax system provides neither an inducement nor a discouragement to U.S. workers in deciding whether to accept employment abroad and to U.S. employers in deciding whether to employ American workers abroad. This principle requires looking at two aspects of foreign employment: foreign taxes and foreign costs of living.

The present U.S. tax treatment of citizens living abroad under section 911 clearly does not achieve neutrality with regard to foreign taxes (for the moment ignoring foreign living costs) because there are tax benefits to working in a low tax foreign country.[1/] The low taxes of the foreign host country, combined with the exclusions of section 911, yield a lower total tax liability than would be experienced by remaining and working in the United States. Thus, the U.S. tax system provides an inducement to U.S. workers to accept jobs in low tax foreign countries. Because of the operation of the foreign tax credit, the U.S. tax system

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1/ In this discussion, "low tax" foreign country and "high tax" foreign country refer to foreign tax systems which produce tax liabilities lower and higher, respectively, than the U.S. tax system .

does not provide incentives or disincentives to U.S. workers with regard to employment in high tax foreign countries.[1/]

Examining the neutrality aspects of taxing income of individuals earned abroad in light of widely varying foreign costs of living is less straightforward. In the first place, it must be observed that considering costs of living in a discussion of appropriate treatment under the U.S. tax code is itself unusual. The U.S. tax system is not inflation-indexed to account for rising costs of living each year, nor is the system indexed to account for variation in costs of living among areas within the United States, though such variation is considerable. In the substantial literature on the taxation of foreign earned income of corporations there is no suggestion that U.S. taxes should be lower on income earned in countries where the cost of doing business is higher. Additionally, the legislative history of section 911 suggests that consideration of foreign costs of living is a relatively

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1/ If the concern were the neutrality aspects of the worldwide tax structure, rather than just the U.S. tax system, attention would have to be focused on foreign taxes which are higher than U.S. taxes and thereby discourage foreign employment by U.S. workers in high tax countries. To achieve worldwide neutrality, such "excess" tax liabilities would have to be refunded.

recent issue in the discussion.[1/] Nonetheless, considerable attention has been focused on the high cost of living in foreign countries in the recent discussions of section 911.

To be strictly consistent with the remainder of the U.S. tax code, no special tax treatment should be accorded foreign individual income on the basis of living costs. However, it may be countered that the variation in living costs abroad is larger than the variation within the U.S. (see discussion on pages 37 and 38 for evidence of this fact) and, therefore, the lack of an adjustment for domestic cost of living variations may not be compelling. The question of whether special treatment of income earned abroad to adjust for high costs of living can be defended without also extending such treatment to domestic workers is, thus, an empirical and judgmental question regarding relative variability of living costs.

If costs of living abroad are extremely high compared to the U.S., the combination of cost of living reimbursement for foreign employees

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1/ See Levine, Mel, Section 911: The Foreign Earned Income Exclusion--Death Blow or Recovery? Taxes--The Tax Magazine, March 1978, pp. 169-178. Apparently the original reason for adopting the predecessor to section 911 in 1926 was to insure that U.S. citizens working abroad had the same overall tax burden as citizens living in the U.S. Later reasons for changes in section 911 were to stimulate U.S. exports and to put U.S. expatriots in a similar tax position to foreign workers from other countries who enjoy home country tax benefits. Since the late 1950's the legislative direction has been toward reducing the benefits available under section 911 to tax overseas American workers more similarly to domestic workers.

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and the progressive rate structure of the U.S. tax system may suggest a tax adjustment based on the principle of tax neutrality. The neutrality concept would require that if, in the absence of tax considerations, it would cost, say, 50 percent more to employ a U.S. worker in a given foreign location than in the U.S., then this relative cost differential should also exist when taxes are considered. If the tax structure reduces the differential it would provide an incentive to foreign employment; if the tax structure increases the differential, it would discourage working abroad. If no adjustment were made to the tax liabilities of foreign workers in high cost areas this would increase the cost differential, and thus discourage employment in such areas, due to the progressive tax rate structure. This is because the 50 percent higher wages paid by the employer to the foreign worker to compensate for the higher living costs become part of taxable income. This taxable income will be taxed at higher marginal tax rates under the progressive tax rate structure. Thus, an employer must increase an employee's salary by more than 50 percent to leave the employee with an after tax income which is 50 percent higher.[1/] In this sense disallowing an adjustment for high costs of living in foreign locations may be nonneutral.

Given this consideration, how should an adjustment for foreign living costs be structured to achieve locational neutrality? Clearly

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1/ This statement is, of course, true whether the salary increase is to compensate for higher foreign living costs or merely to provide a salary increase. However, the issue of locational neutrality arises only with the former purpose.

the adjustment should not be a deduction of an amount equal to the compensation for higher living costs, because such a procedure would make the foreign worker better off than the domestic worker. Consider a domestic worker earning a $20,000 income and paying $5,000 in tax, for an effective tax rate of 25 percent. A U.S. citizen working abroad in an area with a 50 percent higher cost of living would require a $30,000 income to have the same real income before taxes. If the $10,000 cost of living salary adjustment were allowed as a deduction, the foreign worker would pay only $5,000 in U.S. taxes for an effective tax rate of 16.7 percent ($5,000/$30,000). Thus, the foreign worker's after tax income is 83.3 percent of his before tax income and the domestic worker's is only 75 percent even though their real before tax incomes are the same. Their real after tax incomes would be $15,000 for the domestic worker and $16,666.66 for the foreign worker.[1/] As an alternative way of looking at the relationship, if the foreign employee is allowed to deduct the cost of living allowance, his employer can pay him a salary in his foreign location of $27,000 (still assuming a 25 percent effective tax rate on income after adjustment) and leave the employee with the same real after tax income.[2/] Thus, the tax system would reduce the cost differen-

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1/ The foreign worker's after tax income is $25,000, which equals $16,666.66 in real terms after adjustment for the 50 percent higher foreign living costs.

2/ The worker's taxable income would be $18,000 ($27,000 x 2/3) producing a tax liability of $4,500; his after tax income of $22,500 equals $15,000 in real terms after adjustment for the 50 percent higher living costs.

tial to the employer of employing the individual in the foreign location from a 50 percent higher cost to a 35 percent difference.

2. The Tax Neutrality Standard:

To achieve tax neutrality, i.e., a condition in which the percentage differential in after tax employment costs is equal to the before tax differential, the compensation for higher living costs should be taxed at the effective tax rate which would apply to the worker ignoring the cost of living compensation. Under this system, if the cost of living in a foreign location is 50 percent higher than in the U.S., an American citizen who moves to the locality and receives a 50 percent higher salary would pay a 50 percent higher U.S. income tax (rather than more than a 50 percent higher tax in the absence of any adjustment). Another way of perceiving the system is that whatever a worker's effective tax rate in the U.S., if he takes a foreign job and is compensated for the cost of living differential, his effective tax rate would remain constant. Thus, for example, a U.S. citizen who pays 25 percent of his income in Federal income taxes would still pay 25 percent of income in U.S. income taxes if he accepted a foreign job with cost of living compensation.[1/] This system would preserve the relative before tax costs of U.S. versus foreign locations; thus, a location in which living costs are 50 percent higher, ignoring taxes, would also be 50 percent more expensive when taxes are considered.

1/ Of course, his effective tax rate would increase if his foreign salary more than compensated for the cost of living differential.

For illustrative purposes, and for reference in the remainder of this report, it will be useful to specify the mechanics involved in a hypothetical tax provision which would allow neutral adjustments for foreign living costs as described above. This hypothetical tax provision is offered not as a proposal or recommended policy, but merely as a specific reference for measuring the neutrality aspects of the alternative proposals. Such a provision would work as follows:

1. Special deductions from total income would be allowed foreign taxpayers for the costs of elementary and secondary education of dependent children at English language schools. The amount of the deduction would be the minimum cost associated with attaining such educational services at each location (which may be zero in certain English-speaking countries) to include transportation and room and board in areas where no English-language schools are available locally. A special deduction is required for educational expenses because they will generally not be included in normal cost of living indices and because public primary and secondary education is provided free of charge in the U.S.; thus, a percentage adjustment for costs abroad is unworkable. A special deduction for educational expenses is also more neutral because the tax benefit will be conferred only on those who incur the additional expenses.

2. The Treasury would be responsible for determining each year the amount by which costs of living in relevant foreign locations exceed the living costs in the highest cost of living location in the United States. 1/ Based on these determinations the Treasury would devise adjustment factors for each foreign location to be used by taxpayers in determining their "equivalent U.S. income." For example, if the cost of living in a given foreign location

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1/ The approach of most of the cost of living adjustment proposals is to peg the adjustment to an average cost of living in the United States. This is clearly inappropriate since the provision would be nonneutral, inequitable, and inconsistent with regard to the tax treatment of citizens living within the U.S. who live in locations of above average living costs. See further discussion of this point in the Equity section below (especially pp. 37-43).

exceeded by 50 percent the highest cost locale in the U.S., the adjustment factor for that location would be 66 2/3. 1/

3. Foreign taxpayers would multiply their actual adjusted gross income, after subtraction of any foreign educational expense deduction, by the Treasury cost of living adjustment factor to determine their "equivalent U.S. adjusted gross income." Taxpayers who itemize deductions would also multiply their total itemized deductions by the cost of living adjustment factor. They would then compute their U.S. income tax liability based on their "equivalent U.S. adjusted gross income" and adjusted itemized deductions. Their total U.S. income tax liability would then be determined by the following formula: 2/

$$\begin{pmatrix}\text{Total U.S.}\\ \text{income tax}\end{pmatrix} = \left(\frac{\begin{array}{c}\text{income tax based on}\\ \text{"equivalent U.S.}\\ \text{adjusted gross income"}\end{array}}{\begin{array}{c}\text{"equivalent U.S.}\\ \text{adjusted gross income"}\end{array}}\right) \times \begin{pmatrix}\text{Total adjusted gross}\\ \text{income after foreign}\\ \text{educational ex-}\\ \text{pense deduction}\end{pmatrix} - \begin{pmatrix}\text{Foreign}\\ \text{tax}\\ \text{credit}\end{pmatrix}$$

A simple example will serve to illustrate this hypothetical neutral tax adjustment for foreign living costs. Assume a family of two adults and a child has an income, earned by one of the adults and consisting entirely of wages and salary, of $20,000 in the U.S. They move abroad to assume a foreign job with the same company and are exactly compensated for their higher living costs. General living costs are 50 percent higher in their foreign location, and American-type

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1/ To be perfectly neutral with regard to cost of living in foreign locations, the adjustment should also account for locations which have lower costs of living than the lowest cost of living locale within the U.S. This adjustment would require an addition to actual income (rather than a deduction from income) to determine U.S. tax liability on the basis of an equivalent real income.

2/ This adjustment mechanism would achieve the same thing as indexing the income tax for the appropriate cost of living adjustment specific to each foreign location.

education for the child will cost $2,000; therefore, their income in the foreign location is $32,000.

Under tax law applicable to calendar year 1977, the family's U.S. income tax on its $20,000 income earned in the U.S. would be $2,711 (assuming use of the standard deduction and no special deductions or exemptions). Under the hypothetical neutral tax adjustment provision outlined above its U.S. tax liability in the foreign location would be computed as follows:

Total foreign income	$32,000
Minus foreign educational expense deduction	2,000
Total adjusted gross income	30,000
Equivalent U.S. adjusted gross income ($30,000 x .66 2/3) 1/	20,000
U.S. income tax on equivalent U.S. adjusted gross income	2,711
Total U.S. income tax before foreign tax credit (.13555 x $30,000) 2/	$ 4,066.50

Ignoring the special foreign educational costs, this U.S. tax liability leaves the family with an after tax income of $25,933.50 ($30,000 - $4,066.50). Since this is exactly 1.5 times the family's after tax income in the U.S. of $17,289 ($20,000 - $2,711), the family is left with the same after tax real income. Thus, under this system the U.S. tax structure would introduce no distortion in the relationships between foreign and domestic costs to a company of employee location, and relationships between foreign and domestic incomes to employees.

1/ Ignores any difference in the cost of living adjustment due to the adjustment being pegged to the highest cost of living location in the U.S.

2/ $\frac{\$2,711}{\$20,000} = .13555$

The pre-tax relationships in these quantities would be preserved by the tax system; the tax structure would offer neither an incentive nor a disincentive with regard to foreign location of employees.

3. Evaluation of the Alternatives:

Since this hypothetical tax provision would make the U.S. tax system locationally neutral with regard to both foreign taxes and foreign living costs, it may be used as a standard for evaluating the neutrality of other adjustment provisions for overseas Americans. To the extent that taxes in a given location or under specified circumstances under another provision would be less than or greater than the hypothetical neutrality adjustment would suggest, the tax provision would provide an incentive or disincentive to foreign employment.

The prior and present versions of section 911 outlined in section II above clearly are not neutral by this standard. Neutrality requires tax adjustments based on foreign living costs. The past and present versions of section 911 provide flat across-the-board allowances to foreign taxpayers which are unrelated to living costs. Thus, these provisions would make neutral adjustments for foreign living costs only by chance in isolated circumstances.

The foreign tax provision in H.R. 9251 is also nonneutral by the above measure, although it may be less arbitrary in impact than the past and present section 911. In particular it would not bestow benefits on low cost foreign locations as do these provisions.

H.R. 9251 includes a general cost of living adjustment and two specialized separate allowances: housing and education for elementary and secondary students.

It is not clear why housing costs should be adjusted for separately rather than built into a single cost of living adjustment as suggested in the hypothetical neutral tax adjustment provision outlined above. A separate adjustment could potentially lead to overcompensation for cost of living differentials because the overall cost of living in a given locale may not be high, but there may be a relatively higher cost of housing as compared with, say, food or local transportation. Since there is no penalty in the proposal for a lower cost of living on non-housing items, an individual could receive a deduction for housing where the overall cost of living is not higher than--or is even lower than--the U.S.

However, if separate treatment is desirable for measurement or administrative reasons, a more neutral provision would allow a deduction based on the housing cost differential between the foreign location and the highest cost location within the U.S., and the amount of the deduction would be taxed at the taxpayer's effective tax rate based on "equivalent U.S. income." To allow an outright deduction overcompensates for the higher foreign living cost, as explained above on page 17.

The cost of living adjustment in H.R. 9251 is also nonneutral because it is based on average cost of living within the U.S. rather

than the highest cost locale, and because it also does not apply the taxpayer's effective tax rate based on "equivalent U.S. income" to the amount of the deduction. These aspects of the provision tend to overcompensate for foreign living costs. At the same time, however, the cost of living adjustment is based on an assumed salary of $22,000 rather than the actual salary. Thus, although the adjustment varies by locale, it does not vary by income class, and this factor, looked at in isolation, tends to undercompensate for higher foreign living costs for upper income people. The result of this variety of circumstances is that the cost of living adjustment contained in H.R. 9251 has substantial elements of arbitrariness which, in theory, could overcompensate some individuals and have the potential for undercompensating others.[1/]

An additional observation on the tax neutrality aspects of H.R. 9251 is warranted regarding a provision which is primarily administrative in nature. With the exception of employees of charitable organizations, self-employed persons, and employees of foreign corporations (other than U.S. controlled foreign corporations), the bill would allow deductions for higher living costs only to the extent that the taxpayer's employer pays directly or provides reimbursement for the higher costs. For purposes of tax neutrality, in attempting to minimize locational incentives or disincentives in the tax system, direct payment or reimbursement by the employer is immaterial. The interaction of the higher

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1/ In fact, H.R. 9251 would overcompensate in most circumstances compared to the neutrality standard. See analysis in next subsection, pp. 27-34.

foreign living costs and the U.S. progressive income tax are the factors which necessitate an adjustment to achieve locational neutrality; the method of compensating for the higher living costs, or whether they are compensated for, does not affect the appropriate neutrality adjustment.

The Administration's proposal would make adjustments for educational expenses and housing costs similar to those in H.R. 9251, and, therefore, the comments above regarding H.R. 9251 also apply to the Administration proposal. The proposal does not include a general cost of living adjustment for two stated reasons: (1) it would be difficult to administer because of measurement problems, would lead to demands for more tax relief, and add complexity to the tax laws; and (2) a cost of living adjustment for Americans living abroad would be unfair to taxpayers at home who receive no tax relief for wide variations in living costs.[1/]

With regard to the first stated reasons, of course, simplicity is frequently one of the tax policy goals with which the goals of tax equity and efficiency conflict and, therefore, some policy tradeoffs are inevitable. It is correct that administration of a general cost of living adjustment might be somewhat complicated; however, the other proposals made by the Treasury also involve complexity. With regard

1/ See statement of Donald C. Lubick, Acting Assistant Secretary for Tax Policy on Taxation of Americans Working Outside the United States, before the Committee on Ways and Means, February 23, 1978, p. 7.

to the second criticism, the element of unfairness (and nonneutrality) with respect to U.S. residents also applies to the housing cost adjustment and to the Administration's proposed travel allowance discussed below. However, under the neutral tax adjustment standard outlined above this problem does not exist because the basis for adjustment is the highest cost locale in the United States, rather than average costs.

The Administration proposal would allow a deduction for the cost of one round trip visit to the most recent place of residence in the U.S. for each family member every two years (two round trip fares per year between school and home are also allowed for college students and pre-college students in boarding schools). This aspect of the proposal seems inconsistent with the Administration's second reason stated above for rejecting the general cost of living adjustment, namely that no such allowance is provided domestic taxpayers even though they may travel considerable distances to and from their place of employment or schooling and "home" to visit relatives. In many cases the domestic trips would cost more than the foreign travel (see discussion on p. 42).

Thus, overall, all of the provisions would result in a nonneutral allowance for the cost of living abroad. The prior and current versions of section 911 tend to favor lower cost of living, low tax countries as compared to the neutral standard and the other proposals. The Senate Finance proposal would tend to favor high cost of living jurisdictions

and particularly those which have high housing costs. The Treasury proposal also favors jurisdictions with high housing costs.

4. Illustrative Examples:

In order to explore these relative effects of the different tax provisions more fully, a series of hypothetical examples has been prepared. Table 1 compares tax liabilities under the prior section 911, current section 911, allowing no benefits, applying the tax neutrality standard previously described, and the Senate Finance Committee proposal. This table assumes that housing costs are in line with other costs of living and, therefore, the Treasury proposal will have no impact. Education and travel expenses are not considered because of their special nature. The tables cover income levels equivalent to $25,000, $50,000 and $100,000 for the highest cost U.S. location of Anchorage.

The table covers five countries with varying cost of living situations: Japan (the highest cost of living area), Frankfurt (which is also a high cost area), Riyadh, Saudi Arabia (whose cost of living is approximately the same as Anchorage), Rome (whose cost of living is lower than Anchorage but higher than the U.S. average) and London (where the cost of living is relatively close to the U.S. average).

The following results can be gleaned from the table:

(1) Prior section 911 departs most from the neutral standard, particularly for lower cost of living locations. It provides substantial tax benefits in every example.

TABLE 1

COMPARATIVE U.S. TAX LIABILITIES BEFORE FOREIGN TAX CREDIT UNDER ALTERNATIVE PROPOSALS (ANCHORAGE INCOME = 100) 1/

Anchorage Income Levels	$25,000		$50,000		$100,000	
Tokyo, Japan (122)						
Income level	($30,555)		($61,111)		($122,222)	
	Tax	Effective Rate (%)	Tax	Effective Rate (%)	Tax	Effective Rate (%)
Prior 911	$710	2.3	$8,053	13.2	$33,254	27.2
Current 911	3,383	11.1	14,834	24.3	40,807	33.4
No Provision 2/	5,830	19.1	17,282	28.3	43,254	35.4
Neutral Standard	5,255	17.2	15,400	25.2	41,311	33.8
Senate Finance (H.R. 9251) 3/	3,012	9.9	12,605	20.6	38,504	31.5
Frankfurt, West Germany (111)						
Income level	($27,777)		($55,555)		($111,111)	
	Tax	Effective Rate (%)	Tax	Effective Rate (%)	Tax	Effective Rate (%)
Prior 911	$307	1.1	$6,226	11.2	$28,523	25.6
Current 911	2,608	9.4	12,473	22.4	36,085	32.5
No Provision 2/	5,055	18.2	14,920	26.9	38,532	34.7
Neutral Standard	4,777	17.2	13,999	25.2	37,555	33.8
Senate Finance (H.R. 92551) 3/	2,937	10.5	11,378	20.5	34,814	31.3
Riyadh, Saudi Arabia (101)						
Income level	($25,250)		($50,500)		($101,000)	
	Tax	Effective Rate (%)	Tax	Effective Rate (%)	Tax	Effective Rate (%)
Prior 911	$ 0	0	$4,836	9.6	$24,235	24.0
Current 911	1,922	7.6	10,377	20.5	31,788	31.5
No Provision 2/	4,369	17.3	12,824	25.3	34,235	33.9
Neutral Standard	4,343	17.2	12,726	25.2	34,138	33.8
Senate Finance (H.R. 9251) 3/	2,862	11.3	10,282	20.4	31,441	31.1

TABLE 1 (Continued)

Rome, Italy (91)

Income level	($22,777)		($45,555)		($91,111)	
	Tax	Effective Rate (%)	Tax	Effective Rate (%)	Tax	Effective Rate (%)
Prior 911	$0	0	$3,602	7.9	$20,032	22.0
Current 911	1,333	6.0	8,442	18.5	27,585	30.3
No Provision 2/	3,780	16.5	10,889	23.9	30,032	33.0
Neutral Standard	3,780	16.5	10,889	23.9	30,032	33.0
Senate Finance (H.R. 9251) 3/	2,799	12.3	9,293	20.4	28,165	30.9

London, England (75)

Income level	($18,888)		($37,777)		($75,555)	
	Tax	Effective Rate (%)	Tax	Effective Rate (%)	Tax	Effective Rate (%)
Prior 911	$0	0	$1,954	5.2	$13,446	17.8
Current 911	452	2.4	5,671	15.0	20,943	27.8
No Provision 2/	2,898	15.3	8,117	21.5	23,420	31.0
Neutral Standard	2,898	15.3	8,117	21.5	23,420	31.0
Senate Finance (H.R. 9251) 3/	2,698	14.3	7,803	20.7	23,010	30.5

1/ Assumes joint return, two exemptions, itemized deduction equal to 15 percent of actual income. The calculations also ignore the general tax credit since it would be the same under each alternative and, therefore, does not affect the relationships. Housing costs are assumed equal to 16.7 percent of income (average for U.S.) so that no benefits occur under Treasury proposal. Assumes no travel or education expenses. Equivalent indices for U.S. urban average = 100 are:

Anchorage	140	Frankfurt	156	Rome	128
Tokyo	172	Riyadh	142	London	106

(Indices are taken from State Department Index, April 1977, Labor Department Index, Autumn, 1976. State Department Index excludes housing.

2/ Equal to Treasury Proposal under assumptions.

3/ Assumes implementation of proposal will index for cost of living equal to one-half of statutory amount ($11,000).

(2) Current section 911 leads to beneficial taxation at the lower end of the income scale and for lower cost of living jurisdictions as compared with the Senate Finance Committee proposal which tends to favor individuals in the higher cost locations. Both current section 911 and the Senate Finance proposal confer benefits in every case as compared with the neutral standard.

(3) Overall, a policy of no adjustment provision tends to match the neutrality standard more closely than any other alternative.

(4) After the no exclusion option, current section 911 tends to match the neutrality standard most closely at high income levels where the cost of living is higher than the cost in the highest cost U.S. locale. The Senate Finance Committee proposal tends to come closer at lower income levels in lower cost jurisdictions.

Table 2 provides examples for the same income levels and jurisdictions under the alternative assumption that housing costs are twice the percentage of income as housing costs in the United States. This assumption, while somewhat arbitrary, allows analysis of the impact of the proposals, including the Treasury proposal, in the circumstance which has generated the most controversy, namely, the situation of very high foreign housing costs.

The following results can be gleaned from Table 2:

(1) Prior section 911 departs most from the neutral tax standard for the $25,000 income in every case and for other ir ome levels in lower cost of living jurisdictions. The Senate Finance Committee proposal

TABLE 2

COMPARATIVE U.S. TAX LIABILITIES BEFORE FOREIGN TAX CREDIT UNDER ALTERNATIVE PROPOSALS ASSUMING HIGH HOUSING COSTS
(Anchorage Income = 100) 1/

Anchorage Income Levels	$25,000		$50,000		$100,000	

Tokyo, Japan (152)

Income level	($38,210)		($76,267)		($152,591)	
	Tax	Effective Rate (%)	Tax	Effective Rate (%)	Tax	Effective Rate (%)
Prior 911	$2,035	5.3	$13,736	18.0	$46,161	30.3
Current 911	5,814	15.2	21,276	27.9	53,714	35.2
No Provision	8,261	21.6	23,723	31.1	56,161	36.8
Neutral Standard	6,572	17.2	19,219	25.2	51,575	33.8
Senate Finance (H.R. 9251) 2/	2,723	7.1	11,492	15.1	36,116	23.7
Treasury Proposal	5,873	15.3	17,355	22.7	43,420	28.5

Frankfurt, West Germany (144)

Income level	($34,763)		($69,429)		($138,972)	
	Tax	Effective Rate (%)	Tax	Effective Rate (%)	Tax	Effective Rate (%)
Prior 911	$1,387	4.0	$11,040	16.0	$40,323	29.1
Current 911	4,665	13.4	18,391	26.5	47,926	34.5
No Provision	7,112	20.4	20,838	30.0	50,373	36.2
Neutral Standard	5,975	17.2	17,508	25.2	46,973	33.8
Senate Finance (H.R. 9251) 2/	2,675	7.7	10,436	15.0	32,724	23.5
Treasury Proposal	5,093	14.7	15,037	21.6	38,769	27.8

Riyadh, Saudi Arabia (126)

Income level	($31,581)		($63,163)		($126,325)	
	Tax	Effective Rate (%)	Tax	Effective Rate (%)	Tax	Effective Rate (%)
Prior 911	$875	2.8	$8,739	13.8	$34,998	28.0
Current 911	3,696	11.7	15,707	24.9	42,551	33.7
No Provision	6,143	19.5	18,154	28.7	44,998	35.6
Neutral Standard	5,432	17.2	15,917	25.2	42,697	33.8
Senate Finance (H.R. 9251) 2/	2,625	8.3	9,484	15.0	29,543	23.4
Treasury Proposal	4,402	13.9	12,927	20.5	34,449	27.4

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TABLE 2 (Continued)

Rome, Italy (114)

Income level	($28,453)		($56,978)		($113,957)	
	Tax	Effective Rate (%)	Tax	Effective Rate (%)	Tax	Effective Rate (%)
Prior 911	$400	1.4	$6,715	11.8	$29,742	26.0
Current 911	2,792	9.8	13,078	23.0	37,294	32.7
No Provision	5,239	18.4	15,526	27.2	39,741	34.9
Neutral Standard	4,894	17.2	14,358	25.2	38,517	33.8
Senate Finance (H.R. 9251) 2/	2,578	9.1	8,579	15.1	26,452	23.2
Treasury Proposal	3,801	13.4	10,977	19.2	30,227	26.5

London, England (95)

Income level	($23,625)		($47,250)		($94,535)	
	Tax	Effective Rate (%)	Tax	Effective Rate (%)	Tax	Effective Rate (%)
Prior 911	$0	0	$4,005	8.5	$21,487	22.7
Current 911	$1,536	6.5	9,090	19.2	29,040	30.7
No Exclusion	3,982	16.9	11,537	24.4	31,487	33.3
Neutral Standard	3,982	16.9	11,537	24.4	31,487	33.3
Senate Finance (H.R. 9251) 2/	2,521	10.7	7,248	15.3	21,600	22.8
Treasury	2,919	12.4	8,181	17.3	23,594	25.0

1/ Assumes joint return, two exemptions, itemized deductions, equal to 15 percent of actual income. The calculations also ignore the general tax credit since it would be the same under each alternative and, therefore, does not affect the relationships. Housing costs are assumed to be 33.4 percent of income (twice U.S. average) (assumed no travel or education expenses). Equivalent indexes for U.S. urban average = 100 are:

Anchorage	140	Frankfurt	195	Rome	160
Tokyo	214	Riyadh	177	London	132

(Indices recomputed from State Department Index, April, 1977, Labor Department Index, Autumn, 1976.)

2/ Assumes implementation of proposal will index for cost of living equal to one-half of statutory amount ($11,000).

departs from the neutral standard most for the high cost jurisdictions and higher income cases. The Treasury proposal results in lower tax liabilities than prior section 911 in the highest income cases ($100,000 equivalent) in the higher cost jurisdictions.

(2) Prior section 911, the Senate Finance proposal and the Treasury proposal confer benefits in every case, as compared with the neutral standard. Current section 911 also confers benefits except in higher income level, higher cost jurisdictions.

(3) Overall, the no provision alternative comes closest to the neutrality standard in the lower cost areas, whereas current section 911 more closely approximates the neutrality standard in the higher cost areas.

While it is difficult to generalize from these examples, they do suggest certain results. If it were decided to account for greater variability in foreign living costs by reducing taxation in those jurisdictions where costs of living were higher than the United States, a tax neutrality standard has been developed. If this neutrality standard is not a legislative option, then the closest approximation to it among the five alternatives examined would be to repeal section 911 and allow no adjustments for Americans living abroad. This result is substantiated in part by the examples, and also by the fact that the examples are weighted toward high cost of living locations. If this option were not adopted, current section 911 appears to come closer

to the neutrality standard than the other options, especially in the case of the higher income levels and higher cost of living locations.

In every case examined, prior section 911 and the Senate Finance Committee proposals confer benefits compared to the tax neutrality standard and therefore provide an incentive to Americans to work abroad. In general, the Senate Finance Committee proposal, and the Treasury proposal to a lesser extent, tend to favor higher income taxpayers. Current section 911 tends to favor lower income taxpayers more than the Finance Committee and Treasury proposals.

As suggested earlier, the Senate Finance Committee and Treasury proposals tend to favor upper income individuals in higher cost jurisdictions as compared to prior and current versions of section 911.

B. Tax Equity

The second major tax policy principle applicable to an evaluation of the tax treatment of overseas Americans is that of tax equity. There are two aspects of tax equity which are generally considered: horizontal equity, or the equal treatment of those in equal circumstances (generally defined as those with equal incomes), and vertical equity, which is concerned with how the tax burden is distributed across income classes.

1. Horizontal Equity:

The basic idea behind the concept of horizontal equity is that people with equal income and who are equal in other characteristics deemed relevant (such as family size) have an equal ability to pay taxes. The decision as to what constitutes a relevant characteristic is a subjective one; however, the horizontal equity standard tends in most respects to have a basic intuitive attraction to most people. For example, family size and income are generally accepted as relevant characteristics on intuitive grounds, while hair or skin color is rejected.

Horizontal equity tends in most cases to be consistent with tax neutrality since it generally suggests that individuals not be taxed differently due to, among other things, their patterns of consumption or their choices of investment or employment. Those provisions which violate horizontal equity standards usually tend to violate tax neutrality standards as well, although this result is not always the case.

Whether residence abroad should be considered as a relevant characteristic for horizontal equity considerations is, of course, a subjective question. In general, location has not been viewed as a relevant characteristic in the United States in terms of horizontal tax equity. Thus, it would seem initially that a person earning an income abroad should be regarded as having an ability to pay taxes equal to that of an individual earning the same income in the United States, a view consistent with fully taxing income earned abroad and allowing a foreign tax credit. Under this standard, the past and present versions of section 911 are inconsistent with horizontal equity. In both cases, they allow substantial tax benefits to individuals living abroad which are not available to those in equal positions in the United States. The past version of section 911 allowed tax savings up to a maximum of $12,500 ($25,000 times the 50 percent maximum tax rate). The present version provides savings up to approximately $3,000--a saving not available to people in the United States with similar real incomes.

There are two arguments which have been advanced to counter this general view. The first is based on cost of living differentials. The second suggests that another standard of tax equity, the benefits received principle should govern, or partially govern, in the case of income earned abroad.

(a) General Cost of Living Differentials

Location and the differences in cost of living which result from location choice have generally not been treated as relevant characteristics to the standard of horizontal tax equity in the U.S., and thus a family of four with an income of $15,000 would pay the same Federal income tax whether they lived in different States, in urban rather than rural areas, etc.[1/] This approach has obvious administrative advantages, and adjusting taxable incomes for cost of living differentials within the United States has never been seriously considered. Arguments have been made, however, for making such adjustments for those living abroad.

The argument is often made that the variability of cost of living abroad is greater than the variability in the United States. Data from various sources tend to support this argument although they assume that the "basket of goods" purchased abroad will be the same as that purchased in the United States. This method of measurement might tend to increase the apparent cost of living abroad if it includes goods which are in scarce supply or are expensive because they are imported (e.g., Western-style housing in Japan). Using this standard, however, it would appear that there are some very high cost countries and some

1/ Assuming other tax characteristics were the same.

very low cost ones, and the higher variability of cost of living argument cannot be rejected outright.[1/]

In general, the points made above regarding tax neutrality also pertain to the consideration of tax equity. Thus, to avoid discriminating among taxpayers with equal abilities to pay taxes, any cost of living adjustment for citizens living abroad should be based on the highest cost locale within the U.S., and the amount of the deduction should be subjected to the taxpayer's effective tax rate based on his "equivalent U.S. income." The latter point was demonstrated by example above (see page 17). The first point can be illustrated by sample cost of living adjustment calculations.

