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For 50 years, tax exemptions or tax breaks have been given on income earned by U.S. citizens employed abroad. The Tax Reform Act of 1976 reduced the amount of the tax break, and by the spring of 1977, U.S. individuals and businesses operating overseas were expressing concern that this reduction might force many citizens to return to the United States and seriously reduce the competitiveness of U.S. industry abroad. Findings/Conclusions: Companies surveyed overseas indicated increases of up to $22 million a year in employee compensation costs resulting from the tax change. These increased costs could result in lost contracts or in the replacement of Americans with foreign nationals, with possible adverse effects on U.S. exports. Indirect costs could result from: tax reimbursements becoming taxable to both host governments and the U.S. Government, increased complexity and cost of preparing returns, and confusion and apprehension over how U.S. employees abroad will be treated from the tax standpoint. On the assumption that the tax increase would be passed along to customers, an econometric model estimated the economic impact of reduced incentives on the gross national product, exports, and employment. The results showed a generally smaller effect than was forecast by company officials, but the full impact of the tax increase on the U.S. economy cannot be objectively measured. Recommendations: To enhance its oversight of the tax incentives provided for Americans employed overseas, Congress should spell out specifically what it expects the incentives to achieve. The Department of the Treasury, in consultation with the Department of Commerce should: periodically evaluate the effectiveness of tax incentives in achieving their objectives, compare the tax incentives with other policy instruments designed to achieve similar objectives, and report the results of its evaluation regularly to the Congress. (RRS)

5469

BY THE COMPTROLLER GENERAL

Report To The Congress

OF THE UNITED STATES

Impact On Trade Of Changes In Taxation Of U. S. Citizens Employed Overseas

In 1976 the Congress substantially reduced a longstanding tax incentive for citizens employed abroad. At that time there was a high degree of uncertainty as to what the loss of this incentive would mean to individuals, firms, and the U.S. economy. Some answers are provided in this report.

In 1977 the Congress postponed the effective date of the tax incentive reductions until the 1977 tax year. Until a system is established for evaluating the effectiveness of these incentives, policy formulation and congressional oversight will be hindered.

GAO urges that consideration be given to continuing some type of incentive, at least until more effective policy instruments for promoting exports and commercial competitiveness abroad are identified and implemented.

FEBRUARY 21, 1978

ID-78-13

COMPTROLLER GENERAL OF THE UNITED STATES
WASHINGTON, D.C. 20548

B-137762

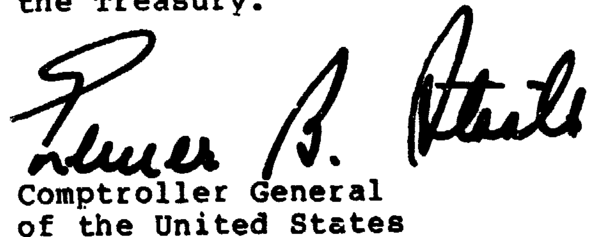
To the President of the Senate and the
Speaker of the House of Representatives

This report describes the impact of the 1976 Tax Reform Act changes on U.S. citizens employed abroad. It assesses the impact on the U.S. economy, business, overseas employees, and Government programs. It also identifies optional methods for taxing income earned abroad and the advantages and disadvantages of each method.

A supplement to this report, to be issued in the spring, will include estimates of tax costs and income flows to the Treasury under a variety of optional methods. Data necessary for preparing these estimates was secured in February 1978 pursuant to Public Law 95-125, signed on October 7, 1977, which provides us with access to data contained in income tax returns.

We made our review pursuant to the Budget and Accounting Act, 1921 (31 U.S.C. 53), the Accounting and Auditing Act of 1950 (31 U.S.C. 67), and the Legislative Reorganization Act of 1970 as amended by Title VII of the Congressional Budget and Impoundment Act, 1974 (31 U.S.C. 1154), which authorizes us to develop and to recommend to the Congress methods for reviewing and evaluating Government programs.

We are sending copies of this report to the Acting Director of the Office of Management and Budget and to the Secretaries of Commerce and the Treasury.



Comptroller General
of the United States

COMPTROLLER GENERAL'S REPORT TO THE CONGRESS

IMPACT ON TRADE OF CHANGES IN TAXATION OF U.S. CITIZENS EMPLOYED OVERSEAS

D I G E S T

For many years the United States generated most of its own raw materials and consumed most of the products it manufactured--exporting less than 7 percent of its gross national product. Today it is running out of raw materials.

Now the United States is increasingly importing raw materials at higher costs to operate its factories. These imports must be paid for by increased exports or by increases in net repatriated profits on foreign investments.

In this situation the United States must remain competitive. To do so, it is essential to maintain a large force of U.S. citizens abroad to promote and service U.S. products and operations. Major industrial competitors of the U.S. do not tax their nonresident citizens. The United States does. This reduces U.S. competitiveness in overseas markets.

For more than 50 years, the United States provided a substantial tax incentive to citizens employed abroad to promote U.S. exports and commercial competitiveness. In 1976 two things occurred which reduced this incentive.

--The Tax Reform Act of 1976 substantially increased the tax liability of citizens employed abroad.

--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.

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These actions increased the estimated tax liability of the approximately 150,000 citizens employed abroad by more than $290 million. 1/

Over the years, little, if any, attention has been given to evaluating the impact of changes such as these in tax incentives. A high degree of uncertainty existed at the time the Tax Reform Act of 1976 was passed as to what would be the probable result.

To find out, GAO surveyed a sample of 367 U.S. citizens working in 11 countries and 183 U.S. firms employing Americans abroad.

IMPACT ON U.S. ECONOMY BY REDUCTION OF TAX INCENTIVE

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

- --A concern with the "ripple effect" on subcontractors 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.

1/ As this report went to press, the Department of the Treasury increased this estimate. Here and elsewhere in this report we use the estimates published by Treasury in October 1977.

--Over 80 percent were of the opinion that the tax changes would result in at least a 5 percent reduction of U.S. exports. (See p. 10.)

On the assumption that the tax increase would be passed along to customers, an econometric model was used to estimate 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. (See pp. 19 to 23.)

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 must 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.

--Living costs and tax structures of other countries are significant to the impact of the tax changes. 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 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. (See pp. 28 to 45.)

Impact on individuals

The GAO survey, together with a preliminary 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. (See p. 46.)

--45 percent of those responding to the survey 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.

--Almost half of the estimated $292 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.

--Taxpayers reporting less than $20,000 income, 53 percent of the total, would have average tax increases of about $120.

--Americans living in the oil-producing countries of the Middle East and Africa will have the largest tax increases, averaging $4,700 per return. Americans working in these countries generally receive relatively large taxable allowances.

--In certain extreme cases in extraordinarily high-cost countries, some individuals who receive large cash allowances may have tax liabilities nearly equal to their basic cash salaries. (See pp. 46 to 60.)

POLICY ISSUES

In the 1970s, for the first time in this century, the United States had a deficit trade balance. Simultaneously, foreign investment in the U.S. is increasing faster than U.S. investment abroad. These trends underline the importance of identifying and implementing public policies that have the greatest potential for strengthening the U.S. international economic position.

These circumstances focus attention on the following issues.

--How can Government policy and resources be used most 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.

A system should be established for evaluating and reporting periodically to the Congress the effectiveness of this tax incentive program. This could provide a solid foundation for deciding which of the available instruments for promoting U.S. exports and competitiveness abroad are most effective. (See pp. 94 to 98.)

POLICY OPTIONS

Taxation of Americans working abroad is part of the continuing conflict among the tax policy objectives of raising revenue, achieving tax equity, achieving tax simplification, and achieving other special aims of public policy. Basic options include fully taxing, partially taxing, or making tax free all allowances and foreign-earned income. Options for granting a greater or lesser tax incentive than now exists include adjusting the existing general exclusion, granting special deductions for extraordinary costs, or modifying available tax credits. GAO identifies a variety of suboptions within each option together with the advantages and disadvantages of each. (See pp. 74 to 94.)

The preferred option must be chosen by the Congress in the light of the objectives it defines.

Because of the seriousness of the deteriorating U.S. international economic position, the relatively few policy instruments available for promoting U.S. exports and commercial competitiveness abroad, and uncertainties about the effectiveness of these, serious consideration should be given to continuing Section 911-type incentives of the Internal Revenue Code, at least until more effective policy instruments are identified and implemented. (See p. 98.)

This report was reviewed informally by officials of Commerce and the Treasury. Their comments were considered in its preparation.

Contents

		Page
DIGEST		i
CHAPTER		
1	INTRODUCTION	1
	Why the review was made	2
	Scope of review	2
2	HISTORY AND PURPOSE OF TAX INCENTIVES FOR CITIZENS EMPLOYED ABROAD	3
	Tax Reform Act of 1976	5
	Comparative tax policies of other countries	6
	Unusual taxable income associated with private sector employment	7
	Inconsistent tax treatment of incentive allowances for Government employees	8
3	IMPACT OF 1976 TAX CHANGES ON U.S. BALANCE OF PAYMENTS AND DOMESTIC ECONOMY	10
	Analysis of economy-wide effects	11
	Methodology	14
	The DRI results	19
	Other relevant considerations	23
	Conclusions	25
4	IMPACT OF 1976 TAX CHANGES ON U.S. INDUSTRY ABROAD	28
	Costs of maintaining U.S. employees abroad	30
	Variables affecting impact of tax changes	32
	Company survey results	38
	Case studies of actual and potential impact	41
	Tax change in perspective	48
5	IMPACT OF 1976 TAX CHANGES ON U.S. INDIVIDUAL TAXPAYERS	46
	Nature and extent of tax changes	46
	Who is affected?	49
	How are taxpayers affected?	53

CHAPTER		Page
6	OTHER IMPACTS OF 1976 TAX CHANGES	61
	Long-term impacts on net tax flow	62
	Potential for increase in taxes to certain foreign governments	64
	Impact on U.S. Government programs abroad	65
	Impact on charitable organizations	71
	Impact on relations with other countries	72
7	OPTIONAL METHODS OF TAXING INCOME EARNED ABROAD	74
	Policy of taxing worldwide income of U.S. citizens	75
	Equity argument for tax relief	76
	Counter-arguments	77
	Principles to be considered	78
	Possible forms of tax relief	79
8	CONCLUSIONS AND MATTERS FOR CONSIDERATION OF THE CONGRESS	94
	Limited policy instruments available	95
	Need for establishing system for periodic evaluation	96
	Matters for consideration of the Congress	97
APPENDIX		
I	Comparative cost-of-living indexes in 40 major foreign and U.S. cities	99
II	U.S. exports and foreign subsidiary sales for countries with over 1,000 Americans claiming Section 911	100
III	Recommended legislation requiring the periodic evaluation of tax incentives for citizens employed abroad	101
IV	Housing market in surveyed countries	105
V	Hypothetical examples of taxation of U.S. citizens in selected countries before and after 1976 tax changes	116

ABBREVIATIONS

DRI	Data Resources, Inc.
GAO	General Accounting Office
IRS	Internal Revenue Service
OPEC	Organization of Petroleum Exporting Countries

CHAPTER 1

INTRODUCTION

The United States has taxed the worldwide income of its citizens, with specifically legislated exceptions, since initiating the Federal Income Tax in 1913. It is the only industrialized country in the world to impose an income tax on this basis, since most countries do not tax income earned outside their borders by their nonresident citizens.

Approximately 150,000 (one-seventh of 1 percent) of the U.S. civilian work force of about 98 million are employed overseas. From 1926 to 1976 a substantial tax break was granted to these employees in order to promote U.S. overseas employment. It was believed that such employment would promote U.S. exports and U.S. business in foreign markets. In 1975, the tax break amounted to an estimated $412 million, or 64 percent of the total U.S. tax liability of overseas employees.

A different system evolved for Federal Government employees working abroad. The 100-percent tax break on earned income, in existence from 1926 to 1932, was terminated and a small tax exemption for overseas allowances was granted in 1943. This was gradually broadened by expanding the allowances and permitting them to rise with inflation.

The Tax Reform Act of 1976 reduced the amount of the private sector tax break, and by the spring of 1977, U.S. individuals and businesses operating overseas were expressing concern that this reduction might force many citizens to return to the United States and seriously reduce the competitiveness of U.S. industry abroad. In May the Congress postponed the effective date of the reduction until the 1977 tax year. In October the House passed an additional 1-year postponement, but the Senate adjourned without acting on the postponement.

During this review, we interviewed individuals and U.S. companies in the following 11 countries which were selected primarily on the basis of (1) size of the American community, (2) costs of living, and (3) degree of taxation.

Australia	Japan	Singapore
Brazil	Mexico	United Kingdom
Hong Kong	Philippines	Venezuela
Iran	Saudi Arabia	

WHY THE REVIEW WAS MADE

At the time the law was amended in 1976, it was not clear what impact the changes would have. Uncertainty existed because no effort had ever been made to determine the impact or evaluate the effectiveness of these tax provisions--not surprisingly, since the Government has no system in force for periodically evaluating tax expenditures. Tax incentives (i.e., tax expenditures) are reductions in tax liabilities made pursuant to tax rules set up to encourage certain private activities for approved purposes. We made this review to reduce the uncertainty over the tax changes, in the expectation that Congress will consider making further changes to these rules in 1978.

We attempted to determine the probable effects of 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 demonstrated 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.

SCOPE OF REVIEW

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. Using the model formulated by Data Resources, Incorporated (DRI), we estimated what effect the increased taxes might have on the U.S. balance of payments, domestic employment, gross national product and Federal budget position. Data gathered from companies and individuals was not used in the DRI model analysis because the samples were non-random and too small to support any quantitative inferences. Also, the DRI model does not have the capability to develop highly detailed analyses in the international sector because of limitations on its breakdown of exports by commodity and geographic destination.

Major Government agencies which have operations overseas gave us assessments of the financial impact the reduced incentives would have on private sector participation in their programs.

CHAPTER 2

HISTORY AND PURPOSE OF TAX INCENTIVES

FOR CITIZENS EMPLOYED ABROAD

Exemption from U.S. Federal income taxes is considered incompatible with an equitable tax system unless:

- --A tax incentive is necessary to promote a vital national policy; if its necessity is doubtful, a tax incentive should theoretically be stricken.

- --Tax equity warrants an exemption (tax equity means the same tax treatment for individuals similarly situated); since the progressive income tax system is based on ability to pay, economic hardship justifies an exemption, deduction, or tax credit.

- --The earnings are not truly "income" because they must be spent to generate income; thus they are not a net addition to wealth but are used for a business as opposed to a personal expense.

- --Administrative costs make it impracticable to impose the tax.

For 50 years exemptions or tax breaks were given on foreign-earned income, but the scope of the exemptions was gradually narrowed.

The foreign earnings exclusion originated in the 1926 Revenue Act and became Section 911 of the current Internal Revenue Code. At first it exempted from U.S. taxation all foreign earnings of U.S. citizens who resided abroad for more than 6 months of the taxable year. A self-employed taxpayer, engaged in a trade or business, was authorized to claim a reasonable allowance (20 percent of his net profits) as compensation for personal services. Deductions for extraordinary expenses related to earning income abroad were prohibited. Under previously enacted tax legislation, a citizen could reduce his U.S. Federal tax by the amount of foreign income taxes paid.

