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News Release

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Princeton Economist Offers Plan to Simplify U.S. International Tax System

THE X TAX IN THE WORLD ECONOMY
Going Global with a Simple, Progressive Tax

By David F. Bradford

International business taxation is notoriously complex and subject to abusive evasion tactics that are extremely costly to U.S. taxpayers. Compaq, for example, arranged to reduce its U.S. taxes by $3 million through the purchase of foreign tax credits, simply by buying $888 million worth of Royal Dutch Petroleum stock, holding it for one hour, and then selling it for a $1.5 million pre-U.S. tax loss.

In his last book *The X Tax in the World Economy: Going Global with a Simple, Progressive Tax* (AEI Press, March 1, 2005), the late David F. Bradford—who was professor of economics and public affairs at Princeton University, adjunct professor at New York University, and one of the nation's leading students of the economics of taxation—explores a new tax system to alleviate abusive tax sheltering, simplify heavy tax planning, and lighten the compliance burdens and competitiveness problems of the current U.S. international tax regime. Bradford calls his proposal to replace corporate and individual income tax in the United States: the "X Tax."

Bradford's X tax is considerably more efficient, equitable, and administratively simpler. In particular, Bradford shows us how the X tax would produce radical simplification of international business taxation, while assuring neutrality with regards to the location and nationality of investing companies.

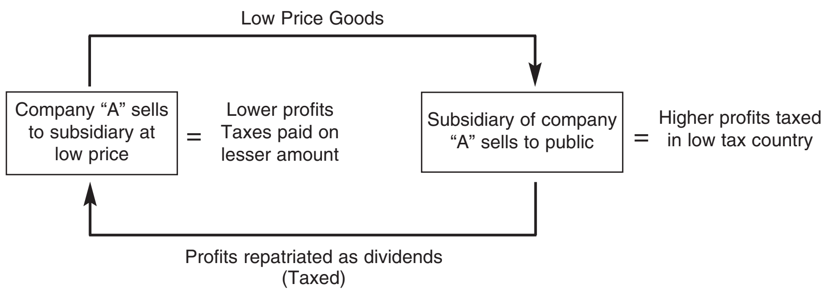
The major simplification in Bradford's plan results from the fact that financial transactions, such as payment and receipt of interest, are excluded from the X tax base. Consequently, corporations would no longer be required to allocate interest expense between domestic and foreign entities. In addition, in an X tax regime, there would be no need for a foreign tax credit, thus eliminating another area of severe complexity, perverse incentives, and dubious tax planning strategies by multinational companies.

Bradford acknowledges that the treatment of export and import transactions—an important dimension of international business taxation—is left open by the X tax concept. To address this problem, he proposes to follow the practice of most value-added tax systems and exempt export sales from tax (while subjecting imports to tax). This "border adjustment" of export sales produces what is called a "destination-basis" tax (i.e., a tax on the total amount consumed in the taxing country). In the current policy debate, some support this treatment because they see it as favoring exports (and think it would be a good idea to do so). Bradford lays out in simple terms the traditional and compelling economic theory that, on the contrary, adjustments in price levels and exchange rate will cancel out any such favoritism. Due to these adjustments, however, making a transition to a destination basis from the treatment under the current income tax (called an origin basis) could have potentially large and disruptive effects.

Nonetheless, Bradford concludes that the destination-basis approach has one significant advantage: it eliminates the "transfer-pricing problem" in tax administration which is serious in the existing income tax system, but could be even more dangerous in an origin-basis X tax. A good example is a situation where a U.S. multinational produces a product in the United States and sells it to a wholly-owned subsidiary in a low-tax jurisdiction abroad, which, in turn, sells the product to final customers. Since the parent company will ultimately reap all profits, the price charged to the subsidiary—known as a transfer price since it is on the books of what is essentially one business—can be set to take advantage of differences in tax rates. By charging an artificially low price, the U.S. parent company can shift the profits to the foreign subsidiary. Under an origin-basis X tax, extra profit from abroad could be repatriated as a dividend without further U.S. tax. However, under the destination-basis approach, since exports are not taxed, the price charged for exported goods is irrelevant. The transfer-pricing problem which is present under our current tax system remains in the origin-basis approach but is eliminated in the destination-basis approach.

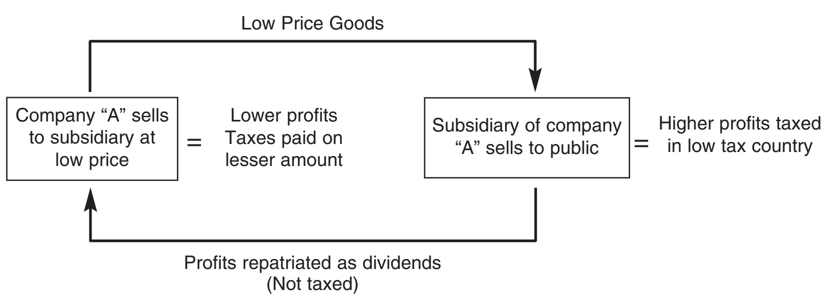
Bradford explains at length the differences between origin- and destination-basis approaches. He also recommends looking into a hybrid treatment of multinational companies that would make it possible to keep some advantages of the origin-basis treatment of exports and imports (mainly, minimal costs of transition to the new rules), while mitigating its principal disadvantage (vulnerability to transfer-pricing manipulation).

Origin-Basis Income Tax (Current Tax System)
Taxes imposed on goods and services produced within the taxing country



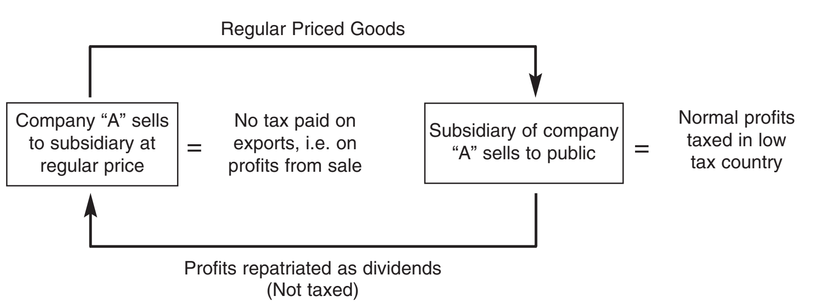
1. Import purchases (not taxed) deducted from tax base.
2. Transfer pricing problem mitigated, U.S. tax is deferred.

Origin-Basis Consumption Tax (Origin-Basis X Tax System)
Taxes imposed on goods and services produced within the taxing country



1. Import purchases (not taxed) deducted from tax base.
2. Transfer pricing problem is exacerbated.

Destination-Basis Consumption Tax (Destination-Basis X Tax System)
Taxes imposed on goods and services consumed within the taxing country



1. Import purchases are taxed, not deducted from tax base.
2. Transfer pricing problem eliminated.

David Bradford died on February 22, 2005, from injuries sustained in a fire. He was one of the nation's leading students of the economics of taxation, with many path-breaking theoretical works and many equally important practical works to his credit. He was a scholar's scholar who also served several accomplished tours in government, at the Treasury and Council of Economic Advisers (CEA). Following his membership at the CEA in the George H. W. Bush administration, he was a visiting scholar at AEI. AEI Press published several of his important works including *Fundamental Issues in Consumption Taxation* (1996), *Intergenerational Transfers under Community Rating* (1996) with Derrick Max, and *Distributional Analysis of Tax Policy* (1995), a volume of essays edited by Bradford. His life's work is a testament to his belief in the potential for serious ideas to influence even the most heavily lobbied area of government policy.

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