A provision allowing deduction of cost of living in excess of average costs in the U.S. would be unfair to the large number of Americans who live in areas or cities within the U.S. where the cost of living is higher than the average. This effect can be substantial as illustrated by the following paired U.S. and foreign cities where the cost of living is roughly equal, listed with the deduction which would be allowed foreign taxpayers under a cost of living adjustment based on the U.S. average. The comparisons assume an average cost of living in the U.S. of $22,000, which is the statutory basis for

1/ Based on Washington, D.C. = 100, costs of living for the nineteen largest cities in the U.S. vary from 122 to 86 (Department of Labor Autumn, 1976 Index). Using the same base, costs of living for the twenty cities in countries with the largest number of Americans working abroad vary from 165 to 78 (State Department Index, April 1, 1977). See discussion in the GAO report, op. cit., p. 99.

determining the cost of living adjustments in H.R. 9251 (although the deduction will actually be figured in a different manner under the bill and could be larger or smaller).

DEDUCTION ALLOWED WITH A COST OF LIVING EXCLUSION BASED ON THE U.S. AVERAGE COST: PAIRED U.S. AND FOREIGN CITIES

Foreign City	Cost of Living Index 1/	U.S. City	Cost of Living Index 1/	Deduction Allowed Foreign Resident Not Allowed U.S. Resident 2/
Riyadh, Saudi Arabia	142	Anchorage	140	$9,240
Rome, Italy	128	Honolulu	127	6,160
Hong Kong	125	New York	125	5,500
Tehran, Iran	123	Boston	123	5,060

1/ Based on Department of State Index for April, 1977; Department of Labor Urban High Budget Index for August, 1978. The foreign indices exclude housing.

2/ This is the deduction which would result from a straight cost of living allowance. It is not equivalent to the expected allowance in H.R. 9251, which is comprised of a general cost of living allowance relating to consumption outside of housing, plus a separate housing allowance.

A provision which allows a $5,060 deduction based on cost of living for a family in Tehran and which does not allow a similar deduction for a family in Boston with an equal income and facing similar living costs, or for a similar family in New York, Honolulu or Anchorage where living costs are even higher, is inconsistent with standards of horizontal equity.

To avoid this violation of the horizontal equity standard would require a cost of living adjustment limited to amounts in excess of the most expensive place in the United States.

(b) Relief for Specified Extraordinary Expenses

Horizontal equity as practiced in the United States has allowed tax relief for particular expenses or circumstances which are deemed to involuntarily reduce the ability to pay taxes. Examples of provisions embodying this principle include the deductions for excess medical expenses and casualty losses. Some proposals for reducing the tax liability of individuals living abroad are similarly couched in terms of an adjustment for extraordinary specified expenses or excess financial burden. Examples are the special deductions included in the Treasury proposal and H.R. 9251 for the "excess" cost of housing abroad, and in the Treasury proposal for the cost of traveling home.

However, the housing and travel costs experienced by foreign employees are distinguished from the present hardship deductions for medical expenses and casualty losses by the fact that foreign employment and its concomitant expenses are a matter of choice, whereas medical expenses or casualty losses represent involuntary reductions in ability to pay taxes. Thus, the same principles of tax equity are not applicable to the two categories of expenses.

Nonetheless, if the decision is made to provide tax relief for specified extraordinary expenses rather than, or in conjunction with, a general cost of living adjustment, two additional points should be made. First, the mechanism of making separate adjustments for specified categories of expenses may, itself, fail to provide appropriate cost of living adjustment when considered on an overall basis. This is clear in the Treasury proposal which provides adjustments for specified extraordinary expenses but allows no general cost of living adjustment. It also may be true in some cases under the provisions of H.R. 9251 if a separate housing cost adjustment leads to larger allowances than would be suggested if overall living costs are considered. (See discussion on p. 23.)

The second additional point about relief for specified expenses is, as mentioned above for general allowances: any relief should be for expenses exceeding the highest levels in the U.S., not average levels. Relief based on average levels of domestic expenditures would discriminate against domestic taxpayers. This was demonstrated for a general cost of living adjustment above; it can also be illustrated for specific adjustments for housing and foreign travel. There is a variation among locations in the U.S. in the average percent of a family's budget spent for housing. According to family budget data from the Department of Labor, Boston appears to have the highest ratio of average housing cost to income in the U.S. at approximately 22 percent.[1/] Thus,

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1/ Labor Department Cost of Living Index, August, 1976.

for example, if an allowance for "excess" housing costs were provided to overseas Americans based on housing costs exceeding one-sixth of their incomes, this provision would discriminate against the residents of Boston by denying them equal treatment despite experiencing similar "extraordinary" expenses. The denied tax benefit would be a deduction averaging 5 percent of Bostonians' incomes.

Similarly, the allowance of a deduction for the cost of travel home in the Treasury proposal would seem to violate the principle of horizontal equity. This proposal, or some modification of it, would be less violative of equity principles if the U.S. were small geographically so that foreign travel almost always involved comparatively high costs. However, this is not the case. Under the Treasury proposal a family living and working in Toronto visiting relatives in New York could deduct the cost of the trip, while a family working in San Francisco also visiting relatives in New York would receive no such deduction. Even when overseas travel is involved, the costs do not necessarily exceed the costs of domestic travel within the U.S. Round trip coach air fare between Boston and London is $409, Boston to Paris is $409, and Boston to Bonn is $434; on the other hand, round trip fare Boston to San Francisco is $462, Boston to Anchorage is $524, and Boston to Honolulu is $584.[1/] Given the mobility of the American population, millions of people within the U.S. live and work long distances from

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1/ Trip fares provided by Library of Congress Travel Office.

their close relatives. Therefore, providing a tax benefit for home travel for people who choose to work in foreign locations may be especially difficult to defend against complaints of unfair treatment from Americans who work far away from "home" but within the U.S.

(c) Taxes as Payments for Benefits Received

The concept of judging the horizontal equity of a tax system based on the ability to pay taxes is one of the two common approaches to the equity issue and the one most appropriate to analysis of the Federal income tax. A second approach to tax equity issues is called the "benefits received" concept, and measures the equity of tax payments by comparing the amount of tax payment to the amount of direct benefit the taxpayer receives from government services financed by the taxes. This concept thus attempts to view taxes as being like prices in the private sector of the economy, i.e., direct payments for goods and services received. While this approach to the equity issue has a certain intuitive appeal, it is obviously limited to the financing of government services which produce benefits which are primarily direct in nature rather than social or humanitarian. For example, judging the appropriate level of taxes to be paid by each taxpayer for support of government services on the basis of their consumption of the services may be appropriate when considering fees to pay for public swimming pool usage or gasoline taxes which are used to finance highways; it is obviously inappropriate

when considering the financing of welfare payments and inapplicable for national defense (how are personal benefits measured?).

The argument is occasionally made that individuals living abroad receive smaller benefits from U.S. Government services than those living in the United States, and therefore overseas Americans should be exempt or partially exempt from the Federal income tax. However, no one seriously argues that the U.S. Federal income tax is based on the benefits received principle of taxation. It is clearly based on the ability to pay principle because most of the expenditures funded by the income tax are services which produce primarily social or humanitarian benefits--national defense, income maintenance, general government, foreign affairs and foreign aid, basic research, natural resource development, health care, and contributions to culture and arts. All of these expenditures primarily provide general benefits to all Americans rather than private benefits to specific individuals who could be charged for the services. Although this issue is obviously more judgmental than others, there seems no strong reason to argue that American citizens living abroad do not share in these general benefits.

2. Vertical Equity:

Another equity standard for judging tax policy is that of vertical equity. Judgment of a tax provision on this ground usually involves the examination of tax levels by income class. The U.S. tax system is progressive, based on the notion of ability to pay and

reflecting the idea that a wealthy individual can afford to pay in taxes a larger fraction of marginal earnings than a poor individual.

Overall the tax provisions benefitting individuals living abroad tend to reduce the progressivity of the U.S. income tax structure. This effect occurs because, by and large, those individuals living abroad tend to have much higher incomes than those in the United States. According to a recent Treasury study,[1/] 47 percent of the individuals claiming a deduction for the prior section 911 had adjusted gross incomes of more than $20,000, as compared with 14 percent in the United States. Taxpayers with incomes of over $50,000 account for 10 percent of section 911 taxpayers while accounting for only 1 percent of U.S. taxpayers. This study indicates that 84 percent of the tax benefit under prior section 911 accrued to individuals earning over $20,000, 65 percent accrued to those with incomes over $30,000, and 31 percent accrued to those with incomes of over $50,000. Therefore the bulk of the tax reduction accrues to individuals in the richest 15 percent of the population.

The 1976 tax increase on overseas Americans which resulted from the revision of section 911 tended to fall more heavily on high income individuals; 96 percent of the increased taxes accrued to those earning over $20,000, 79 percent accrued to those earning over $30,000 and 40

1/ Taxation of Americans Working Overseas, Department of the Treasury, February 1978. The Treasury study notes that higher salaries abroad may reflect higher living costs which would mean real income may be lower than nominal income. However, the reported income levels are net of in-kind allowances for excess housing, education and travel, partially offsetting this effect.

percent accrued to those earning over $50,000. Thus, the current version of section 911 favors lower income taxpayers relative to the prior version.

IV. Effects on Trade and Employment

A. Tax Incidence and Relationship to U.S. Exports

Although the basic policy principles most appropriate for evaluation of the tax treatment of Americans working in other countries are neutrality and equity, provisions which violate those standards may still be desirable policies if they achieve some other beneficial public purposes. The other public purposes most often related to the taxation of Americans living abroad are the effects of the tax treatment on international trade and American "competitiveness"--generally expressed in terms of seeking employment and balance of payments objectives via increasing exports. However, since the link between the level of taxation of Americans working abroad and the level of U.S. exports is somewhat indirect, it is useful to discuss the relationship and the related issue of the incidence of taxes on overseas Americans.

Tax incidence refers to the final burden of taxes after they have been shifted among economic agents, e.g., through higher prices, lower wages, or reduced profits. This shifting process has effects on economic behavior. For example, if taxes are increased on U.S. citizens working abroad, the initial burden of those increased taxes will fall on the employees reducing their after-tax income. This will diminish the willingness of those employees to work abroad, thus, reducing the supply and increasing the cost of American workers to

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foreign employers. In this manner some of the burden of the higher taxes is shifted to employers.

The process may also occur in another manner. Many U.S. companies operating abroad have tax protection or tax equalization programs designed to shelter their employees from any higher taxes associated with foreign employment. If the employer has such a practice and pays the employee higher wages following a tax increase, the initial burden of the tax is shifted immediately to the employer. However, if the resultant increase in employment costs (and decrease in profits) leads the employer to hire fewer American workers, then the wages paid to these workers may decline, thus shifting some of the increased tax burden back onto the employees. The employer may also attempt to pass part of the tax increase on to customers by raising prices. This will likely result in reduced sales and output.

Therefore, U.S. tax benefits to citizens working in foreign countries beyond the treatment which would be suggested by the tax neutrality principle serve to subsidize the operations of business located in foreign countries which employ American workers. Since foreign investment and production by U.S. multinationals is in many cases a substitute for domestic production and exporting to the foreign markets, it seems ironic that subsidizing foreign operations should be perceived as stimulating U.S. exports. The argument is made that foreign operation by U.S. multinationals expands their foreign sales and, because their foreign

production uses U.S. produced inputs, thereby expands U.S. exports. Whether this effect outweighs the effect of foreign production substituting for U.S. produced exports is unknown and cannot be assumed without supporting evidence.

Thus, the relationship between U.S. tax treatment of citizens working in other countries and the quantity of U.S. exports is indirect and uncertain. The GAO report on the trade impact of section 911 suggested that a more direct relationship may exist because "it is essential to maintain a large force of U.S. citizens abroad to promote and service U.S. products and operations";[1/] however, there seems to be no specific evidence in the export experience of the United States or other countries to support this assertion (e.g., the substantial success of imported automobiles, televisions, calculators, etc. in this country has not been accompanied by an influx of foreign nationals to sell and service them).

B. Balance of Payment and Employment Effects

Even if there were a direct relationship between U.S. tax treatment of citizens working abroad and U.S. exports, a tax subsidy would not have a permanent effect on the balance of payments. This is because a flexible exchange rate system will automatically move, through market adjustments in exchange rates, toward a position of balance in the international payments accounts of each country. This movement may be

1/ GAO Report, op. cit., p. i.

somewhat unsteady and protracted, and may be moderated or retarded by the policies of interested governments (as the world is presently experiencing), but in the long run any policy which attempts to increase permanently net export receipts without also increasing exports of investment capital will be rendered ineffectual by market forces. For example, if a tax subsidy were successful in temporarily increasing U.S. exports, under flexible exchange rates this initial effect would eventually cause an increase in the price of the dollar on foreign exchange markets. This exchange rate change would reduce U.S. exports and increase imports, thus offsetting the effects of the original incentive as far as the balance of payments is concerned. Thus, under a system of flexible exchange rates, international currency price adjustments will render ineffective policies which attempt to have a long-term impact on a nation's balance of payments.

These adjustments are part of the normal economic process by which supply and demand adjustments in international markets occur under a system of flexible exchange rates. There might occasionally be reasons a country would wish to intervene on a short-term basis in the foreign exchange market. First, all countries have an interest in smooth adjustments in the exchange markets because erratic adjustments erode planning capabilities and cause a deterioration in trade and investment conditions. This concern for stable adjustments is particularly strong with regard to the U.S. dollar, not only within the U.S. but abroad, because the

dollar is the exchange medium for much of the world's trade. Secondly, net exports (exports minus imports) enter into the aggregate demand of a nation's economy which determines levels of income and employment. Thus, for example, the U.S. may be concerned about an initial deficit in the trade account and wish the price of the dollar to fall more quickly, while foreign countries may be concerned, once the price of the dollar begins to fall, about the effect on their export sector and wish it to fall more slowly. In the case of some foreign countries whose economies are heavily dependent on the international trade sector, this concern may be greater than in the United States.

These reasons for intervening in the foreign exchange markets are short term in nature. They require policies which are temporary, easily controlled, quick acting, and capable of coordination with the policies of other nations. Market adjustment mechanisms such as the buying and selling of foreign currencies meet these criteria; tax subsidies for Americans working in foreign countries do not.

Another argument which has been used in support of tax preferences for foreign employment is the effect of these provisions on employment in the United States through the impact on exports. It is argued that, because tax subsidies for citizens working abroad lead to higher exports (which, as discussed above, is a questionable assertion on at least two grounds), the tax policy will increase domestic employment and thereby help solve the unemployment problem. Unemployment is generally

considered to result from structural and cyclical problems. The structural problems may be considered long term in nature and the cyclical problems short term, although even the short term may be somewhat protracted as demonstrated by current economic conditions. Cyclical unemployment results from a greater number of job seekers than job openings and can result from a number of factors such as a recession (or "growth recession"), an unusually large influx of new labor force entrants, and downwardly rigid wages. Appropriate policy responses to cyclical unemployment include countercyclical fiscal and monetary policy and programmatic responses such as job programs, public works projects, and countercyclical revenue sharing. Tax subsidies for overseas Americans are not candidates for short-term countercylcial policies because they are not amenable to increasing or decreasing as the cyclical pattern of the economy may require, nor can their impact be targetted toward the unemployed.

The structural unemployment problems involve the distribution of skills and the location of the labor force compared to the requirements of the job market. Policy responses to structural unemployment include training, relocation programs, and income maintenance programs. Tax subsidies for overseas workers do not contribute directly to a solution to these structural unemployment problems. Additionally, even if preferential tax treatment for Americans working in other countries creates jobs in the export industries, under a system of flexible exchange rates this policy will likely accelerate the decline of

import competing industries and lead to less employment in those sectors.

Despite these points it is true that expansion or contraction of exports can have temporary impacts on employment and the balance of payments. These impacts were the focus of the recent GAO Report on section 911. The GAO study employed the Data Resources, Inc. (DRI) econometric model of the U.S. economy to estimate the effects on U.S. trade and employment of the 1976 amendments to section 911. The chapter of the GAO Report which gives the results of this analysis is reproduced as an appendix to this report. Basically, the GAO Report concludes that the impact of the tax change on U.S. exports and employment is extremely small. With regard to employment, the report states:

> The largest effect on domestic employment is produced in 1981, when approximately 21,000 jobs are lost. To give some perspective to this number, it should be noted that the average growth rate of the United States creates 30,000 jobs a week. Thus, the largest effect on employment will be about two thirds of a normal week's job creation. In 1978, the estimated job loss is only 4,000 or about the number of jobs added to the U.S. economy in one normal day. 1/

The effect of the increased taxes on the balance of payments is actually to improve it due to the elasticities of demand for exports contained in the DRI model. The improvement is, however, very small. 2/

1/ GAO Report. Op. cit., pp. 22-23.

2/ These results seem inconsistent with the policy recommendation in the GAO Report which was "that consideration be given to continuing some type of incentive, at least until more effective policy instruments for promoting exports and commercial competitiveness abroad are identified and implemented."

Despite the small impact of the tax changes estimated by the GAO study, the methodology employed can be regarded as yielding a maximum, or worst case estimate, because the assumptions made in the analysis bias the results in this direction[1/] (this is not necessarily a criticism; in doing this type of analysis assumptions must be made and, where uncertainty exists, it is often desirable that the assumptions be biased in the opposite direction of the results).

The first assumption in the GAO analysis is that all Americans affected by the revision in section 911 are occupied in selling U.S. produced exports. This is unlikely since at least some Americans abroad are involved in foreign production which might act to substitute for U.S. exports or to increase U.S. imports. To the extent this effect occurs, section 911 acts like a subsidy, not to exports, but to foreign investment.

The GAO simulation also assumes that overseas taxpayers are totally reimbursed by their employer for the higher U.S. tax and do not bear any of the burden of the tax themselves, an assumption which tends to maximize the effect of section 911 on wage costs. GAO's survey of business firms operating abroad indicates that only about one-half of indiv-

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1/ The GAO Report, op. cit., p. 14, states:

> "Our approach to estimating the effect of changes in Section 911 on the U.S. balance of payments, domestic employment, gross national product, and Federal budget position is to make several assumptions that are apt, if anything, to exaggerate the number of Americans abroad engaged in promoting U.S. exports; to compute the maximum effect that the tax increase might have on the prices of U.S. products sold abroad; and to trace the effects of the subsequent decline in export demand back to the domestic economy."

iduals working abroad receive tax allowances from their employers. While the GAO Report notes that the results of the survey cannot be used as input to the simulations because of its non-random nature, nevertheless the survey results and tax incidence theory suggest that this assumption overstates the wage impact of the section 911 change.

The GAO study assumes that the increased wage costs resulting from compensating employees for their higher U.S. taxes are completely passed through to foreign customers in the form of price increases for exports, which, in effect, assumes a perfectly horizontal supply curve.

Finally, the GAO analysis assumes a marginal tax rate of 50 percent, which is the maximum tax rate on earned income.

The GAO Report also points out that the estimates do not include two other effects which would tend to offset the impacts of the tax policy changes. The first is the effects of flexible exchange rate adjustments which are not included in the DRI model and which would tend to mitigate the impact of the changes in section 911, as discussed above. The second is the assumption of an absolute tax increase, rather than an increase in taxes on employees in foreign countries and a decrease in taxes in other areas. Given the Congressional budget process, one would expect an offsetting tax reduction which would reduce the impact of the policy change on employment.

These assumptions could act to significantly overstate the quantitative results in the GAO study. The possible magnitude of this overstatement can be illustrated by changing two assumptions in entirely

reasonable ways. First, assume that only one-half of the foreign firms reimburse their employees for higher taxes, consistent with the GAO survey data. Secondly, assume the average marginal tax rate on U.S. citizens abroad is 40 percent rather than 50 percent, a rate consistent with distributions of the tax benefit across income classes. If these assumptions are more realistic, the effect of the original assumption was to overstate the price effect by 140 percent.[1/] If the first assumption were also modified--only one-half of U.S. citizens abroad in jobs related to export sales, plus one-half of higher taxes reimbursed, plus the 40 percent marginal tax rate--the overstatement would be 380 percent. However, as noted earlier, since the resultant effects are so minor, it is useful to have maximum impact assumptions, since they provide assurance that the true effect will be smaller, and therefore also insignificant.

C. Effects on Competitiveness

An argument which has been used in support of section 911 and which is related both to the effects on trade and employment and to tax neutrality is the issue of competitiveness. U.S. firms operating abroad maintain that increasing U.S. taxes on their employees will increase their wage

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1/ To illustrate this effect, assume the higher taxes on overseas Americans amounted to $100. Under the GAO assumptions the price increase would be twice that amount or $200. Under the new assumptions only one-half, or $50 would affect firms. Furthermore, because the marginal tax rate is 40 percent rather than 50 percent, wages would be increased only by $83.33. The percentage overstatement is then $200/$83.33, or 2.4 times as large, or a 140 percent overstatement.

costs, thus forcing their prices up and reducing their competitiveness. Similarly, U.S. citizens working in other countries claim that higher U.S. taxes will make them less competitive in the foreign job market with foreign nationals who are not taxed by their home countries.

The argument that reduction of tax benefits for overseas Americans would lead to a small reduction in U.S. business activities abroad is correct, and is viewed by firms as reducing their "competitiveness". Similarly, the argument that increased taxation of Americans working abroad would tend to lead to a substitution of foreign for U.S. employees (a substitution which has been occuring for years for other reasons) is also correct—and viewed by U.S. employees as a reduced ability to compete. The implications of this argument must be considered carefully, however.

The standard of tax policy with respect to business and employee location decisions should be to achieve neutrality so that tax provisions do not cause distortions in location decisions unless some clear national purpose is served by such nonneutralities. As indicated in the analysis above, there is no clear evidence that artificially encouraging Americans to work abroad through the tax code serves any identifiable national purpose. Therefore, the resulting increased "competitiveness" of American firms and citizens in foreign locations appears to be at the expense of other Americans--through higher and more inequitable taxes and through less efficient allocation of economic resources.

APPENDIX

CHAPTER 3

IMPACT OF 1976 TAX CHANGES ON U.S. BALANCE OF PAYMENTS AND DOMESTIC ECONOMY 1/

The full economic impact of the reduction in tax incentives for overseas employment cannot be measured precisely not only because needed data are lacking but also because the secondary benefits to the Nation from having Americans abroad are so difficult to determine. Recognizing these limitations, to gage the impact we (1) secured the views of U.S. company officials experienced in foreign sales and/or operations with respect to the probable impact and (2) estimated the effects upon the U.S. economy assuming the tax increase would be passed along to customers.

The tax change may affect not only the company that employs Americans overseas but also other U.S. companies. A contract lost due to the higher costs of tax reimbursements may have a ripple effect on subcontractors and/or suppliers of the primary company. Also, if a company loses or must replace Americans with third-country nationals, the effect may be similar since foreign employees in influential positions may be inclined to deal with their own country's firms rather than those of the United States. These potential impacts were of concern to company officials we interviewed at overseas affiliates of U.S. companies and at domestic headquarters.

About 55 percent of the overseas affiliates responding believed that at least 5 percent of the U.S. companies in host countries would close down operations as a result of the tax change; about 88 percent believed that the change would result in at least a 5 percent reduction in U.S. exports worldwide.

Most of the headquarters of U.S. companies surveyed believed that few if any U.S. companies in their industries would close down operations as a result of the tax change. However, although only 57 percent of them ventured estimates, most of these believed that the change would result in at least a 5 percent reduction in U.S. exports worldwide.

1/ Reproduced from: General Accounting Office, Impact on Trade of Changes in Taxation of U.S. Citizens Employed Overseas, February 21, 1978.

ANALYSIS OF ECONOMY-WIDE EFFECTS

The actions of American citizens residing abroad may have a pervasive effect on the international payments of the United States and thus on domestic income and employment.

As an example, some American citizens abroad may be sales representatives soliciting orders to be filled by U.S. production for export. If the favored status granted their incomes under Section 911 is revoked or modified and U.S. firms must compensate them for their increased taxes, U.S. production costs and product prices may rise, thereby decreasing the competitiveness of U.S. goods abroad. However, in this era of massive multinational corporations, there is no guarantee that U.S. representatives are selling goods produced in U.S. plants; the goods may well be produced in total or in part abroad. If so, revisions of Section 911 should have no detrimental effect on the international trade accounts.

Similarly, American citizens abroad who are likely to bear the burden of a change in Section 911 may be executives in U.S.-based companies who are strategically placed to influence the purchasing decisions of the foreign operations. Higher tax liabilities on these executives, to the extent that they raise the company's production costs, may lead to the recall and replacement of the Americans by less costly foreign nationals, who may then divert purchases to non-American goods. To the extent that such a diversion takes place, U.S. exports will decline.

For analytical purposes, these two examples can be equated to other situations. If one believes that the original Section 911 imposed a fair tax on income earned in foreign countries, its repeal amounts to the imposition of a special tax on those exported commodities sold through the efforts of Americans abroad. On the other hand, if one views the original Section 911 as granting favored treatment to income earned abroad as opposed to similar income earned domestically, its repeal can be viewed as the ending of a special subsidy for certain categories of U.S. exports. Viewed either way, the effect should be the same--certain classes of U.S. exports may suffer a decline in demand.

Before one concludes that Americans residing in foreign countries only contribute positively to the U.S. balance of payments, it should be noted that their contribution may instead be negative.

While the growth of the multinational corporation may be due to many causes (e.g., lower production costs, to get around high or rising tariffs and other impediments to trade imposed by foreign countries or trade blocs, etc.), it certainly is aided by the ease with which U.S. managerial talent can be sent abroad to superintend operations. Production in foreign countries may serve either to replace exports or to increase U.S. imports. This is not to suggest that all production abroad by U.S. firms necessarily has a negative impact on the Nation's balance of payments. To the extent that rising tariff barriers or other trade restrictions would have decreased U.S. exports anyway, U.S. production abroad does not necessarily displace exports. Moreover, it is possible that if U.S. firms did not go abroad to set up production for export to the United States, foreign-owned firms may have come to dominate the U.S. market. To the extent that foreign production by U.S. subsidiaries is either export-replacing or import-increasing, any tax abatement on foreign-earned income may be viewed as a subsidy encouraging U.S. firms to move production abroad, which they use, in turn, to serve foreign markets or to ship to the United States.

As a final example of the effect of U.S. citizens abroad, one should examine their consumption habits and any desire on the part of foreigners to emulate them that may be stimulated. To the extent that these habits require the use of U.S.-produced goods, they may lead to increased U.S. exports.

These examples, which are typical, are constructed in part to indicate that the contribution of U.S. citizens residing in foreign countries to the American balance of payments is not unambiguously positive and may, on balance, be negative. Moreover, capturing all of these effects in a single number is by no means easy, for many assumptions must be made whose realism will undoubtedly affect the confidence with which the conclusions are received.

What effects can be measured?

Role of individuals and companies

An increase in taxes on Americans abroad may affect U.S. exports in several ways. It has been represented to us that many overseas Americans occupy positions in which they are well placed to influence procurement decisions for millions of dollars of goods and services. In these positions they are said to favor American suppliers, to the economic benefit of the United States. It is also claimed that the success of a single American company abroad may be responsible for a large volume of orders for other American firms, assuming as seems reasonable that the company is better acquainted with suppliers of its own nationality than with those of other nationalities. If the increased costs of employing Americans abroad cause them to be discharged from their positions of influence or cause American companies to lose contracts that would have provided orders for many other American firms, the ultimate impact of the tax increases on the U.S. economy may be sizable.

We have not attempted to judge the merits of this position or to appraise its quantitative importance, not because the position seems implausible to us but because we know of no way to evaluate it objectively. Had we tried to do so, we would have had to devise a new research methodology unlike any that has been devised before. Almost surely we would have had to depend on the voluntary cooperation of many firms, foreign and American, as well as foreign governments. A major investment of time and money would have been needed.

Price impact

However important personal or commercial relationships may be in determining trade flows and export success, a rich fund of experience proves that prices and quality also matter. Increased taxes on Americans abroad will also affect export sales by affecting prices, willingness to invest, and willingness to work. To the extent that overseas Americans who are employed in selling U.S. exports remain in their jobs and are compensated by their employers for at least a part of their tax increase, the compensation must come either from the employers' profits or from the prices that foreign customers pay. Or the employees themselves may bear the tax increase and suffer

a reduction in their take-home wages. Any of several assumptions are possible; but whatever assumption one makes, it is possible in principle to trace out the consequent effects on the U.S. economy.

In our analysis we focused solely on the price impact of the tax increase--the impact that the tax increase may have on the prices of U.S. exports. The increase will have no immediate effect on export prices if it is absorbed in full by the American employees or their U.S. employers. (It will have a belated effect if it causes Americans to withdraw from their overseas jobs and they are replaced by other nationals, or if American companies, discouraged by lower profits, abandon some foreign markets.) But we concluded that it would be unreasonable to expect a major part of the tax increase to be borne by employees or employers, since in the long run both capital and labor are highly mobile, an opinion shared by many of the businessmen and employees we interviewed both in the United States and abroad. (See p. 77 for an elaboration of the view that the tax increase will not be borne by American employees overseas.)

In conducting our analysis, we assumed complete shifting of the tax increase to foreign customers in the form of an increase in export prices, because that assumption seemed more reasonable than any alternative. Other assumptions about shifting of the tax increase would have yielded somewhat--not dramatically--different results.

METHODOLOGY

Our approach to estimating the effect of changes in Section 911 on the U.S. balance of payments, domestic employment, gross national product, and Federal budget position is to make several assumptions that are apt, if anything, to exaggerate the number of Americans abroad engaged in promoting U.S. exports; to compute the maximum effect that the tax increase might have on the prices of U.S. products sold abroad; and to trace the effects of the subsequent decline in export demand back to the domestic economy. We assumed that:

1. All Americans affected by a revision in Section 911 are occupied in selling U.S.-produced exports.

2. All reductions in the disposable income of Americans abroad brought about by a revision in Section 911 are offset by increases in gross salaries. If it is assumed that these individuals are in the maximum marginal tax bracket (50 percent), their gross salaries will have to be raised by a sum equal to twice the possible increase in tax to enable after-tax salaries to remain constant.

3. All increases in the gross salaries of individuals due to a revision in Section 911 will raise the production costs of exports. These additional costs, in turn, are passed on to customers in the form of price increases.

4. Not all exports are likely to be equally subject to price increases. The prices of some exports should not be affected, either because they are sold in geographic regions where few Americans reside who are affected by a revision in Section 911 or because these products are unlikely to be sold by Americans abroad. Using the export classification of the Data Resources, Inc. (DRI) econometric model, the increase in export prices has been assumed to be concentrated in (a) industrial supplies and materials, (b) capital goods, except automotive, and (c) consumer goods, except automotive. 1/

1/ The categories of exports excluded were (1) foods, feeds, and beverages, (2) auto vehicles, parts, and engines, (3) military sales and donations and reexports, and (4) services and repatriated investment earnings. Items 1 and 3 were excluded because their sale is unlikely to be promoted by Americans living abroad. Item 2, related mainly to trade with Canada, was excluded because the effect of Section 911 changes on Americans living in Canada is relatively small. Item 4 was excluded because it chiefly contains dividends and interest payments repatriated from U.S.-owned foreign assets.

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In summary, the approach used to estimate the macroeconomic impact of a change in Section 911 is to regard the effects as identical to those that would follow if the Government imposed an excise tax on certain exports equal in size to the increase in gross salary needed to maintain disposable income at the same level as before the change in Section 911.

In deciding on the size of the tax that the Government is assumed to impose upon exports, three possible revisions to Section 911 were considered.

1. Section 911 as it stood until 1975 is repealed.

2. The 1976 Amendment and the decision of the U.S. Tax Court on the taxable status of income received in kind are allowed to stand and go into effect.

3. Only the 1976 Amendment is allowed to go into effect.

Each of these three cases is complicated by the fact that if the gross income of Americans abroad is increased to compensate for the effects of possible changes in Section 911, their tax liabilities to foreign governments may rise. These tax liabilities are used to offset taxes due the U.S. Government. To incorporate this effect into the estimates, two additional assumptions were made.

1. The marginal rate of foreign taxation is zero so that all the increase in taxes accrues to the U.S. Treasury.

2. The marginal rate of foreign taxation is 50 percent so that the increase in taxes is shared equally by the U.S. and foreign governments.

The majority of Americans who are employed overseas and who are affected by the 1976 tax changes probably confront a foreign marginal tax rate that is neither zero nor 50 percent but something between. We believe that the true weighted average of these marginal tax rates is nearer zero than 50 percent and therefore that the estimates prepared under the first assumption are the more realistic ones. Others who prefer another

marginal rate can use the DRI figures to construct new estimates corresponding to their preferred rate simply by interpolating between the estimates in tables 1 and 2 below that correspond to the zero and 50 percent rates.

Each assumed change in Section 911 will yield a certain dollar amount by which the tax revenue of the Treasury will increase. Each change will also cause export prices to rise by twice the amount of the increase in taxes. The increase in export prices and the rise in tax revenue are then introduced into the DRI econometric model to compute values of U.S. gross national product, domestic employment, exports and imports, and Federal budget deficit for the next 5 years.

The size of the decline in the quantity of exports purchased by foreigners depends on the sensitivity of their demand to an increase in the price of American goods. This sensitivity is related to the availability of substitute products. Thus, an increase in price of one product is likely to decrease the quantity that individuals are willing to purchase if a close substitute is available. If no close substitutes are available, consumers are unlikely to cut back purchases substantially, especially if the product is a necessity.

Numerous attempts have been made to estimate the relationship between changes in relative product prices (the prices of U.S. products compared with those of foreign substitutes) and the quantity of American goods that foreigners are willing to purchase--called the price elasticity of demand. Price elasticities are an integral part of the DRI econometric model and they span a range from -1.168 for consumer goods to -.277 for industrial supplies and materials. These values mean that if American export prices rise relative to a weighted average of foreign prices by 1 percent, the quantity of American goods that foreigners are willing to purchase will decline by between 1.168 percent and .277 percent. The reasonableness of the DRI price elasticities was verified by consulting some 120 other studies on the same general topic prepared by the International Monetary Fund, the Board of Governors of the Federal Reserve System, and private individuals (primarily academic economists). The DRI estimates were found to be generally compatible with those reported by the other studies.

