Tax Policy
Issues and Options

URBAN–BROOKINGS TAX POLICY CENTER

No. 8, December 2004

The American Jobs Creation Act of 2004: Creating Jobs for Accountants and Lawyers

Kimberly A. Clausing

The current legislation accomplishes a worthy and necessary step—repealing the ETI provisions—but it does not adequately address either job creation or international competitiveness.

In its last bit of pre-election tax policymaking, Congress passed the American Jobs Creation Act of 2004. The heart of the bill is a repeal of an illegal trade subsidy—the Extraterritorial Income (ETI) exclusion—plus a potpourri of new tax breaks for businesses (box 1).

The bill is designed to be revenue-neutral, but it follows recent practice of using artificial sunset provisions to obfuscate the true cost. Many of the new tax breaks, such as small business expensing and the deduction of state and local sales taxes, are ostensibly temporary. It is hard to imagine, however, that the political pressures that produced those provisions will dissipate over the next few years. If the new tax breaks are extended, one estimate suggests that the bill could add over $80 billion to the deficit over the next 10 years (Friedman 2004).

Repeal of the ETI exclusion is an important and necessary step. However, the tax reductions proposed in the legislation are not the best way to help businesses, even assuming that tax breaks are warranted.

The Extraterritorial Income Exclusion

The original purpose of the American Jobs Creation Act of 2004 was to repeal the export tax incentive, which the World Trade Organization has repeatedly ruled illegal. As retaliation for the export tax incentive, the European Union has levied tariffs on more than 1,600 U.S. products. Tariffs began at 5 percent in March 2004, and have risen 1 percentage point a month since.[1] Repealing the export tax incentive is good tax policy and good trade policy. There is no reason for the tax system to favor export income. Export income is not especially likely to stimulate the economy and does not generate other special benefits. In addition, resolving the ETI issue could benefit future multilateral trade liberalization and resolve a longstanding trading dispute with the European Union, our largest trading partner.[2] Once the repeal is in place, the European Union will remove its tariffs on U.S. products. The U.S. terms of trade will also improve, benefiting the U.S. economy by about $5–6 billion a year.[3]

Further, the U.S. current account deficit is an outcome of the U.S. economy's savings/investment imbalance, not trade measures or tax policy (box 2). Thus, even if exports were considered desirable, the export tax incentive would not effectively improve the trade balance.

New Tax Breaks for Businesses

The American Jobs Creation Act's provisions attempt to offset the tax increases imposed by repealing the ETI export tax incentive with other tax breaks for businesses. The bill provides an income tax deduction for domestic production activities

Box 1. Main Provisions of the American Jobs Creation Act of 2004

ETI repeal	Repeal is phased in over three years. Provides transition relief. Net revenue gain = $49 billion.
U.S. production tax break	Provides a deduction of 9 percent of income generated from domestic production activities; total cost = $77 billion.
Business tax breaks	Provide targeted tax relief provisions; total cost = $7 billion.
International tax changes	Various provisions; total cost = $43 billion.
Revenue raisers	Various provisions; total gain = $82 billion.
Other	Allows taxpayers to temporarily deduct state and local sales taxes. Repeals tobacco support program but provides $10.1 billion subsidy.

Source: Joint Committee on Taxation, "Estimated Budget Effects of the Conference Agreement for H.R. 4520, The 'American Jobs Creation Act of 2004'," JCX-69-04.
Note: All budget numbers are over 10 years.

that is equivalent to a 3 percentage point rate cut. There is little economic justification for giving tax preferences to narrow definitions of activity, as there is no reason to suspect that these activities would be more beneficial to the economy than the excluded activities.

Further, the bill would create compliance and enforcement difficulties, as firms would have incentives to characterize as much income as possible as production income. For instance, firms could be motivated to make those divisions subject to favorable tax treatment more profitable than those that do not receive such treatment. By shifting paper profits among divisions, firms can reduce their overall tax liability. Such efforts will lead to unnecessary accounting and compliance costs for firms and unnecessary enforcement costs for the IRS.

Box 2. The Relationship between Budget Deficits, Saving, and Trade Deficits

Basic national income accounting requires that

$Y = C + I + G + (EX - IM)$,

where Y is GDP, C is consumption, I is investment, G is government consumption, and $EX - IM$ is net exports (exports minus imports).

$C = Y - T - S$ simply states that consumption is equal to GDP minus taxes and saving.

