About Princeton Economics International

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Testimony of:
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Mr. Chairman, members of the committee. I would like to thank you for inviting me here today to offer what information PEI has gathered from our experience in dealing with the multinational corporate and institutional sector in the global economy. As a brief background, PEI maintains offices in the US, Tokyo, Hong Kong, Sydney and London. We currently provide corporate and institutional advice under contract on global assets exceeding US$2.5 trillion, an amount equal to about half of the US national debt.

In our capacity as an advisor serving the international community in real life decision making rather than theory, PEI may be uniquely qualified in providing insight as to how and why both investment and business capital flows are affected by a nation's domestic policy objectives.

It has been our experience, that there are five key factors that provide the core stimulus behind capital flows internationally.

1) Foreign Exchange
2) Taxation

3) Labor Costs
4) Inflation & Interest Rates
5) Security (geopolitical & financial)

Let me begin with foreign exchange as an illustration of how capital is being affected before discussing taxation.

Foreign Exchange fluctuations have become the number one cause of corporate losses. The percentage movement in the exchange value of currencies has become as high as 40% over a two year period. Exchange losses have impacted every sector of business in every nation to the point that the very way multinationals operate today is dramatically shifting from that of only 10 years ago. Multinationals have been forced to change pricing policy as well as the location of manufacture in an effort to reduce extreme financial risks for their shareholders. Transactions such as Rockefeller Center, MCA etc resulted in significant losses to the Japanese investors, more so by the 40% depreciation of the dollar than the actual decline in value of the underlying assets. Japan Airlines was forced to lay-off 25% of its work force last year due to the fact that their cost base was Japanese yen while their revenue was largely foreign currency denominated. In Germany, Mercedes has been forced to restructure their pricing policy as of July 1st, 1996 due to foreign exchange. Instead of pricing the product in DMarks around the world, which has cost them market share, products will now be priced in local currency thereby transferring the currency risk back to Germany.

These are but a few examples of how the more recent extreme fluctuations in the exchange value of currencies has impacted business and investment decisions on a global scale. While it may be politically preferable to manipulate currency values in an attempt to impact trade flows, in reality, trade accounts for less than 10% of the total world capital flow movement. Our warnings delivered in a letter to Congress and the White House back in 1985 cautioned against such intentional currency manipulation as enacted in the G5 September Plaza Accord. The net result of attempts to influence trade through currency manipulation led to the 1987 Stock Market Panic. PEI's research was requested by the Brady Commission and we would like to think that we had some impact upon its findings since two of our clients were on the Commission itself. Mr. Brady later stated that he believed that currency fluctuations had played a role in the Panic of 1987. Offered here is a graphic illustration (figure #1) of the net capital flow movement for that period. The upper portion of the graph plots trade and the lower portion capital movement which included, stocks, bonds and real estate investment. What is important to note is that ever since 1987, the fluctuations in net capital movement have become more than 10 times as volatile when compared to the pre-1987 era.

The second most important factor influencing net capital flow movement is none other than taxation. However, taxation is more than a pure income tax. Taxation contributions imposed on business based upon social objectives involving labor are of greater importance than the mere superficial level of corporate income tax rates alone.

It is wrong to assume that manufacturing jobs flow to merely the lowest possible labor cost. If this were true, then all manufacture should be conducted in Mexico, South East Asia or better still -Africa. In our capacity as a corporate advisor helping to make such strategic decisions as to where companies should or should not locate, there are 5 primary considerations that go into the final decision process on this level.

1) Rule of Law
2) Labor Skill availability
3) Taxation Contributions Required on Labor
4) Corporate Tax Rate
5) Regulation

We have clients who have turned down what appeared to be lucrative business ventures in 3rd world nations as well as Russia or China based upon the lack of a Rule of Law that is required to secure the capital at risk. Without a solid Rule of Law, business cannot operate. Such ventures that do develop in those parts of the world depend upon government guarantees from their native country of origin in an effort to underwrite the political risk at hand.

While it is obvious that labor costs are closely associated with labor skills, what is largely overlooked are the social taxation and regulations associated with a work force. We found Asian companies who wished to open manufacturing plants within the EC made their decision based upon the level of skills available and then secondly chose the lower total cost of labor. For example, the UK attracted more than 40% of all foreign investment into Europe due to the fact that it had a skilled labor force but its cost was much less compared to that of Germany or France. This cost factor was determined not by mere wages, but included the social taxation that companies were required by law to provide. On that score, the labor costs in the UK were 40% less than Germany.