To put the DRI elasticity measures into perspective, they can be compared to two extreme cases cited by economists. When the quantity of a commodity that people are willing to purchase is completely insensitive to price changes, the elasticity is zero. If it is completely sensitive, the elasticity approaches infinity. Measured against this scale, the DRI elasticities are small.

Why questionnaire replies were not used

The replies to the questionnaires that are discussed in chapters 4 and 5 indicate that revising Section 911 would probably most strongly affect certain U.S. industries operating in a few countries. Although it would have been desirable to have used this information in computing the impact on the U.S. balance of payments and other selected macroeconomic variables, it was impossible to do so for the following reasons.

First, the DRI macroeconomic model does not have a highly developed international sector providing a detailed breakdown of exports by commodity and geographic destination. Civilian exports are disaggregated into just five classes by type of product and not at all by destination. Other macroeconomic models are no more detailed. It was therefore impossible to assign all of the increase in costs stemming from a change in Section 911 to as narrow a class of U.S. exports as those that respondents predicted would be most severely affected. Nevertheless, so far as the model permitted, an effort was made to focus on the most relevant exports. The increased costs stemming from a change in Section 911 were assigned to just three of the five classes distinguished in the DRI model on the grounds that producers of the other two would not be much affected.

Second, the replies were gathered from a non-random sample of individuals and companies and we were therefore reluctant to depend on them for quantitative estimates of the economy-wide impact of changes in Section 911.

Finally, even had the sample been randomly chosen, it was too small to support quantitative inferences about individuals in particular countries and occupations. Selecting and interviewing a suitably large sample would have been time consuming and very costly.

THE DRI RESULTS

It is through changes in both tax revenue and the relative prices at which foreigners can purchase American goods versus foreign substitutes that the contemplated changes in Section 911 will have their impact on U.S. gross national product, employment, and the balance of payments.

According to data furnished by the Treasury Department, if Section 911 as it stood until 1976 were abolished, an estimated revenue gain of $412 million would have resulted in 1977. When the effect of the decision of the U.S. Tax Court on the taxable status of income received in kind by U.S. residents abroad is added to the effect of the 1976 Amendment to Section 911, the revenue gain is estimated at $292 million. When only the 1976 Amendment is considered, the revenue gain is estimated at $228 million.

In table 1, using the DRI model, the macroeconomic impact of each of these three possible tax increases is considered. The impacts on the U.S. balance of payments and Federal budget deficit are reported in table 1 under two assumptions: that foreign governments impose no tax on the extra wages paid to overseas Americans to compensate them for the increase in their U.S. taxes, and that foreign governments do tax the extra wages at a marginal rate of 50 percent. The impacts of the three tax changes on U.S. gross national product, domestic employment, and exports and imports were also calculated under the same two assumptions; but the two sets of estimated impacts differed so little that only one was included in table 1, the set that assumed no foreign taxation.

The immediate impression from table 1 is that the effects of changing Section 911 are very small in relation to the values of the variables that they would affect. This is not surprising, in view of the fact that in 1976 American merchandise exports totaled over $114 billion, and the maximum addition to export costs assumed here would be only $824 million.

Table 1

Selected Macroeconomic Impacts of Tax Changes, 1978-82

Year	Projected gross national product (in 1972 prices)	Impact on gross national product (in 1972 prices) (note a): of repealing Section 911	of 1976 amendments to Section 911	of 1976 amendments to Section 911 and 1976 Tax Court decisions
	(billions)	(millions)		
1978	$ 1,393	$ -290	$ -160	$ -200
1979	1,449	-660	-360	-470
1980	1,517	-820	-450	-580
1981	1,582	-840	-470	-600
1982	1,635	-780	-430	-550

Year	Projected domestic employment	Impact on domestic employment (note a): of repealing Section 911	of 1976 amendments to Section 911	of 1976 amendments to Section 911 and 1976 Tax Court decisions
	(000 omitted)			
1978	92,910	-6	-3	-4
1979	95,030	-20	-11	-14
1980	97,380	-27	-15	-19
1981	99,790	-29	-16	-21
1982	101,690	-28	-15	-20

Year	Projected net exports less transfer payments to foreigners	Impact on balance of payments (note b): of repealing Section 911 — Marginal foreign tax rate is Zero	50 %	of 1976 amendments to Section 911 — Marginal foreign tax rate is Zero	50 %	of 1976 amendments to Section 911 and 1976 Tax Court decisions — Marginal foreign tax rate is Zero	50 %
	(billions)	(millions)					
1978	$ -13.4	$ +600	$ +190	$ +330	$ +100	$ +430	$ +130
1979	-8.7	+430	-50	+240	-20	+300	-30
1980	-6.6	+490	-50	+270	-30	+340	-40
1981	-3.5	+580	-20	+320	-10	+410	-20
1982	+2.3	+660	-10	+360	-20	+470	-20

(Footnotes at end of table)

Table 1 (continued)

Year	Projected exports (in 1972 prices)	Impact on exports (in 1972 prices) (note a): of repealing Section 911	of 1976 amendments to Section 911	of 1976 amendments to Section 911 and 1976 Tax Court decisions
	(billions)	(millions)		
1978	$ 102.8	$ -150	$ -80	$ -110
1979	110.0	-300	-160	-210
1980	115.2	-320	-180	-230
1981	120.7	-340	-190	-240
1982	126.8	-360	-200	-260

Year	Projected imports (in 1972 prices)	Impact on imports (in 1972 prices) (note a): of repealing Section 911	of 1976 amendments to Section 911	of 1976 amendments to Section 911 and 1976 Tax Court decisions
	(billions)	(millions)		
1978	$ 90.4	$ +10	$ 0	$ -10
1979	93.2	-30	-20	-20
1980	96.4	-60	-30	-40
1981	101.0	-70	-40	-50
1982	104.4	-60	-40	-50

Year	Projected Federal budget deficit	Impact on Federal budget deficit [increases (+), decreases (-)] of repealing Section 911		of 1976 amendments to Section 911		of 1976 amendments to Section 911 and 1976 Tax Court decisions	
		Marginal foreign tax rate is		Marginal foreign tax rate is		Marginal foreign tax rate is	
		Zero	50 %	Zero	50 %	Zero	50 %
	(billions)	(millions)					
1978	$ 51.7	$ -650	$ -230	$ -360	$ -130	$ -460	$ -160
1979	54.1	-510	-20	-280	-10	-360	-10
1980	31.4	-490	+70	-270	+40	-340	+50
1981	19.2	-560	+70	-310	+40	-400	+50
1982	20.2	-720	+10	-380	0	-510	-10

Source: Data Resources, Inc., econometric model of U.S. economy

a/ Assuming a zero marginal foreign tax rate; figures computed using a 50-percent marginal foreign tax rate were nearly identical.

b/ Impact measured in DRI model was actually on net exports less transfer payments to foreigners. Assuming no significant change in the capital account, this is the same as the impact on balance of payments.

The following conclusions, taken from table 1, summarize the macroeconomic effects that may be expected from the 1976 Amendment to Section 911 and the Tax Court decisions.

1. Gross national product will grow less each year than it would have done in the absence of the tax changes. The shortfall below projected output will reach a maximum of $600 million (in 1972 prices) in 1981.

2. Exports will also grow less than if there were no tax changes, the maximum effect amounting to $260 million (in 1972 prices) in 1982. The small size of the decline is due to the small value of the weighted price elasticity of foreign demand for American goods.

3. U.S. imports will increase more slowly as a result of the decline in U.S. income produced by the fall in exports and the rise in Government tax revenue.

4. The U.S. balance of payments--or balance on current account, measured here by net exports less transfer payments--actually improves. The improvement is produced by a rise in the nominal value of exports, a result of the fact that the increase in export prices more than offsets the decline in volume. The slight increase in the deficit when foreign governments tax additions to wages at 50 percent stems from the fact that the U.S. Government must then share a part of the tax revenue with the governments of the countries where U.S. citizens are working.

5. The largest effect on domestic employment is produced in 1981, when approximately 21,000 jobs are lost. To give some perspective to this number, it should be noted that the average growth rate of the United States creates some

30,000 jobs a week. Thus, the largest effect on employment will be about two-thirds of a normal week's job creation. In 1978, the estimated job loss is only 4,000, or about the number of jobs added to the U.S. economy in one normal day.

6. The effect on the Government budget is generally positive. If foreign governments impose no tax on the wage increases granted to Americans overseas, the deficit is reduced each year in the range of $340 million to $510 million. If the Treasury must share the tax revenue with foreign governments, the reduction in the deficit will be smaller.

OTHER RELEVANT CONSIDERATIONS

The estimates that appear in table 1 do not include the effects of two responses to the assumed rise in U.S. export prices. Both would help offset the macroeconomic effects of the rise. One of the responses would be automatic: a change in exchange rates between the dollar and foreign currencies. The other would be discretionary: a change in fiscal and monetary policies to offset the fall in foreign demand for U.S. exports. Only the latter response can be incorporated into the DRI model to produce revised estimates of macroeconomic effects. In the present state of knowledge, it is impossible to predict how large the exchange rate responses would be, although some general observations on the subject can be offered.

Flexible exchange rates

Since March 1973 the United States has allowed the exchange rate between the dollar and foreign currencies to float in the international money markets. The purpose of the float is to allow market forces to bring the supply of and demand for dollars into equilibrium in order to insure that the flow of dollars from the United States equals the flow to the United States.

Under a regime of floating exchange rates, the balance of payments accounts can have no direct effect on gross national product or employment. For example, the decrease in demand for U.S. exports will cause the dollar exchange rate to fall (each dollar now exchanges for fewer units of foreign currency) decreasing the foreign price

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of American goods and encouraging some foreign purchase of U.S. goods. This also raises the American price of foreign goods, i.e., imports are now more expensive. Americans are therefore led to switch their purchases from foreign goods to the now less expensive domestic substitutes. The depreciation of the foreign exchange rate will continue until the net fall in exports is matched by an equivalent fall in imports.

Thus, the original decrease in exports will have no direct impact on U.S. income or employment because it is offset by Americans switching their purchases from foreign goods to domestic substitutes. While a decline in export sales will normally decrease U.S. income and employment, the diversion of American purchases from imports to domestic substitutes will serve to expand U.S. income and employment. The net direct effect is zero.

Within this framework, the contemplated changes to Section 911 can be easily analyzed. Given our assumptions, the tax revisions will serve to raise U.S. export prices, which will serve to decrease foreign demand for American goods. This will cause the exchange rate to depreciate, setting in motion the two forces described above to restore equilibrium: cheaper export prices and higher import prices. The former serves to offset some of the higher prices induced by the revisions to Section 911 while the latter diverts American demand from foreign goods to domestic substitutes. 1/

Fiscal and monetary policy

A decline in gross national product and employment produced by a fall in export demand is analogous to a decline produced by a decrease in domestic demand for domestically produced goods. Since the latter type of unemployment is frequently addressed by a combination of compensatory monetary and fiscal policy, the same tools can be used to correct unemployment that originates in the international sector.

1/ There may be some indirect, short-term effects on employment if the employment/output ratio in the export sector is not the same as in the sector producing import substitutes. In addition, there may be some geographical employment effects if the export and import substitutes are not produced in the same parts of the country.

A decrease in individual and corporate income taxes was introduced into the DRI model that was just large enough to restore gross national product and domestic employment to their projected levels. The new values of net exports less transfer payments to foreigners and the Federal budget deficit are shown in table 2. These economic variables will be affected differently depending on whether or not foreign governments tax the additional wages that we assume will be paid to overseas Americans. If they tax the wages at the rate of 50 percent, the tax increases on Americans abroad will increase the U.S. balance of payments deficit (or decrease the surplus) and Federal budget deficit in every year between 1978 and 1982. Under the more realistic assumption that foreign governments will tax the additional wages at a relatively low rate, the effects will be mixed: a decrease in both deficits in 1978, an increase in 1979, and little or no change in 1980, 1981, and 1982.

CONCLUSIONS

We attempted to estimate as accurately as possible, using a model of the U.S. economy, what effect changes in Section 911 would have on the U.S. balance of payments, gross national product, domestic employment, exports and imports, and the budget position of the Federal Government. Initially, these estimates were made on the assumption that exchange rates between the dollar and other foreign currencies were fixed and that no compensatory changes would be made in the U.S. monetary or fiscal policy. The net economic effect due to the changes to Section 911 was very small.

In an effort to make these estimates more realistic, individual and corporate income tax collections were assumed to be reduced by an amount sufficient to restore employment and output to the levels they attained before Section 911 was changed. The effect of this compensatory fiscal action plus the changes in Section 911 was to cause actual net exports to fall short of projected net exports by $310 million in 1982 and to increase the Federal budget deficit by $500 million in 1982.

Flexible exchange rates, a recent innovation in the international monetary system, should mitigate the effect of changes in Section 911 on the external accounts of the United States and, as a consequence, on the value of gross national product and employment.

Table 2

Selected Macroeconomic Impacts of Tax Changes With a Compensating General Tax Cut to Restore Employment and Output to Projected Levels, 1978-82

Year	Projected net exports less transfer payments to foreigners	Impact on balance of payments (note a): of repealing Section 911 — Marginal foreign tax rate is Zero	50 %	of 1976 amendments to Section 911 — Marginal foreign tax rate is Zero	50 %	of 1976 amendments to Section 911 and 1976 Tax Court decisions — Marginal foreign tax rate is Zero	50 %
	(billions)	(millions)					
1978	$ -13.4	$ +560	$ -180	$ +310	$ -100	$ +400	$ -130
1979	-8.7	+300	-350	+160	-200	+210	-250
1980	-6.6	+310	-380	+170	-210	+220	-270
1981	-3.5	+350	-400	+190	-220	+250	-290
1982	+2.3	+370	-440	+210	-240	+260	-310

Year	Projected Federal budget deficit	Impact on Federal budget deficit [increases(+), decreases(-)]: of repealing Section 911 — Marginal foreign tax rate is Zero	50 %	of 1976 amendments to Section 911 — Marginal foreign tax rate is Zero	50 %	of 1976 amendments to Section 911 and 1976 Tax Court decisions — Marginal foreign tax rate is Zero	50 %
	(billions)	(millions)					
1978	$ 51.7	$ -300	$ +120	$ -160	$ +70	$ -210	$ +90
1979	54.1	+150	+640	+80	+360	+110	+460
1980	31.4	-10	+550	-10	+310	-10	+390
1981	19.2	+10	+630	0	+350	+10	+450
1982	20.2	0	+710	0	+390	0	+500

Source: Data Resources, Inc., econometric model of U.S. economy

a/ Impact measured in DRI model was actually on net exports less transfer payments to foreigners. Assuming no significant change in the capital account, this is the same as the impact on balance of payments.

Finally, whether or not flexible exchange rates and compensatory monetary and fiscal policy are taken into account, so long as one views the tax treatment under Section 911 as a subsidy to exports, a fundamental question remains unanswered--could the forgone tax receipts represented by the subsidy be more effectively employed to promote U.S. exports?

Appendix B

(Communications Received by the Committee Expressing an Interest in These Hearings)

Statement of the Chamber of Commerce of the United States

(By John L. Caldwell)[1]

The Chamber of Commerce of the United States appreciates this opportunity to present its views on the need for equitable tax treatment under Section 911 of the Internal Revenue Code for American individuals working outside the United States. We commend this Committee's recognition of the complex nature of this important issue.

The National Chamber is the largest federation of business in this country. Its membership consists of more than 69,000 businesses, 2,600 chambers of commerce in the United States and abroad, and 1,100 trade and professional associations. Many of our members are vitally concerned about this issue.

Summary

Time is rapidly running out for Americans employed overseas. Most of them must file their individual income tax returns for 1977 by June 15 of this year. Great uncertainty exists as to how their income earned abroad will be treated for tax purposes under Section 911. In view of the pressing need for relief on the part of these taxpayers and the complexity of the issue involved, the National Chamber urges an additional postponement of the effective date of the changes to Section 911 contained in the Tax Reform Act of 1976, while Congress works out an equitable solution to this problem.

Background

Prior to the Tax Reform Act of 1976, Section 911 of the Internal Revenue Code provided that United States citizens who were bona fide residents of foreign countries for at least one full calendar year or were physically present in foreign countries for 17 out of 18 consecutive months could exclude from their federal income tax the first $20,000, or in some cases the first $25,000, of compensation received for services performed outside the United States.

The Tax Reform Act of 1976 made several significant changes in the tax treatment of income earned by U.S. citizens working abroad. The earned income exclusion provided under Section 911 was reduced to $15,000 ($20,000 for employees of U.S. charitable organizations). Taxpayers can no longer claim a credit against their U.S. taxes for the foreign taxes paid on amounts excluded from income. In addition, income in excess of the exclusion is taxed at higher rates than it would be subject to if no income were excluded. Finally, the Act makes ineligible for the exclusion any income earned abroad which is received outside the country in which earned if one of the purposes of receiving it outside of the country is to avoid tax in that country.

As part of the Tax Reduction and Simplification Act of 1977, Congress delayed the effect of the 1976 Tax Reform Act changes in the earned income exclusion until taxable years beginning after December 31, 1976. The House of Representatives last October overwhelmingly passed, as part of H.R. 9251, an additional one-year extension to the effective date of the 1976 changes. In February of this year, this Committee approved extension of the pre-1976 law for taxable years beginning prior to January 1, 1979. The Chamber welcomes this recognition on the part of Congress that a reasonable period of time is essential to work out a satisfactory solution to a difficult problem.

The National Chamber presented testimony on Section 911 before the House Ways and Means Committee on February 23, 1978. A copy of that testimony is attached to, and is part of, this statement.

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[1] Manager, International Division, Chamber of Commerce of the United States.

ECONOMIC ANALYSIS

A recent economic study on Section 911, "U.S. Taxation of Citizens Working in Other Countries: An Economic Analysis," was prepared by the Congressional Research Service (CRS) of the Library of Congress. This study purports to evaluate alternative 911 policies "according to the principles of tax neutrality, tax equity, and the achievement of national economic goals." In the study it is agreed that reduction of tax benefits for overseas Americans would lead to a decline in U.S. business activity abroad and that increased taxation of Americans working abroad would tend to lead to a substitution of foreign for U.S. employment. The analysis concludes, however, that ". . . there is no clear evidence that artificially encouraging Americans to work abroad through the Tax Code serves any identifiable national purpose. Therefore, the resulting increased 'competitiveness' of American firms and citizens in foreign locations appears to be at the expense of other Americans—through higher and more inequitable taxes and through less efficient allocation of economic resources." The National Chamber disagrees with this conclusion on two main points.

First, the CRS analysis of presumed trade and employment effects of Section 911. Second, the argument that any tax incentives for Americans working abroad would not have a permanent effect on our balance-of-payments because of the operations of the flexible exchange rate system.

The argument is made that foreign investment and production by U.S. multinationals is in many cases a substitute for domestic production and exporting to the foreign market. This generally is organized labor's argument for restricting U.S. direct investment abroad, i.e. direct investment abroad substitutes foreign for domestic production and thus foreign for domestic employment. The available evidence indicates that this argument is not convincing and not widely shared by professional economists. Generally speaking, since the demand for products and not the supply of funds is the determining factor in an investment decision, multinational corporations probably do not substitute foreign for domestic investment. In addition, research shows that large U.S. multinational firms account for a substantial percentage of U.S. exports, while their imports from foreign affiliates constitute only a small percentage of total U.S. imports. On balance, U.S. direct investment abroad has been shown to contribute significantly and directly to domestic employment and economic activity and the increased economic activity from our direct investment abroad has increased foreign demand for our exports indirectly.

The argument is also made that even if there were a direct relationship between U.S. tax treatment of citizens working abroad and U.S. exports, a tax subsidy would not have a permanent effect on the balance-of-payments because of the operations of flexible exchange rates. The example given on pp. 49–50 of the study is correct theoretically, but the analysis is quite superficial and in any event is not realistic. It is quite true, other things being equal, that a tax subsidy could increase U.S. exports which, in turn and over time, could cause the dollar's exchange value to rise, imports to increase and a tendency toward equilibrium in the balance-of-payments to occur. However, this argument works best for a much smaller country, such as Canada, but it doesn't work for the United States. Generally speaking, automatic exchange rate adjustments and their effects admittedly are not as predictable as the CRS study suggests. When governments elect—as they often do—to intervene through the use of monetary and fiscal policies to partially or totally offset exchange rate movements whose sectoral effects they often find unmanageable, the consequences of their actions not only affect the actual value exchange rate but also may reinforce the objective of a given national policy. More specifically, for the United States, whose economy is capital account oriented, changes in the value of the dollar are likely to be more responsive to developments in capital markets such as the capital market consequences of changes in the demand for oil, the Eurocurrency market, etc., since the U.S. dollar is used also as the international means of payment.

Finally, it should be noted that the report concentrates on balance-of-payment effects and says nothing about the sectoral consequences of tax incentives. While Section 911 may have little impact on the overall U.S. balance-of-payments situation (i.e. its macroeconomic impact may be small) it does generate significant microeconomic effects. Generally speaking, tax incentives are not neutral in terms of their impact on sectors of an economy or on factors of production. For

the United States, Section 911 tax incentives promote a more export-oriented, high technology and high skill level U.S. economy that reinforces the U.S. comparative advantage in foreign trade.

THE PRESSING NEED FOR LEGISLATIVE SOLUTION

As we indicated in our February 1978, testimony, the changes made in Section 911 by the 1976 legislation have already begun to jeopardize the competitive position of U.S. firms operating abroad. The National Chamber believes that to halt this effect, the tax laws should be amended to provide equitable treatment in the taxation of Americans employed abroad. The tax treatment of income for these individuals provided under Section 911 should be restored at least to the level that existed prior to the Tax Reform Act of 1976.

Over the past several months, both members of Congress and the Administration have proposed changes to Section 911. Each of these proposals is complex, and each deserves careful and adequate legislative consideration. This takes time. Meanwhile, thousands of American workers abroad face uncertainty as to whether pre- or post-1976 Section 911 will govern their 1977 earned income, since the House of Representatives has passed a one-year extension, and this Committee has agreed to a two-year delay.

The National Chamber urges that Congress quickly adopt a delay to the effective date of the changes to Section 911 contained in the Tax Reform Act of 1976, while pursuing an equitable legislative solution to this problem.

STATEMENT ON INCOME TAX TREATMENT OF AMERICANS EMPLOYED ABROAD BEFORE THE HOUSE COMMITTEE ON WAYS AND MEANS FOR THE CHAMBER OF COMMERCE OF THE UNITED STATES, BY JOHN L. CALDWELL, FEBRUARY 23, 1978

My name is John L. Caldwell. I am Manager of the International Division of the Chamber of Commerce of the United States.

I am accompanied by Robert R. Statham, Director of the Tax and Finance Section of the National Chamber.

Mr. Chairman, the Chamber appreciates this opportunity to present its views on the need for equitable tax treatment under Section 911 of the Internal Revenue Code for American individuals working outside the United States.

The National Chamber is the largest federation of business in this country. Its membership consists of more than 67,000 businesses, 2,600 chambers of commerce in the United States and abroad, and 1,100 trade and professional associations. Many of our members are vitally concerned about this issue.

SUMMARY

The tax treatment of income for American individuals working abroad provided under Section 911 of the Internal Revenue Code should be restored at least to the level that existed prior to the Tax Reform Act of 1976. Further, equity would suggest that the inflationary effects on income in the intervening years should be aken into consideration. Various ways of restoring tax equity include use of a standard exclusion, deductions, or a combination of both a standard exclusion and appropriate deductions. Equitable tax treatment of an American taxpayer residing in a foreign country would include allowing a standard exclusion, indexed for inflation, plus deductions for certain housing, education, cost of living, travel and moving expenses.

In view of the complexity of this issue and the pressing need for relief on the part of Americans abroad, the Chamber urges an additional postponement of the effective date of the changes to Section 911 contained in the Tax Reform Act of 1976, while Congress works out an equitable solution to this problem.

BACKGROUND

Prior to the Tax Reform Act of 1976, Section 911 of the Internal Revenue Code provided that United States citizens who were bona fide residents of foreign countries for at least one full calendar year or were physically present in foreign countries for 17 out of 18 consecutive months could exclude from their federal income tax the first $20,000. or in some cases the first $25,000, of compensation received for services performed outside the United States.

The Tax Reform Act of 1976 made several significant changes in the tax treatment of income earned by U.S. citizens working abroad. The earned income

exclusion provided under Section 911 was reduced to $15,000 ($20.000 for employees of U.S. charitable organizations). Taxpayers can no longer claim a credit against their U.S. taxes for the foreign taxes paid on amounts excluded from income. In addition, income in excess of the exclusion is taxed at the higher rates than it would be subject to if no income were excluded. Finally, the Act makes ineligible for the exclusion any income earned abroad which is received outside the country in which earned if one of the purposes of receiving it outside of the country is to avoid tax in that country.

As part of the Tax Reduction and Simplification Act of 1977, Congress delayed the effect of the 1976 Tax Reform Act changes in the earned income exclusions until taxable years beginning after December 31, 1976. The House of Representatives last October overwhelmingly passed, as part of H.R. 9251, an additional one-year extension to the effective date of the 1976 changes. Earlier this month, the Senate Finance Committee approved a two-year delay, until the end of 1979. The Chamber welcomes this recognition on the part of Congress that a reasonable period of time is essential to work out a satisfactory solution to a difficult problem.

The foreign source earned income exclusion has been part of our tax law since 1926. Initially, U.S. citizens who were bona fide foreign residents were entitled to an unlimited exclusion. In 1953, Congress adopted a $20,000 ceiling for citizens physically present abroad for 17 out of 18 months, which was intended to correct abuses of Section 911 but at the same time not to penalize taxpayers residing abroad for legitimate business reasons. Both the House and the Senate fully considered this issue again in 1962, when Congress put a $20,000 limitation on earned income except for income received by bona fide foreign residents who had been abroad for over three consecutive years, which became subject to a $35,000 limitation. The $35,000 exclusion permitted to certain bona fide foreign residents by the Revenue Act of 1962 was reduced to $25,000 in 1964. Section 911 then remained basically enchanged until the Tax Reform Act of 1976. The ceilings on the amount of earned income that could be excluded from tax under pre-1976 law served as limitations that were sufficient to prevent use of the exclusion as a tax avoidance device.

The reduction of the exclusion to $15,000 by the Tax Reform Act of 1976 represents a substantial departure from the original unlimited exclusion, and was vigorously opposed by the National Chamber. Because of inflationary trends throughout the world, any adjustment in the Section 911 exclusion should have increased rather than decreased them.

IMPACT OF 1976 CHANGES

In order to operate on an international basis, American companies must employ some of our citizens to work in foreign subsidiaries and branches. These American employees are necessary because local nationals often do not possess the needed skills, experience or familiarity with American business methods.

United States citizens representing American businesses abroad frequently have many years of experience with the language, laws, customs, and business techniques of the foreign country in which they live. They are invaluable, and are as essential to companies operating abroad as American capital.

The 1976 changes to Section 911 have begun to substantially increase the financial burden on Americans working abroad, and on the companies that employ them. The Treasury Department has recently estimated that the U.S. tax liability of Americans abroad, already increased as a result of recent Tax Court decisions, will more than double as a result of the 1976 Tax Reform Act changes, from $250 million to $569 million.

Responses to an informal survey conducted by the National Chamber last fall indicate that American companies face significant increased costs of maintaining American workers abroad as a result of the 1976 Act.

Many employers of U.S. citizens abroad use so-called tax equalization programs, under which the employees are provided with the same after-tax income they would have received had they been employed in the U.S. under similar work conditions. The changes in Section 911 have increased these costs substantially. The net effect is to make American businesses abroad less competitive with foreign buinesses, because other major industrial nations generally do not tax the income of their non-resident citizens.

Some companies have indicated that increased costs will force them to replace their American employees abroad with foreign workers. This could have a sig-

nificant impact on U.S. exports, since American employees who have the discretion to determine which goods and supplies will be used in their foreign operations are more likely to seek U.S. products. As Secretary of the Treasury Michael Blumenthal remarked at a press conference last September:

"Most Americans that are employed abroad are employed by American concerns and play an important role in the sale of American products abroad and are really pursuing American economic interests around the world."

The long-range effect of the unfavorable changes in Section 911 will be to undercut our competitive position abroad at a time when inflation and rising operating costs have made it increasingly difficult to compete in foreign markets. The erosion of the ability of U.S. business to compete in international markets would exacerbate our worsening trade deficit, with the effect of increasing our unemployment situation. Additional costs of foreign operations could result in a loss of business, which would have an averse impact on our balance-of-payments. Increased costs could also contribute to a decrease in U.S. corporation tax receipts.

THE NEED FOR A LEGISLATIVE SOLUTION

As we have indicated, the changes made in Section 911 by the 1976 legislation have already begun to jeopardize the competitive position of U.S. firms operating abroad. The National Chamber believes that to halt this effect, the provisions of Section 911 should be changed to provide equitable treatment in the taxation of foreign source earned income.

Critics of the Section 911 exclusion assert that it entices Americans with technical and professional skills not available in foreign countries to work abroad, by offering them tax-free earnings. The assertion completely overlooks the fact that the income of these employees may be subjected to foreign income taxes as well as other foreign taxes. And foreign taxes such as value-added taxes, sales taxes, and customs duties, are not eligible for the foreign tax credit, and may not be deducted or credited in computing U.S. taxes.

American citizens working abroad do not have the benefit of many public services available at home that are paid for by taxes. For Americans overseas, the tax exclusion provided by Section 911 should help to offset the additional costs they incur to obtain comparable services for such essentials as schooling, housing, and transportation. For example, armed forces personnel enjoy facilities at foreign bases which provide an environment comparable to a base in the United States. Civilians employed abroad by the private sector must attempt to create a comparable cultural environment for their families on an individual basis.

In many foreign countries, the cost of living is substantially higher than it is in many major U.S. cities. As this Committee's Task Force on Foreign Source Income recognized, Americans employed abroad often encounter living costs unique to foreign locations. The Task Force Report offers the example of the apartment in a Middle Eastern country which may rent for as much as $20,000 to $30,000 a year. This is not an isolated example, but rather represents a significant problem. In order to enable Americans employed abroad to maintain a standard of living comparable to that enjoyed by their U.S. counterparts, some measure of relief must be provided through our tax system. At a minimum this could most easily be accomplished by restoring tax treatment under Section 911 to its former level. Over the last twenty years, the rates of inflation experienced throughout the world have reduced the value of the $20,000 fixed dollar exclusion far below its 1964 level. The plain fact is that $20,000 is just not worth what it was in 1964. By further reducing the value of the exclusion, which is already so diminished by inflation, Congress has subjected Americans working abroad to substantial additional hardship. As we said before, any adjustment in the exclusion should have been up rather than down.

United States Government employees abroad remain subject to U.S. income taxes on their earnings, but under Section 912 of the Code they are not taxed on shelter, cost of living, education, travel, and other differential cost payments. On the other hand, cost of living and similar allowances are taxable compensation to employees of private businesses. U.S. citizens employed abroad should not be subject to U.S. tax at steep progressive rates when certain costs of living are borne by their employers. For example, employees who receive reimbursements for tuition expenses they incur in order to provide their children with schooling comparable to that obtainable in U.S. public schools should not be treated as having received additional compensation, since these payments do not represent real income to these individuals.

RECOMMENDATIONS

The National Chamber remains deeply concerned about the need for equitable tax treatment for Americans who work abroad. We have been working closely with representatives of American Chambers of Commerce abroad, trade and professional associations, corporations, law firms, and committees of American citizens abroad in a joint effort to formulate a measure of tax relief comparable to that provided under Section 911 prior to the 1976 changes. The consensus of this group is to support a standard exclusion, indexed for inflation, plus deductions for housing, education, cost of living, travel, and moving expenses. While the Chamber has not yet considered and therefore cannot take or offer an official position on the recommendations, we present them as one workable and equitable solution to a difficult problem.

It is the view of this group that a standard exclusion indexed for inflation should be available in order to take into account the foreign taxes paid by Americans working abroad that are not eligible for the foreign tax credit, or for deductions or credits against U.S. tax. An exclusion would be far simpler from an administrative standpoint than would providing deductions for these items based on tax tables developed on a country by country basis.

This group has recommended that, in addition to the exclusion, the following deductions should be allowed:

Deductions should be provided for housing expenses, including maintenance and utilities, which exceed 16⅔ percent of an employee's base salary, or the earned income of a self-employed taxpayer, or the income of a retired individual.

Americans who work outside the United States should be able to deduct education expenses incurred for educating their dependents through the 12th grade and, in those cases where adequate schools are not available locally, room and board and periodic transportation expenses should also be allowed. Reasonable travel costs between the foreign residence and the educational institution for college age dependents should also be allowed.

Deductions for cost of living—excluding housing and education expenses—for the particular foreign area of employment, not to exceed an amount to be determined by Treasury Department indices, should be allowed.

Deductions should be provided for travel expenses equal to the actual cost for transportation, including meals and lodging en route:

(*a*) for the taxpayer and members of the taxpayer's family between the taxpayer's foreign assignment location and the United States, not to exceed one trip per year per person;

(*b*) for the taxpayer and members of the taxpayer's family from the overseas assignment in a "hardship" post to a cosmopolitan area, other than the United States;

(*c*) to obtain emergency medical care not otherwise readily available;

(*d*) for emergency evacuation from a location at which there is imminent danger to life; and

(*e*) in the event of serious illness, injury or death of an immediate family member.