Putting these two equations together, we find another national income identity:

$Y = Y - T - S + I + G + (EX - IM)$

Rearranging, we find that

$(IM - EX) = (G - T) + (I - S)$

Thus, the country's trade deficit is equivalent to the country's government budget deficit $(G - T)$ plus the country's private investment/savings imbalance $(I - S)$.

This is an accounting identity, not a theory, and as such, it holds for all countries at all times. It also implies that measures that increase the government deficit or the private sector's investment/savings imbalance will necessarily worsen the trade deficit. The mechanism behind this link is as follows.

When the government runs a deficit or when private saving falls short of private investment, demand for loanable funds increases relative to supply, and the U.S. interest rate tends to rise. In the world of mobile capital markets, this attracts funds from abroad that appreciate the dollar owing to an increased demand for dollar-based assets. A stronger dollar worsens the trade deficit (as imports increase and exports fall).

This identity also implies that tax or trade policy measures that attempt to affect the trade balance will only be effective as far as they reduce the government budget deficit, increase private saving, or reduce private investment. Therefore, most such measures are unlikely to be effective.

On a more intuitive level, a country that does not save as much as it invests ($S < I$) and/or does not tax as much as it spends ($T < G$), must therefore get the extra goods and services from overseas. Thus, such a country will run a trade deficit. This logic explains why countries that do not save a lot publicly or privately (such as the United States) run trade deficits while more thrifty countries run trade surpluses.

For example, *The New York Times* reported that Starbucks successfully added a provision to the bill that deems coffee roasting, but not coffee preparation, a manufacturing activity.[4] This provision gives Starbucks a tax incentive to increase the bean prices charged to its retail outlets, making the roasting part of the business more profitable and the retail part of the business less profitable. Such efforts could decrease Starbucks's tax bill, but serve no other discernable public policy purpose.

Corporate Income Taxes and International Taxation

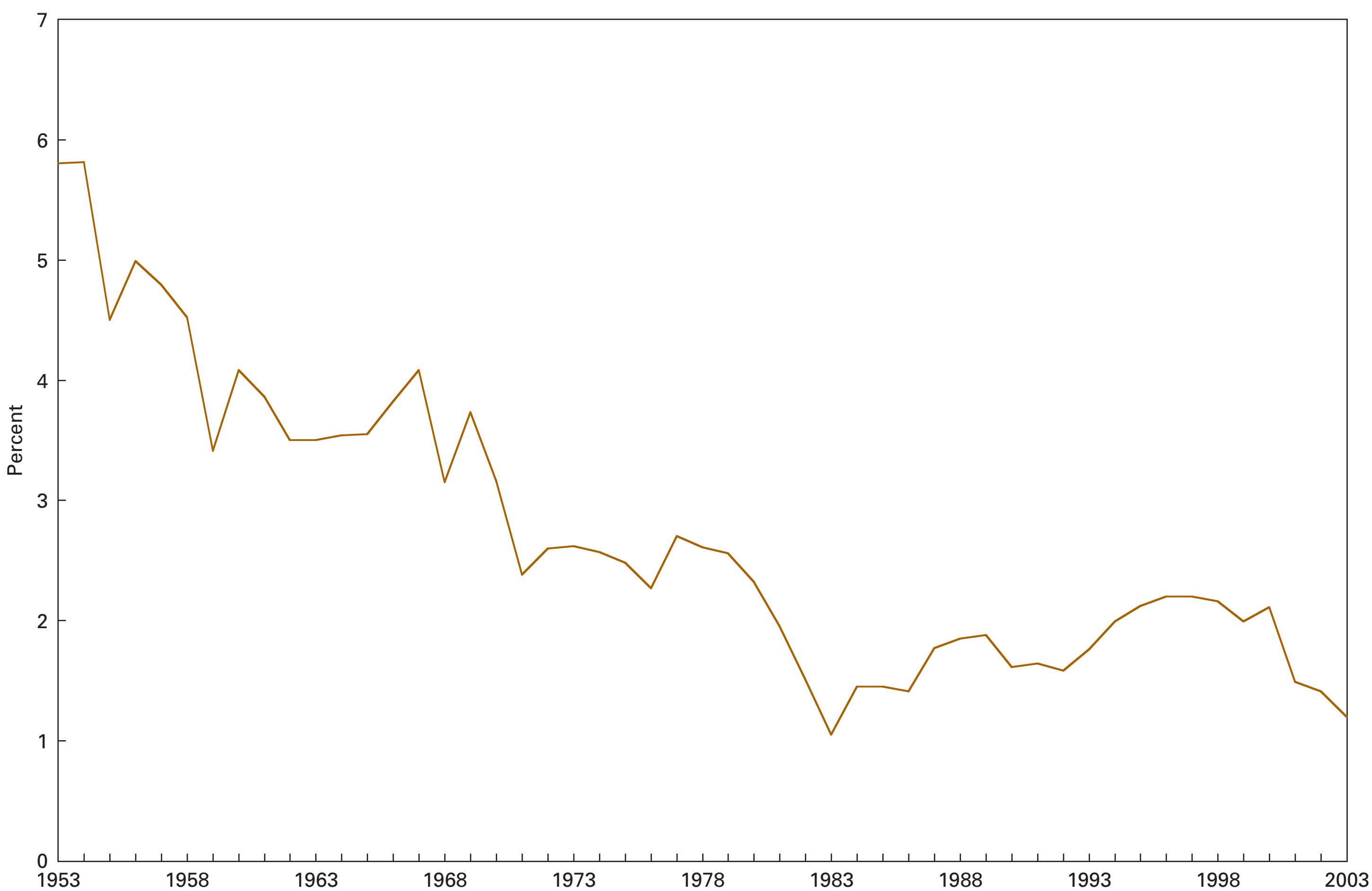
The corporate income tax currently provides 7.4 percent of total federal revenues. Corporate income tax revenues as a share of GDP have declined dramatically over the previous 50 years. After the 1986 Tax Reform Act, corporate tax revenues were expected to increase, and they did, somewhat. In recent years, they have again declined, reaching the previous historic lows of the early 1980s (figure 1).