The Congress' primary purpose in granting the foreign earnings exclusion was to increase the trade of U.S. firms who especially suffered in overseas competition with foreign companies. However, it was recognized that the exemption would also help citizens working overseas to maintain living standards abroad at the level they had been accustomed to in the United States.

Significant changes to the 1926 Revenue Act during the 50 years to the Tax Reform Act of 1976 are shown below.

1932 Congress narrowed the area of exemption to cover only employees of the private sector. Thus, the salaries of Federal workers overseas, which were freed from tax in 1926, were again made taxable.

1942 Congress changed the foreign residence requirement from 6 months to 12, requiring a U.S. citizen to be a bona fide foreign resident for an entire taxable year; absence from the United States was not sufficient to qualify for exclusion of foreign-earned income from U.S. taxation. This change was instituted to prevent tax evasion by citizens merely absenting themselves from the United States for 6 months.

1943 The Federal Government worker was partially compensated for his tax disadvantage. His cost-of-living allowance was made tax exempt by the addition of Section 912 of the Internal Revenue Code. Subsequently, additional allowances and benefits (many of them tax exempt) were made available to Federal workers overseas.

1951 An alternative to the 1-year residence requirement was authorized. This provided that, to qualify for tax exclusion, the citizen need not establish foreign residence if he is present in one or more foreign countries for 510 full days (17 months) out of 18 consecutive months.

1953 Congress limited the exclusion to $20,000 annually if eligibility was based on physical presence overseas for 510 full days out of 18 consecutive months. The ceiling was set to prevent tax evasion by movie stars and other high-income persons.

1954 The allowance a self-employed taxpayer, engaged in a trade or business, was authorized to claim as compensation for personal services was increased from 20 to 30 percent.

1962 For citizens qualifying for the tax exclusion under the 1-year residence requirement, a ceiling of $35,000 annually ($20,000 for the first 3 years) was established.

1964 The $35,000 ceiling was lowered to $25,000.

TAX REFORM ACT OF 1976

For private sector citizens working abroad, the Tax Reform Act of 1976 changed the Section 911 exemption basically in three ways.

1. Cut to $15,000 the amount that could be excluded from their income; the amount for employees of nonprofit institutions, however, remained at $20,000.

2. Changed the way of computing the tax on the remaining nonexcluded income, which in effect reduced the value of the exclusion, particularly for higher income taxpayers. Previously, the excluded income had come "off the top," i.e. from the individuals' highest tax brackets. Now it comes off the bottom, saving tax at the individuals' lowest rates. (See p. 46.)

3. Forbade the use of the foreign tax credit to offset U.S. taxes on the excluded $15,000. (See p. 47.)

The effective date of the changes was retroactive to January 1, 1976 (i.e., the 1976 tax year). However, in May 1977, the Congress postponed the effective date for 1 year, or until January 1, 1977. Later in 1977, the House of Representatives passed a bill further extending the effective date of the changes for an additional year but the Senate adjourned in December 1977 without acting on the bill.

For Government employees, the Congress decided in 1976 to delay any decision concerning changes in the tax treatment of their overseas allowances until it received the recommendations of an interagency committee, made up of 20 agencies, studying the problem.

In March 1977, prior to the completion of the study, a special House Ways and Means task force completed a 15-month study of the issue and recommended that the present blanket exclusion for statutory allowances and benefits be replaced with a system treating private and public employees in the same circumstances more nearly the same.

In June 1977, the interagency committee recommended against repealing the exclusion for statutory allowances and benefits.

COMPARATIVE TAX POLICIES OF OTHER COUNTRIES

The United States is the only industrialized country and one of only a handful of nations as far as we can determine that taxes the worldwide income of all its citizens, regardless of where they reside. Most countries only tax the worldwide income of their residents and grant tax relief for foreign-earned income. For example:

--Canada - Non-resident citizens are completely exempt from Canadian income tax. But if their status remains that of Canadian residents who happen to be working abroad, their total incomes would be taxed. The determination of residency status can be difficult and uncertain.

--United Kingdom - In 1977 the country granted several concessions liberalizing the taxation of citizens employed abroad. Any Briton spending 365 days working overseas is eligible for 100-percent tax relief. One who spends more than 30 days working overseas, whether consecutive or aggregate, is entitled to partial tax relief.

--Sweden - Swedish citizens do not pay Swedish income tax if they are away from Sweden more than 1 year. They are allowed to make short occasional visits to Sweden for key holidays or for business reasons not more than once a month.

UNUSUAL TAXABLE INCOME ASSOCIATED WITH PRIVATE SECTOR EMPLOYMENT

Some costs of maintaining U.S. living standards abroad--housing, education, etc.--are extraordinarily high in many areas and have become far more expensive in recent years due to worldwide inflation, the impact of vastly increased oil prices, the declining value of the dollar, and the short supply of suitable accommodations and facilities in certain areas.

Most Americans, to be able to afford to locate abroad, must be compensated for at least a portion of these additional costs. In the past, many apparently felt that most of their overseas allowances and/or housing, when supplied by their employers, were nontaxable benefits under Sections 61 and 119 of the Internal Revenue Code.

Although the Internal Revenue Service has not always strictly enforced taxation of noncash benefits furnished to employees, section 61 of the Internal Revenue Code generally requires that the value of property or services be taxed if they are provided by the employer as income.

Section 119, enacted in the Internal Revenue Code of 1954, excludes from gross income the lodging and meals furnished by an employer (1) for the convenience of the employer, (2) on the employer's business premises, and (3) if the employee is required to accept lodging as a condition of his employment. (Underscoring supplied.) The basic test of exclusion is whether the meals or lodging are furnished primarily for the convenience of the employer and thus excludable or whether they are primarily for the convenience of the employee and thus taxable. The Internal Revenue Service in 1976 won key court tests denying the section 119 exclusion under certain conditions and taxing as income to the employee the high cost of employer-furnished housing overseas, as opposed to the lower value it would have in the U.S. As a result, it has tightened the enforcement of reporting the full value of such allowances.

Housing is most often a principal component of extraordinary living costs abroad. In Tokyo, Japan, in Lagos, Nigeria, in some Middle Eastern countries, and in remote outposts, a Western-style apartment or house may rent for as much as $15,000 to $30,000 a year. (See app. I for cost of living in 20 areas where large numbers of U.S. citizens reside.) Allowances paid for these high costs often have the effect of doubling or tripling the employee's taxable income. If the changes to Section 911 and the recent Tax Court decisions are applied to the 1977 tax year, the Treasury Department has estimated that overseas employees' taxes would increase by almost $300 million, 1/ as shown below.

Gross tax liability after adjustment for foreign tax credit	1975 law assum[illegible] non-reporting of [illegible]nces			1977 law assuming reporting of allowances		
	(millions)	(percent)	[illegible]erage tax per return	(millions)	(percent)	Average tax per return
Salary	$646		$4,328	$646		$4,328
Allowance	-		-	64		429
	646	100	4,328	710	100	4,757
Section 911 relief	-412	-64	-2,760	-184	-26	-1,233
Net tax liability	$234	36	$1,568	$526	74	$3,524

Some beneficiaries of the foreign earned income exclusion state that they would be unable to remain overseas if the exclusion is reduced and/or repealed. Employers also contend that U.S. citizens would become too expensive to employ in many areas abroad. Chapters 4 and 5 contain information collected in our survey on the number of Americans that have left foreign employment or that have been or are scheduled to be replaced due to the reduced tax break in the Tax Reform Act of 1976.

INCONSISTENT TAX TREATMENT OF INCENTIVE ALLOWANCES FOR GOVERNMENT EMPLOYEES

Some 50 different benefits, allowances, and privileges are available to U.S. Government employees serving abroad,

1/ As this report went to press the Department of the Treasury increased this estimate. Here and elsewhere in this report we use the estimates published by Treasury in October 1977.

depending on their posts and circumstances.1/ For the most part, allowances are authorized either as incentives to induce employees to serve overseas or to reimburse them for costs they would not incur if they remained in the United States.

The incentives authorized as inducement for service abroad include:

--Post differentials ranging from 10 to 25 percent of salary in countries having particularly adverse living conditions.

--Housing allowance; diverse reasons have been given in the legislative history as justification for this allowance. Our analysis indicates that the primary justification is as an overseas incentive; however, in particular circumstances, the allowance also serves the purpose of representational housing and as reimbursement for the extra cost of housing in some locations.

--Home leave (extra vacation) for 5 to 15 days a year and transportation to and from the United States.

--Rest and recuperation; payment of travel costs for vacations to places outside the United States from especially difficult posts.

Post differentials are includable as income and are taxable. The remaining incentive allowances are excludable from income and are not taxed.

Reimbursement for costs that an employee would not incur if he remained in the United States are excludable from income for the most part and are not taxed.

1/ For additional information on these allowances, see GAO report "Fundamental Changes Needed to Achieve a Uniform Government-Wide Overseas Benefits and Allowances System for U.S. Employees," Sept. 9, 1974 (B-180403)

CHAPTER 3

IMPACT OF 1976 TAX CHANGES ON U.S.

BALANCE OF PAYMENTS AND DOMESTIC ECONOMY

The full economic impact of the reduction in tax incentives for overseas employment cannot be measured precisely not only because needed data are lacking but also because the secondary benefits to the Nation from having Americans abroad are so difficult to determine. Recognizing these limitations, to gage the impact we (1) secured the views of U.S. company officials experienced in foreign sales and/or operations with respect to the probable impact and (2) estimated the effects upon the U.S. economy assuming the tax increase would be passed along to customers.

The tax change may affect not only the company that employs Americans overseas but also other U.S. companies. A contract lost due to the higher costs of tax reimbursements may have a ripple effect on subcontractors and/or suppliers of the primary company. Also, if a company loses or must replace Americans with third-country nationals, the effect may be similar since foreign employees in influential positions may be inclined to deal with their own country's firms rather than those of the United States. These potential impacts were of concern to company officials we interviewed at overseas affiliates of U.S. companies and at domestic headquarters.

About 55 percent of the overseas affiliates responding believed that at least 5 percent of the U.S. companies in host countries would close down operations as a result of the tax change; about 88 percent believed that the change would result in at least a 5 percent reduction in U.S. exports worldwide.

Most of the headquarters of U.S. companies surveyed believed that few if any U.S. companies in their industries would close down operations as a result of the tax change. However, although only 57 percent of them ventured estimates, most of these believed that the change would result in at least a 5 percent reduction in U.S. exports worldwide.

ANALYSIS OF ECONOMY-WIDE EFFECTS

The actions of American citizens residing abroad may have a pervasive effect on the international payments of the United States and thus on domestic income and employment.

As an example, some American citizens abroad may be sales representatives soliciting orders to be filled by U.S. production for export. If the favored status granted their incomes under Section 911 is revoked or modified and U.S. firms must compensate them for their increased taxes, U.S. production costs and product prices may rise, thereby decreasing the competitiveness of U.S. goods abroad. However, in this era of massive multinational corporations, there is no guarantee that U.S. representatives are selling goods produced in U.S. plants; the goods may well be produced in total or in part abroad. If so, revisions of Section 911 should have no detrimental effect on the international trade accounts.

Similarly, American citizens abroad who are likely to bear the burden of a change in Section 911 may be executives in U.S.-based companies who are strategically placed to influence the purchasing decisions of the foreign operations. Higher tax liabilities on these executives, to the extent that they raise the company's production costs, may lead to the recall and replacement of the Americans by less costly foreign nationals, who may then divert purchases to non-American goods. To the extent that such a diversion takes place, U.S. exports will decline.

For analytical purposes, these two examples can be equated to other situations. If one believes that the original Section 911 imposed a fair tax on income earned in foreign countries, its repeal amounts to the imposition of a special tax on those exported commodities sold through the efforts of Americans abroad. On the other hand, if one views the original Section 911 as granting favored treatment to income earned abroad as opposed to similar income earned domestically, its repeal can be viewed as the ending of a special subsidy for certain categories of U.S. exports. Viewed either way, the effect should be the same--certain classes of U.S. exports may suffer a decline in demand.

Before one concludes that Americans residing in foreign countries only contribute positively to the U.S. balance of payments, it should be noted that their contribution may instead be negative.

While the growth of the multinational corporation may be due to many causes (e.g., lower production costs, to get around high or rising tariffs and other impediments to trade imposed by foreign countries or trade blocs, etc.), it certainly is aided by the ease with which U.S. managerial talent can be sent abroad to superintend operations. Production in foreign countries may serve either to replace exports or to increase U.S. imports. This is not to suggest that all production abroad by U.S. firms necessarily has a negative impact on the Nation's balance of payments. To the extent that rising tariff barriers or other trade restrictions would have decreased U.S. exports anyway, U.S. production abroad does not necessarily displace exports. Moreover, it is possible that if U.S. firms did not go abroad to set up production for export to the United States, foreign-owned firms may have come to dominate the U.S. market. To the extent that foreign production by U.S. subsidiaries is either export-replacing or import-increasing, any tax abatement on foreign-earned income may be viewed as a subsidy encouraging U.S. firms to move production abroad, which they use, in turn, to serve foreign markets or to ship to the United States.

As a final example of the effect of U.S. citizens abroad, one should examine their consumption habits and any desire on the part of foreigners to emulate them that may be stimulated. To the extent that these habits require the use of U.S.-produced goods, they may lead to increased U.S. exports.

These examples, which are typical, are constructed in part to indicate that the contribution of U.S. citizens residing in foreign countries to the American balance of payments is not unambiguously positive and may, on balance, be negative. Moreover, capturing all of these effects in a single number is by no means easy, for many assumptions must be made whose realism will undoubtedly affect the confidence with which the conclusions are received.

What effects can be measured?

Role of individuals and companies

An increase in taxes on Americans abroad may affect U.S. exports in several ways. It has been represented to us that many overseas Americans occupy positions in which they are well placed to influence procurement decisions for millions of dollars of goods and services. In these positions they are said to favor American suppliers, to the economic benefit of the United States. It is also claimed that the success of a single American company abroad may be responsible for a large volume of orders for other American firms, assuming as seems reasonable that the company is better acquainted with suppliers of its own nationality than with those of other nationalities. If the increased costs of employing Americans abroad cause them to be discharged from their positions of influence or cause American companies to lose contracts that would have provided orders for many other American firms, the ultimate impact of the tax increases on the U.S. economy may be sizable.

We have not attempted to judge the merits of this position or to appraise its quantitative importance, not because the position seems implausible to us but because we know of no way to evaluate it objectively. Had we tried to do so, we would have had to devise a new research methodology unlike any that has been devised before. Almost surely we would have had to depend on the voluntary cooperation of many firms, foreign and American, as well as foreign governments. A major investment of time and money would have been needed.

Price impact

However important personal or commercial relationships may be in determining trade flows and export success, a rich fund of experience proves that prices and quality also matter. Increased taxes on Americans abroad will also affect export sales by affecting prices, willingness to invest, and willingness to work. To the extent that overseas Americans who are employed in selling U.S. exports remain in their jobs and are compensated by their employers for at least a part of their tax increase, the compensation must come either from the employers' profits or from the prices that foreign customers pay. Or the employees themselves may bear the tax increase and suffer

a reduction in their take-home wages. Any of several assumptions are possible; but whatever assumption one makes, it is possible in principle to trace out the consequent effects on the U.S. economy.