The tax treatment of moving expenses permitted under Section 217 of the Code should be amended to allow deductions to Americans employed abroad for actual moving expenses, including so-called indirect moving costs, incurred during a period not to exceed 90 days, and for storage expenses, necessarily incurred incident to establishing the employee, spouse, and dependents at the foreign place of employment. The tax law should recognize that international moving often requires a taxpayer to obtain temporary living accommodations for a longer time than ordinarily required in domestic moving. This Committee's Task Force on Foreign Source Income offered such a rationale in support of providing an expanded deduction for the moving expenses of Government employees.

Finally, the group has recommended that foreign tax credits be available to U.S. taxpayers employed abroad to the same extent that they were available prior to adoption of the Tax Reform Act of 1976, and that these taxpayers be permitted to take the standard personal exemption of $750 for themselves and their dependents.

CONCLUSIONS

We have attempted to set forth the nature of the problems that the Tax Reform Act of 1976 has created regarding tax treatment of Americans employed abroad. Considerations of equity demand that Congress carefully reexamine this complicated area of the tax law. Accordingly, the effective date of the 1976

changes should be postponed until a reasonable solution has been fashioned. The National Chamber urges this Committee at the very least to provide pre-1976 Section 911 treatment to foreign source earned income, and requests that you give serious consideration to the recommendations set forth in this statement.

On behalf of the National Chamber I wish to thank you, Mr. Chairman, and the members of the Committee for this opportunity to testify on the subject of the income tax treatment of Americans employed abroad. We hope we have been helpful in presenting the views of American business, and we again thank you for the opportunity to appear and be heard.

STATEMENT OF THE U.S. SECTION, IRAN-U.S. BUSINESS COUNCIL BY WALTER S. SURREY [1]

The U.S. Section of the Iran-U.S. Business Council is grateful for this opportunity to present its views on Section 911 of the Internal Revenue Code; the section concerning taxation of personal earned income abroad.

There is increasing concern on the part of American business about the heavy burden and impact of Section 911 on the U.S. competitive position abroad and on the U.S. economy. We believe the entire nation shares this concern. We hope that through these hearings, the Congress will be able to enact a more equitable system of taxing Americans working overseas.

As a result of the Tax Reform Act of 1976, which amended, inter alia, Section 911 of the U.S. Code, it has become prohibitively more expensive for U.S. citizens to work abroad and for firms abroad to employ them. The Act specifically affected U.S. citizens overseas in three main ways:—the foreign earnings that U.S. citizens abroad could exclude from their U.S. income tax was reduced from $20,000 or $25,000 to $15,000 per year, depending on how long they had been abroad;—it eliminated a tax credit for foreign taxes paid on any of the $15,000 excluded; and the income left after exclusion was subject to the higher tax.

This exclusion, in one form or another, has been a part of our tax law since 1926. The issue was fully considered by both the House and Senate in 1962, 1964, and 1976 with the result that the original unlimited exclusion has been substantially reduced to the present $15,000 level. Furthermore, the exclusion has been more than enough limited to prevent its use as a tax avoidance device.

Critics of the exclusion assert that it permits Americans overseas to be "high-living, mink-swathed, jet setters, living at the taxpayers expense." Such assertions, however, completely fail to recognize economic realities.

There are approximately 1.3 million Americans, including dependents, in the private sector overseas who have been or will be overwhelmingly burdened by the 1976 Section 911 provisions. Many of these Americans are generating a vital stimulus to the domestic economy by directing business and jobs to American industry. Yet, over the last 25 years living costs abroad have skyrocketed and U.S. citizens have been hard pressed to maintain a living standard comparable to Americans in the States. Under these circumstances, it is often necessary for overseas Americans to receive as much as $70,000 in allowance—to cover housing, schooling, moving, travel and other expenses. As a result of two U.S. Tax Court decisions in 1976, almost all of these allowances are taxable. Thus, even given additional aid by their employers, many Americans overseas simply cannot afford to pay their taxes and will be forced to return to the United States. Indeed, information received by the Iran-U.S. Council indicates this tax law has already caused many U.S. employees to return to America.

In order to operate on an international basis, American companies must employ some of our citizens to work in foreign subsidiaries and branches. These American employees are necessary because local nationals, in many cases, do not possess the needed skills, experience or familiarity with American business methods. United States citizens representing American businesses abroad often have many years of experience with the language, laws, customs, and techniques of the foreign country which they live. They are invaluable and are as essential to companies operating abroad as American capital. It is absolutely essential to have American citizens in overseas positions to manage these investments, as well as to train local personnel.

Moreover, the return of U.S. employees from overseas creates a loss of jobs in the United States which, in this time of high unemployment, can have an absolutely devastating affect on our national economy. Many companies are re-

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placing their American employees abroad with foreign nationals who tend to source subcontracting requirements in countries other than the United States thereby generating non-U.S. exports. This significantly reduces our exports, and correspondingly, the significant number of jobs which are related to supplying those requirements. It is estimated that 40,000 U.S. jobs are dependent on every $1 billion in U.S. exports. With a $26.6 billion trade deficit in 1977, the U.S. needs a substantial and vigorous export program.

Furthermore, American business abroad is being placed at a serious competitive disadvantage since the 1976 revision of Section 911 has effectively increased the cost of keeping an American civilian abroad many times over. This is due in large part to employment terms which require companies to maintain their overseas employees in an after-tax position that is comparable to employees working in the United States. Most companies operate on an overseas profit margin of less than 10 percent and many cannot afford the added costs. Information on these corporate costs indicate the 1976 Section 911 provision will cost many companies an average of almost $2 million in 1977. One company with a large U.S. labor force in the Middle East will have over $10 million in additional costs in 1977 because of the 1976 tax provision.

These huge cost increases have required many businesses to replace many of their American employees with foreign nationals. According to our figures, some companies have reduced their American workers overseas by as much as 30 to 50 percent over the last two years. Data developed for our council clearly show it is far cheaper to employ an Englishman, a German, or a Frenchman than an American (see appendix to this statement).

High personnel costs are also forcing U.S. companies to abandon existing contracts and to refrain from competing for new ones. This comes at a time when U.S. exports of goods and services are running into extremely tough competition from Japan, West Germany, France, Italy and numerous other nations, none of which tax their citizens or corporate earnings overseas.

The Middle East is the world's fastest growing market and is an important area of the world for our exports. For instance, the Saudi Arabian market has been dominated by the U.S. for many years. According to the Wall Street Journal, in 1976, U.S. exports to that country climbed to $2.8 billion from $1.5 billion the previous year. Yet, the U.S. share of the market fell from 31 percent in 1974 to an estimated 25 percent today. American sales to Iran actually declined in 1976 to $2.8 billion from $3.2 billion in 1975. Simultaneously, West Germany's sales to Iran increased by 11 percent and France's by 19 percent.

In general, according to that study, U.S. nonmilitary trade with 19 Middle East and North African countries increased by 10 percent in 1976 from 1975, after an increase of more than 300 percent from 1972 to 1975. Much of this decrease has come from the competitive disadvantage which U.S. tax laws have created for its companies overseas. Hundreds of millions of dollars have already been lost and billions more will follow unless the 1976 Section 911 provisions are amended. As an offset to these tremendous losses, the Department of Treasury estimates a mere $318 million additional tax revenue in 1977 as a result of the 1976 law.

Given the complexity of this issue and the pressing need for effective relief for our citizens working abroad, the U.S. Section of the Iran-U.S. Business Council fully supports a postponement of the effective date of the Section 911 provision of the Tax Reform Act of 1976. As you are aware, a one-year extension of the 1976 law, embodied in H.R. 9251, was overwhelmingly passed in the House by a vote of 411 to 5 during the last session. Just a few weeks ago, the Senate Finance Committee approved that bill and increased the delay to two years, after which time a bill on the substantive provisions of Section 911, S. 2115, would take effect. Moreover, Secretary of the Treasury, Michael Blumenthal, has stated a postponement is necessary to give Congress adequate time to develop new tax rules which would provide "sufficient incentive for Americans to continue to want to live abroad . . ." and to carry out their "very important job for our economy." We urge you to expeditiously enact at least a one-year delay so as to provide a reasonable time cushion to work out an equitable alternative to the 1976 law.

As for the substantive changes of Section 911, the U.S. Section of the Iran-U.S. Council supports, as a minimum, the restoration of tax treatment to pre-1976 levels, either by means of a standard exclusion off the top, with foreign tax credits applicable to the excluded amount, or comparable adequate deductions, or a combination of both a standard exclusion and specific deductions.

The pre-1976 Section 911 exclusion represents a measure of relief and justice for the American citizens abroad. However, because of inflationary trends

throughout the world, any adjustment in the level of tax relief should be up rather than down.

It is worthy to note that United States Government employees abroad remain subject to our income taxes on their earnings, but they are not taxed on fringe benefits such as shelter, cost-of-living, education, travel and other differential cost payments. On the other hand, as we have emphasized, cost-of-living allowances are taxable compensation to employees of private business.

Armed forces personnel enjoy facilities at foreign bases which provide an environment comparable to a base in the States. Civilians employed abroad must attempt to create a comparable cultural environment for their families on an individual basis. Thus, the reduction of the exclusions and the other Section 911 changes of the Tax Reform Act of 1976 discriminate against nongovernment employees.

We sincerely believe in the need for Congress to act promptly by enacting an equitable approach to a complex problem—a problem that affects directly hundreds of American workers upon whom much of our presence and growth in world markets depend. We urge you to give this need your fullest consideration.

On behalf of the U.S. Section of the Iran-U.S. Business Council I wish to thank you, Mr. Chairman, and the members of the committee for this opportunity to testify on the subject of taxation of personal earned income abroad. We hope we have been helpful in presenting the views of American business, and we again, thank you for the opportunity to appear and be heard.

Iran-U.S. Business Council Study of the Effect of Income and Social Security Taxes on the Cost of Employing Expatriates in Iran

The accompanying table illustrates the effect of home country Income and Social Security Taxes on citizens of the United States of America, United Kingdom, West Germany and France employed in Iran for three years by an Iranian firm. To eliminate factors extraneous to the consideration of home country taxes, the following assumptions have been made:

1. "The "Net Cash" to the expatriates would be identical. Therefore, any differences in home country taxes would result in a cost difference.
2. All compensation elements, other than tax costs, would be included in "Net Cash." Thus, no consideration was attempted for cost of living or base compensation differences.
3. The expatriate employee would be married with no children.
4. The computations are based on existing laws or practices. The notes to the study point out the major change expected in respect of U.S.A. taxation of U.S. nationals employed overseas. The change, when implemented, would significantly reduce the cost differences shown.
5. The employer's costs, such as Iranian S.I.O. contributions are not included in the study as it would be identical in the case of each expatriate.
6. For tax purposes, each employee is assumed to be resident in Iran. United Kingdom. Germany and France tax their citizens when they are employed outside their countries for only short periods of time.

IRAN-UNITED STATES BUSINESS COUNCIL—COMPARISON OF EXPATRIATE EMPLOYEE COST IN IRAN, FEBRUARY 1978

Country of citizenship	Compensation required to yield net cash to employee of—		
	$40,000	$50,000	$60,000
United States of America:			
1st year	$59,529	$75,658	$92,014
2nd year	62,065	81,123	100,610
3rd year	62,515	82,141	102,020
4th year	3,802	8,272	12,288
Total	187,911	247,194	306,932
Average annual cost (3 years)	62,637	82,398	102,310
United Kingdom	57,426	73,555	88,991
West Germany	57,426	73,555	88,991
France	57,426	73,555	88,991

NOTES

1. The study assumes the employee is reimbursed for U.S. income taxes in the year of filing his tax return and paying the tax. The cost of a U.S.A. employee in the fourth year is the cost, in both U.S.A. and Iranian income taxes, of settling the last tax reimbursement with the employee which will be regarded as taxable income in both the U.S.A. and Iran in the fourth year. It was assumed that the employees' U.S.A. tax settlement rate would remain 50%.

2. A U.K. expatriate not employed by a U.K. company while working in Iran is not required to make Social Security payments to the U.K. Even though a formal obligation to make payments may not exist, the individual may wish to make voluntary payments in order to preserve his ultimate entitlement to retirement benefits in the U.K.

3. Social Security Taxes of France are uncertain. If a French expatriate wants to maintain his rights in French Social Security, he has to take voluntary insurance. It is not possible to compute the contributions to a voluntary insurance because the rates have not been fixed yet.

4. The calculations have been based on each conutry's taxation of its citizens working in foreign countries at the date of the study—10 February 1978, the Congress of the United States have favorably considered major changes to existing law and further deferral of application of existing law. Either the proposed changes or deferral of application of existing law would sharply reduce the higher tax costs of employing U.S.A. citizens in Iran. The costs of employing a U.S.A. citizen would still be higher (the imposition of social security tax on U.S.A. citizens working in a foreign country distinguishes the tax practice from the other countries in the study) but the effect on income taxes would be significantly reduced or eliminated.

STATEMENT BY THE AMERICAN PETROLEUM INSTITUTE, MID-CONTINENT OIL AND GAS ASSOCIATION, ROCKY MOUNTAIN OIL AND GAS ASSOCIATION, AND WESTERN OIL AND GAS ASSOCIATION

EXECUTIVE SUMMARY

This statement discusses the taxation of Americans employed outside the United States, as provided under Section 911 of the Internal Revenue Code.

The combined effect of Section 911 changes and recent Tax Court decisions might seriously jeopardize the competitiveness of American firms operating abroad. In turn, this could imperil the efforts of the U.S. petroleum companies to explore for and develop needed overseas sources of petroleum.

The Need for an American Presence Abroad—A Petroleum Industry Perspective.—Even the most optimistic forecasts of domestic oil and gas production conclude that the volume of U.S. oil imports will increase for the foreseeable future—mostly from OPEC nations. The American presence within OPEC countries needs to be maintained on a competitive basis with European and Japanese companies lest access to petroleum supplies from that sector of the world be curtailed. At the same time, in order to reduce our nation's very heavy dependence on OPEC oil, it is imperative that American petroleum companies aggressively explore for new petroleum sources in non-OPEC areas of the world.

The Appropriateness of Special Tax Provisions for Americans Working Overseas.—The ability of American companies to compete with European and Japanese counterparts abroad is directly related to employee costs. American firms are already operating at a disadvantage since some reasonable approximation of an American standard of living must be provided in order to induce worker to stay abroad for a productive period. Also, since the U.S. is one of the few countries to impose tax on the worldwide income of its citizens, firms employing Americans must bear the cost of home country taxation of reimbursements for extraordinary living costs faced abroad. A Department of the Treasury study indicates that the combined effect of the changes in Section 911 and the Tax Court decisions on housing costs would increase the tax liability of Americans working overseas (and, thus, employee costs) by over one-half billion dollars. This would have a serious adverse impact on the ability of American firms to compete.

Tax equity—based on the view that taxpayers in comparable environmental and economic circumstances should bear equivalent tax burdens—demands that cost allowances paid to workers overseas for extraordinary expenses associated

with housing, education, home travel and the general cost of living not to be treated as gross income. Tax equity also demands that public and private sector employees be taxed parallelly. Currently there exists a serious inequity in tax treatment between the two, particularly since public sector employees often are provided housing, commissary benefits, and relief from import duties and local taxes.

Recommendations for Legislative Changes.—The Congress should act promptly to defer, for at least an additional year, the adverse changes made to Section 911 by the 1976 Act. Thereafter the Committee might consider permanent reinstatement of Section 911 to its pre-1976 Act form, or at least provide such treatment as an alternative to the ulitization of oather approaches. More appropriately, the Committee should allow exclusions for specific allowances based on the tax equity concept. These exclusions—cost of living, housing, education, and home-leave travel—should not be subject to taxation when they merely provide an an alternative to the utilization of other approaches. More appropriately, the U.S. Provision should also be made for more realistic treatment of moving expenses.

STATEMENT

Introduction

This statement pertains to the taxation of Americans employed outside the United States as provided under Section 911 of the Internal Revenue Code and other provisions thereof. These comments are submitted in behalf of the American Petroleum Institute, the Mid-Continent Oil and Gas Association, the Rocky Mountain Oil and Gas Association, and the Western Oil and Gas Association. These organizations represent memberships which account for upwards of 90 percent of the oil and gas produced in the United States and include all segments of the petroleum industry.

The United States derives a substantial benefit from the presence of American nationals working in foreign countries. Almost invariably such foreign employment imposes more costly living expenses on Americans so engaged than they would incur if similarly employed in the United States. In recognition of this fact, prior to the Tax Reform Act of 1976, such expatriated Americans who qualified were allowed to exclude from U.S. tax liability certain compensation earned abroad. Under present law the adverse changes to Code Section 911 enacted in the 1976 Act apply with respect to 1977 and later years. It is therefore important that the Congress act promptly to alleviate the inequity and hardship that would be imposed on such United States citizens as the law now stands. This paper discusses various considerations bearing on this issue and recommends approaches that might be taken in dealing with the problem.

Americans working overseas over the last two years have been subjected to significant changes in the tax law and interpretations thereof. First, the Tax Reform Act of 1976 severely reduced and restricted the usefulness of IRC Section 911 for private sector employees. Second, the Tax Court concluded in two cases decided in 1976 that the full local market value of housing costs paid by an employer was taxable income to the employee.[1] (Prior to these cases, most taxpayers had excluded from income the excess cost of foreign housing over comparable U.S. housing.) The combined effect of the Section 911 changes and the Tax Court decisions would have been economically disastrous for Americans overseas, and if allowed to continue, would seriously jeopardize the competitiveness of American firm operating abroad.

Even before final passage of the Tax Reform Act of 1976, however, Americans overseas began to communicate with their Members of Congress to protest the Section 911 changes. When Congress was apprised of the extent of hardship that would be imposed on U.S. citizens working abroad by the potential impact of the changes in Section 911, it agreed to delay for one year the effect of the changes.[2] And currently, the Congress is considering further extensions, as well as alternative proposals, for relief for the overseas American taxpayer.

The following paragraphs comment on the need for an American presence abroad, demonstrate the appropriateness of special tax provisions to support that presence, discuss the various proposals for tax relief and, finally, make specific recommendations for legislative changes.

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[1] Phillip H. Stephens, T. C. Memo 1976-13 (#76, 013 P-H Memo T. C.); James H. McDonald, 66 T. C. 223 (1976).

[2] Tax Reduction and Simplification Act of 1977.

The need for an American presence abroad—a petroleum industry perspective

The United States currently is importing almost 50 percent of its petroleum requirements. Even the most optimistic forecasts of domestic production conclude that our volume of imports will increase for the foreseeable future. The preponderance of these imports come from OPEC countries in South America, Africa, and the Middle East.

These enormous volume of petroleum imports not only led to energy dependence on foreign countries, but have resulted in serious balance of payments deficits and concomitant deterioration of the dollar in world money markets. America has become economically dependent as well as energy dependent on foreign countries. The viable solutions to the energy and economic dependence problems are energy conservation, increases in domestic production of energy and increases in the production of energy from diversified sources overseas. The American petroleum industry today is vigorously participating in each of the above solutions, but it is particularly important that it be able to continue its endeavors in the search for overseas sources of petroleum throughout the Free World.

The North Sea, the Canadian Arctic, non-OPEC West Africa, Non-OPEC South America, and the Far East are areas where aggressive exploration will yield significant volumes of petroleum production that will lessen the Free World's dependence on OPEC countries. To expedite and maximize production from these geographically diversified areas, and provide assurance that non-OPEC petroleum will be available to the United States in an emergency, it is important that American Petroleum companies participate in the search for an production of non-OPEC petroleum. But they can only do so if they remain competitive with their European and Japanese counterparts.

In achieving increased geographical diversification, it is vitally important that an American presence continue within OPEC countries. Considering the inevitability of continued imports from OPEC sources, it seems obvious that America's interests are best served by a continuation of the role American petroleum companies are currently playing in the production of OPEC petroleum. If, because of lack of competitiveness, American petroleum companies are supplanted in OPEC countries by European or Japanese companies, America would be the loser. Not only would there be less assurance of supplies of petroleum in an emergency, but whatever profits American petroleum companies currently receive from OPEC activtiies would be lost as an offset to our balance of payments deficit.

While the above discusses the importance of a continuing role for American petroleum companies throughout the Free World, of equal importance would be the continued presence of the myriad of other American firms operating overseas. Petroleum companies call on numerous support industries; e.g., general contractors, drilling contractors and oil well service contratcors to name a few. By and large, these support industries are American firms and their profits reduce our balance of payments deficit.

Within OPEC countries, there are massive construction projects being undertaken and American construction and engineering firms are at the forefront in these activities. Dollars which have flowed to OPEC as a result of petroleum imports would be partially returned to the U.S. through these construction projects—if American firms participate. But again they must remain competitive.

Finally, the presence of Americans and American firms overseas creates a demand for U.S. products. Americans overseas tend to "buy American", and these purchases yield increases in U.S. jobs, exports and foreign exchange. It is the America presence, however, which supports this demand overseas. And that presence will only remain so long as American firms remain competitive.

The appropriateness of special tax provisions for Americans working overseas

There are essentially two reasons why the American worker abroad should be provided with special tax treatment under U.S. tax law. First, the competitiveness of Americans and American firms overseas is directly related to the taxation of the America worker and, second, tax equity itself requires some special relief provision for that worker.

The competitive aspect.—In the above discussion of the need for American presence abroad, the need of American firms to be competitive vis-à-vis their Japanese and European counterparts was emphasized. The ability to compete is

directly related to employee costs and here American firms already operate at a disadvantage. Even without a tax penalty, an American firm operating abroad must bear higher employee costs in order to induce an American worker to go overseas. Though it is virtually impossible to reproduce an exact American environment overseas, some reasonable approximation of an American standard of living must be provided in order to induce the worker to stay for a productive period.[3]

Moreover, the European and Japanese firm's employee costs attributable to employee taxation will be less than those faced by American firms even before the changes in Section 911 and the housing cases.[4] This is because European countries and Japan generally do not tax the extraterritorial earnings of their citizens. Thus, employers of nationals from these countries do not have the competitive disadvantage of having to bear, as employers of Americans do, the cost of home country taxation of reimbursements for extraordinarily high foreign living costs.

The magnitude of the competitiveness problem is illustrated by a study just released by the Department of the Treasury which shows that the combined effect of the changes in Section 911 and the housing cases would be to increase the tax liability of Americans abroad by some $569 million annually.[5] It seems obvious that a number of this magnitude will have a serious adverse impact on the ability of American firms to compete.

It should also be borne in mind that if American firms cannot remain competitive using American employees, they will turn to host country nationals or employees from other countries where available. Since these workers would not be U.S. taxpayers, the U.S. Treasury would be the loser.

Before turning to a discussion of tax equity, one other facet of the Department of the Treasury study should be commented upon. The Treasury emphasizes the fact that Americans overseas have significantly higher incomes than domestic U.S. residents. While these higher income level are directly related to the extraordinary costs of providing American-type housing, commodities, and services, they also reflect the different character of American workers abroad. Typically, the American worker overseas is highly skilled. A much greater percentage of Americans overseas are managers, supervisors, engineers, other professionals, and highly skilled construction workers and technicians than would be the case with a compoiste of domestic workers. An obvious conclusion emerging from this data is that American firms only transfer abroad those employees that are essential to overseas operations.

The tax equity aspect.—The other important argument for special tax treatment for the American worker overseas is tax equity. The tax equity argument takes two forms. First, taxpayers in comparable environmental and economic circumstances should bear equivalent tax burdens. Another way to state this argument is that the net available income of a worker should be taxed comparably with that of another worker rather than just his gross income which may not be available as an economic benefit. While this concept has not always been utilized in a discussion of tax relief for American workers overseas, it is appropriate that it should be.

Americans overseas face a variety of excess costs. These costs include costs of housing, education, home travel, and general cost of living.

As a generalization, housing costs overseas usually exceed such costs in the United States by a wide margin. The U.S. Government's "Annual Housing Survey" for 1974, for example, showed that the average American at home spends less than 20 percent of his income on housing. Americans overseas, on the other hand, frequently have to spend from 75 percent to 150 percent of their incomes on housing! At the extreme, three-bedroom houses in the Middle East rent from $16,000 to $29,000 per year. The comparable figure in Nigeria approaches $40,000 per year!

As to education, many Americans overseas must send their children to expensive private schools simply because adequate public schools do not exist. School costs for only one child range from $4,500 to $7,000 per years.

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[3] With reference to a "reasonable approximation of an American standard of living", it should be realized that duplication of Washington, D.C. or Los Angeles style suburban living is only rarely possible overseas. In Lagos, Nigeria, for example, electricity, running water, indoor toilets, together with some assurance of security, are all that is achievable, regardless of costs.

[4] Supra Footnote No. 1.

[5] "Taxation of Americans Working Overseas," Department of the Treasury, February 1978, p. 2.

Americans overseas desire to and should return home periodically. The cost of such travel home, of course, varies with the location of the overseas assignment. As an example, however, it costs about $6,400 for a family of four to make the round trip home from Iran.

In the context of this statement, the "cost of living" refers to all expenses overseas other than housing, education, and taxes. It, therefore, covers such items as food, clothing, other goods and services, etc. Typically, the cost of living overseas exceeds such costs in the U.S. The cost of living in such cities as Paris and Frankfurt, for example, exceeds that of Washington, D.C. by approximately 50 percent!

These extraordinary costs must be met somehow and in most cases such extraordinary costs (to the extent they exceed the costs for comparable items in the U.S.) are often borne by the employer in the form of allowances paid to U.S. citizens employed overseas. These allowances are not intended to create an economic benefit but to keep the employee in substantially the same economic circumstances as if he had remained in the U.S. Without these allowances or some other compensation for the increased costs overseas, U.S. workers would not willingly accept overseas assignments.

The Internal Revenue Service, however, holds that such allowances constitute gross income to the employee and thus, increase the employee's U.S. tax burden. The inequity of the situation is exacerbated by the progressive nature of our tax system which requires increased percentages of any such "income" to be paid over as taxes.

The American firm does not gratuitously provide its overseas employees with excess compensation. It is merely trying to place the overseas employee in approximate environmental and economic circumstances as experienced in the United States. Where the employee receives no economic benefit from this equalizing compensation, to treat this compensation as taxable income would violate the principle of tax equity.

A second concept of tax equity is that public and private sector employees should be taxed comparably. Even prior to the changes in Section 911 and the housing cases, there was already a disparity in tax treatment between public and private sector employees. Section 911 for private employees provided fixed dollar exclusions, whereas, Section 912 for public employees excludes certain allowances from income. As costs of living rise, the allowance approach becomes more equitable than the fixed dollar exclusion approach. At the same time, public sector employees have been in many cases provided with housing, commissary benefits, and relief from duties and local taxes not generally available to the private sector. Even in the case of hotel rooms, lower rates are generally available for public sector employees.

In the Congress' consideration of proposed legislation it is important that the concept of tax equity between public and private sector employees be taken into account fully and that any resulting legislation reflect equitable treatment for both private and public sector employees.

The various proposals for special tax treatment

There are a number of proposals which have been advanced to provide tax relief for the American worker overseas. Among these are (1) full reinstatement of Section 911; (2) the recommendations of the House Ways and Means Committee Task Force on Foreign Source income;[6] (3) the Senate Finance Committee approach contained in H.R. 9251, and (4) the Administration's proposal presented by the Treasury Department to the House Committee on Ways and Means and to the Senate Committee on Finance.

Reinstatement of section 911.—Perhaps the simplest mechanism for providing tax relief for the American Workers abroad would be reinstatement of Section 911 (as constituted prior to the Tax Reform Act of 1976). For many overseas taxpayers, this approach would provide equitable relief. On the other hand, it provides no relief for the employees who fail to meet Section 911 residency tests. And at the same time, the flat exclusion approach provides inadequate relief for workers in very high cost areas. A philosophical objection to the reinstatement of Section 911 is that it provides only an approximation of tax equity in comparison with allowances directly related to economic benefit. The size of the exclusion ($20,000 and $25,000), although inadequate in high cost areas, causes this provision to be misunderstood and attacked as a "rip-off". And finally, the provision is so unrelated to the Section 912 approach that

[6] 95th Cong., 1st sess., March 8, 1977.

tax equity between public and private sector employees has been disregarded.

Recommendations of the task force on foreign source income.—The Task Force proposed that Section 911 should be retained only for employees of U.S. charities and for U.S. construction and engineering workers employed in building permanent facilities for unrelated parties. For all other U.S. citizens overseas operating in the private sector, Section 911 would be replaced with a deductible allowance for "certain educational expenses" and an exclusion "for the value of employer supplied municipal type services."

The Task Force recommended that Section 912 for public sector employees be phased out and replaced with specific deductions and exclusions for reimbursements for compassion leave, housing costs to the extent they exceed a base amount determined with respect to Washington, D.C., secondary housing costs (to be completely tax free) where conditions are such that a family could not live at the location where the employee works, and private school tuition costs up to $2,000 per year per child. In addition, for the public sector empolyee, it was recommended that the maximum deduction for moving expenses on a foreign move should be increased to $4,500 and that the period for deducting temporary living expenses should commence thirty days preceding a move and end sixty days subsequent to a move. In supporting its recommendations for the Section 912 changes, the Task Force offered the following comment:

"The Task Force recommends that the present system of a blanket exclusion for the statutory allowances and benefits provided to civilian employees of the U.S. government serving overseas be replaced with a system which treats private and public overseas employees in the same circumstances more nearly the same. Such a system would provide for the taxation of that part of the overseas allowance which constitutes an economic benefit to the employee but allow an exclusion or a deduction for that part of the allowance which represents a business cost or which reflect the peculiar nature of being an overseas employee of the U.S. government."

The above comment is an excellent restatement of both tax equity arguments. Unfortunately, the net effect, we believe, of following the Task Force's recommendations for both Section 911 and Section 9112 would be to increase the disparity between public and private sector employees. First, the relief offered for private sector employees is a deduction for "certain education expenses" and an exclusion "for the value of employer supplied municipal type services." These are not the only significant items where tax relief is needed. Very important are the cost-of-living allowances and the excess housing cost allowances. The Task Force recommended that the overall Section 912 allowance should be eliminated; however, it would replace it with specific allowances conceptually similar to those thought to be equitable by private sector employers.

H.R. 9251.—In comparison with the Ways and Means Task Force recommendation, the Finance Commitee approach contained in H.R. 9251 is more equitable to the private sector employee in its general approach of providing deductions for cost-of-living differentials, housing allowances, and student tuition allowances.

The cost-of-living allowance, however, is keyed to the spending pattern of a grade GS–12 employee who presently earns about $20,000 per year. The average private sector American worker overseas, on the other hand, because he is often managerial or highly skilled, earns more (and would have earned more had he been based in the U.S.). The cost-of-living allowance tables on which H.R. 9251 is based also reflect the fact that government employees have the benefits of commissaries, duty free import privileges, exemptions from local taxes, and special hotel rates in many locations. The disparity of this approach is illustrated by recently published indices which show the cost of living for U.S. Government employees to be about 10 percent higher in Tokyo than in Washington, D.C.; whereas, the comparable index for private sector employees in Tokyo shows costs some 65 percent higher than in Washington, D.C.[7] Accordingly, the cost allowance deduction of H.R. 9251 is inadequate.

H.R. 9251 would allow a housing allowance for costs in excess of typical U.S. housing costs computed as 20 percent of earned income less gross housing costs, and the education and cost-of-living deductions provided by the statute. While the approach of H.R. 9251 would provide an adequate housing deduction in certain foreign areas, in others it wou'd provide little or no relief. This is because under H.R. 9251 included in earned income, and thus the U.S. housing element,

[7] *Index of Living Costs Abroad,* National Foreign Trade Council, Inc., January 16, 1978, (based upon a survey conducted in 1977).

are a number of foreign allowances provided employees such as the foreign service premium, reimbursements for foreign taxes, excess U.S. income taxes attributable to foreign service and home-leave travel. None of these amounts, however, are available to the taxpayer in the U.S. to provide housing. Except for the foreign service premium, they are reimbursements of extraordinary costs for an employee solely because he is working abroad and solely for the purpose of placing him in the same economic position as his domestic counterpart. Accordingly, these foreign amounts (except perhaps the foreign service premium) should not be include in earned income for purposes of computing the threshold. Actually, a fairer approach in computing the deduction would be to use as a threshold 16⅔ percent of an equivalent U.S. base salary (excluding the foreign amounts).

The education expense deduction in H.R. 9251 would provide that the deductible allowance would be based on the least of (a) the amount paid by the employer; (b) the actual amount paid by the employee; or (c) an amount listed in IRS tables as representing the average cost of U.S. type schools at that location. H.R. 9251 is deficient in that it would not provide for room and board and reasonable travel expenses where a U.S. type school is not available within a reasonable distance of the foreign post.

H.R. 9251 provides no relief through liberalization of the moving expense deduction to recognize the substantially higher costs incurred by U.S. citizens moving abroad, nor does it provide relief for other allowances or reimbursements which may be required to induce the American worker overseas, but for which he receives no economic benefit. These additional allowances will be discussed below.

Administration proposal.—The Administration proposal, which is similar in approach to H.R. 9251, would eliminate the Section 911 exclusion and substitute in lieu thereof deductions for a number of the extraordinary expenses of living abroad. The Administration's approach would allow deductions for certain expenses incurred for housing, education, and home-leave travel. No separate deduction would be allowed, however, for foreign costs of living in excess of those experienced in the U.S.

The Administration's deduction for excess housing costs is conceptually similar to that contained in H.R. 9251. It also appears, however, to suffer the same flaws in computing the threshold to the deduction.