While corporate revenues tend to decline during economic downturns as business profits falter, tax avoidance has also likely contributed to the recent trend. Increased globalization and foreign direct investment give multinational firms greater opportunities and incentives to avoid taxes. Companies have an incentive to move their operations to low-tax locations abroad. They also have an incentive to shift paper profits to low-tax locations, even if they do not have a large physical presence there. Both actions undermine the U.S. corporate income tax base.

For example, as U.S. corporate profits have decreased, profits abroad, and particularly in low-tax countries, have increased. Economist Martin Sullivan estimates that, between 1999 and 2002, the share of worldwide profits earned in tax-haven jurisdictions increased from 42 percent to 58 percent, a rate far exceeding the share of economic activity occurring in these countries (Sullivan 2004).

In this economic environment, many lawmakers are understandably interested in encouraging domestic economic activity and curbing tax avoidance. The American Jobs Creation Act contains some important provisions in this area. It increases penalties for failure to disclose certain

FIGURE 1. Corporate Income Tax Revenues as a Percentage of GDP, 1953–2003



tax shelters and for promoters of abusive tax shelters (from $1,000 under current law to 50 percent of the gross income derived from the shelter). It also contains some provisions that discourage corporate inversions—that is, when U.S. companies move their putative headquarters to tax havens (even if they move few or none of their actual operations there) to avoid U.S. tax on their worldwide income.

The original provisions in the Senate version of the bill were stronger than the provisions in the Act. The Senate bill would have codified the "economic substance" doctrine to clamp down on tax shelters. Courts developed the "economic substance" doctrine to deny tax benefits associated with transactions that are deemed solely tax-motivated without underlying economic rationale. The Senate bill clarified the circumstances under which this doctrine could be applied. Joint Committee of Taxation estimates indicate that the provisions in the final bill will raise far less revenue than the anti-inversion and tax shelter measures in the original Senate bill.

Many of the other international tax provisions in the bill weaken the integrity of the U.S. corporate income tax. In fact, Republican tax writers admit that they view the bill as taking "baby steps to a territorial system" (Glenn 2004). Under a territorial system, the U.S. government would tax only the domestic income of multinational firms, effectively giving up its claim on the foreign income.