In our analysis we focused solely on the price impact of the tax increase--the impact that the tax increase may have on the prices of U.S. exports. The increase will have no immediate effect on export prices if it is absorbed in full by the American employees or their U.S. employers. (It will have a belated effect if it causes Americans to withdraw from their overseas jobs and they are replaced by other nationals, or if American companies, discouraged by lower profits, abandon some foreign markets.) But we concluded that it would be unreasonable to expect a major part of the tax increase to be borne by employees or employers, since in the long run both capital and labor are highly mobile, an opinion shared by many of the businessmen and employees we interviewed both in the United States and abroad. (See p. 77 for an elaboration of the view that the tax increase will not be borne by American employees overseas.)

In conducting our analysis, we assumed complete shifting of the tax increase to foreign customers in the form of an increase in export prices, because that assumption seemed more reasonable than any alternative. Other assumptions about shifting of the tax increase would have yielded somewhat--not dramatically--different results.

METHODOLOGY

Our approach to estimating the effect of changes in Section 911 on the U.S. balance of payments, domestic employment, gross national product, and Federal budget position is to make several assumptions that are apt, if anything, to exaggerate the number of Americans abroad engaged in promoting U.S. exports; to compute the maximum effect that the tax increase might have on the prices of U.S. products sold abroad; and to trace the effects of the subsequent decline in export demand back to the domestic economy. We assumed that:

1. All Americans affected by a revision in Section 911 are occupied in selling U.S.-produced exports.

2. All reductions in the disposable income of Americans abroad brought about by a revision in Section 911 are offset by increases in gross salaries. If it is assumed that these individuals are in the maximum marginal tax bracket (50 percent), their gross salaries will have to be raised by a sum equal to twice the possible increase in tax to enable after-tax salaries to remain constant.

3. All increases in the gross salaries of individuals due to a revision in Section 911 will raise the production costs of exports. These additional costs, in turn, are passed on to customers in the form of price increases.

4. Not all exports are likely to be equally subject to price increases. The prices of some exports should not be affected, either because they are sold in geographic regions where few Americans reside who are affected by a revision in Section 911 or because these products are unlikely to be sold by Americans abroad. Using the export classification of the Data Resources, Inc. (DRI) econometric model, the increase in export prices has been assumed to be concentrated in (a) industrial supplies and materials, (b) capital goods, except automotive, and (c) consumer goods, except automotive. 1/

1/ The categories of exports excluded were (1) foods, feeds, and beverages, (2) auto vehicles, parts, and engines, (3) military sales and donations and reexports, and (4) services and repatriated investment earnings. Items 1 and 3 were excluded because their sale is unlikely to be promoted by Americans living abroad. Item 2, related mainly to trade with Canada, was excluded because the effect of Section 911 changes on Americans living in Canada is relatively small. Item 4 was excluded because it chiefly contains dividends and interest payments repatriated from U.S.-owned foreign assets.

In summary, the approach used to estimate the macroeconomic impact of a change in Section 911 is to regard the effects as identical to those that would follow if the Government imposed an excise tax on certain exports equal in size to the increase in gross salary needed to maintain disposable income at the same level as before the change in Section 911.

In deciding on the size of the tax that the Government is assumed to impose upon exports, three possible revisions to Section 911 were considered.

1. Section 911 as it stood until 1975 is repealed.

2. The 1976 Amendment and the decision of the U.S. Tax Court on the taxable status of income received in kind are allowed to stand and go into effect.

3. Only the 1976 Amendment is allowed to go into effect.

Each of these three cases is complicated by the fact that if the gross income of Americans abroad is increased to compensate for the effects of possible changes in Section 911, their tax liabilities to foreign governments may rise. These tax liabilities are used to offset taxes due the U.S. Government. To incorporate this effect into the estimates, two additional assumptions were made.

1. The marginal rate of foreign taxation is zero so that all the increase in taxes accrues to the U.S. Treasury.

2. The marginal rate of foreign taxation is 50 percent so that the increase in taxes is shared equally by the U.S. and foreign governments.

The majority of Americans who are employed overseas and who are affected by the 1976 tax changes probably confront a foreign marginal tax rate that is neither zero nor 50 percent but something between. We believe that the true weighted average of these marginal tax rates is nearer zero than 50 percent and therefore that the estimates prepared under the first assumption are the more realistic ones. Others who prefer another

marginal rate can use the DRI figures to construct new estimates corresponding to their preferred rate simply by interpolating between the estimates in tables 1 and 2 below that correspond to the zero and 50 percent rates.

Each assumed change in Section 911 will yield a certain dollar amount by which the tax revenue of the Treasury will increase. Each change will also cause export prices to rise by twice the amount of the increase in taxes. The increase in export prices and the rise in tax revenue are then introduced into the DRI econometric model to compute values of U.S. gross national product, domestic employment, exports and imports, and Federal budget deficit for the next 5 years.

The size of the decline in the quantity of exports purchased by foreigners depends on the sensitivity of their demand to an increase in the price of American goods. This sensitivity is related to the availability of substitute products. Thus, an increase in price of one product is likely to decrease the quantity that individuals are willing to purchase if a close substitute is available. If no close substitutes are available, consumers are unlikely to cut back purchases substantially, especially if the product is a necessity.

Numerous attempts have been made to estimate the relationship between changes in relative product prices (the prices of U.S. products compared with those of foreign substitutes) and the quantity of American goods that foreigners are willing to purchase--called the price elasticity of demand. Price elasticities are an integral part of the DRI econometric model and they span a range from -1.168 for consumer goods to -.277 for industrial supplies and materials. These values mean that if American export prices rise relative to a weighted average of foreign prices by 1 percent, the quantity of American goods that foreigners are willing to purchase will decline by between 1.168 percent and .277 percent. The reasonableness of the DRI price elasticities was verified by consulting some 120 other studies on the same general topic prepared by the International Monetary Fund, the Board of Governors of the Federal Reserve System, and private individuals (primarily academic economists). The DRI estimates were found to be generally compatible with those reported by the other studies.

To put the DRI elasticity measures into perspective, they can be compared to two extreme cases cited by economists. When the quantity of a commodity that people are willing to purchase is completely insensitive to price changes, the elasticity is zero. If it is completely sensitive, the elasticity approaches infinity. Measured against this scale, the DRI elasticities are small.

Why questionnaire replies were not used

The replies to the questionnaires that are discussed in chapters 4 and 5 indicate that revising Section 911 would probably most strongly affect certain U.S. industries operating in a few countries. Although it would have been desirable to have used this information in computing the impact on the U.S. balance of payments and other selected macroeconomic variables, it was impossible to do so for the following reasons.

First, the DRI macroeconomic model does not have a highly developed international sector providing a detailed breakdown of exports by commodity and geographic destination. Civilian exports are disaggregated into just five classes by type of product and not at all by destination. Other macroeconomic models are no more detailed. It was therefore impossible to assign all of the increase in costs stemming from a change in Section 911 to as narrow a class of U.S. exports as those that respondents predicted would be most severely affected. Nevertheless, so far as the model permitted, an effort was made to focus on the most relevant exports. The increased costs stemming from a change in Section 911 were assigned to just three of the five classes distinguished in the DRI model on the grounds that producers of the other two would not be much affected.

Second, the replies were gathered from a non-random sample of individuals and companies and we were therefore reluctant to depend on them for quantitative estimates of the economy-wide impact of changes in Section 911.

Finally, even had the sample been randomly chosen, it was too small to support quantitative inferences about individuals in particular countries and occupations. Selecting and interviewing a suitably large sample would have been time consuming and very costly.

THE DRI RESULTS

It is through changes in both tax revenue and the relative prices at which foreigners can purchase American goods versus foreign substitutes that the contemplated changes in Section 911 will have their impact on U.S. gross national product, employment, and the balance of payments.

According to data furnished by the Treasury Department, if Section 911 as it stood until 1976 were abolished, an estimated revenue gain of $412 million would have resulted in 1977. When the effect of the decision of the U.S. Tax Court on the taxable status of income received in kind by U.S. residents abroad is added to the effect of the 1976 Amendment to Section 911, the revenue gain is estimated at $292 million. When only the 1976 Amendment is considered, the revenue gain is estimated at $228 million.

In table 1, using the DRI model, the macroeconomic impact of each of these three possible tax increases is considered. The impacts on the U.S. balance of payments and Federal budget deficit are reported in table 1 under two assumptions: that foreign governments impose no tax on the extra wages paid to overseas Americans to compensate them for the increase in their U.S. taxes, and that foreign governments do tax the extra wages at a marginal rate of 50 percent. The impacts of the three tax changes on U.S. gross national product, domestic employment, and exports and imports were also calculated under the same two assumptions; but the two sets of estimated impacts differed so little that only one was included in table 1, the set that assumed no foreign taxation.

The immediate impression from table 1 is that the effects of changing Section 911 are very small in relation to the values of the variables that they would affect. This is not surprising, in view of the fact that in 1976 American merchandise exports totaled over $114 billion, and the maximum addition to export costs assumed here would be only $824 million.

Table 1

Selected Macroeconomic Impacts of Tax Changes, 1978-82

Year	Projected gross national product (in 1972 prices)	Impact on gross national product (in 1972 prices) (note a): of repealing Section 911	of 1976 amendments to Section 911	of 1976 amendments to Section 911 and 1976 Tax Court decisions
	(billions)	(millions)	(millions)	(millions)
1978	$ 1,393	$ -290	$ -160	$ -200
1979	1,449	-660	-360	-470
1980	1,517	-820	-450	-580
1981	1,582	-840	-470	-600
1982	1,635	-780	-430	-550

Year	Projected domestic employment	Impact on domestic employment (note a): of repealing Section 911	of 1976 amendments to Section 911	of 1976 amendments to Section 911 and 1976 Tax Court decisions
	(000 omitted)	(000 omitted)	(000 omitted)	(000 omitted)
1978	92,910	-6	-3	-4
1979	95,030	-20	-11	-14
1980	97,380	-27	-15	-19
1981	99,790	-29	-16	-21
1982	101,690	-28	-15	-20

Year	Projected net exports less transfer payments to foreigners	Impact on balance of payments (note b): of repealing Section 911 — Marginal foreign tax rate is Zero	of repealing Section 911 — 50 %	of 1976 amendments to Section 911 — Marginal foreign tax rate is Zero	of 1976 amendments to Section 911 — 50 %	of 1976 amendments to Section 911 and 1976 Tax Court decisions — Marginal foreign tax rate is Zero	of 1976 amendments to Section 911 and 1976 Tax Court decisions — 50 %
	(billions)	(millions)	(millions)	(millions)	(millions)	(millions)	(millions)
1978	$ -13.4	$ +600	$ +190	$ +330	$ +100	$ +430	$ +130
1979	-8.7	+430	-50	+240	-20	+300	-30
1980	-6.6	+490	-50	+270	-30	+340	-40
1981	-3.5	+580	-20	+320	-10	+410	-20
1982	+2.3	+660	-10	+360	-20	+470	-20

(Footnotes at end of table)

Table 1 (continued)

Year	Projected exports (in 1972 prices)	Impact on exports (in 1972 prices) (note a): of repealing Section 911	of 1976 amendments to Section 911	of 1976 amendments to Section 911 and 1976 Tax Court decisions
	(billions)	---(millions)---		
1978	$ 102.8	$ -150	$ -80	$ -110
1979	110.0	-300	-160	-210
1980	115.2	-320	-180	-230
1981	120.7	-340	-190	-240
1982	126.8	-360	-200	-260

Year	Projected imports (in 1972 prices)	Impact on imports (in 1972 prices) (note a): of repealing Section 911	of 1976 amendments to Section 911	of 1976 amendments to Section 911 and 1976 Tax Court decisions
	(billions)	---(millions)---		
1978	$ 90.4	$ +10	$ 0	$ -10
1979	93.2	-30	-20	-20
1980	96.4	-60	-30	-40
1981	101.0	-70	-40	-50
1982	104.4	-60	-40	-50

Year	Projected Federal budget deficit	Impact on Federal budget deficit [increases (+), decreases (-)]: of repealing Section 911 — Marginal foreign tax rate is Zero	of repealing Section 911 — 50 %	of 1976 amendments to Section 911 — Zero	of 1976 amendments to Section 911 — 50 %	of 1976 amendments to Section 911 and 1976 Tax Court decisions — Zero	of 1976 amendments to Section 911 and 1976 Tax Court decisions — 50 %
	(billions)	---(millions)---					
1978	$ 51.7	$ -650	$ -230	$ -360	$ -130	$ -460	$ -160
1979	54.1	-510	-20	-280	-10	-360	-10
1980	31.4	-490	+70	-270	+40	-340	+50
1981	19.2	-560	+70	-310	+40	-400	+50
1982	20.2	-720	+10	-380	0	-510	-10

Source: Data Resources, Inc., econometric model of U.S. economy

a/ Assuming a zero marginal foreign tax rate; figures computed using a 50-percent marginal foreign tax rate were nearly identical.

b/ Impact measured in DRI model was actually on net exports less transfer payments to foreigners. Assuming no significant change in the capital account, this is the same as the impact on balance of payments.

The following conclusions, taken from table 1, summarize the macroeconomic effects that may be expected from the 1976 Amendment to Section 911 and the Tax Court decisions.

1. Gross national product will grow less each year than it would have done in the absence of the tax changes. The shortfall below projected output will reach a maximum of $600 million (in 1972 prices) in 1981.

2. Exports will also grow less than if there were no tax changes, the maximum effect amounting to $260 million (in 1972 prices) in 1982. The small size of the decline is due to the small value of the weighted price elasticity of foreign demand for American goods.

3. U.S. imports will increase more slowly as a result of the decline in U.S. income produced by the fall in exports and the rise in Government tax revenue.

4. The U.S. balance of payments--or balance on current account, measured here by net exports less transfer payments--actually improves. The improvement is produced by a rise in the nominal value of exports, a result of the fact that the increase in export prices more than offsets the decline in volume. The slight increase in the deficit when foreign governments tax additions to wages at 50 percent stems from the fact that the U.S. Government must then share a part of the tax revenue with the governments of the countries where U.S. citizens are working.

5. The largest effect on domestic employment is produced in 1981, when approximately 21,000 jobs are lost. To give some perspective to this number, it should be noted that the average growth rate of the United States creates some

30,000 jobs a week. Thus, the largest effect on employment will be about two-thirds of a normal week's job creation. In 1978, the estimated job loss is only 4,000, or about the number of jobs added to the U.S. economy in one normal day.

6. The effect on the Government budget is generally positive. If foreign governments impose no tax on the wage increases granted to Americans overseas, the deficit is reduced each year in the range of $340 million to $510 million. If the Treasury must share the tax revenue with foreign governments, the reduction in the deficit will be smaller.