Under the Administration proposal an education deduction will be allowed each year for tuition, books, room and board of up to $4000 for each dependent in grades 1 through 12, plus the costs of economy class fare for two round trips each year between the school and the foreign residence. The Administration's proposal, unlike H.R. 9251, therefore, recognizes the significant costs incurred by Americans forced to send their children to boarding schools because an equivalent American style education is not available at a reasonable distance from the foreign post.

A home-leave travel deduction will also be allowed for the costs of an economy round trip fare for the employee and his family between the foreign post and taxpayer's U.S. residence. The deduction will be allowed, however, only for such costs incurred every other year. The Administration thus recognizes the very real need for Americans to return home and the extraordinary costs associated therewith. The deduction should be allowed, however, for such travel every year rather than every other year. Yearly travel home is necessary to maintain employee morale and is by no means extravagant.

The Administration further proposes liberalizing certain aspects of the moving expense deduction by increasing the time limits for a move and associated temporary living arrangements from 30 to 60 days and raising the ceiling on temporary living costs from $1500 to $5000. The Administration would also liberalize for an employee who moves overseas those provisions of the Tax Code which defer gain on the sale of a principal residence. The Administration's proposals to expand the moving expense deduction and liberalize the treatment of gain on the sale of a residence recognize the unique problems faced by Americans moving overseas and deserve support.

Recommendations for legislative changes

The above comments have been directed at various factors which we deem important in considering legislation in the area of taxation of Americans overseas. As a follow-up to that discussion, we would make the following recommendations for appropriate legislative relief:

1. The Congress should act promptly to defer for at least an additional year the adverse changes made to Section 911 by the 1976 Act. In addition to providing

time for a thorough review of the various alternatives presently before Congress with respect to Section 911, prompt action to defer the effective date of the 1976 Act changes would prevent the unfortunate chaos in which nearly 150,000 U.S. citizens abroad found themselves embroiled when, in May 1977, the effective date of the 1976 Section 911 changes was deferred to taxable years after 1976.

Unless one was closely involved in the matter, it is impossible to appreciate the problems which resulted from the retroactive change in the effective date provisions concerning Section 911. Contrary to popular belief, in order to avoid interest charges, many overseas taxpayers file their returns on April 15th. Accordingly, many had already filed their 1976 returns and overpaid their 1976 taxes when the May 1977 change occurred. Amended returns were therefore required, imposing a great burden on both the Service and the taxpayers involved. As a result, because of the greatly increased and unexpected workload on the Service, some of these taxpayers have still not received the refunds of the 1976 overpayments to which they are entitled.

Accordingly, regardless of what action may ultimately be taken by Congress with respect to future changes in Section 911, an urgent need at this time is to defer the effective date of the 1976 Act changes in Section 911 to taxable years commencing after December 31, 1977. Failure to do so promptly will produce the same unfortunate situation and uncertainties which resulted for U.S. citizens abroad when filing their 1976 returns in 1977.

2. Thereafter, the Committee might consider permanent reinstatement of Section 911 to its pre-1976 Act form, or at least provide such treatment as an alternative to the utilization of other approaches.

3. More appropriately, though, we believe that exclusions for specific allowances should be provided based on the tax equity concept.[8] To the extent that forms of compensation merely provide an overseas employee with a comparable standard of living to that experienced in the U.S., and the employee receives no real economic benefit, such compensation should not be subject to tax.

There are four significant allowances which should be considered nontaxable for the private sector overseas employee. First, there is the cost-of-living allowance. This allowance should be provided where the cost of living exceeds the general cost of living in the U.S. It would be appropriate for this allowance to be determined periodically by the Secretary of the Treasury; however, it would not be appropriate that the cost-of-living allowances be tied to a GS-12 employee. If all facets of the tax equity are considered, there should be no tie-in to a particular grade public sector employee nor should cost-of-living tables be utilized for private sector employees that reflect public sector experience. The disparity that can result from utilization of public sector data was illustrated above in the discussion on H.R. 9251.

Secondly, there should be a qualified housin; allowance exclusion. The basic concept of the housing allowance as provided in H.R. 9251 and the Administration's proposal is appropriate. However, since in operation these proposals would not provide adequate relief in many foreign areas, it would be more appropriate to use a threshold of 16⅔ percent of an individual's equivalent U.S. base salary (thus, excluding all foreign overbase amounts as discussed above) rather than the 20 percent gross compensation approach. The costs of providing separate maintenance of a second household where living conditions at the place of employment are dangerous, unhealthy, etc., should be considered a part of the qualified housing allowance.

Thirdly, there should be an education allowance exclusion. The approach of H.R. 9251 appears equitable, provided room and board and travel expenses are included as discussed above, and the IRS education expense tables are reasonable. We favor, however, the Treasury Department recommendation dated February 23, 1978, which generally allows a deduction for educational expenses of up to $4000 per dependent plus travel expenses.

Fourthly, there should be an allowance for home leave as the Administration recommends. This would be limited to no more than one round trip each year to the U.S. for the employee and his dependents. However, it should also provide for a compassion leave allowance to take care of an untimely death or serious illness of a close relative in the United States; and an allowance should be provided for

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[8] An exclusion is preferable to a deduction for two reasons: First, an exclusion is simpler administratively. Secondly, an exclusion more properly recognizes the lack of economic tax benefit to a taxpayer.

rest and recuperation where an employee and his dependents must reside in an extremely harsh environment.

It is submitted that providing exclusions for the above four allowances would go a long way in providing tax equity for the overseas employee. But to provide complete tax equity, the Congress should also consider improvements in moving expense allowances as noted below.

4. While the recommendations in 3 above would provide equitable tax treatment as a substitution for Section 911, other relief is needed in the areas of moving expenses. The Ways and Means Committee Task Force on Foreign Source Income recommended for government workers an increase from thirty days to ninety days for the period in which temporary living expenses could be deducted. It would be appropriate that this relief be granted private and public sector employees. The deductible limits should also be increased for foreign moves. The Task Force recommended that the maximum deduction for indirect expenses be increased to $4,500 for public sector employees. The Treasury Department has proposed this amount be increased to $5,000 for the ceiling on temporary living costs. Again it would be appropriate to increase the limit for both public and private sector employees. Additionally, it would be appropriate to recognize that storage fees are a part of most foreign moves. Deductible moving expenses then should include the reasonable expenses of storing household goods and personal effects as well as the expenses of moving these goods.

Finally, the term "foreign move" should be expanded to include the situation where the return to the U.S. occurs as the taxpayer is entering bona fide retirement (or if the taxpayer has died and his dependents have returned to the U.S.).

The organizations submitting this statement express appreciation for the opportunity to do so and offer such further assistance to the Commitee on Finance as may be requested.

As an addendum to this submission there is included a critique of the Congressional Research Service paper entitled "U.S. Taxation of Citizens Working In Other Countries: An Economic Analysis," Library of Congress, April 20, 1978.

A Critique of a Paper Entitled "U.S. Taxation of Citizens in Other Countries: An Economic Analysis"

The Congressional Research Service (CRS) of the Library of Congress has prepared a study dated April 20, 1978, entitled "U.S. Taxation of Citizens Working In Other Countries: An Economic Analysis." There are some parts of this study which are helpful in shedding light on some of the problems associated with the taxation of U.S. citizens working abroad. However, the study is seriously flawed and, as a result thereof, its major conclusions are invalid. This critique will discuss the fatal shortcomings of the CRS analysis.

Tax neutrality

The study embraces the concept of locational tax neutrality and suggests that this principle should be the guiding light in consideration of legislation to reinstate the former Section 911 I.R.C. or to provide alternative allowances as proposed by Senator Ribicoff (H.R. 9251) and the Department of the Treasury. It is agreed the concept of tax neutrality is germane to this issue; however, there can be no agreement with the study's determination of what is "tax neutrality".

In discussing tax neutrality the study offers an example comparing the after-tax results of a U.S. citizen working abroad vis-à-vis a domestic counterpart earning $20,000 (of adjusted gross income). It embraces the concept of providing the overseas worker with a limited deduction for a cost-of-living allowance, but then suggests that the amount of the deduction should be taxed at the taxpayer's effective tax rate based on "equivalent U.S. income". A requirement of this concept of tax neutrality is that a U.S. worker abroad must bear the same effective tax rate on his adjusted gross income as his domestic counterpart in similar economic circumstances. This concept of tax neutrality is inappropriate because the additional gross income of the overseas worker does not yield additional economic benefits. The end result of this concept of tax neutrality is that substantial additional taxes would be paid to the U.S. Treasury on income yielding no economic benefits to the recipient. The study's own example (reproduced below from page 21) clearly shows this additional tax, which either must be borne by the worker or his employer (with perhaps an additional gross-up to be borne by the latter).

Total foreign income	$32,000
Minus foreign educational expense deduction	−2,000
Total adjusted gross income	30,000
Equivalent U.S. adjusted gross income ($30,000 times .66⅔)	20,000
U.S. income tax on equivalent U.S. adjusted gross income	2,711
Total U.S. income tax before foreign tax credit (.13555 times $30,000)[1]	4,066.50

When this additional tax ($4,066.50−$2,711=$1,355.50) is subtracted from the after-tax income available to the worker, the result is no longer tax neutrality but a further disincentive to overseas employment of an American worker. And he (and his employer) will be less competitive with European and Japanese workers and firms.

In discussing tax neutrality, the study refers times to *real* income (emphasis added) but nowhere discusses economic income or available income to the worker. If a cost-of-living allowance is to be fair, tax neutral, and not a disincentive to Americans working abroad, additional income which does not yield any economic benefit (vis-à-vis the U.S.) should not be taxed.[2]

In point of fact properly structured cost-of-living allowances should not even be treated as deductions, but rather as exclusions—thus, more correctly recognizing the character of this "income" which yields no economic benefit to the recipient.[3]

The study's concept of tax neutrality is incorporated into a so-called "hypothetical neutral tax adjustment" which yields "neutral standard" cases. These "neutral standard" cases are then compared to cases of reinstatement of Section 911, or enactment of H.R. 9251 or the Treasury proposal. However, since the "neutral standard" is flawed, the conclusions reached in comparison with the other proposals are seriously distorted and, in fact, invalid.

The problem with basing allowances on highest U.S. costs

The study strongly urges that all allowances should be based on the difference between the highest U.S. costs and the applicable foreign costs. Superficially, this sounds appealing in that the U.S. tax code does not provide allowances for the substantial differences in costs of living within the U.S. Such a position, however, ignores the more serious competitive aspects involved vis-à-vis the U.S. worker overseas and his foreign counterparts.

It is acknowledged that there are competitive aspects involved with respect to an American worker moving within the United States; but, the U.S. worker transferring overseas must compete with a foreign worker whose country of origin does not tax extraterritorial earnings of its expatriates.[4] Any additional tax costs create serious competitive disadvantages for the U.S. worker (or his employer). If certain isolated high cost areas of the U.S. were used as a base, the proposed allowances would likely be reduced to the point that the U.S. income tax would be a substantial disincentive to overseas employment.

Statement of Petroleum Equipment Suppliers Association

The Petroleum Equipment Suppliers Association represents approximately 200 companies with over 200,000 employees which supply a substantial portion of the equipment and services used by the oil and gas producing industries in all parts of the world. We are manufacturers, service companies and distribution companies operating in almost all areas where oil and gas are produced. With few exceptions, PESA members do not engage in exploration and development of oil and gas properties, nor do they buy and sell oil and natural gas. We are a group of small, medium and some large companies with many of our employees on assignment overseas.

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[1] Effective tax rate calculation is $2,711 over 20,000 equals .13555.

[2] Curiously and inconsistently, the study would not subject a proposed educational allowance to additional taxation and it would, thus, be truly tax neutral.

[3] Treatment of allowances as exclusions would not only recognize that they provide no economic benefit, but should tend to lessen the likelihood of improper categorization as a preference item.

[4] No major industrial countries tax the extraterritorial earnings of expatriate workers.

The changes made to Section 911 in the 1976 Tax Reform Act, along with recent Tax Court decisions affecting the taxable income generated by allowances and facilities furnished to our overseas employees are unfair and inequitable to both Americans working overseas and the companies which employ them and we contend that the provisions of the 1976 Tax Reform Act and the decisions of the Tax Court were ill-advised and, if not corrected, will ultimately cause severe and irreversible economic problems for our nation.

In view of the requirement that Americans working overseas file their 1977 income tax returns by June 15, it is essential that the Congress take immediate action on the bills pending to delay the effective date of the 1976 Tax Reform Act changes to Section 911.

We also strongly recommend that the Congress enact legislation which would exclude from earned income the excess cost of housing, cost of living, education, home leave expense and moving expense by Americans working overseas. Additionally, since these excess costs are incurred from the day an employee makes initial arrangements for his move overseas, they should be excluded without meeting any length of residence requirement.

This Committee should also consider the tenuous circumstances of our overseas markets due to severe foreign competition by companies and their employees not taxed on income by their home governments. Consider as well the potential economic effects of the loss of these markets in terms of loss of tax revenues, loss of U.S. jobs, the deleterious effects on our balance of payments, and the special problems such loss of markets create for our industry. The adverse effects might well justify a general exclusion for Americans working overseas to help equate U.S. companies to their untaxed foreign competitors.

Rumors and misconceptions being expressed regarding our employees on foreign assignment and the information set forth in a recent Treasury publication entitled "Taxation of Americans Working Overseas" as well as the Library of Congress publication, "U.S. Taxation of Citizens Working in Other Countries: An Economic Analyses," do not accurately present to the American public or to the Congress the conditions that actually exist in the foreign areas in which we operate.

CHANGES TO SECTION 911 IN 1976 TAX REFORM ACT AND TAX COURT DECISIONS DURING 1976 WERE ILL-ADVISED AND UNFAIR TO U.S. EXPATRIATES

During 1976 the Tax Reform Act of 1976 was passed changing the provisions of Section 911 and these changes along with Tax Court decisions affecting the taxability of overseas housing caused Americans working overseas to be taxed on the excess costs of facilities and allowances furnished by their employers which do not represent anything of value to the employee. Their living facilities, in most instances, do not meet standards for homes in the United States. Food, clothing and other necessities of life are no better and, in most cases, not of the same quality available in the United States and the education they provide their children is substandard compared to free public education in the United States.

The home leave furnished to them by their employers on an annual basis does no more than cover the expense of allowing employees to vacation in the same area that they would if assigned to the United States and moving expense payments or allowances do no more than cover actual moving expenses incurred because of overseas assignment. These employees have nothing to show for the facilities furnished or allowances paid since only excessive costs are covered. The standard of living for these employees is in no way improved. There is no theory of taxation which would justify such excess costs generating taxable income for an employee. It is not fair or equitable and creates a severe hardship since what was furnished generates no cash which can be used to pay these taxes.

In order to keep their employees overseas, most companies in our industry will find it necessary to bear the increased tax through a program of tax equalization. Since most of our industry's members compete directly with foreign companies, the increased cost of such tax equalization may well make them noncompetitive causing a loss of overseas business and, since most of the equipment and service units sold and used by our industry are produced in the United States, a loss of U.S. jobs and an adverse effect on our balance of payments.

A substantial portion of the excess costs to which we refer is caused by the explosive inflation rates being encountered in overseas areas which are handled by "trading" dollars with our customers. What justification is there for the

Treasury Department to cash in on these high rates of foreign inflation? How does the Treasury Department expect our U.S. citizens working overseas to compete with foreign workers who are not taxed by their home governments on their income? A U.S. company has no choice but to replace its U.S. employees working overseas with foreigners because its U.S. employees have lost their ability to compete in the overseas labor market.

It has been said that 2½ Englishmen can be hired for the cost of one American. Our experience is that American salesmen, servicemen and technicians are better trained, more dependable, more experienced and more loyal to U.S. companies and products than foreign nationals. Nevertheless, if we cannot secure contracts because of the excessive tax cost of hiring U.S. nationals and hope to remain in business abroad, we must hire foreign nationals.

One of our member companies has been forced to establish training facilities in Montrose, Scotland, and Singapore to insure that if no tax relief is provided U.S. citizens it will be able to continue servicing overseas customers. This action was taken only after long, hard consideration. Foreign competitors have the capability of copying this company's products and its foreign markets are maintained through the superiority of its U.S. technicians overseas who make its equipment work in customers' wells. Once the Scotsman, Britishers, French, German, Norwegians, Danes and other nationals now attending schools have been trained to service and install this company's equipment, it will be difficult for it to maintain these foreign markets on a long term basis.

By training foreign nationals we are exporting our technology and rapidly eliminating any U.S. technological advantage. The long range effects of this on U.S. jobs, exports, and investments in manufacturing machinery and equipment could be disastrous for this country.

We have little choice, however, since most commitments to overseas customers are on a long term basis, in many instances at fixed prices which were established under cost calculations made prior to the 1976 Tax Reform Act changes and the Tax Court decisions. Now our industry is faced with a drastically different cost picture and must take extreme actions in order to cope with greatly increased costs.

Our government and the Congress has encouraged us during past years to develop our foreign markets and now that we have done so, the rules are changed, making it difficult and perhaps impossible to continue serving these markets. It is unfair and, in our opinion, ill-advised.

WHAT SHOULD BE DONE?

Since the deadline for the filing of tax returns by our overseas employees is June 15, 1978, it is essential that Congress acts on the pending bills to delay the effective date of the Section 911 changes. We also urge prompt action to exclude from the taxable income of Americans working overseas the excess costs that are incurred merely by the fact that they are on overseas assignment. In all fairness, these excessive costs should be excluded in the same bracket of income in which they were included in income.

The excess costs for which an American working overseas receives no benefit and ends up with no money in his pocket include the excess costs of housing, the cost of living for himself and his family, the cost of educating his children, the cost of returning with his family to his home in the United States for home leave, and the cost of moving overseas.

These excessive costs for an employee sent overseas on permanent assignment start from the time the employee begins arranging for the move overseas and there is no justification for making the exclusion subject to a length of residence requirement. The man who is transferred overseas and then must return after a short period of time for health reasons or inability to cope with foreign assignment, or other reasons, should not be penalized because he has not maintained his foreign assignment for a specific period of time. He has incurred the excess costs for which he has received nothing of value and should have these costs excluded on the same basis as an employee who has worked overseas for a number of years.

We are asking for tax equity. We are asking for fair treatment of our overseas employees as compared with comparable employees in the United States. We do not ask for any unfair benefit and do not contend that a foreign tax credit should be allowed for taxes paid on these excluded amounts. We do not ask that our employees be allowed to receive lavish living quarters or other benefits which should be taxed without being subject to tax. Our primary concern is for our technicians and technical people and the men who are generating the sales of

our U.S. products. They should not be penalized by unfair tax laws simply because they agreed to go abroad on behalf of their employer. The spectre of the 911 changes made in the 1976 Tax Reform Act and the Tax Court decisions hangs heavy on our members' overseas employees, many of whom accepted the hardships of overseas assignments in order to advance with their companies and now face the prospect of being replaced with foreign nationals.

For the past two years, our companies have been experiencing difficulty in meeting their overseas personnel requrements with U.S. employees. They are just not willing to transfer overseas with their tax status in doubt. Equipment is unmanned in many areas of the world and we even have difficulty soliciting U.S. employees to transfer overseas on temporary assignment. Our competitors are regularly submitting bids for technical personnel 25% below our bid figures. We will not be able to maintain our foreign markets on this basis. It must be remembered that U.S. manufacturers and exporters are in competition with foreign companies which receive numerous tax and other export incentives from their governments.

A strong case can be made for a general exclusion from income for Americans working overseas to help equate U.S. companies' costs to those of their foreign competitors. For example, during early 1977, one of our member companies was required to bid on a service contract covering operations in a Middle East country involving approximately 15 U.S. employees. Included in the costs were the tax costs required to keep these fifteen employees on foreign assignment. A French competitor submitted a bid approximately 25% less. Consequently, our company lost the contract. This contract would have called for four service vessels, which were to have been built in New Orleans, Louisiana. The company forecast the annual sale of approximately two and one-half million dollars of equipment for this customer which would have been produced at its plant in Dallas, Texas and substantial rental charges for these service vessels. Let us consider what our nation lost in this attempt to unfairly collect additional taxes from these fifteen Americans working overseas. The Treasury Department has lost the tax revenues on the profits from the overseas equipment sales and rentals and the tax on the income of these fifteen employees. Additionally, taxes on the U.S. manufacturing profits, the profits on the production and sale of the service vessels, taxes on the navigational equipment, the engines, the steel and other components used in the production of the service vessels and the equipment in the United States, and the taxes on the income of the workers producing the equipment, service vessels, materials and components. Let us also look at the loss of jobs. Each of these four service vessels produced in the New Orleans, Louisiana, area would produce jobs for one year for six workers. This, along with the machinists and other workers required to produce the equipment which would have been sold, may not seem significant but when multiplied by the effect of other contracts lost and other markets in jeopardy, it could well cause severe aggravation of our employment problem in the United States.

We must also take into account the severe impact the loss of overseas markets will have on our trade deficits and the deterioration of the value of the U.S. dollar as compared with other foreign currencies.

There are additional considerations with regard to the overseas markets served by our industry. The development of the equipment and services we sell and provide and the supporting technology are a direct result of the variety of well conditions we encounter in our worldwide operations. Subsurface and surface conditions vary from one producing area to another and, in many instances, problems are encountered in other areas of the world before they are faced by our domestic petroleum industry. In such cases our overseas customers pay the cost of the development and manufacture of required equipment or the development of necessary services and service equipment and when our U.S. petroleum industry faces similar problems the equipment that will be needed is perfected and stocked in inventory.

Subsurface safety devices operated by remote surface equipment were developed for the oil wells of Lake Maracaibo, Venezuela, long before required in the Gulf of Mexico. Equipment to meet the highly corrosive conditions being encountered by the U.S. petroleum industry was ready and waiting because of well conditions in Canada and the Middle East. Equipment necessary to complete and produce wells on the ocean floor was installed and tested years ago in wells Gabon. Would oil be flowing through the Alaska Pipeline if our industry had not been able to call upon their experience in other areas of extreme cold to produce the equipment and provide the services required on the North Slope of Alaska?

If our industry loses its overseas markets, the increased costs and delays that will be suffered by our U.S. petroleum industry could well make it impossible for our nation to meet its energy goals and would undoubtedly increase the price each of us will have to pay for energy.

RUMORS AND MISCONCEPTIONS

We are most concerned about the way Americans working overseas and our overseas markets are being portrayed to the U.S. public and to the Congress. In reading information appearing in our newspapers, statements being made in the Congress, and in studies prepared by the Treasury Department and the Library of Congress, one is left with the impression that overseas employees are paid at a substantially higher rate than comparable U.S. employees; that foreign sales and service generates higher profits than comparable operations in the United States; that U.S. companies will always "follow these profitable foreign markets"; that employees live will and even lavishly abroad; and that the U.S. companies control these overseas markets because of their vastly superior technology. We do not believe, at least for our industry, that these views of overseas employees and markets is correct.

If you were to travel to our foreign locations you would find that our overseas employees under the tax laws now in effect receive less take-home pay than comparable U.S. employees, in most instances live under conditions of hardship not faced by U.S. employees and that the profit margins on foreign operations have been reduced to the point that, when these markets are evaluated in terms of risk, companies may well feel that they are not worth pursuing.

If you would attend the Offshore Technical Conference which is held annually at Houston, Texas, you might well wonder what has happened to the U.S. technological lead when visiting the booths of hundreds of foreign manufacturers ready to take over our overseas markets the minute we stumble or fail to pursue these markets as diligently as we have in the past. Why are these foreign manufacturers so ready and willing to pursue these markets and why do their governments encourage and subsidize their activities in this regard? Could it be that these foreign governments see the value of these foreign markets in terms of jobs, balance of payments, and the effect on their economies? Why should the U.S. government view these markets any differently?

The publication of the Treasury Department entitled "Taxation of Americans Working Overseas" and the analysis of tax returns and conclusions drawn therefrom do not conform to our view of the realities of the situation of our overseas employees. The statements contained in this publication indicate taxpayers abroad have higher incomes on average than U.S. taxpayers. They do not mention or take into account the fact that the labor force overseas does not include workers at the lower end of the wage spectrum since it would not be economical for U.S. companies to send this type of worker overseas, nor would it be acceptable to the governments in the foreign areas in which these companies operate. Since the employees at the lower end of the wage spectrum have been eliminated from the analysis, it tends to make any averages or statistics based on averages meaningless. The only way that such comparisons could properly be made would be to compare an overseas taxpayer with a U.S. taxpayer holding a comparable job in the United States.

In our industry employees working in the U.S. and in foreign locations on similar jobs are paid the same base pay. The overseas worker receives additional allowances designed to insure that he has the same take home pay as the U.S. employee after he pays the additional costs of living abroad.

The Treasury has attempted in their analysis to quantify in terms of dollars the additional tax revenues that will be generated by the Tax Court decisions. We submit that it would be impossible to place a dollar figure on these additional revenues since the Treasury Department does not have available to it information concerning the value of facilities furnished and allowances paid overseas employees by U.S. companies. In addition, they admit that no consideration is given the ripple effect as demonstrated by the example of our member company losing a contract to its French competitor and the change in behavior which will surely follow.

The Library of Congress study does not take into account the actual problems being faced by Americans working overseas; and the study, therefore, compounds and adds to the misconceptions to which we have referred. It is based on numerous assumptions which fly in the face of reality as we experience it abroad.

RECOMMENDATION

We recommend the adoption of H.R. 9251 to extend the effective date of Section 911 changes and to provide substantive relief to Americans abroad with the modifications set forth in the attached exhibit.

EXHIBIT TO STATEMENT OF PETROLEUM EQUIPMENT SUPPLIERS ASSOCIATION

1. Amendment to H.R. 9251 to permit a $15,000 exclusion "off the top" as an alternative to the specific deductions which would be allowed under section 221.

DRAFT AMENDMENT

Subsection (b)(2) of section 4 of H.R. 9251 is deleted and the following is substituted in lieu thereof:

"(2) Amendments relating to section 911.—

(A) Subsection (d) of section 911 is deleted and subsections (e) and (f) are redesignated as subsections (d) and (e), respectively.

(B) Section 911 is amended by adding the following new paragraph at the end of subsection (d) (as redesignated by subparagraph) (A) above):

(3) Election of Section 221.—The provisions of this section shall not apply for any taxable year for which the taxpayer has elected the application of section 221."

1. Amendment to H.R. 9251 to permit a $15,000 exclusion "off the top" as an alternative to the specific deductions which would be allowed under new Code section 221.

GENERAL EXPLANATION

As an alternative to the specific deductions which would be allowed by H.R. 9251 to U.S. taxpayers living abroad, a blanket exclusion of $15,000 a year should be allowed employees who meet the requirements of present section 911 of the Code (including the residency requirements). This would benefit employees who suffer expenses from living abroad which are not in the categories enumerated in new Code section 221 (such as value added taxes or other non-creditable taxes, specific hardship allowances, and similar items). Moreover, the specific requirements of new section 221 will be difficult for some taxpayers to comply with as a practical reporting matter. A blanket exclusion alternative would permit such taxpayers to forego the benefits of section 221 and take the more simple approach of a flat exclusion. Since the taxpayer would be forced to choose between the blanket exclusion and the new specific deductions allowed under new section 221, no double benefit could result.

The specific exclusion should be "off the top" of the taxpayer's income since it is designed to remove from the taxpayer's taxable income unusual items which are not normally considered economic income (the value of excessive cost housing furnished to the taxpayer by him employer, for example). This will prevent such extraordinary items from pushing the taxpayer's other, unrelated income into higher U.S. tax brackets. Without this change a tax penalty results from the presence of the extraordinary foreign items even though they may be technically excluded from the taxpayer's income under the blanket exclusion.

2. Amendment to H.R. 9251 to allow a deduction for one round trip to the United States each year.

DRAFT AMENDMENT

On page ——, line ——, delete "and education expense amounts," and insert in lieu thereof, "education expense, and home leave amounts."

On page ——, the following shall be added immediately after line ——:

"(5) HOME LEAVE AMOUNT.—The term "home leave amount" means the reasonable amounts provided to, or paid or incurred by, an individual for one round trip and return each year between the location of the individual's principal place of work and a place in the United States approved by his employer (if any), for such individual, his spouse and each dependent of the taxpayer with respect to whom the taxpayer is allowed an exemption under section 151(e)."

2. Amendment to H.R. 9251 to allow a deduction for one round trip to the United States each year.

GENERAL EXPLANATION

H.R. 9251 should be amended to permit, as an additional special deduction allowed for U.S. citizens employed abroad, a deduction for the actual costs incurred

for one round trip to the United States and return to the place of employment each year for the employee, his spouse, and his dependents. Most employers pay the cost of such a trip as a standard policy.

Such deduction would not be subject to abuse; only the actual tourist fare paid by the employee would be allowed so no economic benefit could accrue to the employee. In addition, the encouragement of such periodic returns to the United States would seem to be a good policy from the standpoint of the United States government as well as the employer.

3. Amendment to H.R. 9251 to remove the residency requirement for special deductions from income earned abroad.

DRAFT AMENDMENT

On page ——, delete line —— through line —— and insert in lieu thereof the following:

"SEC. 221. ADDITIONAL FOREIGN LIVING COSTS.—

"(a) General Rule.—

"(1) There is allowed as a deduction to an individual citizen of the United States whose principal place of work is located outside of the United States for any portion of the taxable year the amount determined under subsection (c) for the taxable year.

"(2) In the case of an individual described in paragraph (1) whose principal place of work is located within the United States for a portion of the taxable year, the amount determined under paragraph (1) shall be adjusted (to the extent appropriate, if any) under regulations issue by the Secretary to take into account the period of work in the United States."

3. Amendment to H.R. 9251 to remove the residency requirement for special deductions from income earned abroad.

GENERAL EXPLANATION

The special deductions which would be allowed for U.S. taxpayers living abroad under H.R. 9251 would be limited to taxpayers who meet the residency requirements imposed under present section 911 of the Internal Revenue Code. These require that the taxpayer either be (i) a bona fide resident of a foreign country for the entire year, (ii) or during any period of 18 consecutive months be present in a foreign country or countries during at least 510 full days in such period.

This foreign residency requirement may serve a meaningful purpose in connection with the blanket exclusion of section 911 of the Code, but it serves no useful purpose where the intent of the statutory provision is to exclude from taxable income extraordinary items paid to or provided for an employee while he is working outside of the United States. The only requirement should be that the taxpayer's principal place of work be in a foreign country. The deductions which would be permitted by new section 221 with respect to the period of time a U.S. taxpayer lives abroad should be available for the period his bona fide tax home is in a foreign country even if that period is only, for example, eight months during the taxable year. Otherwise a taxpayer who unexpectedly is required to return to the United States would have large taxable income due to extraordinary foreign income items with no offsetting deduction for the period he lived abroad. In such a case the purpose of S. 2115 would be wholly frustrated.

In addition, Petroleum Equipment Suppliers Association supports the proposal of the Treasury Department which would require amendments to H.R. 9251 to:

4. Expand the Section 119 exclusion of meals and lodging furnished for the convenience of the employer to include "camp style" meals and lodging furnished near the employer's premises.

5. Provide a deduction for education transportation expenses where no adequate U.S. type school is available in the country of employment and for college students.

6. Liberalize the deduction for moving expenses to recognize the increased time and costs involved in foreign moves.

AMERICAN CHAMBER OF COMMERCE OF VENEZUELA,
Caracas, Venezuela, May 5, 1978.

Hon. RUSSELL B. LONG,
Chairman,
Senate Finance Committee,
2227 Dirksen Senate Office Building,
Washington, D.C.

DEAR MR. LONG: On behalf of the American Chamber of Commerce of Venezuela, I submit the following statement for inclusion in the record of your committee hearings on "Taxation of Americans Working Abroad" of May 8, 1978.

I thank you for this opportunity to express our views to you and your committee.

Very truly yours,

GABRIEL J. BAPTISTE, *President.*

WRITTEN STATEMENT OF THE AMERICAN CHAMBER OF COMMERCE OF VENEZUELA

The following is submitted as a statement of the views of the American Chamber of Commerce of Venezuela with respect to taxation of Americans working abroad, presently under consideration by the United States Congress.

INTRODUCTION

Who we are

I am Gabriel J. Baptiste, President of the American Chamber of Commerce in Venezuela located in Caracas: I have lived in Venezuela for 20 years. Our Chamber is a binational organization with over 1,000 individual and 448 corporate members. The majority are branches or affiliates of U.S. companies. In addition, many of the Venezuelan corporate members employ U.S. citizens in managerial or technical positions.

Our organization is associated with the Council of the Americas, the Chamber of Commerce of the United States, and the Association of American Chambers of Commerce in Latin America.

We appreciate very much this opportunity to submit this written testimony with respect to proposals relating to taxation of Americans abroad. We wish to express our support for S. 2115 introduced by Senator Abraham Ribicoff on September 21, 1977 and for H.R. 9251 which incorporates the Ribicoff bill in addition to a provision which would extend to taxable years beginning prior to January 1, 1979, the application of new section 911 of the Internal Revenue Code as amended by the Tax Reform Act of 1976; both bills would grant certain deductions for additional foreign living costs to U.S. citizens living in Venezuela and elsewhere overseas where the cost of maintaining a U.S. standard of living is considerably higher than that of the United States, and where governmental services range from poor to nonexistent. In addition, we advocate the further relief requested in the part of this written testimony entitled "Conclusions and Recommendations".

Present law

The Tax Reform Act of 1976 made several changes in the taxation of individuals working abroad which were originally effective for taxable years beginning after December 31, 1975. Under the law in effect prior to the 1976 Act, U.S. citizens could exclude up to $20,000 of earned income abroad during a period in which they were overseas for 17 out of 18 months or during a period they were bona fide residents of a foreign country or countries (section 911). In the case of individuals who had been bona fide residents of foreign countries for three years or more, the exclusion was increased to $25,000 of earned income. Individuals electing the standard deduction were not allowed to claim the foreign tax credit for foreign taxes paid.