The current tax law already favors foreign income earned in low-tax locations. Foreign income of U.S. multinational firms is taxed only upon repatriation, although credit is given for taxes paid to foreign governments. There is therefore a substantial incentive to generate income in low-tax locations, as income can grow abroad tax free for years before being brought to the United States. This process is called "deferral," as taxation of profits earned abroad is deferred, often indefinitely.[5]

The new bill further weakens U.S. taxation of international income in several ways. It reduces the number of foreign tax credit baskets from nine to two.[6] It allows companies to carry foreign tax credits forward for 10 years instead of the current 5 years. The bill contains an overall domestic loss rule that allows firms to recharacterize some domestic income as foreign in order to claim unused foreign tax credits. Such steps strengthen the already strong incentives of U.S. multinational firms to operate abroad and shift profits to low-tax locations.

In addition, the bill allows a temporary tax holiday for dividend repatriations. Under current law, when a corporation repatriates income from a low-tax country, it must pay the difference between the U.S. tax rate (35 percent) and the foreign tax rate, although in many cases it can use excess foreign tax credits from affiliates based in high-tax countries to offset taxes due. A provision of the new bill temporarily allows repatriated dividends to be taxed at a rate of 5.25 percent, providing a substantial tax advantage to repatriating funds from low-tax countries now rather than later. Some companies have already accumulated substantial profits abroad as a result of the tax-minimizing incentives in current law, discussed above. It is possible that this build-up inspired lawmakers to encourage repatriation through a special tax holiday. It is also possible that firms built up profits abroad *anticipating* such a tax break.[7]

These dividend tax provisions give firms an incentive to repatriate dividends during the temporary holiday period, providing a "sale" on repatriating income from low-tax locations. While such a provision increases revenue temporarily, it would reduce revenue over a longer time frame; firms would have less accumulated income to repatriate at the normal rate. The provision also sends firms a strange message; they have an incentive to leave income abroad in the hope of similar holidays in the future.

The bill's provisions require firms to reinvest repatriated funds in the United States, but in practice such a requirement is unlikely to spur new investments effectively. Firms have substantial flexibility in how they finance new projects. By rearranging their financing sources, they will be able to meet the requirements of the law without changing their underlying investment decisions. In addition, even if a substantial inflow of capital results from the tax break, in the world of mobile capital markets, this inflow would likely just displace other inflows of funds from abroad, leaving total investment and interest rates in the United States unchanged.

Tobacco and Other Special Interest Provisions

In addition to the production tax reductions and the international tax provisions, the bill includes a number of special measures that are irrelevant to the main intent of the legislation. By far the largest unrelated measure is the $10 billion tobacco quota-holders buyout. The measure eliminates tobacco quota and price support programs, compensating current quota-holders with transition payments. According to the Joint Committee on Taxation, these payments would total $10.1 billion over 10 years.

Further, myriad other provisions give tax breaks to narrow interests. Such provisions include a charitable contribution deduction for expenses incurred while whaling, more generous tax treatment of bows and sonar fish-finding devices, and tax reductions for those engaged in producing or marketing distilled spirits, wine, and beer. Defense contractors will regain a valuable tax subsidy (previously reined in by the Tax Reform Act of 1986) that allows them to postpone paying tax for years on multiyear contracts to build ships and submarines for the Navy. The JCT estimates that subsidy alone is worth half a billion dollars.

Better Alternatives

The provision to repeal the ETI exclusion is estimated to generate about $5 billion a year in new tax revenue over the next 10 years. There appears to be a political consensus that this new revenue should be spent on offsetting business tax breaks. However, in today's fiscal environment, one alternative worth considering is deficit reduction.

Still, even assuming that reduced business taxation is desirable, broader tax reductions would be more desirable than the narrow provisions in the legislation. A simple across-the-board reduction in the corporate income tax rate from its current 35 percent rate to 33 percent would provide several advantages over the current legislation. Such a rate reduction could be designed to be revenue-neutral, together with the ETI repeal. It would benefit many firms without altering the nature of their economic decisions. Plus, a rate reduction is simple to implement: it would not add complexity to the current tax system, it would not create incentives to label more income as "production," and it would not discriminate in favor of firms with more successful lobbyists. Further, a broad U.S. corporate tax rate reduction reduces the tax incentives associated with operating in low-tax countries and shifting income there to avoid U.S. taxation.