OTHER RELEVANT CONSIDERATIONS

The estimates that appear in table 1 do not include the effects of two responses to the assumed rise in U.S. export prices. Both would help offset the macroeconomic effects of the rise. One of the responses would be automatic: a change in exchange rates between the dollar and foreign currencies. The other would be discretionary: a change in fiscal and monetary policies to offset the fall in foreign demand for U.S. exports. Only the latter response can be incorporated into the DRI model to produce revised estimates of macroeconomic effects. In the present state of knowledge, it is impossible to predict how large the exchange rate responses would be, although some general observations on the subject can be offered.

Flexible exchange rates

Since March 1973 the United States has allowed the exchange rate between the dollar and foreign currencies to float in the international money markets. The purpose of the float is to allow market forces to bring the supply of and demand for dollars into equilibrium in order to insure that the flow of dollars from the United States equals the flow to the United States.

Under a regime of floating exchange rates, the balance of payments accounts can have no direct effect on gross national product or employment. For example, the decrease in demand for U.S. exports will cause the dollar exchange rate to fall (each dollar now exchanges for fewer units of foreign currency) decreasing the foreign price

of American goods and encouraging some foreign purchase of U.S. goods. This also raises the American price of foreign goods, i.e., imports are now more expensive. Americans are therefore led to switch their purchases from foreign goods to the now less expensive domestic substitutes. The depreciation of the foreign exchange rate will continue until the net fall in exports is matched by an equivalent fall in imports.

Thus, the original decrease in exports will have no direct impact on U.S. income or employment because it is offset by Americans switching their purchases from foreign goods to domestic substitutes. While a decline in export sales will normally decrease U.S. income and employment, the diversion of American purchases from imports to domestic substitutes will serve to expand U.S. income and employment. The net direct effect is zero.

Within this framework, the contemplated changes to Section 911 can be easily analyzed. Given our assumptions, the tax revisions will serve to raise U.S. export prices, which will serve to decrease foreign demand for American goods. This will cause the exchange rate to depreciate, setting in motion the two forces described above to restore equilibrium: cheaper export prices and higher import prices. The former serves to offset some of the higher prices induced by the revisions to Section 911 while the latter diverts American demand from foreign goods to domestic substitutes. 1/

Fiscal and monetary policy

A decline in gross national product and employment produced by a fall in export demand is analogous to a decline produced by a decrease in domestic demand for domestically produced goods. Since the latter type of unemployment is frequently addressed by a combination of compensatory monetary and fiscal policy, the same tools can be used to correct unemployment that originates in the international sector.

1/ There may be some indirect, short-term effects on employment if the employment/output ratio in the export sector is not the same as in the sector producing import substitutes. In addition, there may be some geographical employment effects if the export and import substitutes are not produced in the same parts of the country.

A decrease in individual and corporate income taxes was introduced into the DRI model that was just large enough to restore gross national product and domestic employment to their projected levels. The new values of net exports less transfer payments to foreigners and the Federal budget deficit are shown in table 2. These economic variables will be affected differently depending on whether or not foreign governments tax the additional wages that we assume will be paid to overseas Americans. If they tax the wages at the rate of 50 percent, the tax increases on Americans abroad will increase the U.S. balance of payments deficit (or decrease the surplus) and Federal budget deficit in every year between 1978 and 1982. Under the more realistic assumption that foreign governments will tax the additional wages at a relatively low rate, the effects will be mixed: a decrease in both deficits in 1978, an increase in 1979, and little or no change in 1980, 1981, and 1982.

CONCLUSIONS

We attempted to estimate as accurately as possible, using a model of the U.S. economy, what effect changes in Section 911 would have on the U.S. balance of payments, gross national product, domestic employment, exports and imports, and the budget position of the Federal Government. Initially, these estimates were made on the assumption that exchange rates between the dollar and other foreign currencies were fixed and that no compensatory changes would be made in the U.S. monetary or fiscal policy. The net economic effect due to the changes to Section 911 was very small.

In an effort to make these estimates more realistic, individual and corporate income tax collections were assumed to be reduced by an amount sufficient to restore employment and output to the levels they attained before Section 911 was changed. The effect of this compensatory fiscal action plus the changes in Section 911 was to cause actual net exports to fall short of projected net exports by $310 million in 1982 and to increase the Federal budget deficit by $500 million in 1982.

Flexible exchange rates, a recent innovation in the international monetary system, should mitigate the effect of changes in Section 911 on the external accounts of the United States and, as a consequence, on the value of gross national product and employment.

Table 2

Selected Macroeconomic Impacts of Tax Changes With a Compensating General Tax Cut to Restore Employment and Output to Projected Levels, 1978-82

Year	Projected net exports less transfer payments to foreigners	Impact on balance of payments (note a)					
		of repealing Section 911		of 1976 amendments to Section 911		of 1976 amendments to Section 911 and 1976 Tax Court decisions	
		Marginal foreign tax rate is		Marginal foreign tax rate is		Marginal foreign tax rate is	
		Zero	50 %	Zero	50 %	Zero	50 %
	(billions)	(millions)					
1978	$ -13.4	$ +560	$ -180	$ +310	$ -100	$ +400	$ -130
1979	-8.7	+300	-350	+160	-200	+210	-250
1980	-6.6	+310	-380	+170	-210	+220	-270
1981	-3.5	+350	-400	+190	-220	+250	-290
1982	+2.3	+370	-440	+210	-240	+260	-310

Year	Projected Federal budget deficit	Impact on Federal budget deficit [increases(+), decreases(-)]					
		of repealing Section 911		of 1976 amendments to Section 911		of 1976 amendments to Section 911 and 1976 Tax Court decisions	
		Marginal foreign tax rate is		Marginal foreign tax rate is		Marginal foreign tax rate is	
		Zero	50 %	Zero	50 %	Zero	50 %
	(billions)	(millions)					
1978	$ 51.7	$ -300	$ +120	$ -160	$ +70	$ -210	$ +90
1979	54.1	+150	+640	+80	+360	+110	+460
1980	31.4	-10	+550	-10	+310	-10	+390
1981	19.2	+10	+630	0	+350	+10	+450
1982	20.2	0	+710	0	+390	0	+500

Source: Data Resources, Inc., econometric model of U.S. economy

a/ Impact measured in DRI model was actually on net exports less transfer payments to foreigners. Assuming no significant change in the capital account, this is the same as the impact on balance of payments.

Finally, whether or not flexible exchange rates and compensatory monetary and fiscal policy are taken into account, so long as one views the tax treatment under Section 911 as a subsidy to exports, a fundamental question remains unanswered--could the forgone tax receipts represented by the subsidy be more effectively employed to promote U.S. exports?

CHAPTER 4

IMPACT OF 1976 TAX CHANGES

ON U.S. INDUSTRY ABROAD

The original Section 911 was intended to promote U.S. business abroad, but its effectiveness has never been evaluated. After Section 911 was amended in the Tax Reform Act of 1976, primarily for reasons of tax equity, it became clear that the change would affect not only U.S. workers abroad but also their U.S. employers.

A company that reimburses its American employees for higher taxes must either absorb the increased costs or pass them on to customers, thus becoming less competitive vis-a-vis other firms. Losing a contract to a foreign competitor may have a ripple effect, since other U.S. companies which would have provided services and/or material on the lost contract would also suffer. To the extent possible, a company may try to replace its American employees with less costly local and third-country nationals. The ripple effect could be similar, since foreign employees in influential positions are apt to deal with their own countries' firms rather than U.S. firms. A company that does not reimburse its American employees for higher taxes may find them leaving because of the higher tax burdens and may have to replace them with local and third-country nationals.

To evaluate the potential effects of the Section 911 tax change on U.S. industry abroad, we surveyed about 50 companies in the United States and 160 foreign affiliates of U.S. firms in 11 countries. 1/ (It should be noted that the companies may tend to overstate rather than understate the effects.) Responses were also solicited from the Tax Executives Institute, a professional association of corporate tax executives.

The precise impact of the Section 911 change is difficult to measure because (1) companies were largely adopting a wait-and-see attitude and (2) a host of other factors affect U.S. companies abroad. Nonetheless, certain relationships can be drawn between company and host-country characteristics and the effects of the change.

1/ Australia, Brazil, Hong Kong, Iran, Japan, Mexico, Philippines, Saudi Arabia, Singapore, United Kingdom, and Venezuela.

Companies which rely heavily on American employees would be much more affected than those with only a few Americans in key positions. The former tend to be in the building/construction and service industry sectors, operating incountry for a relatively short time and on a contract basis. More significantly, they tend to be in countries, such as Saudi Arabia and Iran, that are undertaking large-scale projects and/or that have insufficient local labor for technical/skilled and clerical as well as management and sales positions. These companies are selling the services of their American employees, and if the costs of their employees increase, so must the prices of the services if profit margins are to be maintained.

Several factors make the position of such companies especially difficult. First, if to maintain what many of these companies consider is an already low profit margin, a company tries to increase the contract price to compensate for the increase in employee compensation costs, it may find itself less competitive. Second, if to avoid the increased costs of maintaining U.S. employees, the company attempts to replace them with locals or third-country nationals, it may find itself in an unworkable situation because such labor may simply not be available and because the other party to the contract may expect and demand that Americans provide the services for which it has contracted.

The host-country tax structure and living costs also significantly affect the impact of the Section 911 change. U.S. companies operating in countries which impose low or no taxes on foreigners and/or where the living costs are high would experience more of an impact than those operating in countries which impose high taxes and/or where the living costs are more moderate. 1/ Among the countries we surveyed, Saudi Arabia, Japan, Iran, and Hong Kong rank as very high-cost locations. It is difficult to characterize countries from the tax standpoint; Saudi Arabia, however, is clearly a low-tax country.

Before analyzing in detail the results of our survey and providing examples of actual and potential impacts on U.S. companies, it is necessary to examine the compensation programs provided by U.S. companies to their American employees.

1/ This assumes similar ratios of U.S. personnel costs to total operating costs.

COSTS OF MAINTAINING
U.S. EMPLOYEES ABROAD

In 1975, the value of U.S. direct investment abroad totaled $133 billion and overseas sales of U.S.-controlled firms totaled $458 billion. Foreign operations account for an estimated 25 to 30 percent of total U.S. corporate profits. According to the 1975 edition of the "Directory of American Firms Operating in Foreign Countries," over 4,500 U.S. corporations controlled 17,000 foreign business enterprises. No accurate data is available on the number of Americans working for U.S. companies overseas.

Americans are employed by U.S. companies abroad for a variety of reasons. Those given most frequently by companies we surveyed (which employed more than 9,000 Americans overseas) were the desire for more direct responsiveness to company management and the lack of adequate local labor. To induce their employees to work overseas, most companies provide financial incentives in addition to a base salary. These incentives may vary from company to company and within a company from country to country.

The overseas premium is designed to compensate the individual for uprooting his family and for living in a different culture. The home leave allowance covers a return trip home for the employee and his family. Several of the other allowances are designed to enable the employee to maintain the standard of living to which he was accustomed in the United States without incurring additional costs. These include the cost-of-living, housing, and education allowances, and the reimbursement for increased taxes as a result of being overseas. Hardship and rest and recuperation allowances are inducements provided primarily for employees working in hardship locations.

According to our survey, over 90 percent of the 161 companies provide education allowances; over 80 percent provide cost-of-living, housing, and home leave allowances; almost 70 percent provide overseas premiums; between 15 and 20 percent provide hardship and rest and recuperation allowances. (See graph on p. 31.)

The definition of taxable income varies from country to country, but allowances, including the tax reimbursements, are generally taxable. The United States considers all these allowances taxable in full, and in 1976 the Tax Court ruled that housing provided must be declared at its

PERCENTAGE OF OVERSEAS CORPORATIONS PROVIDING ALLOWANCES TO AMERICAN AND THIRD-COUNTRY NATIONAL EMPLOYEES

ALLOWANCES	Allowances to Americans	Allowances to Third-Country Nationals
OVERSEAS PREMIUM	69	49
COST OF LIVING	81	48
HARDSHIP	17	12
EDUCATION FOR DEPENDENTS	91	57
HOME LEAVE	86	60
REST AND RECUPERATION	19	12
HOUSING	83	50
ADDITIONAL TAXES	77	13

10 20 30 40 50 60 70 80 90 100

LEGEND

ALLOWANCES TO AMERICANS

ALLOWANCES TO THIRD-COUNTRY NATIONALS

fair market value incountry. This figure is often much higher than the fair market value of similar housing in the United States. In any case, it is not uncommon for an employee's total tax burden to be significantly higher than it would have been had the employee received only his base salary in the United States. According to our overseas survey, 77 percent of the companies provide explicit reimbursement for all or part of the additional taxes incurred by their American employees overseas.

As a result of allowances, the cost to a U.S. company of maintaining an American employee overseas can become rather high. It should be noted that third-country companies provide similar financial incentives to persuade their nationals to serve abroad. Moreover, although somewhat fewer U.S. companies surveyed offer each of these allowances to third-country nationals working for them, they are generally provided. The one notable exception is the reimbursement for additional taxes, which only 13 percent of the 161 foreign affiliates of U.S. companies provide to third-country nationals.

Since almost no other country imposes taxes on its nationals working overseas, the question of additional home-country taxes on various allowances does not arise. Consequently, an additional tax burden is faced by third-country nationals abroad only if the effective tax rate is higher in the host country than in the home country. Anything which increases reimbursements to American employees further widens the cost differential between maintaining them and third-country national employees overseas.

VARIABLES AFFECTING IMPACT OF TAX CHANGES

Reliance on U.S. employees

The most significant factor determining the impact of the tax law change is the extent to which a company relies on Americans to conduct its operations abroad. This reliance varies from country to country, from industry to industry, and from company to company. Of the overseas companies we surveyed about 96 percent used Americans in management positions, 58 percent in administrative/professional positions, 47 percent in technical/skilled positions, 38 percent in sales positions, and 17 percent in clerical positions. Companies with employees in technical/skilled and clerical positions cited insufficient local labor as the primary reason for employing Americans. This, plus the

desire for more direct responsiveness to company management were the reasons cited most frequently for using Americans in other positions.

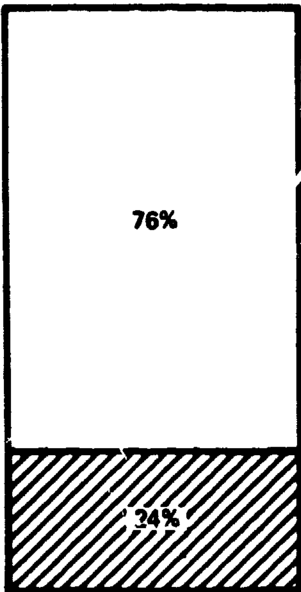
There are no overall statistics on the number of Americans working for U.S. companies abroad. A U.S. company overseas that has a large number of total employees does not necessarily employ a large number of Americans. Of 37 companies that have more than 1,000 employees, 18 employed 20 or fewer Americans. Interestingly, while companies that have been incountry for a long period of time have more employees than those relatively new incountry, they appear to employ fewer Americans; 22 of 37 companies surveyed with over 1,000 employees have been incountry for more than 20 years. In sharp contrast, only 3 of 23 companies that employ more than 100 Americans have been incountry for more than 20 years, as shown on the following graph.