The Tax Reform Act of 1976 generally reduced the earned income exclusion for individuals working abroad to $15,000 per year (the Act retained a $20,000 exclusion for employees of charitable organizations). In addition, the Act made three modifications in the computation of the exclusion.

First, the Act provided that any individual entitled to the earned income exclusion is not to be allowed a foreign tax credit with respect to foreign taxes al-

locable to the amounts that are excluded from gross income under the earned income exclusion. Second, the Act provided that any additional income derived by individuals beyond the income eligible for the earned income were not so exclude. Third, the Act made ineligible for the exclusion of any income earned abroad which is received outside the country in which earned if one of the purposes of receiving such income outside of the country is to avoid tax in that country. In addition to these changes made in the computation of the exclusion, the Act provided an election to an individual not to have the earned income exclusion apply. This provision of the Act also allowed individuals taking the standard deduction to claim the foreign tax credit.

The Tax Reduction and Simplification Act of 1977 delayed the effective date of the 1976 Act changes with respect to the taxation of income earned abroad for one year, or until 1977.

Tax Treatment Extension Act of 1978 (H.R. 9251).

H.R. 9251 incorporates with some slight changes S. 2115 (the Ribicoff bill.)

1. Postponement of 1976 act changes.

H.R. 9251 extends the law in effect prior to adoption of the Tax Reform Act of 1976 to taxable years beginning prior to January 1, 1979. The House bill would have extended pre-1976 Act law only to taxable years beginning prior to January 1, 1978. Individuals who take the standard deduction but do not qualify for the earned income exclusion will be able to claim the foreign tax credit for taxable years beginning December 31, 1976.

2. New deductions for excess foreign living costs.

Under the provision of H.R. 9251, the changes in the earned income exclusion (sec. 911) made by the 1976 Act will not take effect. Instead, the exclusion will be replaced for taxable years beginning after December 31, 1978, by a deduction for excess housing and education costs and the excess costs of living (apart from housing and education) for individuals working abroad.

Those persons eligible for the new deduction will generally be the same as are now eligible for the earned income exclusion. U.S. citizens (other than U.S. Government employees) will be eligible if they are bona fide residents of a foreign country or countries for a period which includes an entire taxable year, or if they are physically present in a foreign country or countries for 510 days out of a period of 18 months. Also, resident aliens who are nations of a foreign country having a tax treaty with the United States which contains nondiscrimination provisions will be entitled under such tax treaty to the deduction if they otherwise meet the eligibility requirements imposed on U.S. citizens.

H.R. 9251 makes the deduction for additional foreign living costs a deduction from gross income in determining adjusted gross income. As a result, a taxpayer will be able to claim the deduction for additional foreign living costs without losing the ability to claim the standard deduction.

Legislative history of section 911

Originally enacted in 1926, the exclusion under Section 911 was an unlimited exemption of foreign earned income for citizens spending six months a year outside the United States. It was intended as an incentive to encourage Americans to live overseas and sell U.S. products abroad. The House Committee Report of the time clearly indicated that the language first proposed was meant to benefit export salesmen and thereby increase U.S. foreign trade.

The provision as enacted was not limited to export salesmen, being broader in scope. Over the years section 911 has undergone a series of modifications, introducing concepts of bona fide foreign residence, physical presence abroad, and limitation on dollar amounts excludable, all designed primarily to curb abuses by those who could arrange their employment abroad so as to take advantage of an opportunity to avoid U.S. taxes.

OUR POSITION ON SECTION 900

We firmly believe that failure to grant some consideration to U.S. expatriate personnel with regard to earned income abroad would result in the withdrawal of U.S. citizens from foreign markets and subsequent shrinking of sales and exports abroad. It stands to reason that if it costs an American more to live abroad so that he is worse off financially, net after all host-country and U.S. income taxes, he would prefer to return to the United States and live in the greater safety and comfort of his home country.

Jobs and unemployment

We are convinced that Americans abroad in less-developed countries, such as Venezuela and the other areas of Latin America, generate jobs in the United States rather than take away jobs. Most of the countries in the world today have closed the frontier on imports of many items; American companies must either get into the foreign market with a local organization or get completely out. In the last two decades, protective tariffs or prior licensing systems have vitrually prohibited the importation into Venezuela and other Latin American countries of such finished products as tires, textiles, automobiles, food stuffs, household appliances, television sets, and a host of other articles. As a general rule, we can no longer ship into Venezuela and similar countries finished consumer products. We must either import components or nothing in many areas. In Venezuela and many other developing countries, these products do not come back to the United States with local labor added; they are consumed by the ever increasing local population with its constantly rising purchasing capacity.

Intimately linked in many cases with the creation of markets abroad for U.S. products, it should be noted that in 1974 U.S. firms earned $3.6 billion from foreign-located companies and individuals in the form of royalty and fee payments for the use of U.S. technology. Approximately $2.8 billion of those came from investment-related technology transfer and $0.8 billion from non-investment related royalties and fees. Although in some cases such fees may be generated by the licensing of patents alone, in most cases they are coupled with or dependent upon U.S. management, know-how and technical experience rendered in the foreign country by U.S. citizens. These receipts are the same as exports, since they add to our balance of payments earnings and are extremely important to the total U.S. balance of payments position. The 1951 amendment to the Internal Revenue Code was intended, in large part, to encourage U.S. technicians to seek employment abroad, and the proposal to take away the exclusion would discourage such employment and, in our opinion, decrease receipts from technology transfer fees.

The value of Americans abroad is simply this: they insure that the United States gets its fair share—or hopefully, more than a fair share—of the existing foreign market for U.S. components in more sophisticated items not manufactured in the foreign country—heavy machinery or technical services. In ordering equipment, supplies, raw material of all types, replacement parts, etc., a U.S. citizen abroad is in a position to favor his country of origin, the United States. An estimated 10% of the U.S. employment force depends upon exports; cut off our U.S. representatives abroad and you will drastically reduce exports, precisely at a time when our balance of payments deficit is worse than ever.

Examples

Let me give you a few specific examples, if I may, as to what Americans abroad mean to the United States exports of goods and services to a country such as Venezuela:

(a) One of the nationalized oil companies in Venezuela is embarking upon a refinery expansion which, it is estimated, would cost from $850 million to $1 billion. It will involve 16 million man hours and approximately 4,000 people. The company that gets the job—hopefully, American—will have to put about 350 technicians and supervisory personnel into Venezuela, with a support team back in the United States. Most of that money—$850 million to $1 billion—will come to the United States for the purchase of equipment and services if we are not priced out of the market by the cost of U.S. personnel abroad.

(b) The sales of a leading U.S. earth-moving equipment firm distributor in Venezuela were approximately $125 million last year. Household appliances sold by the same company amounted to $100 million. This company operated with a U.S. staff in Venezuela of 28 persons. These 28 persons generated $125 million in U.S. exports of new equipment, parts and services for earth-moving equipment and about half the value (in components from the United States) of $100 million in sales of household appliances.

(c) A U.S. contractor is building with local partners a dam in Venezuela for the Venezuelan government with 68 U.S. employees. The job is just commencing and $20 million in U.S. equipment have been imported to date. It is estimated that another $33 million will be imported within the next several years. The job itself will generate revenues of $150 million which hopefully, will produce a substantial profit for the American partner to be brought home. The estimated cost of maintaining these 68 employees abroad, if the 1976 Act version of section 911 is enacted, is between $300,000 and $400,000. That additional cost is what can make a

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U.S. company noncompetitive. If it loses the bid, it is needless to add that there will be no exports of U.S. equipment, and no profits will be brought home to help the balance of payments.

(d) Senator Proxmire from Wisconsin will, I hope, find the next example of particular interest. Racine, Wisconsin, as you know, is the headquarters for Johnson's Wax. In the supermarkets of Venezuela you will not find any imported household wax or insecticide products; all are made locally. Johnson's has a local plant and has the major share of the household wax market and a large portion of the home and insecticide market. If Johnson's had not established a plant and distribution system in Venezuela almost two decades ago with U.S. personnel, there would not be a nickel remitted to Racine, Wisconsin, in the form of equipment purchases or profits. This is a clear case of "Get in or get out."

These are simply four concrete examples. We could report many more.

The United States exports over $3 billion of goods and services to Venezuela per year. Venezuelan exports grew 30 percent last year. Venezuela is the best market for U.S. goods in Latin America aside from Mexico and Brazil: We Americans cannot afford losing it.

The price Americans pay to work abroad

Americans working abroad are working for America. We, the American Chamber of Commerce in Venezuela representing most of the employed Americans in Venezuela, are not movie stars trying to take advantage of United States tax laws. Far from it. The truth of the matter is that we are simple American citizens who are both employees of large American businesses as well as traditional American entrepreneurs. Some of us came to Venezuela of our own free will; others of us were assigned here by our companies. Considering the personal and financial difficulties which many of us have had to endure as a result of our residence in Venezuela, it is unfair to inject into the tax laws a further penalty on those of us who are bringing profits to America by working abroad. We who work abroad are subject to privation and hardships which are unknown to the average American taxpayer. I would like to be more precise in stating what these hardships are, not to win you over by sympathy, but rather to demonstrate the true extent of our plight.

Inconveniences

We lead, in the United States, what is probably the most comfortable life in the world; we are the "affluent society." Telephones cover the nation, as do power facilities; the existence of laundries and dry cleaning establishments is taken for granted; service companies of every type abound; supermarkets and department stores offer every variety of food and merchandise at reasonable prices; no linguistic problems exist. In less developed countries, on the contrary, most or all of those goods and services are not readily available in the same quality, or are available only at prices which would make them luxury items in the States. We do not contend that all underdeveloped or developing countries are "hardship posts", but life for most people who work abroad is not as comfortable as in the United States and is considerably more expensive.

Education and governmental services

Educational facilities are, in general, inferior to or far more expensive than comparable schools in the United States. Many federal and municipal services, which we take for granted in the United States, such as interstate highways, sewage disposal, water, fire protection, etc., are not available or are woefully inadequate in many areas. To pay U.S. taxes, without receipt of such services from the U.S. government, also seems manifestly unfair.

Health

Medical statistics indicate that the less developed countries are not as healthy as the United States or Western Europe. The life expectancy is shorter, and U.S. life insurance companies apply a higher premium rate for those U.S. citizens residing in Latin America. Medical specialists and well-equipped hospitals are not as readily available. There is clearly a health risk in living in many countries abroad.

Political, security and economic risks

Many U.S. citizens living in Latin America have been through revolutions, attempted coup d'etats, street riots, etc. In many countries U.S. citizens living abroad are subject to physical danger and psychological terrorism, as kidnapping

and terrorists acts occur. U.S. citizens living abroad run the risk that their possessions and savings may be confiscated (Cuba) or devalued (most South American countries). What is earned in one year may be lost in the next.

Cost of living

The cost of living in Venezuela and many of the less developed countries is far higher than in the United States. For example, the rental of a modest 3-bedroom home or apartment in the residential areas of Caracas will range from $1,400 to $2,200 per month, unfurnished. Cars cost at least 220 percent of equivalent models in the United States. Appliances usually sell at various multiples of U.S. prices.

Higher salaries in Venezuela are necessary as an incentive to compensate for high living costs, the economic and psychological dislocation ("uprooting") factor, greater political, security and economic risks, inconveniences and lack of governmental and other services taken for granted in the United States.

The argument has been made that U.S. companies should simply increase their remuneration to U.S. citizens abroad to prevent their flight back to the United States. This would increase significantly the cost of those corporations doing business abroad and, accordingly, make them less competitive in bidding on international contracts or in selling their products. As you know, the United States is about the only country in the world that taxes its citizens abroad on locally-earned income. In addition to this loss of potential future business for U.S. companies and exporters, many U.S. citizens abroad who generate export markets do not work for large U.S. companies; they work as entrepreneurs, or for foreign companies or for small businesses which cannot afford the additional costs required to keep the U.S. citizens in the same net after-tax position as his compatriot back home, since he must pay higher bracket taxes on the additional income, which in turn, requires additionay pay, with an overall spiraling effect.

CONCLUSIONS AND RECOMMENDATIONS

It seems ironic that while the communists paint on the walls of many foreign countries "Yankee Go Home", there are many who by a short-sighted tax policy are perhaps unwittingly saying, "Yankee Come Home."

Our Chamber firmly believes that it is to the benefit of the U.S. balance of payments and to the maintenance of employment in the U.S. export industries that U.S. citizens be encouraged to live abroad and certainly not be penalized for working abroad.

We, therefore, advocate the adoption of amendments to section 911 of the Internal Revenue Code which would:

(a) As an alternative to the specific deductions allowed to U.S. taxpayers living and working abroad, permit a blanket exclusion of $15,000 a year for those employees who meet the residency requirements of present section 911 of the Code. A blanket exclusion alternative would permit such taxpayers to forego the benefits of the specific deductions and take the more simple approach of a flat exclusion. The specific exclusion of $15,000 per year should be "off the top" of the taxpayer's income.

(b) Permit section 911 benefits to apply to resident aliens of the United States (green card holders).

(c) Permit a deduction from earned income of an amount equivalent to the additional cost of living (housing and education excluded) as compared with some base city such as Washington. (We do not believe that cost-of-living indexed should be limited to the GS-12 Step-1 salary level, since most U.S. citizens abroad would, within the United States, be earning more than that level [$21,883] in managerial and technical positions).

(d) Permit a deduction for "school fees" to include room, board, and two round trips (tourist class) per year between the dependent's school and the employee's principal place of work in cases where a U.S. type of school is not available within daily commuting distance of the employee's principal place of work in a foreign country. Similarly, a deduction for two trips per year should be allowed for college students.

(e) Permit a deduction for U.S. citizens employed abroad for the actual costs incurred for one round trip (tourist class) to the United States (point of entry) and return to the place of employment each year for the employee, his spouse, and his dependents.

(f) Amend the residency requirements imposed under present section 911 of the Internal Revenue Code; the only requirement should be that the taxpayer's

principal place of work be in a foreign country. Under the proposed amendment, the special deductions should be permitted for the period of time the U.S. taxpayer's bona fide tax home is in a foreign country (with a limitation of eight months during the taxable year). Otherwise, a taxpayer who unexpectedly is required to return to the United States would have large taxable income due to extraordinary foreign income items with no offsetting deduction for the period he lived abroad.

(g) Permit the expansion of Internal Revenue Code section 119 exclusion of meals or lodging furnished for the convenience of the employer to include "camp-style" meals and lodging.

(h) Permit the deduction for moving expenses (allowed under present section 217 of the Internal Revenue Code) to be liberalized in the case of moves to foreign countries by (i) allowing 60 days occupation of temporary quarters at the new principal place of work abroad (rather than the present 30 days); (ii) increasing the ceiling on temporary living costs to $4,500 (from the present $1,500); and (iii) by allowing a deduction for storage of household goods and personal effects for the duration of a foreign assignment.

The rationale behind allowing the $15,000 exclusion option and the special deductions is, of course, to arrive at an equitable tax on the individual's disposable income in relation to what he would be paying if he were residing in the United States. These allowances are generally paid by the U.S. corporation to allow the individual to maintain that standard of living he was accustomed to in the U.S. and do not, in any way, increase his disposable income or personal net worth. These deductions we feel are the major additional expenses over and beyond those normally incurred by U.S. citizens living in the United States which need to be granted so that U.S. citizens will be encouraged to go abroad or continue to reside abroad for the creation of U.S. export and bolstering of the U.S. balance of payment.

The GAO report and the Library of Congress study

The recent report of the Congressional Research Service of the Library of Congress, "U.S. Taxation of Citizens Working in Other Countries: An Economic Analysis" dated April 20, 1978, commissioned by Senator Edward Kennedy (D-Mass.) merits some comments. It appears that this study has borrowed data from an earlier comprehensive report issued by the GAO on February 21, 1978 entitled "Impact on Trade of Changes in Taxation of U.S. Citizens Employed Overseas". The conclusions reached by the Study and the Report differ from each other.

The GAO Report was prepared from actual visits made by investigators to 11 countries, of which 3 located in Latin Ameriva, 1 in Europe and 6 in Asia. From the data gathered, the GAO Report concludes that generally section 911-type incentives must be retained at least until more effective policy instruments are identified and implemented.

The Library of Congresse Study, on the contrary, seems to hold that generally taxation and trade are not necessarily connected and that Americans will remain in their overseas positions regardless of how much they are taxed.

We refute the conclusions of the Library of Congress Study on this so-called "tax neutrality". Furthermore, in our view, common sense would seem to conclude that American firms will not hire Americans when the tax load becomes a multiple of the salary paid to the employee. Accordingly, sole proprietors of American businesses abroad cannot remain in business if their annual tax bill increases in geometrical progression. As a result, it would seem that, as the number of Americans abroad diminishes, the amount of U.S. tax revenues will likewise decline. Without Americans abroad selling American products, sales will decline and the whole problem of taxing Americans working abroad will disappear: economic isolation would seem to be the end product.

Urgency of action

U.S. citizens living abroad are granted a period of time until June 15th to file their 1977 returns. In reliance upon the House action postponing the effective date of the 1976 Tax Reform Act for an additional year (calendar year 1977) for Section 911, almost all U.S. citizens residing abroad counted upon being subject to taxation (for calendar year 1977) under the pre-1976 Section 911 provisions and have not yet filed returns for 1977. If no remedial legislation is enacted prior to June 15, 1978, U.S. citizens residing abroad would be required to make a totally unexpected and onerous taxpayment. We therefore urge immediate action.

MAY 5, 1978.

Hon. RUSSELL B. LONG,
Chairman,
Senate Finance Committee,
2227 Dirksen Senate Office Building,
Washington, D.C. 20510

DEAR MR. LONG: On behalf of The Association of American Chambers of Commerce in Latin America (AACCLA), The Asia-Pacific Council of American Chambers of Commerce (APCAC) and The Association of American Chambers of Commerce in Europe and the Mediterranean (AACCEM), we submit the following statement for inclusion in the record of your committee hearings on "Taxation of Americans Abroad" of May 8, 1978.

We thank you for this opportunity to express our views to you and your committee.

Very truly yours,

PATRICK N. HUGHSON,
President, AACCLA,
MICHAEL L. EMMONS,
Vice Chairman for Taxes, APCAC,
WILLIAM H. SINGLETON,
Chairman, AACCEM.

PREPARED STATEMENT OF THE ASSOCIATION OF AMERICAN CHAMBERS OF COMMERCE IN LATIN AMERICA (AACCLA); ASIA-PACIFIC COUNCIL OF AMERICAN CHAMBERS OF COMMERCE (APCAC); AND ASSOCIATION OF AMERICAN CHAMBERS OF COMMERCE IN EUROPE AND THE MEDITERRANEAN (AACCEM)

The American Chamber of Commerce in Latin America (AACCLA), the Asia-Pacific Council of American Chambers of Commerce (APCAC) and the Association of American Chambers of Commerce—Europe and the Mediterranean (AACCEM) represent forty-five Chambers of Commerce with a combined membership of some 39,000 firms, corporations and individuals. We represent the vast majority of those Americans living and working overseas to generate export sales and foreign income vital to maintain employment in the United States and healthy international commercial exchanges. In recent years, the U.S. balance of payments deficits have grown dramatically. Correcting the trend requires increased efforts in the international trade area and yet, paradoxically, if the 1976 Amendments to Section 911 of the Internal Revenue Code come into force as enacted, the effort will be to drive many Americans firms overseas, and their employees, to withdraw from the intense competition we encounter througuhout the world with the inevitable effect of further dramatic deterioration in our international economic strength.

These considerations are of great importance to the future position of the United States in the world economy. Yet, unfortunately, they are not widely known. We therefore believe it desirable to set forth a history of section 911 since first enacted in 1926, and an analysis of the 1978 rationale for revision of the restrictive amendments of 1976. We conclude with our views as to the nature of the amendments which, in our collective judgment, should be enacted by the Congress in the joint interests of equitable treatment of individuals and strengthening the international competitive position of the United States in the world economy.

We appreciate very much this opportunity to submit this written testimony with respect to proposals relating to taxation of Americans abroad.

We wish to express our admiration and gratitude to Senator Ribicoff. His early recognition of the inherent flaws in the Tax Reform Act of 1976 led to his introduction of S. 2115 that pioneered the necessary remedial action we all now seek. Also, we wish to express our thanks to Senators Bartlett and McClure for their bills (S. 2529 and S. 2576) that seek to correct and improve the tax laws applicable to overseas American taxpayers. Without the foresight and dedicated efforts of these distinguished members of the Senate, a great and irreversible injustice would be done to Americans abroad.

PRESENT LAW

The Tax Reform Act of 1976 made several changes in the taxation of individuals working abroad which were originally effective for taxable years be-

ginning after December 31, 1975. Under the law in effect prior to the 1976 Act, U.S. citizens could exclude up to $20,000 of income earned abroad during a period in which they were overseas for 17 out of 18 months or during a period they were bona fide residents of a foreign country or countries (Section 911). In the case of individuals who had been bona file residents of foreign countries for three years or more, the exclusion was increased to $25,000 of earned income. Individuals electing the standard deduction were not allowed to claim the foreign tax credit for foreign taxes paid.

The Tax Reform Act of 1976 generally reduced the earned income exclusion for individuals working abroad to $15,000 per year (the Act retained a $20,000 exclusion for employees of charitable organizations). In addition, the Act made three modifications in the computation of the exclusion.

First, the Act provided that any individual entitled to the earned income exclusion is not to be allowed a foreign tax credit with respect to foreign taxes allocable to the amounts that are excluded from gross income under the earned income exclusion. Second, the Act provided that any additional income derived by individuals beyond the income eligible for the earned income exclusion is subject to U.S. tax at the higher rate brackets which would apply if the excluded earned income were not so excluded. Third, the Act made ineligible for the exclusion any income earned abroad which is received outside the country in which earned if one of the purposes of receiving such income outside of the country is to avoid tax in that country. In addition to these changes made in the computation of the exclusion, the Act provided an election to an individual not to have the earned income exclusion apply. This provision of the Act also allowed individuals taking the standard deduction to claim the foreign tax credit.

The Tax Reduction and Simplification Act of 1977 delayed the effective date of the 1976 Act changes with respect to the taxation of income earned abroad for one year, or until 1977.

TAX TREATMENT EXTENSION ACT OF 1978 (H.R. 9251)

Postponement of 1976 act changes

H.R. 9251 extends the law in effect prior to adoption of the Tax Reform Act of 1976 to taxable years beginning prior to January 1, 1979. The House bill would have extended pre-1976 Act law only to taxable years beginning prior to January 1, 1978. Individuals who take the standard deduction but do not qualify for the earned income exclusion will be able to claim the foreign tax credit for taxable years beginning December 31, 1976.

We strongly support the provisions of H.R. 9251 that postpone the effective date of the Tax Reform Act of 1976. We consider, however, the substantive changes contained in this bill to be inadequate. We favor an exclusion from earned income in addition to a cost of living allowance and a series of deductions that will permit Americans to remain abroad selling American products and services in fair competition with European and Asian companies.

LEGISLATIVE HISTORY OF SECTION 911

Originally enacted in 1926, the exclusion under section 911 was an unlimited exemption of foreign earned income for citizens spending six months a year outside the United States. It was intended as an incentive to encourage Americans to live overseas and sell U.S. products abroad. The House Committee Report of the time clearly indicated that the language first proposed was meant to benefit export salesmen and thereby increase a U.S. foreign trade.

The provision as enacted was not limited to export salesmen, being broader in scope. Over the years section 911 has undergone a series of modifications, introducing concepts of bona fide foreign residence, physical presence abroad, and limitation on dollar amounts excludable, all designed primarily to curb abuses by those who could arrange their employment abroad so as to take advantage of an opportunity to avoid U.S. taxes.

Throughout the history of taxing Americans abroad, there has been a consistent and continuing intent by the Congress to improve our foreign trade status by recognition of the special needs of Americans working abroad. The facts of our failing international trading position in 1978 emphasizes the continuing need to promote our export trade by favorable tax legislation.

OUR POSITION ON SECTION 911

We firmly believe that failure to grant some consideration to U.S. taxpayers working abroad with regard to their earned income would result in the withdrawal of U.S. citizens from foreign markets and subsequent shrinking of sales and exports abroad. It stands to reason that if it costs an American more to live abroad so that he is worse off financially, net after all local and U.S. income taxes, he would prefer to return to the United States and live in the greater safety and comfort of his home country.

Jobs and Unemployment

We are convinced that Americans abroad in countries such as Venezuela, Indonesia and Spain generate jobs in the United States rather than take away jobs. Most of the countries in the world today have closed the frontier on imports of many items; American companies must either get into the foreign market with a local organization or get completely out. In the last two decades, protective tariffs or prior licensing systems have virtually prohibited the importation into many countries of such finished products as tires, textiles, automobiles, food stuffs, household appliances, television sets, and a host of other articles. In such cases, we can no longer ship finished consumer products into these countries. We must either import components or nothing in many areas. In many countries, these products do not come back to the United States with local labor added; they are consumed by the ever increasing local population with its constantly rising purchasing capacity.

A foreign investment is intimately linked in many cases with the creation of markets abroad for U.S. products. In 1974, U.S. firms earned $3.6 billion from foreign-located companies and individuals in the form of royalty and fee payments for the use of U.S. technology. Approximately $2.8 billion of those came from investment-related technology transfer and $0.8 billion from non-investment-related royalties and fees. Although in some cases such fees may be generated by licensing of patents alone, in most cases they are coupled with or dependent upon U.S. management, know-how and technical experience rendered in the foreign country by U.S. citizens. These receipts are the same as exports, since they add to our balance of payments earnings and are extremely important to the total U.S. balance of payments position. The 1951 amendment to the Internal Revenue Code was intended, in large part, to encourage U.S. technicians to seek employment abroad, and the proposal to take away the exclusion would discourage such employment and, in our opinion, decrease receipts from technology transfer fees.

The value of Americans abroad is simply this: they insure that the United States gets its fair share of the existing foreign market for U.S. components in more sophisticated items not manufactured in the foreign country—heavy machinery or technical services. In ordering equipment, supplies, raw material of all types, replacement parts, etc., a U.S. citizen abroad is in a position to favor his country of origin, the United States. An estimated 10 percent of the U.S. employment force depends upon exports: cut off our U.S. representatives abroad and you will drastically reduce exports, precisely at a time when our balance of payments deficit is worse than ever.

Examples

Let us give you a few specific examples, if we may, as to what Americans abroad mean to the United States exports of goods and services:

(a) One of the nationalized oil companies in Venezuela is embarking upon a refinery expansion which, it is estimated, would cost from $850 million to $1 billion. It will involve 16 million man hours and approximately 4,000 people. The company that gets the job—hopefully, American—will have to put about 350 technicians and supervisory personnel into Venezuela, with a support team back in the United States. Most of that money—$850 million to $1 billion—will come to the United States for the purchase of equipment and services if we are not priced out of the market by the cost of U.S. personnel abroad.

(b) The sales of a leading U.S. earth-moving equipment firm distributor in Venezuela were approximately $125 million last year. Household appliances sold by the same company amounted to $100 million. This company operated with a U.S. staff in Venezuela of 28 persons. These 28 persons generated $125 million in U.S. exports of new equipment, parts and services for earth-moving equipment and about half the value (in components from the United States) of $100 million in sales of household appliances.

(c) A U.S. contractor is building with local partners a dam in Venezuela for the Venezuelan government with 68 U.S. employees. The job is just commencing, and $20 million in U.S. equipment have been imported to date. It is estimated that another $33 million will be imported within the next several years. The job itself will generate revenues of $150 million which hopefully, will produce a substantial profit for the American partner to be brought home. The estimated cost of maintaining these 68 employees abroad, if the 1976 Act version of section 911 is enacted is between $300,000 and $400,000. That additional cost is what can make a U.S. company noncompetitive. If it loses the bid, it is needless to add that there will be no exports of U.S. equipment, and no profits will be brought home to help the balance of payments.

(d) An American taxpayer and his wife opened an importing company in Hong Kong a few years ago. They imported American foodstuffs such as Alaskan salmon, California vegetables, Washington and Oregon apples and candy. This business grew quickly to more than $5,000,000 a year in purchases from the United States.

As a sole proprietor, this taxpayer had to pay for all his business and personal expenses from his own pocket. Housing took 25% of his disposable income. School costs for his two children ran several thousand dollars each year.

This popular business attracted intense competition from Japanese and Australian produce importers. They pay no income taxes to their governments on their overseas earned income. The American could not carry the tax load and he had to close.

More than $5,000,000 a year in produce sales was lost to West Coast producers. The Treasury Department is collecting less taxes. The taxpayer and his family returned to the States.

(e) The Asia Development Bank located in Manila dispenses loans for equipment, capital goods and technology to aid the emerging nations of Asia. Until recently, the ADB employed several Americans in highly placed, supervisory positions. One of these Americans is the representative of the U.S. government and as a U.S. employee abroad, he receives all the benefits under Internal Revenue Code Section 912.

The remaining Americans are direct employees of the ADB. They received a salary, post differential allowance, housing allowance, education allowance and a home leave allowance. Because they are under section 911 and not under 912, all these allowances are treated as income. The ADB does not pay a tax equalization allowance because their non-American employees are not taxed by their own governments.

All the Americans under section 911 will resign from ADB and return to the States. Although the United States continues to fund the ADB, without American influence in purchases for ADB projects, the United States is losing untold millions in export sales.

(f) Senator Proxmire from Wisconsin will, we hope, find the next example of particular interest. Racine, Wisconsin, as you know, is the headquarters for Johnson's Wax. In the supermarkets of Venezuela you will not find any imported household wax or insecticide products; all are made locally. Johnson's has a local plant and has the major share of the household wax market and a large portion of the home and insecticide market. If Johnson's had not established a plant and distribution system in Venezuela almost two decades ago with U.S. personnel, there would not be a nickel remitted to Racine, Wisconsin in the form of equipment purchases or profits. This is a clear case of "Get in or get out".

(g) There is another unexpected and unjustifiable consequence of the Tax Reform Act of 1976. Many countries are aware of the "gross up" treatment of company-furnished allowances for housing, education, travel and tax equalization. For example, in Japan the total, worldwide income of American residents must be reported if the American has been a resident for five years. That means that all salary, allowances and income from any source and wherever derived must be reported and is subject to the Japanese Income Tax Law. The American resident taxpayer in Japan, or his employer if there is a tax equalization plan in effect, pays Japanese income tax on the entire amount. That tax paid to the Japanese Finance Ministry is then claimed as a foreign tax credit against the American tax liability. So, it is Japan, and not the United States, that reaps the benefits of the Tax Reform Act of 1976. Considering our present trade relationship with Japan, how do we justify this defacto aid program?

A prominent American banker now residing in Tokyo, under the present tax laws and regulations, will pay an amount twice his salary in income taxes this

year. While it is the American law that creates this ridiculous situation, the Empire of Japan will collect the taxes. Next year our American banker will pay three times his salary in Japanese income taxes. The United States Treasury will collect nothing!

These are simply some concrete examples. We could report many more.

The price Americans pay to work abroad

Americans working abroad are working for America. We, the American Chambers of Commerce around the world representing most of the employed Americans abroad, are not movie stars trying to take advantage of United States tax laws. Far from it. The truth of the matter is that we are simply American taxpayers, some employed by large American businesses and some are traditional American entrepreneurs. Some of us went abroad on our own; others of us were assigned there by our companies. Considering the personal and financial difficulties which many of us have had to endure as a result of our residence overseas, it is unfair for Congress to inject a further penalty into the tax laws for those of us who are bringing profits to America by working abroad. We who work abroad are subject to special conditions outside the experience of the average American taxpayer.

Special conditions

We lead, in the United States, what is probably the most comfortable life in the world; we are the "affluent society." Telephones cover the nation, as do power facilities; the existence of laundries and dry cleaning establishments is taken for granted; service companies of every type abound; supermarkets and department stores offer every variety of food and merchandise at reasonable prices; no linguistic problems exist. In many foreign countries, on the contrary, most or all of these goods and services are not readily available in the same quality, or are available only at prices which would make them luxury items in the States. We do not contend that all foreign countries are "hardship posts," but life for most people who work abroad is not as comfortable as in the United States and is considerably more expensive.

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Medical statistics indicate that most foreign countries are not as healthy as the United States. Medical specialists and well-equipped hospitals are not as readily available. There is clearly a health risk in living in many countries abroad.

Political and economic risks

Many U.S. citizens living in Latin America have been through revolutions, attempted coup d'etats, street riots, etc. In many other countries U.S. citizens are subject to physical danger such as kidnappings and terrorist acts. U.S. citizens living abroad run the risk that their possessions and savings may be confiscated (Cuba, Vietnam, Cambodia) or their currency devalued (South America, Asia and Europe). What is put aside in one year may be lost in the next.

Cost of living

The cost of living in many foreign countries is far higher than in the United States. For example, the rental of a modest 3-bedroom home or apartment in the residential areas of Caracas will range from $1,400 to $2,200 per month, unfurnished. Cars cost at least 220% of equivalent models in the United States. A 16-oz. can of applesauce costs $1.75 while a 12-oz. jar of peanut butter costs $1.50. Appliances usually sell at various multiples of U.S. prices.

The argument has been made that U.S. companies should simply increase their remuneration to U.S. citizens abroad to prevent their flight back to the United States. For example, the rental of a modest 3-bedroom house or apartment in the business abroad and accordingly, make them less competitive in bidding on international contracts or in selling their products. As you know, the United States is about the only country in the world that taxes its citizens abroad on locally-

earned income. In addition to the loss of actual and future business for U.S. companies and exporters, many U.S. citizens abroad who do not work for large U.S. companies are generating export markets; they work as entrepreneurs, or for foreign companies, or for small businesses which cannot afford the additional costs required to keep the U.S. citizens in the same net after-tax position as his compatriote back home, since he must pay higher bracket taxes on the additional income, which in turn, requires additional pay, with an overall spiraling effect.