When a company did NOT require a major work force but instead merely needed a legal entity within the EC, then the primary deciding factor became the corporate tax rate. While the UK corporate tax rate was 19% less than Germany, they were still more than twice that of nations such as Spain and Ireland. Therefore, corporate headquarters or low skilled labor requirements tended to gravitate to the lowest possible corporate rate within the EC. This is illustrated by the impressive Irish economic growth rates of 9% compared to European economic growth rates of 2.5%.

We have found that there is a correlation between high unemployment and high total taxation and regulation costs across Europe today.

Of course, regulation was a major factor as well. This we can see within our own US borders as well. Southern States are actively competing for Northern corporations and jobs. If we look at those states where regulation is the least intrusive and taxation is the most favorable, you will find the highest number of corporate relocations and new foreign business ventures within the United States.

Domestic Taxation policy must take into consideration our new global economy. We must be sensitive to being competitive not merely on labor costs, but also on the total taxation and regulation costs if we hope to avoid the dismal European example with its chronic unemployment in excess of 10% year after year. We must also keep in mind that taxation itself is largely influenced by philosophical decisions made by governments without considering the true total economic impact. For this reason, taxation has been a major factor in altering world capital flows as well as economic growth levels. When the US corporate tax rate hit nearly 70% during 1968-1969, virtually every American company began shifting manufacture offshore. Today, over 65% of the US trade deficit is made up of US companies importing their own goods manufactured somewhere else. In fact, if we allocate world trade according to the flag a company flies instead of the last port of assembly, you will find that the US has a net trade surplus in excess of $150 billion.

Much of the economic turmoil in Japan today is being caused by excessively high tax rates. In fact, three of the first section listed companies on the Tokyo Stock Exchange have renounced their Japanese heritage and moved to Hong Kong due to a 15% tax rate compared to nearly 70% in Japan. Our economy contracted from the 1960s for 12 years. Japan appears to be facing the very same long-term trend. After 6 years, the Japanese economy remains in the throws of a near depression and taxes have still not been reduced. Despite the fact that interest rates have fallen in Japan to 0.25%, there remains no interest in borrowing for domestic economic expansion.

The method of taxation through domestic social objectives is also a key factor in shifting global capital flows. For example, the US is one of the very few nations that seeks to tax their citizens and corporations on worldwide income. Most British Commonwealth nations tax worldwide income if earned in a tax free zone. Therefore, if the US were to totally eliminate the corporate income tax, we would run the risk of corporate earnings in the US being considered as income from a tax free zone.

Furthermore, US tax code classifies income made overseas as if any overseas income is derived solely to avoid domestic taxation. The 50% and/or control rule for US companies as the sole criteria for taxation penalizes US enterprises forcing many into joint ventures simply to avoid double taxation in the US. We also discriminate against American companies trying to enter foreign markets by passing the tax burden directly to personal income even if such earnings are not distributed. Our tax code assumes that any offshore entity is merely trying to avoid taxes without testing whether or not an actual business is being developed as compared to an offshore account for investment purposes.

In addition, our prejudice against capital gains versus short-term income within our tax code provides a incentive to manufacture and develop domestic products offshore. The US is one of the few nations whose tax system punishes long-term investment while rewarding short-term speculation. Again, the capital gains taxation has exported more American jobs not because of the mere rate, but due to the fact that losses have been treated differently from short-term income while disallowing the impact of inflation indexing. Consequently, while virtually every electronic product from VCRs, CDs and assorted appliances were designed and patented in the US, their final development and manufacture have been more fairly treated by nations such as Japan. This uncompetitive social philosophy inherent within American tax code has been one of the major causes of forcing US companies offshore into joint ventures than even the net level of income tax itself.

While many will argue that corporations pay little in income tax, what is grossly ignored is the taxation of labor that is a huge direct cost to business. If we look at our own revenue statistics, you will find that the taxation contributions to the payroll tax paid by corporations is substantial - generally twice the level of corporate income taxes.

We must also take into consideration the net cost of taxation upon the nation as a whole. While it is true that the national debt doubled under Ronald Reagan moving from $1 to $2 trillion, this alone does not mean that lower taxes or Reaganomics failed. Under Bush and Clinton, the national debt has now more than doubled from $2 to $5 trillion despite raising taxes.

We must honestly review the economic facts of the past 16 years in order to understand our future. Since Ronald Reagan, we have actual ly had a balanced budget from the perspective of revenue vs spending. At 8% compounded, you double your money in a bank in about 8 years. The interest expenditures during the Reagan period were equal to nearly $1 trillion. Today, we actually collect about $100 billion more in revenue than Congress actually spends on programs. This is being absorbed by our interest expenditures. In fact, since 1950, the total interest expenditures paid now equal 68% of the total outstanding national debt. We are indeed becoming a Banana Republic.