Companies permanently based incountry are less likely to employ large numbers of Americans than those incountry on a project or contract basis. Only 9 percent of the permanently based companies employed 100 or more Americans, while 36 percent of those on a project basis employed 100 or more Americans. Americans tend to be concentrated on large-scale projects in areas that have insufficient local labor. The Middle Eastern countries, where massive projects have been undertaken in the last few years, have especially large numbers of Americans working for U.S. companies. Of the 23 companies that employed more than 100 Americans, 20 were located in Iran and Saudi Arabia, while only 9 of the 37 companies that had more than 1,000 employees were located in those two countries. Companies in Iran and Saudi Arabia tend to employ Americans in technical/skilled and clerical positions as well as in management and sales positions.

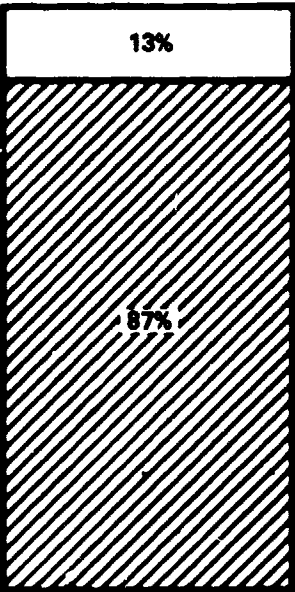
The building/construction and service sectors seem to rely more on Americans than do the equipment and supply sectors. While 40 percent of the 52 companies in the equipment and supply sectors had more than 1,000 employees, only 8 percent employed more than 100 Americans. In contrast, only 15 percent of the 106 companies in the building/construction and service sectors had more than 1,000 employees, but some 18 percent had more than 100 American employees.

LOCATION OF COMPANIES WITH LARGE NUMBERS OF TOTAL EMPLOYEES AND OF AMERICAN EMPLOYEES

COMPANIES EMPLOYING OVER 1,000 TOTAL EMPLOYEES



COMPANIES EMPLOYING OVER 100 AMERICAN EMPLOYEES



LEGEND

COMPANIES IN ALL OTHER COUNTRIES SURVEYED

COMPANIES SURVEYED IN SAUDI ARABIA AND IRAN

Host-country tax structure

Companies which reimburse their American employees for additional taxes paid because of being overseas are concerned not only with the U.S. tax structure but also with host-country tax structures. Countries with higher tax rates than those of the United States are considered to be high tax while those with lower tax rates are considered to be low tax.

The Treasury Department categorizes the 11 countries in our survey as follows: Philippines and Singapore, high tax; Australia, Brazil, Iran, Japan, and Mexico, generally high tax; and Hong Kong, Saudi Arabia, United Kingdom, and Venezuela, low tax. However, there is a problem in classifying certain countries as either high tax or low tax, because, depending on the tax rate structure, a country may be high tax over certain income ranges and low tax over others and what is considered taxable income varies from country to country. Consequently a total compensation package, depending on its makeup, may be more heavily or more lightly taxed overseas than in the United States. In addition, a country may be high tax in theory but not in practice because of weak enforcement procedures. Finally, tax evasion or avoidance may make a high tax country low tax for a particular individual.

Since taxes paid to a foreign country may be used as a credit against one's U.S. tax liability, the tax owed to the host government is of great concern. Individuals in high-tax countries have been able to reduce significantly or even eliminate their U.S. tax liability, while those in low tax countries have owed U.S. taxes even after making use of the credit for taxes paid to the host government. An increase in the U.S. tax liability of individuals in low-tax countries will definitely raise their actual U.S. taxes but may or may not raise those of persons in high-tax countries. Consequently, companies in low-tax countries will face increased U.S. tax bills for all their American employees while those in high-tax countries will face them only on a case-by-case basis.

Host-country living costs and standards

The cost of living in a host country significantly influences the impact of the tax change on a company's operations. It determines the amount of several allowances provided to American employees, which in turn

determines the amount of taxable income for the host country and the United States. This figure is the basis of the tax reimbursement to the employee. Housing is the most significant living cost in most countries. Although Saudi Arabia represents the extreme case (over $2,000 a month for a two-bedroom house), monthly rentals of $1,000 or more are not uncommon in Japan, Iran, Hong Kong, Brazil, the Philippines, Venezuela, and Singapore.

Similarly, education expenses for employees' children are substantial in many countries. Although Saudi Arabia, again, is an extreme case (over $5,000 a year per dependent child), more than $2,000 is standard in Japan, Iran, the United Kingdom, Hong Kong, and Venezuela. Yearly cost of living allowances (exclusive of housing) for married employees with two children are about $15,000 in Japan; $5,000 in Saudi Arabia, Hong Kong, Venezuela, and Iran; $4,000 in Singapore; $3,000 in Brazil; $2,000 in Australia and the United Kingdom; $1,000 in the Philippines; and zero in Mexico.

Home leave costs depend on distance, so in Asia and the Middle East, leave allowances of over $5,000 a year per emp[illegible]vee with wife and two children add another substant[illegible]l element to taxable income.

Compan[illegible]es in countries with low living standards often provide hardship and/or rest and recuperation allowances to attract U.S. employees. In Saudi Arabia, 74 percent of the companies surveyed provide rest and recuperation allowances to their employees. In Iran and Hong Kong, 25 percent or more of the companies provide such allowances. Some 25 percent or more of the companies in Saudi Arabia, Iran, the Philippines, and Singapore give hardship allowances. The hardship allowance was highest in Saudi Arabia, where 20 or 25 percent of base salary was not uncommon.

Table 3 represents typical compensation packages (exclusive of tax reimbursement) for employees in the 11 countries in our survey. From table 3, we classified Mexico, the United Kingdom, and Australia as moderate-cost countries; Venezuela, Brazil, Singapore, and the Philippines, as high-cost countries; and Iran, Hong Kong, Japan, and Saudi Arabia as very high-cost countries.

TABLE 3
TYPICAL COMPENSATION PACKAGES
(Exclusive of Tax Reimbursement)

EMPLOYEE WITH $20,000 BASE SALARY – SINGLE

	MEXICO	UNITED KINGDOM	AUSTRALIA	VENEZUELA	BRAZIL	SINGAPORE	PHILIPPINES	IRAN	HONG KONG	JAPAN	SAUDI ARABIA
BASE SALARY	$20,000	$20,000	$20,000	$20,000	$20,000	$20,000	$20,000	$20,000	$20,000	$20,000	$20,000
OVERSEAS PREMIUM	3,000	3,000	3,000	3,000	3,000	3,000	3,000	3,000	3,000	3,000	3,000
COST OF LIVING		744	1,380	2,244	1,140	1,932	516	2,088	2,640	6,588	2,544
EDUCATION											
HOUSING	4,164	3,768	3,000	6,696	8,880	8,436	9,336	10,548	12,072	13,860	16,908
HOME LEAVE	380	626	1,922	512	1,104	1,854	1,554	1,400	1,670	1,362	1,726
HARDSHIP							2,000	2,000			4,000
REST AND RECUPERATION											1,588
TOTAL	$27,544	$28,138	$29,302	$32,452	$34,124	$35,222	$36,406	$39,036	$39,382	$44,810	$49,368

EMPLOYEE WITH $40,000 BASE SALARY – MARRIED – 2 CHILDREN

	MEXICO	UNITED KINGDOM	AUSTRALIA	VENEZUELA	BRAZIL	PHILIPPINES	SINGAPORE	HONG KONG	IRAN	JAPAN	SAUDI ARABIA
BASE SALARY	$40,000	$40,000	$40,000	$40,000	$40,000	$40,000	$40,000	$40,000	$40,000	$40,000	$40,000
OVERSEAS PREMIUM	6,000	6,000	6,000	6,000	6,000	6,000	6,000	6,000	6,000	6,000	6,000
COST OF LIVING		1,668	1,860	5,004	2,544	1,140	4,296	5,880	4,656	14,644	5,904
EDUCATION	2,436	5,400	3,700	4,810	3,600	2,662	3,992	4,968	5,850	6,290	10,740
HOUSING	6,636	6,468	5,376	11,376	14,712	16,200	15,108	20,268	18,840	23,628	30,420
HOME LEAVE	1,520	2,504	7,688	2,048	4,056	6,216	7,416	6,680	5,600	5,448	5,304
HARDSHIP						4,000			4,000		8,000
REST AND RECUPERATION											2,676
TOTAL	$56,592	$62,040	$64,624	$69,238	$70,912	$76,218	$76,812	$83,796	$84,946	$96,010	$109,044

COMPANY SURVEY RESULTS

The impact of the tax change should, in theory, be greatest in those countries which have both very high costs and low taxes and least in those countries with moderate costs and high taxes. This, however, assumes that companies provide allowances similar to those outlined above, and that (1) the companies are equally reliant on the use of Americans and (2) personnel costs are similar percentages of total operating costs. If these factors were equal, then companies that do not reimburse their American employees for the increase in taxes would experience the greatest loss of Americans (and replacement with local and/or third-country nationals) in very high-cost, low-tax countries, while companies that do reimburse their American employees would experience the greatest increases in employee compensation costs, total operating costs, and prices of goods and services in those same countries.

Loss of Americans

Except in the Philippines and Saudi Arabia, 70 percent or more of the companies in every country surveyed generally reimburse their U.S. employees for additional taxes resulting from their overseas employment. Only 57 percent of the firms in Saudi Arabia and 50 percent in the Philippines provide such reimbursement. Of the companies surveyed, 60 percent indicated they would reimburse their employees for the entire amount of the increase in taxes expected in 1977, 32 percent would make no reimbursement at all, and 8 percent would make partial reimbursement. It should be noted that only 42 percent of the companies in Venezuela and 35 percent in Saudi Arabia said they would provide total reimbursements.

Only 32 percent of all companies indicated a loss of American employees because of the Section 911 tax change. However, 40 percent of the companies in Venezuela, 58 percent in Iran, and 81 percent in Saudi Arabia said U.S. employees had been lost as a result of the change. These results were expected, except for Iran where 75 percent of the companies indicated they would provide tax reimbursements.

At least 70 percent of the companies in each of the building/construction, services, supplies, and equipment sectors generally provide allowances for additional taxes to their employees. However, when

asked whether they planned to reimburse their employees for the increased taxes as a result of the change in Section 911, only 30 percent of the companies in building/construction indicated they would provide total reimbursements and 55 percent said they would provide no reimbursements. For the other sectors, 62 percent in services, 65 percent in supplies, and 77 percent in equipment indicated they would provide total reimbursements.

Loss of American employees was indicated by 47 percent of the companies in the building/construction sector, compared with only 36 percent in serv.ces, 23 percent in equipment, and 13 percent in supplies.

While 83 percent of companies permanently based in countries generally provide allowances for additional taxes, only 55 percent of those on a project/contract basis provide them. For increased taxes expected in 1977 due to the change in Section 911, 69 percent of the permanently based companies and only 27 percent of those on a project/contract basis indicated they would totally reimburse their employees. Moreover, 55 percent of the companies on a project/contract basis indicated they would provide no reimbursement at all.

Of the permanently 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.

Increase in employee compensation and total operating costs

Only 65 percent of the companies surveyed ventured estimates of increased employee compensation costs resulting from the Section 911 tax change, and we considered some of the higher estimates to be very questionable. Nonetheless, of the 104 companies that did respond:

24 percent indicated increases of less than 1 percent
13 percent indicated increases from 1 to 3 percent
13 percent indicated increases from 3 to 5 percent
14 percent indicated increases from 5 to 10 percent
16 percent indicated increases from 10 to 15 percent
8 percent indicated increases from 15 to 20 percent
11 percent indicated increases from 21 to 30 percent
1 percent indicated increases of over 40 percent

Iran and Saudi Arabia 1/ were the only countries where 50 percent or more of the companies forecasted increases in employee compensation costs of 10 percent or more. As indicated earlier, not only are both countries very high cost, but companies in both these countries rely heavily on American employees. Although 86 percent of the companies in Hong Kong, a very high-cost, low-tax country, indicated increases of 3 percent or less, companies in Hong Kong tend to rely less on American employees.

From an industry standpoint, significant percentages of the equipment and supplies companies indicated increases in employee compensation costs of less than 1 percent (48 percent in supplies and 31 percent in equipment). On the other hand, only 7 percent of the companies in building/construction and 17 percent in services predicted that small a rise in such costs.

Companies based permanently incountry indicated generally smaller increases in employee compensation costs than did companies on a contract/project basis. Of the permanently based firms, 57 percent projected increases of less than 5 percent; of the contract companies, only 20 percent showed that small an increase. On the other hand, 65 percent of the contract companies estimated increases in employee compensation costs of 10 percent or more.

Only 66 percent of the companies supplied estimates of increases in total operating costs. For the 107 companies responding:

37 percent indicated increases of less than 1 percent
22 percent indicated increases from 1 to 3 percent
11 percent indicated increases from 3 to 5 percent
15 percent indicated increases from 5 to 10 percent
10 percent indicated increases from 10 to 15 percent
5 percent indicated increases from 15 to 20 percent

In only 4 countries did 25 percent or more of the companies expect increases in total operating costs of more than 5 percent--Brazil (26 percent), Saudi Arabia (27 percent), Venezuela (30 percent), and Iran (44 percent). Of the companies permanently based incountry 68 percent indicated increases of less than 3 percent;

1/ Responses from Australia and Singapore on this question were too few to provide meaningful information.

of the contract/project companies only 24 percent foresaw that small an increase. Indeed, 43 percent of the contract companies indicated increases of more than 10 percent.

Increase in prices

Price increases of goods and services as a result of higher employee compensation costs due to the Section 911 change were indicated by only 28 percent of the companies overall. In Iran and Saudi Arabia, however, 89 percent and 67 percent, respectively, of the companies reported they had been forced to raise the prices of goods and services. By industry sector, the following percentages of companies indicated increases.

44 percent in the building/construction sector
32 percent in the services sector
17 percent in the equipment sector
13 percent in the supplies sector

In addition, whereas only 20 percent of the permanently based companies indicated they had increased prices of goods and services, 62 percent of those on a contract/project basis indicated such increases.

CASE STUDIES OF ACTUAL AND POTENTIAL IMPACT

The above statistics are based on information obtained from companies during the summer of 1977. Since no actual reimbursements for additional taxes have been made, much of the information consists of estimates, sometimes guesswork, of expected increases in employee compensation costs and total operating costs. Other information, however, indicates loss of Americans and increases in prices that have actually occurred due to expected increased taxes. The statistics indicate certain relationships between characteristics of company and host country and actual and potential impact of the tax increases. Company characteristics include the industry sector, contract or permanent status, number of years incountry, and especially, reliance on American labor. Country characteristics include tax structure, cost of living (especially housing), skills of the local labor force, and whether the country has undertaken especially large projects.

In the following section, we have supplemented the statistics presented with several cases based on information provided by members of the Tax Executives Institute. The information below, representing some of the more serious impacts assessed by member firms, was not verified by GAO. 1/

1. A company that produces, installs, and maintains equipment used on oil and gas wells was required in late 1976 to bid for renewal of its service contract in a Middle East country. After adjusting its rates to provide for tax equalization under the Section 911 changes, the company's bid was so high that it lost the contract to a European competitor. It also lost the sale of three lift vessels, (selling for $1.5 million each) from which the service crews work.