Indirect taxes

A further inequity in the present tax treatment of U.S. taxpayers working abroad stems from the heavy reliance of many foreign countries on indirect taxes, such as value added taxes and very high customs duties, the primary source of tax revenues.

Illustratively, France and Italy generate some 33 percent of total tax revenues from indirect taxes on goods and services while the figure for the United States is 18 percent.

These taxes are neither creditable nor deductible for U.S. income tax purposes. It is particularly unfair that Americans living abroad and paying their full share of taxes in the host country are subject to a substantial double taxation because that country has chosen a tax system which differs from the U.S. system. The impact is substantial, far exceeding the sales taxes which we are used to in the U.S. To illustrate: a family of four with $30,000 gross annual income will pay about $2,500 per year in indirect taxes in France. That same family in New York City would pay about $500 per year in sales taxes.

The most logical way to achieve equity would be to permit a credit for foreign value-added and other indirect taxes.

The GAO report and the Library of Congress study

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The Library of Congress Study, on the contrary, seems to hold that generally taxation and trade are not necessarily connected and that Americans will remain in their overseas positions regardless of how much they are taxed.

We refute the conclusions of the Library of Congress Study on this so-called "tax neutrality". Furthermore, in our view, common sense would seem to conclude that American firms will not hire Americans when the tax load becomes a multiple of the salary paid to the employee. Accordingly, sole proprietors of American businesses abroad cannot remain in business if their annual tax bill increases in geometrical progression. As a result, it would seem that, as the number of Americans abroad diminishes, the amount of U.S. tax revenues will likewise decline. Without Americans abroad selling American products, sales will decline and the whole problem of taxing Americans working abroad will disappear: economic isolation would seem to be the end product.

Conclusions and recommendations

Our Chambers firmly believe that it is in the national interest of the United States—to our balance of payments and to the maintenance of full employment in the U.S. export industries—that U.S. taxpayers be encouraged to live abroad. Under the present law, they are penalized.

We therefore advocate that qualifying tests of residence and physical presence contained in section 911 should be retained, and that the rest of the section should be repealed and replaced by provisions which would provide for the following treatment of U.S. taxpayers, including U.S. resident aliens working overseas:

A. The following amounts would be deducted from gross income:

1. An annual exclusion of $25,000 appropriately indexed to provide for inflation.

2. *Housing expenses.*—The total cost of housing (including maintenance, utilities, furniture and fixtures and any other expenses relating to the providing of housing) which is reasonable in the existing environment less 16⅔% of the base salary (determined in relation to normal working week) of an employee, earned income of self-employed individual or the taxable income of a retired individual. The 16⅔% reduction shall be reduced by the amount of any shelter deduction withheld by the employer from the employee. An employee or a self-employed or retired individual who owns his home shall be allowed a deduction equal to the average housing deduction for individuals in the same foreign area for the prior year as determined by the Treasury Department through regulations.

3. *Education expenses.*—The actual cost of education through secondary school for the taxpayer's dependents and, in those situations where adequate schools are not available locally, board and room and periodic transportation between the foreign residence of the dependent and the educational institution in which the dependent is enrolled, plus travel costs for dependents attending college in the United States.

4. *Cost of living allowance.*—An amount relating to the increased cost of living actually incurred by the taxpayer (excluding housing and educational expenses) in the foreign area of employment, not to exceed an amount determined annually by the Treasury Department through regulations.

5. *The actual cost for transportation, including meals and lodging on route.*—

(a) For the taxpayer and members of the taxpayer's family between the taxpayer's foreign residence and United States location not to exceed one trip a year per person;

(b) For the taxpayer and members of the taxpayer's family from the overseas assignment in a "hardship" post to a cosmopolitan area, other than the United States;

(c) To obtain emergency medical care not otherwise readily available;

(d) For emergency evacuation from a location at which there is imminent danger to life, and

(e) In the event of serious illness, injury or death of an immediate family member.

6. *Moving expenses.*—Actual moving expenses and temporary living expenses for a period not to exceed 90 days and storage expenses necessarily incurred incident to establishing the taxpayer and dependents at the foreign place of employment.

7. *Indirect foreign taxes.*—Foreign value added taxes and similar indirect foreign taxes based on individual country tables developed by the Treasury Department, or on actual amounts paid.

B. All foreign income taxes paid on the above amounts should be allowed as a foreign tax credit under section 904.

C. Taxpayers should be permitted to claim a standard deduction when electing to take foreign tax credits.

Taxation of Americans abroad raises complex issues, many of which we believe were not adequately considered at the time of the adoption of the 1976 amendments to section 911. We are heartened to find an increasing awareness of these issues in the Administration and in Congress. We are confident that once the issues are fully understood, American taxpayers abroad will receive equitable tax treatment from their government, that employment in the United States will be increased, and that our balance of payments position will be strengthened.

Thank you very much.

Statement of the Associated General Contractors of America

Mr. Chairman, distinguished members of the Senate Finance Committee, the Associated General Contractors of America is the leading construction trade association in the United States, with over 8,200 general contractor members, who account for approximately 70% of all domestic construction put in place and nearly half of all work performed abroad by U.S. firms. We would like to take this opportunity to bring to the attention of this committee some matters of grave importance to the international construction industry.

Mr. Chairman, the taxation of foreign source income, Section 911, has, in the last two years, undergone considerable transformation. The changes implemented by the Tax Reform Act of 1976, coupled with recent tax court decisions supporting the taxation of company-paid allowances such as housing, education and cost of living, have had the effect of increasing the tax burdens of a substantial population of construction personnel abroad to intolerable levels.

The construction industry is labor intensive, and production costs on many projects are based, to a large extent, on the input labor, its cost effectiveness and efficiency. Under present law, it is not unusual for construction personnel working in Saudi Arabia, Iran or other high cost developing economies to incur tax liabilities approaching or in excess of base salary. Firms attempting to reimburse such employees for these increased tax costs soon find this to be a highly uncompetitive practice in markets where taxation on foreign source income is the exception, rather than the rule.

We recognize and applaud the efforts of this committee in seeking to legislate an appropriate and equitable solution to the 911 dilemma. In response to these efforts, we respectfully contribute our criticisms of a recent Congressional Research Service entitled "The Taxation of Americans Working in Other Countries—An Economic Analysis." The Study, commissioned by Senator Ted Kennedy, establishes and proceeds under a set of provocative theoretical assumptions and in result, creates an unreal situation primed for the application of unrealistic policy solutions. It is our thinking that such unfounded and unworldly analysis perpetuates the uncertainty and confusion which has characterized the 911 debate.

The tax policy assumptions upon which this analysis is based speak to a system of taxation lacking in priority—a system which neither discourages nor promotes sectorial activity within the economy—a system which is blinded to the particular necessities of deserving individuals by impractical visions of hybrid tax equity. When confronted with inconsistent elements, the analysis proceeds unfettered by merely reinterpreting the unsupportable.

The initial and most devastating failing of this study is the positioning of the "Tax Neutrality Concept" in close proximity to the principles of tax equity and national economic policy objectives. This close and consistent association, coupled with a creative interpretation of the U.S. tax code, results in a rather deceptive set of conclusions.

Objective reading requires the segregation of the terms of neutrality and equity, no matter how persuasive the suggested resemblance. In the creation of this unholy-alliance, the analysis rather abruptly establishes the similarities and the shared objectives of these widely diverse concepts.

Early on in the introduction, the reader is informed that:

"There are two aspects of tax equity which are usually considered: horizontal equity, or the equal treatment of those in equal circumstances (generally defined as those with equal incomes), and vertical equity, which is concerned with how the tax burden is distributed across income classes. In general, the points regarding tax neutrality also pertain to the consideration of tax equity."

And there you have it—the basis for a lengthy Congressional Research Service Study, prepared at the taxpayers expense, which furthers an illogical and impractical system of taxation. The excerpt above ignores, sidesteps and covers up basic and primary elements of tax equity, which not only differ from neutrality, but negate any perceived similarities.

The above excerpt suggests that ability to pay taxes is the underlying principle of both tax equity and neutrality, and there is consistent denial in the analysis that the present tax code contains any concessional treatment for cost of living differentials among taxpayers. The Study furthers that in the interest of neutrality any concessional tax treatment afforded workers abroad who may encounter increased costs of living must be based on an impractical neutrality equation. When applying the suggested equation to the actual cases of construction workers abroad, a tax liability results which in some cases approaches salary. Such punitive tax policy serves neither the principals of tax equity nor neutrality.

These rather presumptuous conclusions fail to elaborate on any of the various deductions granted taxpayers, or their status as valid considerations of realistic tax policy. These deductions are geared toward lessening the increased cost of living associated with residence in a particular locale, size and compositions of the family unit or occupational category, without regard to income. The study suggests that tax concessions for increased costs of housing are unprecedented in the tax code. However, the tax credit on interest for home mortgages is a recognition on the part of the government that the price of housing in certain parts of the country can be more costly, i.e., New York, Savannah/urban, rural. By granting an interest tax credit for home mortgages, the government supports the costs of housing on a progressive basis and does so without regard to income or ability to pay.

It should at this point be noted that many construction employees working abroad are not afforded this deduction, due to their inability to live abroad and

maintain a U.S. domicile or purchase a home in their country of residence, due to excessive costs of suitable housing in many developing nations. Deductions for dependents recognize the higher cost of living borne by large families, extended dependent status for college students, support the costs associated with educational expenditures. Deductions for automobile use necessitated by employment support the increased costs associated with certain occupational categories.

The Congress, in establishing tax policy, has consistently looked beyond the ability to pay and has established an equality of circumstances via the granting of individualized deductions. The resulting tax policy creates an horizontal tax equity concept based on individual and demonstrated need. The concept of equity furthered in the CRS Study would assess taxes based solely on ability to pay regardless of the costs with the particular condition in order to eliminate illusionary discriminatory effects.

In order to qualify for a deduction under the CRS neutrality analysis, needs would have to exceed the extreme case. For example, the analysis suggests that, if construction workers living abroad are to be granted a housing deduction for the excessive costs of housing in a particular locale, the deduction should cover only those costs which exceed the most expensive housing locale in the U.S., i.e., Anchorage, rather than the average price index of housing throughout the U.S. The Study furthers this form of housing deduction as neutral and equitable, stating that if an average U.S. housing cost index were employed in the overseas deduction formula, the people of Anchorage would be discriminated against. Such interpretation ignores the basic principles of equity raised previously. Bona fide residents of Anchorage and construction workers temporarily employed in the developing nations of the world occupy very distinct and differing positions with respect to horizontal equity. The principles of equity are not served by attempts to condition the tax treatment of overseas construction workers by the tax treatment of a dissimilar entity.

As a prospective Anchorage resident considers the opportunities afforded by the area, a primary consideration in any decision to relocate is the availability of suitable housing. Based on his salary expectations, the taxpayer enters the housing market and seeks affordable housing. It should, at this point, be established that in the U.S., housing costs are principally a function of income and rarely, to any significant degree, reflect non-economic pricing considerations, such as those confronting overseas workers, i.e., cultural or nationality biases.

If the prospective Anchorage resident is frustrated in his attempts to obtain affordable housing, his income potential is, to a major extent, to blame. A mortgage tax credit remains available to him in the Code, nonetheless. In such cases, it is not uncommon for new arrivals to a particular locale, with lower incomes, to settle for more affordable housing, perhaps some distance from town or in a less desirable section, and major disparities between income and housing costs in the city of Anchorage are likely to reflect temporary shortages of housing in the local market, and in the long run are to be alleviated by either a lessening in demand for housing, accompanied by a reduction in housing costs, or upward pressure on wages, accompanied by an increased demand for housing. On the other hand, a construction employee considering an assignment overseas, is offered a salary which, in few cases, cases, reflects the price of housing in the country of project location.

The chronic scarcity and undersupply of housing in many developing nations far exceeds any demand solutions afforded by the income levels of construction workers temporarily employed in the local economy. On the contrary, such a foreign national presence oftentimes accentuates the problem and existing or newly constructed housing is offered at blackmarket prices, far exceeding the local resident's, or the U.S. construction worker's, ability to pay. The companies employing construction personnel, therefore, grant housing allowances which are then passed on to the ultimate purchaser of the finished construction, in the form of increased operating costs.

It should be noted that, while this comparable U.S. housing is oftentimes substandard and lacking in the barest of comforts, its monthly rental price may well exceed the salary of its occupant. A recent investigation of the housing market in Tehran, Iran, reveals that, while no suitable housing could be purchased at any realistic price, three 2-year leases on unfurnished apartments were obtained for the following monthly rental figures: $3,561, $2,633, $2,701. When contrasting these rents with an average monthly salary of $2,100 for construction employees, the unique and deserving condition of these taxpayers is obvious.

If the construction employee is required to adjust his income for tax purposes to reflect the full local market value of such housing, the resulting liability is con-

fiscatory. Further, such tax practices are not equitable or neutral, because nonrecognition in the Code of the unique condition of the overseas construction employee denies to him the benefits made available in the Code to all taxpayers resident in the U.S., including Anchorage. In short, the present law punitively discourages employment in this sector.

While the CRS Study does acknowledge that certain preferential tax treatment may be justifiable if a greater economic benefit is achieved in the process, the study denies that any such benefits are to be gained in the special tax treatment of overseas workers. The Study dismisses any direct relationship between the competitiveness of the U.S. labor in the international markets and exports, and determines that if one existed, no policy of tax subsidies to improve an overseas worker's competitiveness would maintain its cost effectiveness, because any improvements in exports achieved via tax subsidies to workers would be eventually erased by the appreciation of the dollar, causing higher prices for U.S. goods and services in global markets, followed by a fall in exports.

Therefore, the Study concludes that a policy of tax assistance for overseas workers is not, in the long run, an efficient method of increasing exports. This absurd application of the flexible exchange rate as the long-term solution to our trade imbalances ignores several significant empirical obstacles, namely trade barriers, money market intervention, gentlemen's agreements and rising protectionist sentiments. Consider it further in the harsh light of 22 consecutive monthly trade deficits for the U.S., coupled with the inability of the dollar to adjust low enough to reverse the trend, and the entire assumption is groundless, because in the real world freely floating exchange rates do not exist.

However, there is hard evidence which reveals that increased 911 taxation costs are not to be borne solely by a few companies working abroad and their employees. U.S. corporations operating abroad wishing to employ Americans must conduct tax equalization programs to attract qualified personnel for foreign assignments. These compensation programs attempt to offset the increased tax burden imposed by the present Section 911 and the tax court decisions, leaving the employee with an after-tax income no less than one afforded by a comparable salary earned in the U.S. It should be noted that while most construction firms operating in these competitive markets offer employee allowances for housing, education and travel costs, only U.S. firms wishing to employ Americans are required to compensate employees for income taxes assessed on these allowances.

The costs associated with such tax reimbursement programs are not borne solely by the contractor. Such programs increase operating expenses, reducing profits and at the same time corporate tax liabilities. U.S. corporations pay a 48% marginal rate of tax, and therefore, approximately one half of the increased costs imposed by tax compensation programs will be shouldered by the U.S. Treasury and all U.S. taxpayers. It is doubtful that a tax neutralist would deem such revenue-raising measures as equitable, neutral or an efficient allocation of resources.

As previously stated, the CRS neutrality analysis portrays as doubtful any connection between the competitiveness of U.S. labor in the international markets and exports. However, the experience of the construction industry constitutes a direct contradiction to these assumptions. International contractors do not sell patented processes, franchises or trademarks, they do sell services and are able to do so only to the extent that they remain competitive. These services are rendered by qualified labor and if these services can be offered at a price responsive to the prevailing competitive factors of the market, an eventual project award to a qualified U.S. contractor is assured. Such awards result in the direct expenditure of between 40 percent and 60 percent of total contract volume in the United States. This contract procurement includes the purchase of sophisticated capital equipment such as hydro-turbine generators for an electrification project, or primary construction material required for the performance of the work. A recent $50 million water line project in the United Arab Emirates resulted in the following U.S. procurement:

	Amount	Percent
Expatriate payrolls and travel expenses to job	$1,000,000	2
Parts, tools, and supplies	300,000	1
Equipment (Koehring, Cat, Grove cranes, GM, and miscellaneous)	2,500,000	5
Materials (mostly American Cast Iron Pipe Co., but many small suppliers too)	25,000,000	50
Total	28,800,000	58

These exports are credited to the U.S. merchandise trade account and the contractor receives little credit for his role in directing the trade. Such exports are, however, a direct function of a project award to a U.S. contractor and therefore to a major extent dependent upon the competitiveness of U.S. labor in the international marketplace.

The tax policy furthered in studies such as this regrettably avoids consideration of the effects such policies will have on not only the construction industry but all exporting industries sensitive to the competitive forces of the international markets. By applying such unrealistic and antiquated economic theories to disprove or criticize legislative proposals attempting to restore or improve our competitive standing abroad, the CRS Study contributes nothing to an issue deserving constructive input.

We are again hopeful that the opinions and comments expressed herein will assist this committee in its continuing efforts to legislate a realistic and equitable solution to the 911 problem. Staff members of our legislative and international divisions remain available for further discussions of the criticisms presented above.

STATEMENT OF ROBERT M. GANTS, VICE PRESIDENT, NATIONAL CONSTRUCTORS ASSOCIATION AND DIRECTOR, U.S. AND OVERSEAS EMPLOYEES TAX FAIRNESS COMMITTEE

FACTS OR THEORIES: THE 911 TAX ISSUE

Mr. Chairman and members of the committee, I am Robert M. Gants, Vice President of the National Constructors Association and Director of the U.S. & Overseas Employees Tax Fairness Committee. I'm submitting this statement on behalf of the nation's engineering and construction industry involved in overseas work.

The subject is the problems created by recent changes in the tax treatment of incomes earned by American at work overseas—notably improvident changes in Section 911 of the Tax Code.

For all practical purposes, our government is imposing huge tariffs on the export of certain goods and services that originate in our own country. That's the effect of recent changes in the tax treatment of individual incomes earned by Americans at work overseas.

It's a bizarre situation. It's killing our industry—the engineering and construction industry—in the overseas markets. It's pricing us out of competition. It's helping the industrial nations with which we must compete increase their share of the international market at our expense.

No other nation places what amounts to a tariff on its own goods and services. We're unique. Predictably, a tariff of this sort—one that works against the continued growth of American business into new markets and denies us old ones overseas—produces substantial losses in American jobs both at home and abroad. Surely that kind of tariff runs counter to every rational principle of tax equity.

To put it bluntly, it defies common sense.

We're aware, of course, of the economic theories that suggest that special tax considerations are not needed in order to assure that American industry remain competitive overseas. The most notable recent example of that kind of theory is the thesis advanced in the study completed by the Congressional Research Service for Senator Kennedy.

The thesis of that study is that tax policies are somehow neutral and have no bearing on our current balance of trade and payments deficits. No special tax considerations are warranted, it is argued, to encourage the export of U. S. goods and services.

That, in a nutshell, is the theory.

The facts, however, don't support the theory.

We've just completed a survey among our members in the engineering and construction industry involved in overseas work. We have new factual data on our industry's overseas contract losses due to the current tax treatment of individual incomes overseas.

The losses run into the billions of dollars. More than half of those dollars would normally flow directly to our domestic economy. Instead, they're flowing to the economies of the other industrial nations. They're generating new jobs in Japan, Germany, Italy and the rest of the industrial nations. They're not generating jobs here at home.

The losses of those billions of dollars—and the jobs that go with them—are not theoretical. They're fact. They're the kinds of losses that have helped produce U.S. trade deficits for twenty consecutive months and that will produce a record $60 billion deficit in our nation's trade account for 1977 and 1978 combined.

Now, when we're faced with those kinds of facts, I think it's very difficult to make the case that a tax law that functions very much like a tariff imposed by our own government on the export of certain of our own goods and services can be justified in the national interest.

Let's deal with facts, not theories.

And let's start with the most fundamental of all the facts that bear on our problems overseas: If we're forced by our own government to add substantial costs that no other competing nation imposes—all other things being equal—our bid costs are going to be substantially higher. It's a matter of simple mathematics. If our costs are higher than all of our competitors we're not cost-competitive. I know of no theory of economics that can dispute that simple equation.

As one of our member firms with long experience overseas puts it: "Our companies are losing contracts overseas because they're being forced to add 30 percent or more to their bids in order to absorb the added taxes imposed on the earnings of their American employees overseas."

Fact: American firms—especially engineering and construction firms which must maintain relatively large staffs overseas in order to perform on their contracts—cost more than the firms of competing nations.

Fact: When price is the deciding factor—as is commonly the case—American companies lose.

I can't speak to the question of how great the U.S. losses in overseas business have been throughout all sectors of our domestic economy because of the current improvident tax policies applied to Americans at work overseas. But I can show you that if the experience in other sectors of our economy is anything like the experience in our own industry—the engineering and construction industry—we're talking about a national disaster.

One of our companies reported that it had lost contract bids with total face value of $4.157 billion over the past twelve months due principally to recent changes in U.S. tax policies and the added personnel costs that have resulted. Another lost $4.076 billion. Another lost $1.4 billion. Still another lost 25 contracts with a total value of $1.3 billion.

Consider the impacts of the smallest of the losses I've just cited—the firm that lost $1.3 billion in contracts: The losses cost 598 potential U.S. engineering and supervisory jobs overseas. The losses cost easily three times that many jobs for engineering support at home. The losses cost $367,594,000 worth of goods that were to have been purchased in the U.S. for the projects—or easily 13,000 jobs in the domestic economy by the most conservative estimate.

I've given just four examples of actual losses. We have more. I've shown the impcts of just one example. I can cite more.

The cases I've just cited are typical of the kinds of losses being experienced by as many as 50 of our larger engineering and construction firms with overseas involvement. We don't have data for all of the somewhat smaller engineering and construction firms—perhaps 50 to 75 of them—that have been bidding on overseas work. Their losses are likely to be proportionate.

Neither have we data on the 75 to 100 architectural, engineering and planning firms that are known to have been bidding on overseas work and losing. I won't venture any estimates. I'll stick to the facts we know. They're sufficient—or should be. They certainly identify a devastating trend.

Consider the experience of one of our member firms. H. Jack Leonard, Executive Vice President of Edwards and Kelcey, Inc., reports that his firm:

Has been forced to discontinue its operations in Brazil—which had been going since 1970—because the firm's entire American staff had been forced to return home due to the intolerable tax costs imposed upon them.

Lost another major contract in Syria valued at $120 million—of which more than $50 million was earmarked for the purchase of U.S. goods and services—again because personnel costs were judged to be too high.

Had to fill American vacancies on a large job in Paraguay with third country nationals in order to complete the two years remaining on the contract—which started in 1970—at the rates originally stipulated.

The added tax costs imposed on Americans were the reason. The firm's Board of Directors is now actively considering phasing out its international operations as current obligations are fulfilled.

Not all American firms are able to fulfill their contract obligations to the original terms—due to the added tax costs. W. E. Leonhard, President and Chief Executive Officer of The Ralph M. Parsons Company, notes that many firms have been "denied the opportunity to bid on new work because of their inability to meet contractual requirements on existing work." He notes that, on seven existing contracts dating back to 1973 in Iran, Saudi Arabia, and Algeria, his firm is in difficulty:

"These contracts specify that we provide U.S. field staffs totalling 1,100 at this time. In spite of the current level of unemployment in our industry and in spite of the heaviest recruiting effort in our company's history, we are able to fill only 710 positions, leaving a deficiency of 390. One hundred percent of the cause of this shortfall is the real or threatened tax consequences of Section 911."

In spite of the problems imposed by the added tax costs in Americans, The Ralph M. Parsons Company was able to win a large contract recently with Saudi Arabia. But the award is conditional. Leonhard notes:

"This work was awarded to our firm on the assumption that Section 911 will be corrected, thereby enabling us to send 500 to 700 U.S. citizens needed to man the project in Saudi Arabia and abroad for some years to come. The continuation of this contract with Parsons by the Saudis and the related participation by other American firms are absolutely dependent on correction of the punitive features of Section 911."

A number of our member firms are in a similar situation. Because they had no chance whatever of winning substantial overseas bids under the new tax ground rules, they've made bids under the pre-1976 formulas in anticipation that the Congress will take remedial action to correct a tax law mistake. In some cases, the overseas clients have tentatively accepted the bids pending resolution of the overseas tax problem by the U.S. Congress.

As one of the firms that responded to our survey put it, "The problem is that our company has been and still is counting on the postponement of Section 911 and so are our employees. So we have been continuing business on a usual basis."

Not all U.S. firms are prepared to take that kind of chance. But, in order to remain in the overseas market, some have attempted another strategy: They're replacing American national with third country nationals on their projects.

Procon Incorporated, for example, reports that, "We have had to change from U.S. to U.K. or French supervision on projects valued at approximately $500 million in Northern Iraq and another $100 million in Iran."

Berger Engineering reports that 40 percent of its employees before the passage of the 1976 Tax Act were Americans. They've cut that to 17 percent and are continuing to de-Americanize their overseas projects to the extent that their current contracts will permit it.

Others report similar experiences. I'll quote some of them verbatim:

"Percentage of U.S. employees (supervisory) working overseas: October 1976 was 94 percent reduced to 79 percent by April 1978."

"This is to advise that we currently have 3 key positions on a highway construction management project in Kuwait which we have been unable to fill with Americans because of the potential tax liabilities. Over the past several months we have filled 6 key positions with Englishmen and Europeans because of our inability to recruit American staff."

"If our company believed Congress would not realize basic unfairness of Section 911 and provide remedial legislation, we would not have entered into contracts valued at approximately $8 million and would have decreased U.S. staff by about 50 jobs."

"911 requirements remain in the picture as overseas assignment of personnel is restricted due to high costs. Forced to use English, Irish nationals, etc."

"Our manpower commitments are increasingly being met by supplying personnel from our affiliates in U.K., Italy, France, and Spain. In a major contract in Saudi Arabia, 95 percent of the 300 expatriate supervisors, including those at top level, are supplied by our U.K. affiliate. This work force mix has obvious ramifications as far as purchasing policies are concerned."

A Pearce Godley o. Raymond International, Inc., puts it this way: "To continue operating overseas, American contractors are forced to replace U.S. citizens with foreign nationals. Every day of delay in correcting 911 reduces the employment opportunities for U.S. citizens."

T. A. Howell, President of Procon International, Inc., "Americans will not go overseas unless they have a retained income potential equal to that they received under old 911 provisions."

Now, from time to time, the Treasury Department releases figures estimating the tax costs of Section 911 or of any proposed legislation bearing on the tax treatment of Americans at work overseas. The data—as the Treasury Department, itself, is prudently careful to point out—are based on one underlying theory: The theory is that shifts in tax policies will not result in changes in taxpayer behavior.

Quite clearly. As I have shown, drastic changes in the overseas employment of Americans are occurring as a result of changing tax policies.

The theory, clearly, isn't valid.

Any estimates of tax costs based on such a theory are meaningless—utterly useless—and, worse, terribly misleading.

I don't think, at this point, that any reasonable person can accept them or—no matter how official they may be—cite them in good conscience.

Fact: Recent tax changes are producing major reductions in the employment of Americans overseas.

Fact: Reductions in the numbers of Americans at work overseas means fewer Americans overseas to pay taxes.

Fact: Fewer American taxpayers overseas means a smaller tax base overseas.

If current trends continue over the next eighteen months, conservatively more than half of the positions now occupied by Americans overseas will be occupied by non-Americans. Likely, seventy five percent or more of the potential new positions that would normally be staffed by Americans will go to non-Americans. That's assuming that by staffing our projects overseas with non-Americans we'll be able at least, to slow the rate of decline in our share of the overseas engineering and construction market—a rather, optimistic assumption.

Fact: You can't tax people who aren't there.

Fact: Non-Americans don't pay U.S. taxes.

Fact: You don't have an actual tax cost if you don't have an actual tax source.

You simply have an empty theory.

Worse, what is presented as a theoretical tax cost is, in fact, a substantial tax gain.

Fact: Americans at work overseas create new markets for U.S. goods and services and generate new jobs for our domestic economy.

Fact: If Americans are not overseas generating new jobs, then they're back home absorbing existing jobs at a time when there aren't enough jobs in the domestic economy to go around. They're swelling the welfare rolls—and therefore, tax costs—not the tax rolls.

Fact: You can't employ people in jobs that don't exist or tax salaries—or corporate earnings—that aren't made.

I won't attempt to assign an actual dollar figure to the tax gain that has been produced annually because of earlier tax policies that have encouraged American overseas commerce, or the tax costs of current tax trends that work as a disincentive.

Possibly, that is a task that might be directed to the Treasury Department. It should be far more instructive and useful to know actual tax gains rather than theoretical tax losses.

Now, I've pointed out that many U.S. firms, in order to save what they can of their overseas markets, have been replacing Americans with non-Americans.

That is not— over the long run—a satisfactory solution, nor will it cut our losses substantially, it's really a "quick fix"—an effort to cut our losses and preserve our markets overseas until remedial action is taken on the tax front.

T. A. Howell of Procon points out that: "The disadvantage of offering European alternate personnel is that they do not perform utilizing the American management principles, and overall job efficiency suffers."

One of our members observes, "When we sell American engineering and construction services overseas, what the client expects—and has every right to expect—is American know-how and technology. That means American staffing overseas, not non-American. When a client contracts with an American firm only to discover that what he's getting is an American corporate name and a non-American technical staffing, our credibility is blown away. It's not worth it."

For that reason, at least one of the firms we surveyed noted that, "Effective January 1978 our company curtailed international promotion efforts a great deal."

That is an increasingly typical decision among American engineering and construction firms overseas. As another of the firms we surveyed noted, "On numer-

ous occasions we have refused to quote on projects that have a substantial number of foreign bidders because we felt that we would be unable to compete."

We have no way of estimating the losses in potential new business that can be attributed to decisions not to bid. While we know why the decisions are being made—because of the problem of the tax burden and the resulting higher personnel costs—we cannot gauge the magnitude of additional business that might have resulted had the companies (1) chosen to bid and (2) been price-competitive. It could be very substantial.

The fact is that many of our firms are now refusing to bid on projects they'd have bid on, without hesitation, before the current tax problems made bidding an evercise in certain failure.

In a growing number of cases, of course, the opportunity to bid is being denied U.S. firms by overseas clients, themselves. Some of that, as I mentioned before, is due to the failure of a number of U.S. firms to keep within budgets on current projects—owing to the added tax costs. But a great deal of it is also due to the growing reputation of U.S. firms for excessive personnel costs due to the current tax mess—and the refusal of potential overseas clients to pay what is seen, increasingly, as a tax tribute to the U.S.

There's an even more subtle source of loss. We can't measure it readily, But, based on aur industry's years of experience overseas, we know it's substantial.

Consider: A great deal of the early engineering work that's currently being put out for bid in the developing nations is for engineering feasibility studies and preliminary engineering design on potentially huge projects. I'm referring to preliminary work for whole new cities, regional infrastructure designs, major harbors and airports and the like.

The initial fees for preliminary engineering work are fairly modest. The contract value is relatively small. But successful completion typically leads to follow-on contracts for complete engineering development and construction. The contract value then becomes substantial. Typically, we're talking about projects with contract values from $500 million to several billions of dollars.

Well, if you don't get the initial contract, your prospects of getting the follow-on work are greatly diminished.

When I presented some examples of contract losses earlier, the figures included a number of projects of this sort—feasibility and engineering studies leading to huge projects in later years. To cite just one example, one of the firms that responded to our survey reported that it lost a contract with $5 million in fees to develop a Master and Engineering Infrastructure Plan for a new capital city for Nigeria.

How do you measure the loss that's actually involved in a case like that?

A loss that can be measured more readily is the replacement market on manufactured goods. If U.S. manufactured goods aren't specified on overseas projects because U.S. engineers and buyers aren't overseas to specify them, the replacement parts market will be diminished greatly in coming years. We're currently seeking data from our larger suppliers to more fully quantify the value of the replacement parts market based on experience on our earlier overseas projects.

I think it's clear that the facts I've presented point to very disturbing trends. It should be noted, again, that they're the products of (1) recent changes in interpretations of the tax codes bearing on the tax treatment of certain allowances to off-set extraordinary living costs overseas and (2) anticipation of the 1976 revisions in Section 911 should they come into full force.

The result has been that our industry, which was performing about 15 percent of all overseas engineering and construction work before 1976, is now performing about 10 percent.

That's not theory. That's fact.

If remedial action is not taken by the Congress to correct the current tax situation, the downward trend can only continue.

We obviously cannot present, today, hard data on the full impacts of current tax policies for the years immediately ahead. We can show what's already happening. But we cannot show, in hard facts, what's not yet happened.

We hope that the Congress will see, based on current data, that nothing is to be gained—and a great deal is to be lost—by waiting to see the full impacts of current tax policies before action is taken.

By then, it will be too late.

It's a great deal more difficult to get back into a market that's been lost than it is to remain in the markets and to continue to grow with them.

If we don't have contracts and sales because we don't have the markets, we can't offer jobs. That means greater unemployment.

There's nothing theoretical about unemployment.

There's nothing theoretical about the fact that if you have no income you pay no income taxes. There's nothing theoretical about the fact that if you receive welfare payments you're being supported by tax dollars.

We can't meet payrolls with theories.

If we must deal with theories, let's deal with theories that explain the facts, not with ones that attempt to explain them away—or don't consider them at all, as was the case with the Congressional Research Service's thesis prepared for Senator Kennedy.