At times, up to 40% of our national debt has been held by offshore investors who pay no income tax in the US. This means that domestic spending from Congress is no longer stimulating our domestic economy. If fact, an analysis of capital flows reveals that the Japanese earned more from the US on their investment income in the past 16 years than they did on trade.

By taxing interest income, we penalize Americans and overpay foreign investors exporting more capital than would otherwise take place. If we eliminate the income tax on government bonds, we could reduce the interest rate to the actual net return after taxation. This alone could result in an instantaneous balanced budget since we currently collect more in revenue than we spend on programs with the excess being consumed by interest.

Capital is rushing around the globe today much in the same manner as it did going into the Great Depression. Herbert Hoover wrote in his Memoirs that"capital acted like a loose cannon on the deck in the middle of a torrent." In 1985, the largest futures mutual fund was $100 million. Today, $1 billion funds are a dime a dozen. Everyone is investing somewhere else to avoid local taxation. It is now estimated that over $2 trillion sits offshore, untaxed and unregulated emanating from all nations. If we eliminate the personal income tax, then America itself will become the international magnet for this vast pool of capital. Our interest rates would decline as it always does whenever excess capital emerges. This single step alone, combined with creating a tax free government bond structure, could spark untold economic growth and help to actually begin reducing our national debt rather than waiting for everything to go bust beyond the year 2000.

Suggestions:

1) End the discrimination against long-term investment by at least allowing capital gains to be indexed to inflation retroactively.

2) Promote honest reform of the Social Security System whereas contributions made should be privately managed as is the case in many other nations. The Postal Savings System in Japan actually has on deposit in real funds nearly $10 trillion which is then managed by the private sector under the watchful eye of government. This will help reduce the cost of labor in the US, create jobs through increased savings, and result in lower payroll tax contributions for business over the long-term while safeguarding the long-term viability of these critical social programs.

3) Eliminate the taxation on government bonds.

4) Eliminate the personal income tax and replace it with a national sales tax of 10% as originally intended by the founding fathers with just cause.

5) Reduce the corporate tax rate to 15% matching Hong Kong thereby transforming the US to the international magnet for capital. Allow interest paid to be deducted as a part of the cost of doing business.

QUESTIONS:

Mr. McCrery. I just want to ask a few questions before going to my colleagues. There seems to be, and maybe I misunderstood, but there seems to be some disagreement among the panelists on the efficacy of going from an income tax system to a consumption tax in terms of encouraging foreign business to relocate in the United States.

Mr. Armstrong, I thought you said that if we did away with the income tax, went to a consumption tax, you would find that those businesses would simply have to pay their domestic income tax and, in many cases, that would discourage them from coming to the United States, while the other two panelists seem to imply that going from an income tax system to a consumption-based system would encourage foreign investment.

Did I miss something there or is that a correct interpretation?

ANSWER:

Mr. Armstrong. From my perspective, we see two types; one, if you are talking about a company that is setting up a plant. Because of the international tax code, for example, many British Commonwealth nations do not tax foreign income, however, there is a kicker to it. If it is income earned in a tax-free zone, then it is subject back. They do that for offshore investors, etc.

Our concern is that if you had a complete zero income tax rate here and even though the company would be subject to a consumption tax in some way or another along the line, that could be interpreted from a foreign perspective as being a tax-free zone, and I would like to point out that last April, Germany was very interested in how it is dealing with its budget crisis.

Germany surrounded all of the offices of Merrill Lynch and several other banks. They attacked the company as if it was a drug raid. They cut off all the phones of Merrill

Lynch, all the hand-held cellular phones that the brokers had. They went in, raided all the files, looking for German citizens putting capital offshore.

The net result of those raids effectively sent the Deutsche Mark down, the Swiss Franc up, and the London Financial Times even reported that it was incredible the amount of capital that was suddenly leaving Germany for Switzerland.

That has not resulted in if you are in the financial industry, you are better off working out of London. You cannot do business in Germany.

If I were to go to Germany and answer a question on taxes to be more competitive and if my answer can be interpreted as helping someone avoid taxes, that is a 5 year jail term for me personally now in Germany.

So you have to be very careful about the international tax code. My lawyers go crazy every time I even have to go to Munich. So I think there is a different side to that.

Now, a consumption tax with zero income tax, from an investment perspective -- we are talking about interest income, etc., investments in stock markets -- absolutely positive, you would have capital flowing in here. This would be like the Cayman Islands of the global economy.