2. A company found that "tax protecting" its employees in Iran would cost it approximately $60,000 in increased salaries, or about 15 percent of its total salary costs in Iran and concluded that "Due to marginal profitability of the operation, and our inability to obtain more favorable contract terms, we elected to close our Iranian operations."

3. A large multinational corporation estimated that employee compensation costs would increase over $5,000,000 a year (before considering the effects on corporation taxes) as a result of tax reimbursements to its 350 American employees overseas. That company, while stating that "it is not clear at this time the extent to which the new law will cause U.S. citizens employed overseas to be replaced by host- or third-country nationals," noted that "the higher cost of maintaining Americans overseas is a significant factor in determining the value of keeping a U.S. employee on a foreign assignment."

1/ Responses were received from 38 of the 3,200 members from whom information was solicited.

4. Another large multinational corporation which employs about 180 U.S. citizens abroad and whose policy was to keep its employees "whole" through tax equalization at a cost of about $5,000 per employee estimated that the Section 911 change would increase tax equalization costs threefold, to about $15,000 per employee. It stated that "the uncertainty as to the future of Section 911 is causing an excessive amount of confusion to the employer-employee relationship. At this time, we have recalled only one employee from foreign service because of excessive tax costs which threaten to increase."

5. A company currently employing over 200 Americans who provide technical services in oil and gas well drilling stated that, as a result of the increased costs due to the changes in the tax law which "cannot in the long run be borne by customers," it had accelerated the substitution of local foreign personnel and third-country nationals for Americans. In 1975 Americans constituted 28 percent of the company's overseas personnel; in 1978, it is estimated they will constitute 15 percent.

6. A large retailing firm noted that the preparation and expertise required to prepare individual tax returns for its 75 to 100 U.S. employees had always been immense and that because of the Section 911 changes it had engaged an outside public accounting firm (also considered taxable income to the company's employees). The costs for about 60 individual returns for 1976 were approximately $100,000 (much of which was admittedly start-up and nonrecurring expenses).

Conclusion

Companies surveyed overseas indicated increases of zero to $22 million a year in employee compensation costs resulting from the tax change. These increased costs may be the cause, in part or in full, of lost contracts or of the replacement of Americans with foreign nationals, with their possible adverse effects on U.S. exports. Indirect costs may result from (1) the tax reimbursement itself becoming taxable to both host governments and the U.S. Government, (2) the increased complexity and cost of preparing returns, and (3) the general confusion and apprehension over how American employees overseas will be treated from the tax standpoint. Several companies asserted that the Section 911 change was but another example of the United States restricting the overseas operations of U.S. companies.

TAX CHANGE IN PERSPECTIVE

When the tax change was first enacted, companies began extensive lobbying to seek what they believed was more equitable treatment for their U.S. employees. They succeeded in postponing implementation of the law until January 1977. At the time of our survey, company officials generally anticipated changes in the U.S. tax law to eliminate what they believed was unfair treatment of U.S. employees.

Most firms indicated they would provide total reimbursement for the increased taxes on earned income of their U.S. employees. Fifty-nine percent of the corporate headquarters (and 42 percent of U.S. foreign affiliates) surveyed indicated they currently had plans to reduce the number of American employees overseas (and incountry) because of the increase in compensation costs resulting from the Section 911 change. Many firms, however, had not yet decided whether their American employees would be replaced by foreign nationals and were awaiting clarification as to when, if at all, the Section 911 tax change would take effect.

It should be noted that the replacement of Americans by local and third-country nationals has been taking place over several years. Some of the largest U.S. affiliate operations have only a handful of U.S. expatriates. The longer a company is incountry, the more opportunity it has to train local nationals and substitute them for Americans. For these companies, the Section 911

change more appropriately could be seen as accelerating rather than causing this replacement. As noted previously, however, firms incountry on a contract basis are often heavily reliant on Americans who are hired for the duration of a project. Such companies generally have no plans for gradually replacing U.S. employees. If higher personnel costs stemming from increased tax burdens lead these companies to replace Americans with third-country nationals, the Section 911 change could be considered the cause.

CHAPTER 5

IMPACT OF 1976 TAX CHANGES ON U.S. INDIVIDUAL TAXPAYERS

The amendment of Section 911 of the Internal Revenue Code and the recent Tax Court decisions will increase the taxes paid by each American working overseas an average $1,956 in 1977 and will provide $292 million in additional U.S. tax revenues, according to Treasury estimates.

The prospective tax increases will vary greatly according to income levels, employer compensation policies, and geographic location. However, the Government has not established a system for determining the extent of the tax increase for individuals in varying circumstances or for evaluating how the increase will affect those individuals. We interviewed Americans employed in 11 countries to obtain their views on the tax changes, and 77 percent of them believed their taxes would be increased by more than $2,000 a year. Although half of them received tax allowances, only 38 percent expected their employers would reimburse them for more than half the tax increase. Those interviewed tended to be pessimistic; 51 percent (167 of 330 responding) expected the tax change would cause them to return to the United States at or before the end of their present tours. This included 42 (26 percent) who were expecting substantial tax reimbursement from employers, since they perceived that employers might seek to replace them with third-country nationals who would cost less.

NATURE AND EXTENT OF TAX CHANGES

How the tax changes will affect American overseas employees will depend on the amount of tax increase and how they are able to deal with it. For many, there will be little or no increase; others will have increases ranging up to $17,500, depending on income level, extent of foreign taxes paid, and source of income. Some employees will be protected by tax allowances from employers.

Changes in exclusion and rates

The tax-free status of many individuals was eliminated when the amount they could exclude from income was lowered from a maximum of $25,000 to a general level of $15,000 ($20,000 for employees of U.S. charitable organizations). The major change, however, was to calculate the tax on total income, including the $15,000, and then subtract the

tax on the $15,000 from the total tax. This sets the maximum benefit available to all with foreign-earned income of more than $15,000 at $3,004 for a married taxpayer and $3,512 for a single taxpayer.

The prior exclusion reduced the taxpayer's total taxable income and provided a tax reduction based on the highest rates that would have otherwise applied to gross income. Therefore, the value of the exclusion was progressively higher as gross income increased, up to a maximum of $17,500, or 70 percent (the maximum tax rate) of the $25,000 exclusion.

<u>Changes in foreign tax credit and option to waive use of Section 911</u>

The Internal Revenue Code was amended in 1976 to permit individuals who take the standard deduction to also claim a credit for foreign income taxes paid. Previously, individuals who claimed a foreign tax credit were required to itemize deductions. That requirement was unfavorable because many individuals overseas did not have large itemized deductions, such as mortgage interest and State and local taxes, that would equal the standard deduction. The value of this change will vary according to the person's tax bracket and the amount by which the standard deduction exceeds the itemized deductions.

The amendment to Section 911 disallowed any credit for foreign taxes allocable to income excluded under Section 911 on the premise that allowing a credit for foreign taxes paid on excluded income provided a double benefit. In effect, however, it reduces and may eliminate the value of the exclusion for all persons subject to foreign income tax.

In certain high-tax countries, the foreign tax allocable to excluded income--and therefore disallowed as a credit--may exceed the benefit of the Section 911 exclusion. Accordingly, the amendment provided that taxpayers may elect to waive the use of Section 911. Such election, however, would apply to all subsequent years unless the taxpayer obtained consent of the Secretary of the Treasury to revoke the election. Therefore, a taxpayer anticipating a possible move to a country having lower taxes might be reluctant to waive use of Section 911.

Several methods have been proposed to determine the amount of foreign tax allocable to excluded income and, therefore, not creditable against U.S. tax. The following example bases the allocation on the ratio of U.S. tax on excluded income to U.S. tax on foreign taxable income.

$$\frac{\text{U.S. tax on excluded income}}{\text{U.S. tax on foreign taxable income}} \times \text{foreign tax} = \text{foreign tax not creditable}$$

An individual with $40,000 in foreign-earned income, paying $8,000 in foreign tax and filing a joint return would determine the tax credit reduction as follows.

$$\frac{\text{U.S. tax on \$15,000}}{\text{U.S. tax on \$40,000}} \times \$8{,}000 = \frac{\$3{,}004}{\$12{,}140} \times \$8{,}000 = \$1{,}979$$

Because this individual would lose $1,979 in foreign tax credits, he would realize an actual U.S. tax benefit of only $1,025 ($3,004 - $1,979) under Section 911.

If the individual resided in a country that imposed the same tax on $40,000 as the United States ($12,140), the disallowed foreign tax would be $3,004, or equal to the tax savings under the $15,000 exclusion. In such a case, Section 911 would provide no benefit.

Varying benefit in selected countries

U.S. citizens working and residing abroad are subject first to income taxes imposed by the country of residence, and second to U.S. income taxes. The U.S. tax system, to safeguard against double taxation of the same income, permits a qualified credit for taxes paid to foreign countries by U.S. citizens. Thus the ultimate tax liability of U.S. citizens may be greatly affected by foreign tax systems.

There is great disparity among foreign country tax systems, with the extremes ranging from no income tax on individuals to a tax burden much heavier than that of the U.S. The disparity arises from differences in tax rates, definitions of taxable income, tax administration practices, and, in some cases, special provisions for non-citizens. With this disparity, the effect of foreign taxes on a citizen's U.S. tax liability may range from no effect in a country with no income tax, such as Saudi Arabia, to complete offset in very high tax countries such as Mexico.

For countries with effective tax rates between these extremes, the foreign tax credit would be less than the U.S. tax, leaving some amount payable to the United States.

The Tax Reform Act changes in Section 911 altered the relationship between U.S. and foreign taxes by increasing the U.S. liability and limiting the amount of foreign taxes that may be credited against U.S. tax. Appendix V contains examples showing the application of U.S. and foreign taxes to hypothetical taxpayers before and after the Tax Reform Act changes for selected countries. The examples also demonstrate as an intermediate step, the impact of 1976 Tax Court rulings that require a taxpayer to report a housing allowance, or overseas fair market value of employee-provided housing, as taxable income.

The examples show that in no-tax countries the United States would receive the entire tax increase caused by the tax changes; in a high-tax country an individual would have no increase in total taxes or in tax payments to the United States, but simply a reduction in his foreign tax credit carryover. In a less extreme case, the married taxpayer in Japan would have an increase in U.S. (and total) tax payments of $8,125, consisting of a $6,010 increase in U.S. tax before credits and a $2,115 reduction in the foreign tax credit.

WHO IS AFFECTED?

It is difficult to assess the overall effect of the tax changes because the Government has no current and accurate census of overseas taxpayers eligible for Section 911 benefits. The State Department estimates that 1.3 million U.S. citizens, not including Government personnel and their dependents, reside in foreign countries but has no information about their eligibility for Section 911 benefits. The best information available was an Internal Revenue Service (IRS) count, which indicated that about 140,000 tax returns claimed Section 911 benefits for 1975. In 1977 significantly more taxpayers may be eligible for Section 911 because:

- --IRS data indicated that the number was growing (an increase of 38,000, or 38 percent, from 1972 to 1975);

- --There has been a surge in U.S. business activity in Middle East oil-producing countries

since 1974; the 18-month qualifying period would have prevented many persons from claiming the benefit for 1975.

--Some eligible individuals may not have filed tax returns in the past.

Treasury estimates of impact

When the Tax Reform Act became law, the changes in Section 911 were expected to produce additional estimated revenues of $40 million a year, an average tax increase of $300 for each taxpayer claiming the Section 911 benefit. That estimate was based on outdated information, and Treasury initiated a project to obtain more currnet information. As part of that project, IRS developed a statistical sample from about 8,000 of the 140,000 tax returns showing Section 911 benefits for 1975. Treasury used that sample to analyze and assess the effect of changes in Section 911 as well as the effect of anticipated changes in reporting, stemming from recent Tax Court decisions. In October 1977, one year after the Tax Reform Act was signed into law, Treasury reported that the changes would increase 1977 taxes by $292 million. The average individual tax increase due to the changes is estimated at $1,956.

Treasury's analysis confirmed that the tax changes would vary greatly according to income level and geographic location. As shown in table 4, almost half the increase will fall upon the 10 percent of taxpayers that have adjusted gross incomes of more than $50,000. Even so, the tax increases will be greater than the total tax under prior law for all other income classes except those under $10,000. The analysis also indicated that taxpayers reporting less than $20,000 income (53 percent of the total) would average tax increases of $120.

Table 5 shows that U.S. taxpayers living in the Organization of Petroleum Exporting Countries (OPEC) of the Middle East and Africa will have the largest tax increases, averaging $4,700 per return. Americans in these countries generally receive relatively large taxable allowances for housing, dependent education, and general living costs. They also have unusually high gross incomes; 44 percent earn more than $30,000 a year, according to the Treasury estimates, compared with 29 percent of all taxpayers residing abroad and 4 percent of taxpayers residing in the United States, as shown in table 6.

Table 4

Estimated 1977 Tax Increases By Income Class

Estimated 1977 adjusted gross income	Individual returns: Number of returns	Individual returns: Average increase per return	Total returns: Based on 1975 reporting	Total returns: Tax Reform Act 1976	Total returns: Increase
			----------(millions)---------		
Less than $10,000	36,465	$ (a)	$ 1	$ 1	$(b)
$10-$20,000	42,527	212	7	16	9
$20-$30,000	27,469	1,165	22	54	32
$30-$40,000	16,865	3,083	32	84	52
$40-$50,000	10,454	5,739	30	90	60
More than $50,000	15,470	8,985	142	281	139
Total	149,250	1,956	$234	$526	$292

a/ Less than $14.
b/ Less than $500,000.

Table 5

Estimated 1977 Tax Increases By Geographic Area

Area	Individual returns: Number of returns	Individual returns: Average increase per return	Total returns (note a): Based on 1975 reporting	Total returns (note a): Tax Reform Act 1976	Total returns (note a): Increase
			----------(millions)---------		
OPEC - Middle East & Africa	15,466	$4,720	$ 27	$100	$ 73
Latin America	17,955	2,729	29	78	49
Japan	5,251	2,095	11	22	11
Western Europe	45,703	1,860	111	196	85
Other Asia	18,442	1,735	24	56	32
Oceania	9,727	1,028	6	16	10
Other Middle East & Africa	11,416	788	8	17	9
Canada	20,684	774	11	27	16
All other	4,606	1,086	7	12	5
Total	149,250	1,956	$234	$526	$292

a/ May not add to totals because of rounding.

Table 6

Classification of U.S. Taxpayers
By Income and Residence

	Number of returns	Cumulative percent of returns by adjusted gross income (note a)				
		Under $10,000	$20,000	$30,000	$40,000	$50,000
Citizens residing abroad:						
Total	149,250	24	53	71	83	90
Canada	20,684	29	66	85	92	96
Western Europe	45,703	33	49	65	77	85
Japan	5,251	31	60	73	78	85
Middle East and Africa - OPEC	15,466	7	25	56	77	88
Latin America	17,955	27	51	66	79	87
Other Middle East and Africa	11,416	41	73	88	93	97
Oceania	9,727	26	72	87	94	97
Other Asia	18,442	23	49	69	83	91
All other	4,606	26	55	81	87	94
Citizens residing in United States (note b)	82,176,778	55	86	96	98	99

a/ Estimated 1977 income levels based on 1975 data.
b/ From data in Statistics of Income: 1975 Individual Income Tax Returns (Preliminary).

