TAX POLICY IS TRADE POLICY

"Testimony regarding federal tax reform
and its impact on U.S. trade performance."

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A Free Trade Tradition

For more than four decades, the United States has been the leading proponent of the world's free trade system. This has been especially true of the American electronics industry, which has flourished for the past twenty-five years.

Yet today, more and more Americans are questioning the validity of the free trade philosophy. They look at the growing trade deficit -- a record $123 billion last year and expected to be $160 billion this year -- and the seemingly resultant loss of thousands of manufacturing jobs. The cry of "fair as well as free" trade has become a chorus of voices from many quarters.

What has happened? Has our national prosperity made us complacent and less competitive? Has "Yankee ingenuity" died off? Or is something else going on? Have the rules of the trade game changed, and, if so, how should national policies be improved to reflect those new realities?

The New Reality

America emerged from the Second World War producing more than half of the world's goods. Through programs such as the Marshall Plan, we helped rebuild the economies of our trading partners. At the same time, we established an open and competitive market structure through treaties and multilateral trade agreements. The General Agreement on Tariffs and Trade (GATT) is the symbol of this valiant international effort toward commercial cooperation.

Multinational corporations sprang up, and global production was rationalized by market forces as never before in history. An expanding free trade network seemed to enhance prosperity for all who participated. As testament to this fact, the U.S. contribution to global GNP fell to 25% by 1960, yet our nation itself saw a GNP increase.

This new-found prosperity was particularly manifest in America. With vast natural resources and unmatched industrial might, we developed the world's first "consumer" society. The standard of living rose dramatically, and we could afford to import nearly as much as we produced.

America's last positive trade balance was recorded in 1975 and deficits have accelerated ever since.

The U.S. tax code encouraged this drift from a saving to a spending society. Mortgage and loan interest are tax deductible, while interest on savings and investments is taxable. A clear preference favoring real estate over securities investments was established and persists to this day.

Public debt was allowed to rise along with private borrowing. The federal government has not balanced its budget since 1970, and today we face deficits in excess of $200 billion as far as the eye can see.

While America evolved from a saving to a consumption society, the seeds of future trade friction were being sown. Witnessing the great benefits of U.S. industrial expansion, developed and developing countries alike began to fashion national strategies to accelerate their own commercial growth. It became popular to "target" key industries and to protect those industries with import barriers. The Japanese semiconductor industry, for example, was officially protected until 1975.

Domestic content requirements proliferated, as did limitations on ownership of direct investments. To this day, Mexico generally requires 51% local ownership of its industry, and Brazil and others require certain industries to produce locally in order to sell locally. The list of tariff and non-tariff barriers is long, indeed.

Watershed

America's industrial machine can no longer withstand the twin shocks of deficits at home and unfair trading practices abroad. It has been estimated that each manufacturing job carries along five other jobs: the banker and baker, the inn keeper and insurance agent, and the like. Who will be the customers for these workers if the basic wealth-creating jobs in manufacturing are lost? While we may survive in servicing manufacturing activities abroad for a while, the infrastructure supporting overseas manufacturing will surely move overseas as well. Our reentry into manufacturing will be much more difficult, depending on lower wages (an unmentionable) as we try to compete on the world market.

American consumerism is one of the major forces limiting our ability to act in our own self-interest. We like to have cheap cars, TV sets and VCRs. But what does it really cost us? Those inexpensive imports cost us a great deal more than the price tag on the item in the store. Each million dollars per year worth of goods imported rather than produced locally cost ten jobs in manufacturing. That costs the loss of another fifty jobs in service and support industries. So long as those workers are unemployed, their cost to the American public - to other workers through unemployment benefits, or to the taxpayer through assistance programs - is around $7,000 per year. Thus the initial million dollars of imports cost Americans another $420,000 of hidden costs so long as we are not at full employment.

If the consumer had to pay the full cost at the time of purchase rather than in his taxes (payroll or other), would he buy that Japanese auto?

Perhaps we are at a watershed period in economic history. The time for fundamental policy change -- in both the trade and tax areas -- is now at hand.

With respect to trade, markets such as the Japanese must be truly opened to the rest of the world. The semiconductor industry, for instance, has recently filed a 301 Trade Petition asking <u>not</u> to close the U.S. market, but to open Japan's. Our Japanese competitors must be exposed to the risks involved with foreign competition, just as we are in this country. As it now stands, Japanese chip manufacturers have enjoyed a constant 90% market share at home, no matter how dramatic are currency fluctuations or how low tariffs have dropped. Such a protected export base is a Japanese advantage U.S. industry may not be able to withstand long-term.

Japan is now enjoying a trade surplus greater than OPEC at the height of the oil crisis. This is largely due to the carryover of the policy of import substitution, along with the promotion of saving and investment in post-war Japan. Today that policy is outmoded, and Japan's prosperity is based on the destruction of other countries' economies.

We cannot ask Japan to have an equal balance of trade with the U.S., for Japan is dependent on imported energy, foodstuffs and raw materials. But we can ask that Japan, or other nations, move toward an overall trade balance. We have done that in the past ourselves, and should be doing so today, albeit in the opposite direction.

What, then, should we as a nation do toward this end? Product specific quantitative limits on imports are dangerous, and usually do not work in the long run, as is amply demonstrated by steel and autos. Rather, to allow the shifting of American industry to those areas most appropriate to our nation, and accommodate the inevitable change in our industry, we should tip the balance to favor local production rather than imports.