QUESTION:

Mr. Houghton. I guess the issues that I worry about are fairly simple. They have to do with cash. The United States generates about, I would say on the previous figures -- I guess it was 1995 -- $800 billion in terms of income taxes and about $600 billion in terms of other taxes, FICA taxes, things like that.

So, all of a sudden, you really sort of throw that out and you move towards a different tax system. You have got to generate at least $1.4 trillion, and it will probably be up now to $1.5 trillion or $1.6 trillion. How do you do that? I mean, that is a real tricky question because somebody sitting here or elsewhere has to make that decision.

We can talk about this thing intellectually, and we can talk about it in terms of competitive reasons, but the question is how do you make that switch. How can you make sure that we don't end up with a $500 billion deficit because we have miscalculated this thing? Maybe you would like to make a comment on that, anyone.

ANSWER:

Mr. Armstrong. We looked at some of those numbers to perhaps answer that question, and we were looking at taking the BEA numbers.

We found that if you instituted a 10% sales tax with also a 2% sales tax on real estate transactions, that in combination with only a 15% flat or fairer- type corporate tax was actually scored revenue neutral, and it is quite surprising when if you really start putting in some of the other aspects which would be more dynamic considerations.

For example, the Internal Revenue Service itself claims that close to 17% of the economy is underground. You are never going to capture any form of an income tax from that side, from the illegal aliens or things of that nature. They will contribute to their local sales taxes, but they will never file an income tax return.

So if you look at the income tax versus a consumption tax from the total GDP perspective, the revenue would actually increase because income tax will never capture that 17% portion of the economy that the IRS says is underground. The other problem is -- there is a very interesting article on the front page of the New York Times today where 600 are suspected in plots to evade taxes on income. These are 600 government employees.

The income tax is, quite honestly, easier to avoid than the sales tax. It is much easier to do so. If you really look at the numbers objectively, I think that you are looking at least at a potential of actually collecting more revenue.

Then, if you look at the income tax and its effect on interest rates, I mean, we can supply you with a study of interest rates for this country back for 200 years. Every time the government raised income taxes, interest rates rose basically in direct proportion. Capital invests on a net basis. It doesn't want to hear, well fine, I will pay you 20%, but by the way, I want 95% of that back. Capital looks at whatever it is going to have on the table at the end of the day.

So, consequently, the points in my opening statement about Japanese earning more money from us on investments versus trade is very important to understand because, in effect, we are paying more in interest expenditures on our national debt than maybe is really necessary. We are paying a higher rate to compensate Americans that are paying a very high tax rate, but foreigners are buying our bonds paying zero in income taxes.

Mr. Houghton. But you are not suggesting that the foreigners pay a tax on interest.

Mr. Armstrong. No, no. They won't pay it. What I am suggesting is that you perhaps even the playing field and make at least interest paid on government bonds tax-free.

Mr. Houghton. Sure.

Mr. Armstrong. If you could reduce the interest rate itself on the national debt by a third, you have created a surplus, eliminating the deficit. You can create about a $150 billion surplus.

QUESTION:

Mr. Gibbons. Mr. Armstrong, you have more experience in exchange rates than I do, and let me pump your mind for a while.

What really controls the exchange rates? In the long, long run, probably international trade has something to do with it, but in the short run, is it more financial considerations than it is trade considerations?

ANSWER:

Mr. Armstrong. Yes. Quite frankly, trade is minimal.

Mr. Gibbons. That is my impression.

Mr. Armstrong. If you look at the U.S.-Japanese trade deficit, it has not changed dramatically in 2 years. Yet, the Japanese Yen went up 40% and down 40%.

If you look at, for example, Nippon Life, the largest insurance company in Japan, they have a portfolio of about $1.2 trillion. If they decided to move 10% of their portfolio to the U.S. stock market, that is more than 2 years worth of trade numbers.

The trade is more of a psychological impact, but in my opinion, the currency markets have been reduced to the fact of almost an international polling.

Mr. Gibbons. An international what?

Mr. Armstrong. An international poll where the markets and capital is voting on the confidence of countries on a daily basis.

So, consequently, you will find with the elections with Yeltsin, the dollar restrengthened because of concerns that, well, maybe if Yeltsin lost, then you are going to have problems in Europe.

So you have capital movements that are taking place for a variety of reasons: geopolitical security, financial security, rules of law. Trade is also part of it, and the other part of it is taxes and how they impact investment, and that is the point I was trying to make about the national debt.

