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Impact on Trade of Changes in Taxation of U.S. Citizens Employed Abroad. May 8, 1978. 13 pp.

Testimony before the Senate Committee on Finance; by Elmer B. Staats, Comptroller General.

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Until 1976, the United States provided substantial tax incentives to citizens employed abroad to promote U.S. exports and commercial competitiveness. This tax incentive, under 1975 tax practices, would have amounted to an estimated \$563 million in 1977 or 7% of the total U.S. tax liability of overseas employees. However, in 1976 the Tax Reform Act increased the tax liability of citizens employed abroad by about \$319 million, and the U.S. Tax Court reaffirmed the taxable status of some overseas allowances. The probable impacts on trade which could be attributed to the 1976 tax increases were examined, and alternative methods of granting tax relief to these taxpayers were appraised. Of the companies surveyed, 77% 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 local or third-country nationals. Companies that do not reimburse their American employees may lose them because of the higher tax burdens. Potential tax increases will vary greatly according to income levels, employer compensation policies, and geographic locations. The companies advised that either the increased costs or loss of U.S. citizen employees associated with the tax changes may be the cause of lost contracts and adverse effects on U.S. exports. Basic options with regard to the question of the tax incentive involve fully taxing, partially taxing, or making tax free all allowances and foreign-earned income. (RRS)

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UNITED STATES GENERAL ACCOUNTING OFFICE
WASHINGTON, D.C. 20548

For release on delivery
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STATEMENT OF
ELMER B. STAATS
COMPTROLLER GENERAL OF THE UNITED STATES
BEFORE THE
SENATE FINANCE COMMITTEE
ON
IMPACT ON TRADE OF CHANGES IN TAXATION
OF U.S. CITIZENS EMPLOYED OVERSEAS

Summary

U.S. Government incentives for promotion of U.S. exports and U.S. competitiveness abroad are limited. Relief from taxation of U.S. citizens employed overseas is one such incentive. Although its overall effectiveness is uncertain, a GAO study does provide concrete evidence of the relationship of the incentive to maintaining and enhancing U.S. exports. It may be that alternative incentives can be devised which are more cost effective. To date, such alternatives have not been found. Until such alternatives are found we believe the overriding issue is the need to promote U.S. trade and exports and that a convincing case exists for continuing this type incentive for such purposes. If Congress continues this incentive, we recommend that its effectiveness be evaluated periodically, and the results reported to Congress.

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We are pleased to be here today to discuss with you the impact on trade of changes in the taxation of U.S. citizens employed overseas. Our remarks are based on a review we initiated last May and the resulting report entitled, "Impact on Trade of Changes in Taxation of U.S. Citizens Employed Overseas", issued February 21, 1978.

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 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 \$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.

REDUCTION OF TAX INCENTIVE

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 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 incountry 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 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 individuals

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.

--45 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 average tax increases 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 these 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 school aged 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 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.

Impact on U.S. economy

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

- A concern with the "ripple effect" on sub-contractors 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 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.

POLICY ISSUES

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.

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?

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. 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 a convincing case exists for continuing to use the 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, this concludes my prepared statement. We will be glad to respond to questions.