Source: Office of Tax Analysis, Department of the Treasury.

U.S. taxpayers in Latin America would also have relatively large tax increases. U.S. taxpayers in Western Europe and in Japan and other Asian countries, would tend to have average tax increases.

The smallest average increase, $774, would apply to the 20,000 U.S. taxpayers residing in Canada, the foreign country with the largest number of U.S. taxpayers. In non-OPEC Middle Eastern and African countries and in Oceania (Australia, New Zealand, etc.) U.S. taxpayers would also have relatively small average tax increases, $1,028 or less. In these countries, 15 percent or less of the U.S. residents have estimated gross incomes in excess of $30,000.

HOW ARE TAXPAYERS AFFECTED?

The majority of overseas taxpayers who claimed Section 911 benefits in 1975 reported incomes of less than $20,000 so they will have little or no tax increase due to the tax changes. Taxpayers who do face a significant tax increase may cope with it in various ways, depending on such factors as employer compensation and hiring policies, individual skills, and personal preference. Those with employers that provide compensation for higher taxes overseas are the most fortunate. Others must decide whether it is to their advantage to remain overseas with less disposable income or to return to the United States. Although the Treasury Department's special project developed estimates of the tax increase in varying situations, there is still no system to determine how the tax changes will affect individuals. Because of this, and because the factors determining that effect are very subjective and personal in nature, we obtained the views of 367 taxpayers directly affected in 11 countries through interviews and in-depth questionnaires. This group was not necessarily representative of the 50,000 Americans in the 11 countries that claimed Section 911 benefits for 1975. We recognize that those interviewed might tend to overstate the adverse effects of the tax change because of their financial interest in the matter. However, the information obtained does provide a perspective on the conditions under which Americans live and work overseas, the manner in which they are compensated, and the amount and probable impact of recent tax changes.

Individuals in the survey group were predominant employed in management, administration, and professional positions by American companies; 75 percent were over 35 years of age and almost half were over 45, indicating they were fairly advanced in their careers. About 50 percent made annual salaries above $30,000, including one-fourth with salaries over $40,000. Another 36 percent had salaries between $20,000 and $30,000. Most were not long-time foreign residents; 78 percent had been overseas 10 years or less and almost half had been there 4 years or less. Although 85 percent were married, 37 percent did not have their families with them and the remainder had an average of 2 dependents with them.

Taxation of allowances

As discussed in chapter 4, most U.S. companies operating overseas pay allowances to compensate for higher overseas living costs and to provide incentives for employees

to work abroad. Most of the survey group received some allowances, and a substantial majority received at least housing allowances and home leave transportation, as shown below.

Type of allowance	Percent of survey group receiving allowances
Housing	73
Home leave transportation	71
Cost of living	58
Allowance for taxes	49
Overseas premium	48
Dependent education	39
Hardship	14
Rest and recuperation	10

These allowances are all considered taxable income under current law, particularly in view of recent Tax Court rulings. (See p. 7.) However, under Section 119 of the tax code, some taxpayers might be eligible to exclude from reported income the value of housing provided by their employers. Allowances can greatly increase taxable income, particularly where living costs are very high. However, much if not all of the additional income must be spent for essential living expenses. For example, the average monthly housing costs for the survey group was $1,025, with individual monthly costs as high as $5,600. According to 54 percent of those receiving housing allowances, the allowance covered less than three-fourths of their housing costs; 80 percent considered the housing inferior to housing they would occupy in the United States. Appendix IV describes the housing market in each of the 11 countries we surveyed.

In the survey group, 58 percent received cost-of-living allowances. This allowance may vary from country to country and from company to company. A typical allowance would be determined by multiplying the employee's spendable income (salary less such expenses as housing, education, and income taxes) by the difference in cost of living indexes for his locality and Washington, D.C. (See app. I for cost-of-living indexes for various overseas and U.S. locations.) Tokyo had the highest index--165, using Washington, D.C., as the base of 100--while the highest in the 48 contiguous United States was New York City at 120. At least 10 major foreign cities had living cost indexes equal to or higher than New York. The

cost-of-living allowance can significantly increase taxable income and therefore tax liability, even though it is intended only to compensate for the higher prices of goods and services purchased overseas. For example, a person in Tokyo with a $40,000 salary might receive an allowance of about $14,000, thereby increasing his tax liability by $7,000 at the incremental rate of 50 percent.

Only 40 percent of the survey group received education allowances for dependents, reflecting the high proportion (46 percent) that were single or not accompanied by dependents. Payment of education allowances is based on the assumption that dependents would obtain free public education if resident in the United States. In actuality, employees in the United States pay some part of U.S. education costs in the form of State income and local property taxes. However, allowances are generally based on the total cost of tuition, books, and related fees for adequate schools at the overseas locations. These cost-based allowances can be minimal in countries like Australia and Canada where adequate public schools are available at little or no cost. Generally, dependents must attend private schools in non-English-speaking countries at annual costs of $1,000 to $3,500 a student. However, in high-cost areas like Saudi Arabia, education costs can exceed $4,000 a year for each student. If adequate schools are not available, education allowances may be even greater to cover the costs of room and board and transportation. Education allowances are regarded as compensation to employees for income tax purposes. For an employee with several children in a high-cost country, the allowances could add more than $10,000 to his taxable income and, at the 50 percent rate, more than $5,000 to his tax liability.

Some individuals have not paid taxes on the value of dependent education benefits when their companies were large enough to provide educational facilities in lieu of paying allowances. Taxation of such benefits has been a controversial issue. At least one large company has persuaded IRS that where adequate public schools are not available the value of the benefit should not be taxable income to its employees. It contended that the benefit does not represent compensation associated with specific positions nor provide the employees with any value that they did not have before employment with the company. If this reasoning is accepted, however, it would appear to apply equally to education allowances, since the form of payment (in cash or in kind) is not generally a factor in the Internal Revenue Code definition of income.

Home leave transportation allowances are received by 71 percent of the survey group. Home leave is provided to help employees return home to renew contacts with family, friends, and associates. The allowance usually is based on the cost of round trip air fare for each family member once every year or two; the frequency may vary by company and location. The amount of tax to be paid on the related taxable income will vary according to points of origin and destination and family size. For example, a family of five traveling between Saudi Arabia and the East Coast of the United States could have a home leave transportation allowance of $10,000 ($2,000 for each round trip), which would increase the tax liability by $5,000 at the assumed 50 percent tax rate. On the other hand, a single person traveling between England and the East Coast might have an allowance as small as $650 and a related tax liability of only $325.

Finally, 49 percent of the survey group received allowances for taxes. Typically, this allowance compensates an employee for only the increase in taxes associated with overseas employment--an increase primarily caused by high foreign taxes and U.S. taxes on overseas allowances. The tax allowance itself becomes taxable income in the year received, thus further increasing the individual's tax and the amount of tax allowance in the following year in a continuous cycle. In such high-cost areas as Saudi Arabia, the tax allowance may be $22,000 for a married taxpayer with two dependents having a base salary of $40,000 and typical allowances. At the 50 percent tax rate, this would cause an additional tax increase of $11,000 for the year received and require an additional tax allowance. The 1977 tax increase would thus cause a cycle of increased tax allowances and taxes on those allowances that would continue in succeeding years, but in diminishing amounts. In addition, the tax increase caused by the tax changes would recur in 1978 and future years, cauing additional cycles of increased tax allowances and taxes thereon each year. (See p. 65 for an example.)

In some extreme cases the recent tax changes may cause some individuals to pay out most of their cash salaries for taxes, as the following example of a taxpayer residing in Saudi Arabia shows.

	1975 law	Tax Reform Act of 1976
Income and tax		
Base salary	$25,000	$25,000
Housing (employer-provided)	24,000	24,000
Cost-based allowances:		
Transportation	900	900
Education	15,000	15,000
Home leave travel	8,000	8,000
Gross income	$73,900	$73,900
U.S. tax (standard deduction and 5 exemptions)	$15,735	$23,246
Cash flow		
Salary	$25,000	$25,000
Less U.S. tax	15,735	23,246
Disposable income	$ 9,265	$ 1,754

The full impact of tax changes on this taxpayer was even greater than indicated. He had accepted overseas employment prior to certain changes in tax administration, and he had understood that the education allowance was not taxable and that only $2,600 would have to be reported as income for the value of employer-provided housing. With those assumptions, his U.S. income tax under the old rules (with a $20,000 exclusion) would have been only $1,815. Accordingly, his $25,000 salary would have covered his tax payment and his planned $15,000 living expense budget and still left more than $8,000 for savings or other purposes. Instead, based on a recent tax audit of a fellow employee, he now expects IRS will require that he report as income IRS's valuation of his housing ($24,000) as well as the full value of education costs paid by his employer. He now expects to pay 93 percent ($23,246) of his cash income (excluding allowances) for U.S. income tax. This individual worked for a foreign employer and, therefore, had little hope for additional compensation to help pay the increased tax. If the employer should provide additional compensation, it would be taxed at the rate of 50 percent because the employee's allowances had boosted

him into the maximum tax bracket. Thus the employer would have to pay out $2 in order to add $1 to the employee's spendable income.

Taxpayers without protection

Taxpayers whose employers do not provide additional compensation to cover tax increases will suffer a loss of spendable income. If the loss is significant, many will return to the United States to seek employment that does not entail the inconvenience, discomfort, and risks often associated with overseas employment. Most of the survey group had been away from the United States for relatively few years and they had management, administrative, or professional skills common to both the U.S. and overseas labor markets so their reentry into the U.S. labor market would not be difficult. In the survey group, about 60 percent of the 197 not expecting substantial reimbursement for the tax increase said they intend to return to the United States.

There are many reasons why individuals might elect to remain overseas even with reduced take-home pay. Some have been overseas for a long time and have close ties to the local community or highly specialized skills not readily marketable here. Also, the costs of moving and reestablishing themselves in the United States could be significant. A majority of those in the survey group that were self-employed or employed by local companies planned to remain. About 85 percent of all those planning to remain work for employers permanently located overseas.

Managerial personnel, particularly in the upper echelons, may feel a commitment to carry on, even with lower rewards. In the survey group a majority of those in managerial positions and a majority of those earning more than $35,000 a year, intended to remain overseas. The higher income individuals would have the largest tax increases, but they would also be most able to pay.

There are some Americans who have remained overseas for a very long time and who have founded their lifestyles on the premise of receiving a substantial tax break on their U.S. income tax. Some individuals surveyed fell in this category of long-time foreign residents and asserted that the tax increase due to the change in Section 911 will be a major financial hardship for them.

Taxpayers protected by employers

Individuals who will be reimbursed by their employers for tax increases will feel little immediate impact from the tax changes. However, as employers adjust to the increased cost of tax reimbursements, employees may find that they are forced to bear all or part of the cost through reductions in salaries or in such allowances as overseas premiums. Ultimately, some U.S. employees may lose their jobs to individuals of other nationalities should employers become either unable or unwilling to meet the higher cost of U.S. employees.

Many American companies overseas have been willing to pay a premium for U.S. workers. They expected greater productivity and more responsiveness to company interests. However, in industrialized developed countries, these companies may be able to obtain local skilled workers much cheaper than U.S. workers because they need not pay overseas allowances. In countries where skilled local workers are not available, American companies may obtain third-country nationals willing to accept lower wages and living allowances than U.S. workers because they could not do so well in their home countries. Third-country workers have a particular advantage in countries that impose little or no income tax. In such locations they would be essentially tax free, while U.S. workers would still be taxed by the United States.

The danger of being replaced by foreign nationals was apparently perceived by many individuals in the survey group. Of the 158 individuals planning to remain overseas, 35 percent expressed specific concern about the possible loss of their jobs to workers from another country. In addition, 42 (or 36 percent) of 117 expecting reimbursement for more than three-fourths of the tax increase indicated their intention to return to the United States.

Individuals expecting reimbursement for the tax increase might have another reason for returning to the United States. The reimbursement might be limited to the tax increase on compensation paid by employers. Individuals having substantial unearned income--interest, dividends, etc.--would pay tax on such income at a much higher rate. For example, a married taxpayer with $49,000 taxable income, including $4,000 unearned income, would now pay tax at the rate of 50 percent on the $4,000. Previously, the $4,000 would have been taxed at the rate of

32 percent, assuming the individual was eligible for the full $25,000 exclusion. In the case of very high income, the incremental tax rate could go as high as 70 percent on unearned income.

CHAPTER 6

OTHER IMPACTS OF 1976 TAX CHANGES

The 1976 Amendment to Section 911 is likely to have secondary impacts in addition to the primary impacts on taxpayers, employers, and the economy. These secondary effects will either reinforce or diminish the primary revenue effects. For example, if taxes are raised for Americans abroad, the primary effect will be an increase in tax revenues from those individuals. But if some Americans respond by leaving their overseas jobs and returning to the United States, tax revenues may either increase further or decrease. Revenues may increase if the returning Americans take well-paying positions without displacing other persons and pay more tax than they would have abroad. Revenues may decrease if the new positions do not pay well or if the returnees cause others to become --or remain--unemployed.

Even if the Americans remain overseas, the revenue gain from the Section 911 Amendment may either exceed or fall short of current estimates, depending on who bears the tax increase. If American employees bear it as a reduction in wages, the current estimates may be accurate. If companies bear the increase as a reduction in profits, the estimates may be too high because they take no account of a fall in corporate income tax collections. If the tax increase is passed on to customers, the estimates may be too low. It is impossible to predict through deductive reasoning whether tax collections will increase by more or less than the Treasury Department's estimates, which consider only the primary impact, or even whether they will increase at all. The analyses in chapter 3 indicated that, under two slightly different sets of assumptions, tax receipts would increase either substantially more or substantially less than Treasury estimated, illustrating the hazards of venturing predictions.

The tax changes are likely to produce windfall tax revenues for foreign governments. Company payments to employees to compensate for U.S. tax increases will be subject first to foreign tax and second to U.S. tax if the U.S. rates are higher than the foreign rates.

The tax changes will marginally increase the cost of U.S. Government programs overseas, currently budgeted at $7.3 billion excluding U.S. military programs. U.S. companies that contract with the Government and organizations

supported by it are expected to seek additional funds to compensate employees for the tax increase. The budget impact of these cost increases had generally not been assessed by the various agencies, but indications were that it would be marginal in relation to total program costs. Some portion of these cost increases will be recovered by the Government in the form of increased tax receipts.

Employees of U.S. charitable organizations operating overseas will be less affected by the tax changes than other private individuals, but even so, they will be taxed more than before. Several charities we surveyed expected the tax changes to significantly increase their costs, thus adversely affecting their overseas programs.