You really have foreigners paying no tax and penalizing Americans. Then, you look at our American corporations, we tax them on worldwide income. Nobody else does. It seems like when you look at the broad scope of everything, Americans are the number-one prejudiced people in the entire world. Nobody else is as punitive on their citizens as the United States, and it seems ironic that we are supposed to be the leader of the free world, but when it comes to tax code, we seem to be absolutely backwards.

Mr. Gibbons. I apologize for taking this extra time.

I am amazed that America has done so well when I look at our system and the penalties that we put on our people for jobs and for taxes and for everything else, and that really concerns me. We have got a very expensive system to administer.

I don't know how expensive, but it is horribly expensive, probably the most expensive system in the world to administer, and I worry about America's future when I see us dragging along as economic baggage, useless baggage, our horribly expensive tax system, and then not doing perhaps as much as we should as far as education is concerned because I think the future of our country depends upon how well we educate our minds and how efficiently we operate our economy.

I am very pessimistic that we seem to be headed in the wrong direction.

Mr. Armstrong. I agree. I am always impressed by some of my European friends whose little children may be five or six and they are speaking four different languages.

Mr. Gibbons. Yes.

Mr. Armstrong. It is quite impressive to see, quite honestly, but I totally agree with you.

QUESTION.

Mr. McCrery. Mr. Armstrong, do you happen to know the current percentage of public debt that is held by foreigners? You said in your testimony that we have had up to 40% of it.

ANSWER.

Mr. Armstrong. I would have to check the 1995 numbers. The highest number I have seen that fluctuate to is about 42%.

Mr. McCrery. Was that recently?

Mr. Armstrong. Yes, within the last several years. It has been coming down largely because of concerns about the dollar. It has caused a lot of foreigners to sell government bonds, particularly in the United States, also Canada. One of the largest institutions in Japan lost so much money on the foreign exchange on our bond markets here that they actually announced that they are no longer going to buy government bonds from anybody in the world again.

Mr. McCrery. But it is still a significant portion. Is that your appreciation?

Mr. Armstrong. I would only be taking a guess. I think it might be down to maybe the 25-30% area at this point.

QUESTION.

Mr. Portman. I wish I had more time, Mr. Armstrong, but maybe someone else can go into this further. This fascinates me, this notion of tax-free bonds because it would put us in a level playing field with foreign investors and government bonds.

You mentioned the figure of $250 billion. Where do you come up with that? Our interest on the debt is, what, about $200 billion a year?

ANSWER.

Mr. Armstrong. We now, I believe are collecting close to $100 billion more than we are spending on actual programs, which is being absorbed by interest.

Mr. Portman. Okay. so what would be the net effect of your proposal in terms of government revenues' impact on the budget?

Mr. Armstrong. It would really depend on how much of the national debt you could shift over.

I can tell you in the financial community, there is something else that has happened here, and that is that in 1993, the Treasury began trying to take advantage of the steep yield curve in this country, and they started shifting the national debt short term. I will be glad to provide the Commission with a chart on that. We are now 70%.

Mr. Portman. This was in 1992 or 1993?

Mr. Armstrong. In 1993.

Mr. Portman. Okay.

Mr. Armstrong. Yes. We are now funded 70% 5 years or less. One-third of the entire national debt is funded 1 year or less. All right. This is why short- term interest rates have doubled in the last 2 years, and we now have a yield curve that is practically flat.

Initially, the Treasury was doing that, trying to save on interest expenditures to bring the deficit down.

Mr. Portman. Right.

Mr. Armstrong. It is now backfiring, but it has a very serious impact in the financial pension fund community. What happened was that pension funds had gone out and bought mortgage-backed securities. Well, mortgage-backed securities can be recalled, and that is what happened. So many people went out and began refinancing their mortgages.

The pension funds lost that long-term maturity and ended up being thrust into the short-term because at the same time the Treasury cut the 30 year bond auction down.

Well, at this point, you ended up with companies, for example, Coca-Cola and Disney, who were suddenly able to issue 100 year bonds and the marketplace bought them immediately because the pension funds, their liabilities and their investments are not matched.

I believe, and I have talked to a number of people in the industry about this, if the Treasury were to take advantage of this particular point in time and perhaps issue zero coupon bonds that were tax-free, you could effectively reduce your interest expenditures dramatically in the short-term, which would give you more than enough time to help really change the total outlook for this country, but you have to follow through. You can't use those savings and spend the, but you could save a substantial amount of money doing that right now, and there is a marketplace for them because the pension funds need the long-term maturities right now.

This is kind of a Keystone Cop maneuver. I have never seen this happen before in the 25 years that I have been in the financial consulting industr