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Statement of

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before the

House Committee on Ways and Means

on

Impact on Trade of Changes in Taxation of

U.S. Citizens Employed Overseas

Mr. Chairman and Members of the Committee:

We are pleased to have the opportunity to consider with you the impact on trade of changes in the taxation of U.S. citizens employed overseas.

The United States has taxed the worldwide income of its citizens, with specifically legislated exceptions, since initiating the Federal Income Tax in 1913. It is the only industrialized country in the world to impose an income tax on this basis, since most countries do not tax income earned outside their borders by their nonresident citizens.

Approximately 150,000 (one-seventh of 1 percent) 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. In 1975, the tax incentive, according to an October 1977 Treasury estimate, amounted to $412 million, or 64 percent of the total U.S. tax liability of overseas employees.

In 1976 two things occurred which reduced this incentive.

--The Tax Reform Act of 1976 substantially increased the tax liability of citizens employed abroad.

--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.

These actions increased the estimated tax liability of Americans employed abroad by more than $290 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 tax changes, in the expectation that Congress will consider making further changes to these rules in 1978.

We attempted to determine the probable effects of 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 demonstrated 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.

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

REDUCTION OF TAX INCENTIVE

Impact on individuals

The GAO survey, together with a preliminary 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.

--45 percent of those responding to the survey 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.

--Almost half of the estimated $290 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.

--Taxpayers reporting less than $20,000 income, 53 percent of the total--would have average tax increases of about $120.

--Nearly 75 percent of those surveyed received housing and home leave allowances; approximately 50 percent received cost-of-living and tax equalization allowances and overseas premiums.

--Within the survey 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 $4,700 per return. Americans working in these countries generally receive relatively large taxable allowances for housing, dependent education, and general living costs. They also usually have high gross annual incomes--44 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 nearly equal to their basic cash salaries.

Impact on firms

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 must 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 incountry for a relatively short time and on a contract/project basis.

--Living costs and tax structures of other countries are significant to the impact of the tax changes. 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 were adopting a "wait and see" approach.

--About 65 percent of the companies estimated their increased costs if they reimbursed employees for the tax increases. 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.

Impact on U.S. economy

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, an econometric model was used to estimate 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 data limitations as well as to intangible values accruing from having Americans employed abroad.

In summary, the results of the econometric model showed that the tax increase, assuming that it will be passed along and that its impact will not be offset by appropriate fiscal and monetary policies, might

--cost as much as 4,000 jobs in 1978, increasing to 21,000 jobs in 1981;

--adversely affect the gross national product, in real terms, by up to $200 million in 1978, increasing to $600 million in 1981; and

--adversely affect real exports by $110 million in 1978, increasing to $260 million in 1981.

POLICY ISSUES

In the 1970s, for the first time in this century, the United States was confronted with a deficit trade balance. Simultaneously, foreign investment in the

United States is increasing faster than U.S. investment abroad. These trends, together with the recognition that policy instruments for promoting U.S. exports and commercial competitiveness abroad are limited, underline the importance of identifying and implementing those policies that have the greatest potential for strengthening the U.S. international economic position.

They also focus attention in 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?

We have concluded and are recommending that a system should be established for evaluating and reporting periodically to the Congress the effectiveness of this tax incentive program. This could provide a solid foundation for deciding which of the available instruments for promoting U.S. exports and competitiveness abroad are most effective.

POLICY OPTIONS

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. Options for granting a greater or lesser tax incentive than now exists include adjusting the existing general exclusion, granting special deductions for extraordinary costs, or modifying available tax credits. In our report, we identify a variety of suboptions within each option 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 available for promoting U.S. exports and commercial competitiveness abroad, and uncertainties about the effectiveness of these, we believe serious consideration should be given to 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.

Mr. Chairman, this concludes my prepared statement. We will be glad to respond to questions.