That might be accomplished by developing a real "buy America" attitude on the part of all purchasers. Although that is very effective in Japan, it is doubtful it would work in the U.S. with its wide diversity. Since Americans typically act in their own self interest, rather than that of the nation, a more effective method would be to increase the cost of imported goods to the American consumer. Imposition of a business transfer tax (BTT) might be a very effective solution. It is a tax on consumption, not savings. It would be added as imports arrive, and "forgiven" as exports are shipped abroad. Further, it would help us address these huge budget deficits that inflate the dollar, increase capital costs, and threaten our financial future.

In more general terms, trade must be a two-way street or the street will one day be closed off. As in any relationship, if one party seems at a constant disadvantage, the relationship will become less than valuable to that party.

With respect to tax reform, we must understand how closely tax policy is tied to international competitiveness. Our tax system is "de facto" industrial policy, and a bad one presently. It discourages saving and encourages borrowing. It also results in the highest effective tax rate for the sector of our economy most affected by competition from abroad -- manufacturing.

What is critically needed is reform that makes a fundamental shift from a consumption to a savings based tax system. Savings and investment are the lifeblood of our economy. Capital formation and its prudent use determine productivity growth, and ultimately, the standard of living of our citizens.

In this regard our record is unimpressive. American productivity growth has been surpassed by all our major trading partners. The Japanese growth rate since 1960 has been five times greater than our own.

This productivity rate is directly linked to savings. If you take our six major trading partners and rank them from top to bottom on capital formation, that listing will almost exactly mirror their ranking in productivity growth; and you will find Japan at the top of both lists, the United States at the bottom.

We favor tax reform, particularly regarding the encouragement of savings rather than consumption. The President and several members of the Congress are to be commended for bringing this issue to the nation's attention.

Since the "Treasury II" proposal is the most active initiative currently, I will focus specific comments on its provisions. In general, Intel supports basic reform, but cannot endorse Treasury II. Frankly, it misses the mark to-date in terms of international competitiveness. I am informed, by the way, that the full Treasury report does not even mention trade as a consideration.

Specifically, here is what we would like to see modified in that proposal:

Research and Development Tax Credit. The Treasury proposal would extend the R&D Tax Credit for another three years. While we applaud this recognition of the importance of technology advances to American competitiveness, the credit should be made permanent. Typical R&D projects have a four to six year life span, and the Japanese permanent R&D Credit recognizes this reality. So should ours.

Intel expends 15% of net revenue for R&D. Our industry average is 8.5%, much higher than the 2.8% average for all manufacturing. In addition, to fully encourage R&D the current moratorium on the allocation of R&D expenses to foreign source income should not be allowed to expire.

Capital Cost Recovery System (CCRS). Treasury II would replace the Investment Tax Credit (ITC) and the Accelerated Cost Recovery System (ACRS) with the Capital Cost Recovery System.

Once we do the R&D, we must put it to work. That means new plant and equipment, and that involves capital spending. The current cost of capital in the U.S. -- according to the Department of Commerce -- is 16.6%. The Japanese cost averages 9.2%.

The semiconductor industry is America's most capital intensive business. Dataquest figures show that we plow 20% of net revenues back into factories, land, and machinery. During this decade alone, our industry spending in this area will exceed $33 billion! Therefore, the capital cost issue is vital to us. While the proposed Capital Cost Recovery System may be an acceptable alternative, our equipment must be re-categorized from Class 4 to Class 1 in terms of useful life. Due to constantly changing technology of semiconductor manufacturing, Intel's equipment has lives much shorter that the seven years of the Capital Cost Recovery System Class 4.

Depreciation Recapture. This unprecedented ex-post-facto attempt to tax past investments is unfair and penalizes those companies that invested in this country rather than abroad. The tax bill of 1981 encouraged the very same investments that would now be penalized. Intel made many such investments. This proposal would impose an additional tax on so-called excess depreciation. The problem is that the measurement of excess depreciation is wholly unrealistic. Intel's equipment have much shorter economic lives than the 12 year category in which we would largely find ourselves.

Foreign Tax Credit. The Foreign Tax Credit allows a credit for taxes paid on non-U.S. earnings. Our major trading partners have similar laws, or only tax income where earned. These provisions are recognition of the need to compete abroad as well as at home.

The "per country" limitation proposal could expose U.S. companies to double taxation, and would surely be an administrative nightmare. In addition, it is premised on the incorrect notion that international investment decisions are made for purely tax reasons. In fact, tax is but one relatively minor factor. The proposed change in the sourcing of export sales income will compound the exposure to double taxation.

Puerto Rico "936". Intel has produced computers in Puerto Rico since 1980, and today employs nearly 1,000 workers there. Investment in Puerto Rico makes business sense (versus non-U.S. locations) due to the "936" tax incentives. Our hourly costs in Puerto Rico are nearly equal to our cost for identical processors in Oregon, for example. The Japanese offer equitable tax benefits for manufacturing in numerous sites via "tax sparing" in tax treaties. "936" was meant to enhance that small island's economy and it has worked beyond expectations. The proposed "wage credit" will not continue this progress as the Treasury believes, but will in fact reverse it. In our case, our entire Puerto Rico operation would be in jeopardy.

Summary

These are our reflections on tax reform, and its substantial relation to trade competitiveness. The standard of living of a society such as ours can only be sustained by thinking smarter (promoting R&D) and working smarter (promoting capital investment).

To maintain our prosperity and social advances, we must encourage saving, investment in new ideas and processes, and sale of American products worldwide.

Today's new reality is, "if you cannot compete internationally, you may not be able to compete at all."

Thank you.