The hard fact is that we have the highest unemployment rate of any industrial nation in the world. The hard fact is that we still have more than six million Americans on welfare rolls rather than on payrolls. The hard fact is that our own industry in the domestic economy has one of the highest rates of unemployment in the nation.

We know where the market is to help address that problem. It's overseas.

For those who advance the doubtful theory that any special tax consideration to encourage far greater U.S. participation in the global markets in order to create more jobs at home is not justified and costs too much in tax revenues, we suggest that a great deal more thought be given to the tax costs—not to mention the human costs—of six million unemployed Americans.

To those who argue for tax purity and vague notions of tax neutrality, we suggest a more global view.

What's neutral about a tax law that penalizes Americans at work overseas to the benefit of the people of all of the competing industrial nations who are not taxed on their overseas earnings at all?

Let's not enact tax policies based on theories that produce facts we can't live with.

MACHINERY AND ALLIED PRODUCTS INSTITUTE,
Washington, D.C., May 10, 1978.

Hon. RUSSELL B. LONG,
Chairman, Senate Committee on Finance, 2227 Dirksen Senate Office Building, Washington, D.C.

DEAR CHAIRMAN LONG: On May 8, the Senate Finance Committee conducted a one-day hearing on taxation of Americans working abroad. On February 23, 1978 the Machinery and Allied Products Institute (MAPI) submitted its views on this subject during public hearings conducted by the House Ways and Means Committee. The pertinent provisions of the Internal Revenue Code are contained in section 911 which was amended drastically by the Tax Reform Act of 1976. The tightening provisions of the Tax Reform Act, however, have not been in effect because the applicability of those provisions has been deferred by congressional action.

MAPI wishes to present to the Committee for inclusion in the record of the May 8 hearing a summary of its views and recommendations. We will not burden the Committee and its record by treating the issues in detail as we did before the House Committee on Ways and Means. The thrust of our position, however, should be restated. Such a reiteration is the purpose of this communication which begins with a brief introduction, a statement of the problem, and a summary of our recommendations.

Preliminarily we wish to state that we are in general agreement with the testimony of George P. Shultz, President of Bechtel Corporation, who spoke for that corporation and, in addition, for the Fluor Corporation, Pullman-Kellogg, and Dresser Industries. Mr. Shultz pointed out that his statement has also been endorsed by the Tax Fairness Committee and the National Constructors Association.

We also concur with the general thrust of the statement of Richard M. Hammer, a partner in Price Waterhouse & Co. In addition, the testimony presented at the hearing on May 8 by Elmer B. Staats, Comptroller General of the United States, which is based on a recent report of the Comptroller General to the Congress entitled "Impact on Trade of Changes in Taxation of U.S. Citizens Employed Overseas," is also consistent with the MAPI position.

On the other hand, although we have not had an opportunity to study in detail the pertinent report of the Congressional Research Service dated April 20, 1978, a quick review of this document reveals a clear bias, fundamental error both as to concepts and details, and a lack of understanding of the "real world" regarding international competitiveness of American industry. Prior to the issu-

ance of this study, there was almost unprecedented agreement between the views of the Administration, the Congress, business, and interested professions. This agreement in principle, with some differences as to detail, was reflected in the House hearings, the position of the Administration including testimony by Treasury officials, and the action by the Senate Finance Committee in reporting favorably H.R. 9251, the proposed Tax Treatment Extension Act of 1978 (Report No. 95–746).

With particular reference to the Congressional Research Service study, we wish to express a general concern about the operations of the Congressional Research Service. We state this concern in the form of a question: Does the Congressional Research Service perform objective and independent research or does it primarily serve as an organization which documents on request the predetermined views of a member or certain members of Congress?

INTRODUCTION

As the national organization of capital goods and allied equipment manufacturers, MAPI has a direct interest in the May 8 hearing and its subject matter. Most of the Institute's member companies do very substantial amounts of business abroad through exports from the United States and manufacturing conducted in other countries. For many of these enterprises, it is either necessary or highly desirable to have certain of their employees provide service for extended periods of time at foreign locations. Because individuals cannot be expected to serve abroad under conditions of economic harm to themselves and their immediate families, employers customarily provide special allowances for the added costs incurred in foreign service to maintain something approaching the higher standard of living normally experienced in the United States. The size of these allowances is governed in part by how the U.S. employee serving abroad is taxed under the U.S. federal income tax, and recent changes in the law, if implemented, would impose an unacceptable burden.

THE PROBLEM

Our position in brief is that the changes made to Code section 911 by the Tax Reform Act of 1976 were, in major part, ill-advised, and should not be allowed to become effective. The uncertainty caused by these changes in the law already has cost jobs for Americans, and more such employment will be sacrificed to foreign nationals if the 1976 "reforms" are implemented. For companies which do not find foreign nationals to be a practical alternative to U.S. employees abroad, the burden of continuing the latter at greatly increased cost would cause such firms to become less competitive, sacrificing employment not only for U.S. citizens in foreign service but also for U.S. citizens stateside producing goods for export.

The myopia of the 1976 tax law amendments is perhaps best seen in the fact that Congress chose to act as it did even though other major industrial nations impose no taxes at all on their citizens working abroad. Indeed, even as Congress now seeks to resolve the section 911 dilemma, it has before it other proposed tax revisions which would create a similar problem by repealing Domestic International Sales Corporation (DISC) and imposing current taxation on unremitted earnings of controlled foreign corporations.

Our recommendation, in brief

Before restating our central recommendations, it seems appropriate to point to testimony before the House Ways and Means Committee by the Treasury Department's Acting Assistant Secretary (Tax Policy), Donald C. Lubick, that if the changes in section 911 were allowed to become effective, they would more than double the tax liability of Americans claiming section 911 in 1977, with the increase intensifying as income levels exceed $15,000.

In our opinion, Congress should promptly extend the current moratorium on the 1976 Act changes through calendar year 1978. Regarding substantive amendment to section 911, we feel that the $20,000 and $25,000 general exclusions of section 911 are appropriate, but should be adjusted upward to reflect inflation since the early 1960s. The public record of this Committee, and of the Ways and Means Committee, will show that we have espoused this view whenever section 911 has come under review, and that we cautioned both tax-writing committees in advance of the 1976 Act changes—regrettably to no avail—about the adverse consequences of new restrictions in this area. The virtue of a general exclusion

lies partly in its simplicity. As to the excluded amounts, they were originally set at levels which were intended to discourage U.S. tax avoidance by wealthy taxpayers while providing tax relief to the great number of foreign service employees who obviously have no tax avoidance motives. We think the exclusion should be reestablished at adjusted levels, without the 1976 Act's structural changes.

If the Congress still does not accept the wisdom of a general exclusion which will help retain jobs for U.S. workers at home and abroad, then we recommend as a second-best approach that the Congress enact more specific provisions to allow tax relief for extraordinary costs associated with foreign service. We have in mind deductions for employer-paid or reimbursed cost-of-living, housing, separate maintenance, education (including related travel), home leave, hardship post, tax equalization, and other appropriate allowances, in reasonable amounts. As the Committee knows, government employees in foreign service have many allowances excluded from their income. The objective of Congress should be to treat all persons in foreign service fairly and, to the extent feasible, similarly. Other changes which are in order for private-sector U.S. employees abroad would liberalize the moving expense deductions; allow more time for a foreign-service employee who sells his principal residence to reinvest in a new one without incurring taxable gain on the sale; make clear that such an employee may exclude from his income the value of meals or lodging furnished to him, his spouse, and dependents for the convenience of the employer at foreign camp-like facilities, whether or not on the business premises; and relieve the employer of any obligation to withhold taxes on any amounts expected to be deducted or excluded.

Still another option would be to couple a limited general exclusion from income with special deductions for various foreign-service allowances, giving the taxpayer an annual election between one or the other. However, we are not concerned here about the precise form of relief eventually to be provided. Rather, we simply wish to convey to the Committee the urgency of Congress' further suspending the 1976 Act changes and then resolving the 911 matter expeditiously and on a basis that will not cause Americans to become noncompetitive in foreign service. H.R. 9251 as reported by the Senate Finance Committee meets this objective, although there may be some difference of opinion as to details.

We wish to commend you and the Senate Finance Committee for conducting the May 8 hearing on this important subject. The hearing was especially timely and useful because of the release of the Congressional Research Service study to which we have referred and which was analyzed and criticized by competent and experienced witnesses appearing before the Committee.

Respectfully.

W. STEWART, *President.*

THE LIBRARY OF CONGRESS,
CONGRESSIONAL RESEARCH SERVICE,
Washington, D.C., May 12, 1978.

Hon. RUSSELL LONG,
Chairman, Committee on Finance, U.S. Senate,
Washington, D.C.

DEAR SENATOR LONG: This is to convey my deep concern, as Director of the Congressional Research Service, over certain extemporaneous statements made by Robert Best, an unscheduled witness at recent hearings held by the Senate Committee on Finance on the tax treatment of United States citizens employed overseas. In our judgment, Mr. Best's disparaging remarks, which were directed both to CRS generally and to one of our staff members who had previously testified before the Committee, are wholly unjustified and unsubstantiated.

Mr. Best seriously impugns the objectivity of CRS by distorting the contents of recent reports prepared by the Service on several issues. While Mr. Best is certainly entitled to his own opinions as to the objectivity of our analyses, his exaggerated and over-simplified characterizations of our work are not in accordance with the facts and do not advance the cause of responsible discussion and debate. Had Mr. Best been more attentive to the CRS testimony at the hearing, particularly the colloquy with Senator Packwood, and had he been more familiar with the actual content of the studies he referred to, he might have realized how inaccurate and misleading his representations were.

Mr. Best also calls into question the capacity of a valued CRS staff member to treat major policy issues without bias. Mr. Best bases this allegation on work which the CRS analyst performed while serving as a staff aide to a United

States Senator. It is neither logical nor fair to imply that, because this individual competently prepared materials for legislation sponsored by his employer, he necessarily shared his employer's views on the subject. It is even more fallacious to suggest that he can not now comply with the standards of impartiality required in his present position. So far as CRS is concerned, this analyst has carried out his assignments in the best tradition of the Service, demonstrating both outstanding professional competence and the ability to deal with controversial topics in a balanced, nonadvocative manner.

As a general rule, we are more than willing to let the record of the Service speak for itself. Since the case at hand involves an individual CRS researcher, who has had no opportunity to respond to Mr. Best's testimony, I respectfully request that this letter be entered into the hearing record.

Sincerely,

GILBERT GUDE,
Director.

STATEMENT OF THE NATIONAL SOCIETY OF PROFESSIONAL ENGINEERS

The National Society of Professional Engineers appreciates the opportunity to present its views on the income tax treatment of American ciitzens employed in foreign countries. NSPE, a nonprofit organization headquartered in Washington, D.C., represents nearly 76,000 members engaged at home and abroad in nearly all disciplines of the engineering profession.

NSPE is particularly concerned with this tax issue because of its significance not only to the engineering profession but to all American enterprise, foreign and domestic. The resolution of this tax issue, we believe, will profoundly affect not only income taxes but also the strength of the American dollar in world currency markets, our balance of trade, and even our international standing and security.

The engineering and construction industry is probably the largest single employer of American citizens abroad. In recent years, approximately 25 percent of all engineering and construction work by America's 400 largest firms has been performed overseas, and that work translates into more business and jobs domestically. Depending on the method used to calculate this multiplying effect, some estimates put the number of jobs generated in the United States by overseas contracts at 400,000; others estimate this figure may be as high as 800,000. But regardless of how the figure is calculated, it does realistically represent a very positive contribution to our balance of trade. It additionally strengthens the competitiveness of American products and services, and it helps to maintain our technological superiority at home and abroad.

But due to the 1976 revisions in the tax treatment of Americans employed abroad, the American engineering and construction industry has been placed at a distinct competitive disadvantage with other nations. This disadvantage is reflected in the $28 billion deficit in the 1977 U.S. balance of payments, and in the distressing fact that America's share of the international engineering and construction market is declining steadily. In 1975 and 1976, before the 1976 income tax revisions, American industry was earning an average of $18.5 billion per year in foreign engineering and construction work. In 1977, the amount of that work declined to about $11.5 billion. In 1975, America had more than 15 percent of the world-wide engineering and construction market. We are now down to, at best estimate, 11 percent of the market. In 1975, America ranked first among the competing nations in engineering and construction work abroad. In 1977, the U.S. ranked fourth.

The current income tax situation has made it very difficult—in some cases, impossible—to compete in the international market place. In order to pay the higher costs of American workers, competitive firms must pass on this increase in a contract bid. Many firms have already found it necessary to replace their American employees with foreign workers. This situation has had and will continue to have a significant impact on U.S. exports. American employees with the discretion to determine which materials and supplies will be used in their foreign operations, are more likely to seek American products. In 1975, these materials and supplies amounted to $4 billion in exports.

NSPE believes that this situation must be changed. We urge the Committee to take whatever action is necessary to restore the tax treatment of income for Americans employed abroad at least to the level prior to the Tax Reform Act of 1976. Prior to that Act, Section 911 of the Internal Revenue Code provided that

U.S. citizens who were residents of foreign countries for at least one full calendar year, or were physically present in foreign countries for 17 of 18 consecutive months could exclude from their Federal income tax the first $20,000, and in some cases the first $25,000 of income received for services performed overseas.

Additionally, the untaxable status of non-salary amenities should be restored. These items include:

Housing, where western-style accommodations are priced out of reach or are completely unavailable. The housing provided is rarely luxurious and the alternative is frequently substandard.

Schooling, for children living abroad with their working parents, where no U.S.-type educational system is available. The schools or tuition paid to boarding schools are not luxuries, but rather replacements for public school systems which would be provided were those same employees working in the U.S.

The costs of periodic rest and rehabilitation trips back to the United States. These R&R trips are not luxuries but necessities for our employed citizens to maintain their health and sense of national identification.

And, the costs incurred in the relocation of a family to and from an assignment site.

Restoring the basic intent of the pre-1976 revision tax laws will not result in a loss of tax revenue for the United States, but in an increase in total tax revenue caused by increased employment stimulated internationally and domestically.

Because of the importance of this issue, we urge the Committee to take immediate action on the tax treatment of Americans employed abroad. All U.S. taxpayers must be able to plan their tax affairs properly; yet even now, Americans employed overseas are unsure as to which tax rules will be used to compute their income tax liabilities. Under presently enacted law, the 1976 Tax Reform Act applies to 1977 earned income; yet, H.R. 9251, as already approved by the House, provides for an extension through 1977 of the pre-1976 tax regulations. The Senate Finance Committee version of H.R. 9251 provides for a two year extension, through 1978, of these same regulations. NSPE feels that it is essential that clear guidelines be given as soon as possible to the many thousands of Americans employed abroad, in order that they may plan their financial affairs with the same certainty that domestically-employed Americans have.

Unless this issue is resolved, and soon, we must face a balance of trade deficit as a matter of policy, lower our sights for economic growth, and retreat from our traditional international role of economic and technological superiority. NSPE urges the Committee to take the decisive action necessary to see that these frightening possibilities do not come about and that reason and equity are restored to the income tax treatment of Americans employed abroad.

Statement of the Air Transport Association of America

The Air Transport Association, which represents virtually all of the scheduled airlines of the United States, requests that this statement be included in the Committee hearing record regarding the taxation of income earned abroad by citizens in private industry. The airline industry is pleased that this Committee is reviewing the changes in the taxation of individuals working abroad as embodied in the Tax Reform Act of 1976. While the avowed purpose of this legislation was tax reform, the result has been the creation of a tax inequity which penalizes Americans working overseas.

By virtue of our international carriers having routes to other nations, they must employ individuals in foreign locations. These individuals, who service the needs of our passengers and cargo and who promote travel to the United States on U.S. airlines, can be either U.S. nationals or foreign nationals. This is not a question of exporting jobs, but rather a question of employing people.

In addition to these standard roles, several airlines have management contracts to assist in the operation of a foreign airline. These positions have traditionally been filled by dedicated Americans willing to live abroad. The U.S. airline manufacturers have been exceedingly aided by U.S. nationals in the maintenance and purchasing functions of these airlines. The commitment to U.S. standards of quality help insure the safety of U.S. nationals being transported via foreign carriers.

As the Task Force on Foreign Source Income states, the earned income exclusion results in a U.S. income tax savings. This fact is not being disputed. In 1972 there were 102,000 individuals living abroad who claimed the earned income exclusion. The total income excluded was only $1.4 billion, for an average of approximately $14,000 per return. The revenue loss to the Treasury is estimated at approximately $60 million since, without the exclusion, foreign taxes paid would be allowable as a credit against U.S. income tax.

While these statistics are interesting and reveal the almost inconsequential revenue impact of the income exclusion, the pertinent question is, why has there been an exclusion for foreign source income? Section 911 of the Tax Code was enacted into law over 50 years ago to encourage foreign commerce by citizens of the United States. This Section was designed simply as an incentive to get Americans to forego the benefits of their native soil for the hardships of living in a foreign land.

The current circumstances surrounding a foreign resident have not changed dramatically over the years. For several reasons it would be difficult without tax incentives to recruit U.S. nationals to work and live abroad. The first and most obvious reason is the substantial differences in costs of living. As the Task Force on Foreign Source Income points out, an apartment in the Middle East may rent for as much as $20,000–$30,000 per year—certainly an amount somewhat greater than the cost of renting an apartment in the United States. The Task Force goes on to note:

"Reimbursement of this excessive cost by an employers would be taxable income for which the employee would be liable for additional income tax. Neither the reimbursement of the excessive housing cost nor the reimbursement (if any) for the additional income tax would appear to be taxable compensation in the normal way that this term is understood."

In addition, individuals working abroad must purchase services normally provided by state or local government agencies in this country. One important example, as noted by the Task Force, is schooling costs. In this country the cost of public education is borne by the state, but in a foreign land private schooling is often the only alternative.

It must also be realized that many foreign nations raise substantial amounts of revenue through a value added tax or a sales tax. Individuals living abroad are discriminated against because they are unable to deduct these foreign taxes while residents of the United States can deduct state or local income, sales and property taxes. It is clearly evident that if the United States desires its nationals to further the export of goods and services by living and working abroad, tax incentives will have to be provided.

The real impact of the 1976 tax revision is to increase the cost of employing U.S. nationals abroad. This has two adverse side effects. Either the U.S. enterprise replaces the U.S. nationals abroad with native personnel which takes hard-working people off payrolls; or the enterprise maintains the U.S. nationals which increases the cost and price of U.S. produced goods and services. As the increased costs are reflected in the international market by higher prices, demand for U.S. goods will diminish with the resultant effect of a reduced level of employment at home.

To put international sphere in its proper perspective, we must realize that, based upon Department of Commerce figures, 40,000 jobs are created for every $1 billion of exports. Some have even estimated the range as high as 70,000 jobs. If only 10 percent of our nation's economic activity ($80 billion) is dependent upon exports, then we are talking about 3.2 million jobs in the domestic economy and approximately $5 billion in federal income tax revenue on corporate profits.

In view of our current economic circumstances, a relatively high rate of unemployment and a $27 billion balance of trade deficit, can we run the risk of reducing our exports and removing people from payrolls, placing them on welfare rolls? The airline commuity does not feel such risks are warranted merely to tinker with the tax system in order to recapture $60 million.

Therefore, we recommend that the earned income exclusion be retained and, in addition, deductions should be provided for reasonable housing, education, travel and moving expenses to offset the burdens of residing away from home.

Thank you for this opportunity to provide a statement for the record. We hope our comments will be of assistance in your deliberations.

AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS,
Washington, D.C., May 10, 1978.

Hon. RUSSELL B. LONG,
Chairman, Senate Committee on Finance, U.S. Senate, Washington, D.C.

DEAR SENATOR LONG: On behalf of the 135,000 members of the American Institute of Certified Public Accountants, I would like to submit the following information for the Committee's consideration and for insertion into the record.

I testified at the hearings of the Ways and Means Committee of the House of Representatives on February 23, 1978 on behalf of the American Institute of Certified Public Accountants Federal Tax Division concerning modification of the tax treatment of American individuals working abroad. (A copy of the statement included in the record of the Ways and Means Committee Hearings is attached.)

Rather than repeat the comments made to the Ways and Means Committee, or modify them for developments since those hearings, our purpose here is to urge two vital steps in regard to the taxation of Americans working abroad.

(1) The prompt enactment of the provision delaying until 1979 the effective date of the changes made by the 1976 Tax Reform Act relating to Americans working abroad, and

(2 Following this step, continuation of the careful review by Congress of this matter with a view to enacting legislation which will provde a long term solution to the tax treatment of Americans working abroad. This legislation should be separate and apart from the delay provision.

The support of Congress and the Treasury Department for the additional delay in the effective date of the changes made by the 1976 Tax Reform Act relating to Americans working abroad has already been announced. Of major importance is the timing of enactment of this delay provision. With the June 15 due date for 1977 U.S. income tax returns of Americans working abroad rapidly approaching, the delay provision needs virtually immediate enactment. It is already very late in the tax return filing season for expatriate personnel. The IRS, the taxpayers involved and their tax advisors are now faced with a probable repeat of the difficult administrative problems that were encountered last year. These problems should not be compounded further. The filing of amended returns or delayed filing of tax returns should be avoided to enhance the orderly process of our self assessment system and to reduce the heavy work load of the Internal Revenue Service and tax practitioners.

The enactment of this delay provision should *not* be tied to a specific legislative change such as Senate Bill 2115 which has been added to H.R. 9251 as reported out by your Committee. As previously indicated, a great deal of time is needed to develop viable and equitable legislation for taxing Americans working abroad. The goal should be to enact such legislation as soon as possible.

The Federal Tax Division of the American Institute of Certified Public Accountants stands ready to provide assistance to the Senate Finance Committee in its consideration of appropriate legislation in this area.

Sincerely,

SAMUEL M. FROHLICH,
Federal Tax Division.

Enclosure.

STATEMENT OF THE AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS, FEDERAL TAX DIVISION

The need for legislation to deal with the presently unsettled and unsettling tax treatment of United States individuals working abroad i., clear.

As the first step, a further two year delay of the effective date of the Section 911 related changes made by the Tax Reform Act of 1976 (1976 TRA 911 changes) is needed. This will allow time for comprehensive study of the provisions of Senate Bill 2115 introduced by Senator Ribicoff, Senate Bill 2529 introduced recently by Senator Bartlett and the Treasury's proposal, and consideration of statements being made at these hearings. It will also provide an opportunity to consider the results of various studies conducted on this subject, including the one performed by the United States General Accounting Office.

The one-year delay of the effective date of the 1976 TRA 911 changes from 1976 until 1977 was enacted into law by the Tax Reduction and Simplification Act of 1977 in May of 1977. This was less than one month before the due date of the 1976 U.S. returns of most U.S. individuals working abroad. As a result,

significant problems were, and are still being encountered by the Internal Revenue Service, the individual taxpayers affected, their employers and tax return preparers

The House Bill H.R. 9251, passed last year, contained a provision delaying until 1978 the effective date of the 1976 TRA 911 changes. The Senate Committee on Finance reported out on February 3, 1978, a bill delaying until 1979 the effective date of the changes, and the Administration, through Secretary Blumenthal, has indicated its approval of such a provision. The intention to enact a delay provision into law is clear. The timing of enactment is also important. We strongly urge that action on this effective date delay provision be taken at the earliest possible time with a view towards avoiding a repeat of the difficult administrative problems that were encouraged last year. The filing of amended returns, refund claims or delayed filing of tax returns should be avoided if at all possible in order to enhance the orderly process of our self assessment system and not add to the already heavy work load of the Internal Revenue Service.

We suggest that the delay provision not be tied to a specific legislative change such as Senate Bill 2115. Rather, the further two-year delay of the effective date of the Section 911 related changes made by the Tax Reform Act of 1976 should be used to study the approaches covered in Senate Bill 2115 and Senate Bill 2529 and to carefully analyze the various studies that have taken place on this subject with a view to the development of a meaningful permanent solution to this matter.

We are providing below, specific comments on Senate Bill 2115. These comments are designed to provide input to the Ways and Means Committee on the type of issues that need to be dealt with in this very complicated area. We feel that Senate Bill 2115 is a good starting point for studying these issues but that there is considerably more study needed to properly handle this situation.

We have not had sufficient opportunity to review Senate Bill 2529 so are not providing comments at this time. However from a quick review of material published on this proposal it appears to deal effectively with some of the issues raised below in our comments on Senate Bill 2115. It is an important step forward in giving recognition to the key problem areas facing U.S. individuals working outside the United States.

COMMENTS ON SENATE BILL 2115

The provisions contained in Senate Bill 2115 (hereafter referred to as "the Bill"), are designed to develop a comprehensive system of taxing United States individuals working abroad. The Federal Tax Division of the American Institute of Certified Public Accountants, as well as numerous other groups, have previously recommended an approach somewhat similar to that taken in the Bill, and it is interesting to note that the focus on allowances would not be new in this area since Section 912 in dealing with government employees provides for an exemption for foreign areas, cost-of-living and Peace Corps allowances. The "excess cost deduction approach" seems to place individuals working abroad more on a par with those who are working in the United States, which we feel should be the objective of any legislation in this area. However, more study and work is required.

GENERAL RULES

Items allowed as deductions

There is no question that the sum of an individual's expenditures with regard to excess cost of living, housing, and education represent a major portion of the cost of maintaining employment (or one's own business) outside the United States. However, there are a number of other expenditures made by such individuals, often reimbursed by their employers, which would not be made at all by their U.S. counterparts. These reimbursements do not represent economic benefits to the employee, but rather are designed to cover costs which the employee would not incur were he to remain in the United States.

For example, home leave costs, as well as temporary living costs in connection with moving one's residence, are items which should be considered in the proposals. In addition, a key expenditure is the excess of U.S. and foreign taxes over the U.S. taxes the individual would have paid had he remained in the U.S. Such excess taxes are often reimbursed to employees by their employers, the purpose of such "tax equalization" or "protection" payments being to make the employees whole with respect to their U.S. counterparts. Because this tax reimbursement is itself subject to U.S. tax there is a "pyramiding" effect of a tax on a tax.

The vast majority of United States individuals working abroad do not intend to become permanent residents of foreign countries. As part of their compensation package these individuals are often entitled to "home leave" for themselves and their families each year. The employers reimburse the individuals for the cost of transportation for the employee and his family to and from their foreign location. This amount would not be expended if the individual were working in the United States. It follows that a deduction should be provided for such amounts.

Further, a major element in establishing an overseas employment is the moving expense incurred. The existing moving expense provisions are usually adequate in their coverage of a solely domestic move. They are, however, usually inadequate with respect to an overseas move primarily in the area of temporary living expenses. It is common for more than the statutory 30 days to go by before an individual can obtain an overseas residence. Also, it often takes two to three months for an individual's furniture to be shipped from the United States to the foreign location. Legislation should take this problem into account by amending Code Section 217 to provide an extended period for temporary living costs as well as an increased ceiling in the deductible dollar amount. Further there should be allowed as a deduction the reasonable cost of moving and storing household goods and personal effects during the foreign assignment.

Cost-of-living expense amount

The Bill permits a deduction for cost of living expense in an amount equal to the lesser of the following amounts:

(1) The amount paid to an individual by his employer for the increased cost of living in the foreign location; or

(2) The amount set forth in tables to be prescribed by the Secretary of the Treasury.

For a number of reasons, the limitation as to the employer-provided amount seems unnecessary and in some cases inequitable. First, an individual will incur the increased costs of living in the foreign location regardless of whether he receives an allowance therefor. Where an individual does not receive a cost of living allowance from his employer or receives less than the Treasury prescribed amount, a limitation of the deduction to the employer-provided amount would defeat one of the purposes of the Bill which is to permit a deduction for the increased cost of living overseas. In addition, if the Bill is enacted with this provision intact, employers will in many cases either award their employees a cost of living allowance equal to the table amount, or reclassify a portion of their salary as a cost of living allowance thus negating the employer-provided amount limitation. A deletion of the employer-provided amount limitation would simplify this provision.

The Bill directs the Secretary of the Treasury to develop tables setting forth the typical cost of living expense amount for an American family in various foreign locations. These tables will be provided for families of various sizes and will be based upon the salary of an employee of the United States who is compensated at a rate equal to the annual rate paid for step 1 of grade GS-12.

It is suggested that the tables be prepared for varying salary ranges as well as for various family sizes and foreign locations in order to deal equitably and realistically with the varying levels of income of many United States individuals working abroad and that there be a provision that such tables be updated annually.

Education expense amount

The Bill permits a deduction for education expense in an amount equal to the least of the following amounts:

(1) The amount paid to an individual by his employer for educational expenses;

(2) The amount expended by the individual for such expenses; or

(3) The amount set forth in tables to be prescribed by the Secretary of the Treasury.

The limitation as to an employer-provided education expense amount seems unnecessary and in some cases inequitable and should be deleted. The reasons for recommending this deletion are similar to those for recommending deletion of the employer-provided cost of living amount limitation. Further, if the deduction were limited to amounts "reasonably" expended, the limitation of point (3) above would be unnecessary.

The Bill as originally introduced appeared to require that the children of a United States individual working abroad attend a school in the foreign place

where such individual resides as a condition of such individual being entitled to a deduction for education expense. According to the statement by the Senate Finance Committee on Actions Taken on February 3, 1978, where there is no local U.S. type school the deduction would also cover room and board in addition to tuition, etc. The deduction for education expense should be further expanded to allow, as a deduction, the cost of transportation to and from the location where the children attend school where there is no local U.S. type school at the foreign location.

Housing expense amount

The Bill permits a housing expense deduction in an amount by which the lesser of (1) the amount paid to an individual by his employer as compensation for the reasonable cost of housing, or (2) the amount which an individual reasonably expended for such housing, exceeds an amount representing typical U.S. housing costs. Here again, as in the case of cost of living and education expenses, we recommend the deletion of the employer-provided housing expense limitation.

"Typical United States housing costs" is deemed to be equal to 20 percent of the individual's "earned income" for the taxable year, after such "earned income" is reduced by the deductions allowed for cost of living and education as well as the amount of housing reimbursement received by the individual. The objective of the provision should be to limit the housing expense amount to that which exceeds a percentage of the individual's base-salary which he would have received had he been in the U.S. including such items as regular bonuses. However, by defining the limitation in terms of "earned income" this objective will not be reached, because there are several other items of "earned income" peculiar to U.S. individuals working abroad which may be significant in amount and will therefore distort the amount to which the 20 percent factor is applied. (Examples of such other items are tax equalization payments, home leave allowances, and moving expense reimbursements.) As a result, the definition of "earned income" for this purpose would unrealistically reduce the allowable housing expense deduction. We therefore suggest that the 20 percent limitation be applied to an individual's "base salary"—a term which should then be defined in the Bill.

Further, in view of the fact that a highly paid individual may spend less than 20 percent of his salary on housing, consideration should be given to providing for a sliding scale with respect to the housing expense limitation.

Interplay with section 119

The Bill provides that an individual who is entitled to an exclusion under Section 119 (value of meals and lodging funished by the employer) may not claim any of the Section 221 deductions for cost of living expense, education expense and housing expense. In order for an employee to avail himself of the benefits of the Section 221 deductions he is required to elect out of Section 119.

Even though an individual is entitled to exclude the value of housing furnished by h's employer under Section 119 he will still incur increased cost of living and education expenses and thus should continue to be entitled to the deduction for such expenses and other expenses that may be included in the Bill. The Bill should be modified accordingly.

It must also be roted that Section 119 applies to both the value of lodging and the value of meals provided to the employee. Where the employee is required to elect out of the benefits of Section 119, the value of meals provided to him will be included in his income. This appears to be an unintended result since this portion of the legislation is designed to deal with the housing problem only. A possible solution to this problem would be to segregate the two portions of the Section 119 exclusion and tie in the Section 221 provision only to the housing portion, while continuing the allowance for the meal portion.

Further, Section 119 is not now an elective section. The Internal Revenue Code requires the exclusion of such income where the Section 119 provisions are met. A conforming amendment would have to be introduced to provide for such an election.

Special rules

The Bill provides special rules for determining the deduction for cost of living expense, education expense and housing expense of four special categories of individuals— self-employed individuals, employees of foreign persons, employees of charitable organizations, and employees in camps. These special rules require reference to amounts appearing in tables to be prepared by the Secretary of the

Treasury setting forth the average deduction for each of these three elements on returns filed for the preceding year by individuals subject to the general rules.

In order to avoid dual systems—one for general taxpayers, and the other for the four special categories of individuals—the Bill should provide for the application to all taxpayers of the general rules as advocated above: i.e., deduction related to expenditures (as limited) in the case of education, to the amount reasonably expended for housing in excess of U.S. housing costs, and to the amount per tables, in the case of cost of living. There should also be general application of other deductible expenses that may be included in the Bill.

It should be noted that the Bill's provision for "special average tables" presents several drawbacks.

The amounts in the special average tables will always be less than the amounts in the tables to be used by individuals who are subject to the general rules. This follows because the amounts used in determining the average will be the "lesser" amounts under each of the categories which are actually deducted by the individuals subject to the general rules. Thus those individuals subject to the special rules will be entitled to a lower deduction than those individuals subject to the general rules.

For the first year that the new law is in effect it will be impossible for the tables to be prepared until after the due date of the individual's return. This will lead to uncertainty as to the individual's tax liability and will require the individual to obtain an extension of time to file his return until some date after the tables will be available.

To summarize, we strongly urge that the provision to delay for an additional two years the effective date of the Section 911 related changes of the Tax Reform Act of 1976 be enacted at the earliest possible time. This will provide sufficient time to review this entire area and proposals such as those contained in Senate Bill 2115 and Senate Bill 2529, and to develop a meaningful long range tax structure for U.S. citizens working outside the United States.