Conclusion

The current legislation accomplishes a worthy and necessary step; repealing the ETI provisions that have worsened our relationships with key trading partners, led to tariffs on U.S. products, and provided an unjustified tax subsidy on export income. Still, the current legislation falls short of its stated aim. It does not adequately address either job creation or international competitiveness. Instead, it offers several narrow tax breaks that will have little positive effect on the U.S. economy and several negative effects on the U.S. tax system. A broader corporate tax reduction would provide greater stimulus than tax breaks that favor production income. Further, the international tax provisions in the legislation do not enhance the competitiveness of U.S. firms but, rather, work to undermine U.S. taxation of corporate income. In many cases, the provisions increase the complexity of the tax system and generate new loopholes. Finally, the holiday on the repatriation of foreign profits sends a confused message about the intent of the U.S. international tax system, and it perversely provides a greater incentive for firms to avoid repatriating funds from abroad in the future, in the hope of another such holiday.

Notes

1. See European Council regulation no. 2193, 8 December 2003. As of November 2004, the tariffs stood at 13 percent. The European Union announced that it will suspend the tariffs effective January 2005, when the American Jobs Creation Act takes effect.

2. Considering the European Union as a whole, trade with Europe (exports plus imports) totaled $395 billion in 2003, slightly more than trade with Canada, which totaled $394 billion. (From the U.S. International Trade Commission web site, http://dataweb.usitc.gov/.)

3. An export subsidy (or a tax break for export income) worsens a country's terms of trade by lowering the price of its exports on world markets. This occurs for the same reason that a subsidy to a domestic firm making a particular good would be expected to lower the market price of that good. With the subsidy, the firm is more willing to supply the good, so the market equilibrium price of the good falls. This terms of trade effect affects export prices but need not influence the trade balance, which is determined by the savings/investment balance of the country, as explained in the box. For an estimate of the magnitude of this effect, see the Congressional Budget Office, letter to Nickles, dated 24 February 2004, "An Economic Analysis of Alternatives to Tax Reductions in S. 1637."

4. See Edmund Andrews, "Negotiators Approve Big Tax Cuts for Business," *The New York Times*, 7 October 2004.

5. The tax law does limit deferral under certain circumstances, widely known as subpart F for the portion of the tax code containing the limitations. Recent legislation has reined in subpart F in key ways, and the JOBS bill further weakens subpart F.

6. The Tax Reform Act of 1986 increased the number of "baskets"—or categories of foreign income—as a way to limit multinational companies using taxes paid in high-tax jurisdictions to shelter income earned from unrelated activities in low-tax countries or tax havens.

7. See Sullivan (2004) for a similar argument.

References

Friedman, Joel. 2004. "Temporary Tax Provisions in the Corporate Tax Bill Mask Its Long Term Impact on the Deficit." Washington, DC: Center on Budget and Policy Priorities.

Glenn, Heidi. 2004. "House-Passed ETI Bill Sets Stage for Difficult Conference." *Tax Notes*, 21 June, 1439.

Sullivan, Martin. 2004. "Data Show Dramatic Shift of Profits to Tax Havens." *Tax Notes*, 13 September, 1190–1200.

About the Author

Kimberly A. Clausing is an associate professor of economics at Reed College.

THE URBAN INSTITUTE
2100 M Street, NW
Washington, DC 20037

Nonprofit Org.
U.S. Postage
PAID
Permit No. 8098
Ridgely, MD

Address Service Requested

To order additional copies
of this publication, call
202-261-5687
or visit our online bookstore,
http://www.uipress.org.

THE BROOKINGS INSTITUTION
1775 Massachusetts Avenue, NW
Washington, DC 20036
Phone: 202-797-6000
Fax: 202-797-6004
E-mail: info@brookings.edu
http://www.brookings.edu

THE URBAN INSTITUTE
2100 M Street, NW
Washington, DC 20037

Phone: 202-833-7200
Fax: 202-467-5775
E-mail: pubs@ui.urban.org
http://www.urban.org

THE TAX POLICY CENTER

The Tax Policy Center (TPC) aims to clarify and analyze the nation's tax policy choices by providing timely and accessible facts, analyses, and commentary to policymakers, journalists, citizens, and researchers. TPC's nationally recognized experts in tax, budget, and social policy carry out an integrated program of research and communication on four overarching issues: fair, simple, and efficient taxation; long-term implications of tax policy choices; social policy in the tax code; and state tax issues.

A joint venture of the Urban Institute and the Brookings Institution, the TPC receives support from a generous consortium of funders, including the Annie E. Casey Foundation, Charles Stewart Mott Foundation, Cummings Foundation, Ford Foundation, George Gund Foundation, and Lumina Foundation for Education.

http://www.taxpolicycenter.org