The tax changes were viewed as having a potential impact on U.S. relations with a few countries. This potential impact was largely seen as the loss of influence in government, education, and development activities if Americans involved in these activities should return to the United States because of the tax changes.

LONG-TERM IMPACTS ON NET TAX FLOW

The primary congressional intent behind the 1976 Tax Reform Act amendment of Section 911 was tax equity, that Americans living and working abroad for private companies no longer be accorded a tax advantage over Americans living and working in the United States. An additional factor was the estimated revenue gain to the Government as a result of the tax law changes.

In 1972, about 102,000 taxpayers claimed exclusions aggregating $1.4 billion. Had this excluded income been taxable in full, it was estimated there would have been a net revenue gain of about $60 million after foreign tax credits. The 1976 Tax Reform Act changes were expected to increase fiscal year 1977 revenue by about $44 million. Treasury recognized that these estimates were based on incomplete and outdated information, and it initiated a special project to secure better data, as discussed in chapter 5. An October 1977 estimate, which Treasury is in the process of revising, projected a 1977 revenue gain of $292 million as a result of changes in Section 911 and the Tax Court decisions. As Treasury itself noted, if the effect of the 1976 Tax Court decisions that housing provided be declared at the fair market value incountry had been

considered subsequent to, rather than prior to, the Tax Reform Act change, then the revenue gain due to the Section 911 changes would have been reduced.

Several factors were not taken into consideration in Treasury's preliminary analysis of the revenue impact. These factors affect overall tax revenue to the Government and would apply to any tax increase for U.S. citizens working abroad; they are not limited to the Section 911 change exclusively.

First, if U.S. companies must reimburse their employees for the tax increase, corporate tax collections may fall. They will certainly fall if the reimbursement comes out of company profits. In that case, nearly half the increase in employee taxes will be offset by a reduction in company tax revenues.1/ But if the company succeeds in passing its wage increases on to its foreign customers, corporate tax collections may fall very little. Then net U.S. tax revenues may increase by more than the Treasury Department's estimates; for there may be little or no impact on corporate profits, but a larger wage bill to be taxed.

Second, over a period of several years, the number of Americans working abroad might decline as a result of increased taxes. Companies that generally reimburse employees for increased taxes might replace Americans with less expensive third-country or local nationals. Also, Americans not reimbursed for the tax increase might return to the United States for financial reasons. In either case, a decline in the number of American taxpayers overseas will mean a decrease in tax revenues if the increase in their wages fails to offset the decline in their number. However, any decrease in total taxes paid by overseas Americans will be offset to some extent --perhaps even fully--by taxes collected from the returning Americans in their new positions, unless they remain unemployed or merely displace other Americans from jobs.

Third, companies that reimburse employees might become less competitive and lose contracts to non-U.S. companies. Lost contracts might result in reduced profits and, consequently, less tax on repatriated profits for the Government.

1/ Corporate income over $50,000 is taxed at a rate of 48 percent.

Fourth, if Americans are replaced by third-country or local nationals, U.S. companies might lose export sales as non-Americans in procurement and other influential positions would tend to purchase materials and services from companies with which they were most familiar (i.e., other than U.S. companies). To the extent that U.S. exports would decrease, potentially lower profits of U.S. companies would result in lower taxes paid to the Government.

As these remarks indicate, it is impossible to determine by deductive reasoning whether the tax increases, on balance, would be larger or smaller than the Treasury Department's estimates--or whether collections might even decrease. A great deal depends on the assumptions one makes. The analyses in chapter 3 showed that, under one set of assumptions, tax receipts would increase substantially more than the Treasury estimated (if Americans remained abroad, the tax increase were passed forward to customers, the increases in the salaries of Americans were not taxed by foreign governments, and U.S. authorities adopted no compensatory fiscal stimulus). They would increase much less, however, if authorities cut other taxes to remedy the decrease in domestic employment and gross national product.

POTENTIAL FOR INCREASE IN TAXES TO CERTAIN FOREIGN GOVERNMENTS

Certain foreign governments may obtain added revenue by taxing reimbursements that U.S. companies provide to their employees because of the tax changes. Foreign taxes paid on the tax reimbursement can be credited against their U.S. taxes to the extent of U.S. tax on the reimbursement. If the incremental foreign tax rate is lower than that of the United States, some portion of the tax on the reimbursement would flow to the U.S. Government. However, in countries where the incremental tax rate on the reimbursement is equal to or higher than the U.S. rate, the foreign government would be the only beneficiary of tax on the reimbursement. It should be noted that in particularly high-tax countries, companies might provide tax reimbursements outside the country in order to avoid further tax at high foreign tax rates.

The following schedule demonstrates the changes in an individual's U.S. and foreign tax payments over time because of the changes in Section 911. The example is based on a married taxpayer in Japan with $60,000 U.S. taxable income (salary plus allowances) filing a joint return. It

is simplified to reflect only the first year change in tax for 1977 and subsequent tax reimbursements and taxes thereon. Other cycles of tax increase would begin in 1978 and each subsequent year. It assumes that all other factors remain constant and that the employer fully reimburses for tax increases in the following year.

		Tax payment on 1977 income to the United States	to Japan
1977	U.S. tax increase (§911)	$9,136	
1978	Tax on tax reimbursement ($9,136) to Japan at 52% (note a)		$4,751
1979	Tax on tax reimbursement ($4,751) to Japan at 52%		2,471
1980	Tax on tax reimbursement ($2,471) to Japan at 52%		1,285
1981	This cycle of declining amounts would continue indefinitely		

a/ The taxpayer would also report the reimbursement on his U.S. tax return, increasing his liability by 50% of that amount. However, he would receive an equal credit for the tax paid to Japan on that amount.

IMPACT ON U.S. GOVERNMENT PROGRAMS ABROAD

The Federal Government has extensive overseas operations amounting to about $7.3 billion a year, excluding U.S. military programs. The changes in Section 911 will lead to increased program costs as employees under Government contracts and other Federal-funded arrangements seek reimbursement for increased taxes. Federal agencies expect these individuals to seek compensation through their employers for increased tax liability. In some instances, requests for compensation have already been planned. In general, agencies had not yet assessed the budget impact of potential cost increases. The cost of the increases, however, will be marginal in relation to program and agency budgets. Furthermore, some portion of these increased costs will be recovered by the Government in the form of increased tax receipts.

Government employees overseas receive special tax benefits under Section 912 of the Internal Revenue Code, rather than Section 911, and are therefore not affected by the recent changes (see page 8).

State Department

According to State Department officials, only a contract with E-Systems, Inc., for operation of the early warning system in the Sinai 1/ will have a cost increase resulting from Section 911 changes. American Embassy officials in the countries we surveyed were not aware of any other contracts or projects that would be affected.

E-Systems had 139 civilian contractors in the Sinai, but only 19 E-Systems direct employees received tax reimbursements to compensate for additional taxes. According to State Department contract officers, tax reimbursements have added $21,500 to this year's $7,465,831 contract. The remaining 120 people will have to pay the tax increase from their present salaries. Despite the prospect of reduced employee take-home pay, E-Systems had not reported any problems in recruiting people for this assignment.

The State Department also administers a grant program to assist in improving the quality and quantity of U.S. teachers and administrators in overseas schools. About 150 overseas schools received grants and technical assistance totaling $5 million to assist them in providing an American-style education.

The program director's concern is that Section 911 changes will have a negative impact on professional recruitment and student enrollment. Although the changes will make it more costly to employ American teachers and administrators, the major problem will be reduced student enrollment if American families affected by the tax changes return to the United States. This had already happened in Brazil where school administrators reported losses of students of 5 to 13 percent which they attributed primarily to the change in Section 911. To compensate for reduced enrollment, schools will either have to increase tuition or enroll more foreign students with a resulting shift to an international style of education.

Agency for International Development (AID)

AID employs personnel eligible for Section 911 benefits for its Technical Assistance Service contracts and Capital Development Loan program. As a result of Section 911 changes, officials expected program costs to increase.

1/ See our report, "An Evaluation of the U.S. Early Warning System in the Sinai," June 6, 1977, (ID-77-11).

Technical Assistance Service

For the past several years, AID has spent about $225 million annually for Technical Assistance Service contracts. The contractors have generally been universities, engineering firms, and consulting firms. Contracts have included such projects as helping to increase agricultural production and income in central Afghanistan; providing population-planning advisory services to USAID/Philippines; helping to develop a low-cost rural health delivery system in Bolivia; and studying rice development in the Sahel region.

For fiscal year 1976, the value of new contracts was $226.5 million. As a result of Section 911 changes, AID estimated cost increases amounting to $5,451,138 for fiscal years 1977-79, as follows.

	Fiscal year		
	1977	1978	1979
Number of employees affected (note a)	280	420	560
Estimated Federal tax increase (note b)	$ 1,863	$ 2,484	$ 3,105
Increase in base salaries	521,640	1,043,280	1,738,800
Fringe benefits (note c)	52,164	104,328	173,880
	573,804	1,147,608	1,912,680
Overhead (note d)	286,902	573,804	956,340
Total	$860,706	$1,721,412	$2,869,020

a/ An average of 560 U.S. nationals were stationed overseas in 1976. AID expects that new contracts may reflect increased base salaries to offset the increase in Federal taxes. Half the employees will be under new contracts in fiscal year 1977, another 25 percent in 1978, and the remainder in 1979.

b/ For a family of four with average deductions, the estimated Federal income tax increase was $3,105. AID assumes full compensation for the tax increase will be phased in over a 3-year period as new contracts are awarded.

c/ Estimated at 10 percent of base salaries.

d/ Based on average contract overhead rate of 50 percent.

SOURCE: AID Office of Contract Management.

Capital Development

AID officials in Washington expect cost increases for capital development projects as new contracts are negotiated, but they could not estimate the increases. We requested AID Missions to estimate the cost and impact of Section 911 changes on their operations. Below is a summary of responses from 45 overseas Missions.

Negligible cost increase	3
Increase to project now	7
Increase greater for grants than loans	5
Future cost increase	8
Host-government cost increase	2
Personnel vacancies	2
No impact	25
Too soon to tell	3
Did not know	8

It should be noted that these responses included multiple answers.

Department of Agriculture

The Foreign Agriculture Service and the Economic Research Service through contracts and other agreements, provide compensation for some individuals affected by Section 911 and have, at least temporarily, protected these individuals from the tax increase.

Cooperatives

As a part of its market development program, the Foreign Agriculture Service shares the cost of stationing employees of 27 private agricultural cooperatives overseas. It pays all overseas allowances for all the cooperatives as well as the overseas salaries of four cooperatives. Salaries of the other 23 cooperatives, domestic program costs, and any supervisory costs are paid by the cooperatives. For fiscal year 1976, the Service's share of the $39 million program was about $12 million.

The Service decided to compensate the cooperatives for their employees' Section 911 tax increases and it estimates 1977 cost increases at $150,000 to $250,000. Payment will be made on a cost-reimbursement basis, limited to tax increases on cooperative salaries and overseas

allowances. The cooperatives' tax liabilities and reimbursements are expected to increase each year due to the "pyramiding effect" of Section 911 (see page 65).

Contractors

The Economic Research Service had only four contractors that would have been affected by Section 911 changes because its policy has been to hire personnel directly for long-term projects. Federal employees' overseas tax benefits are provided by Section 912 and are not affected by changes in Section 911. The Service protected the four contractors by converting them to direct-hire Agriculture employees.

The Service has five agricultural projects and 33 employees in Saudi Arabia. The value of the projects for June 16, 1977, to June 15, 1978, is about $7 million and is projected to be about $10 million for the next year. Four of the six contractors on a project to establish an agriculture water research center are Americans who threatened to quit due to the higher taxes. Reimbursement for the tax increase would have cost $90,000 to $100,000 a person, and the Saudi Arabian Government was not willing to increase project funding. The four contractors were converted to Agriculture employees for the remainder of their 1-year contracts and will then be replaced with non-Americans for the remainder of the multiyear project. The Service expects that the only Americans working on these Saudi Arabian-funded projects in the future will be Government employees.

Department of Defense

Defense officials believe that Section 911 changes will increase their program costs and adversely affect the U.S. competitive position in the world arms market. However, they had no specific estimates how much program costs will increase or trade will decline.

Contracts

Defense was caught between increasing the taxes of Americans overseas and implementing its programs (contracts in 1976 amounted to $42 billion). Defense issued guidance in June 1977, that would deny compensation for increased contract costs based directly on employees' tax increases. The guidance would permit compensation increases on current contracts only for performance adjustments. For future contracts, the guidance states that:

"There is no intent on the part of the DOD to determine as allowable and thereby compensate a U.S. contractor doing business overseas on a DOD contract for increased compensation to employees calculated directly on the basis of each employee's specific increase in U.S. income tax. Nevertheless, the DOD accepts the premise that such contractors must establish both salary and overseas differential compensation sufficient to recruit and retain competent employees to perform a particular contract. In establishing employee compensation including overseas differential, the contractor would properly consider all expense associated with foreign employment, including taxes (other than the amounts of U.S. income tax described above), housing, cost of living adjustments, transportation, bonuses and other related expenses. This compensation may be considered allowable provided it is reasonable and allocable in according with ASPR Section XV."

Since the cost of tax increases is not a distinct element of overall personnel costs it is difficult, if not impossible, to estimate the cost of Section 911 to Defense.

Contractors will seek higher contract prices to cover the cost of reimbursing employees for tax increases and may also seek greater profit on the higher costs. The Navy had already experienced this problem and issued the following instruction to prevent a contractor from trying to increase profit based on added taxes.

"*** it is Navy policy not to pay profit on the incremental element of salary increase due to the change in the Internal Revenue Code unless the contractor can clearly demonstrate a substantial miscalculation of his return on investment and the contracting officer is able to satisfy himself that the return on investment criteria has been met."

Foreign Military Sales

Officials who administer the $9.9 billion Foreign Military Sales program were concerned that Section 911 changes will reduce U.S. competitiveness. In the near term, they believe increased costs will reduce the price competitiveness of U.S. suppliers; in the long term, they

are concerned that reduced availability of qualified personnel for service contracts will reduce U.S. performance competitiveness.

Central Intelligence Agency

We were informed that increased costs resulting from changes in Section 911 will be negligible for this Agency.

IMPACT ON CHARITABLE ORGANIZATIONS

The Tax Reform Act amendment of Section 911 affected overseas employees of U.S. charitable organizations less than other private individuals overseas. This minimized the increased expense that charities would incur in reimbursing employees for U.S. tax. Several charities we surveyed, however, expected the tax changes to significantly increase their costs and adversely affect overseas programs.

Section 911, as amended, permits overseas employees of U.S. charitable organizations to exclude $20,000 a year of earned income, compared to $15,000 for other private individuals overseas. All other changes in Section 911 apply equally to such employees. The maximum benefit of the $20,000 exclusion is now $4,331 for a married taxpayer filing a joint return and $5,221 for a single taxpayer. This represents an advantage over other overseas taxpayers of $1,369 and $1,709 for the two categories, respectively. The benefits are, however, much less than benefits prior to the tax changes and the maximum benefits would be reduced to the extent of any foreign tax credit allocable to the excluded income.

The charitable organizations we surveyed expected to have to provide employees some compensation for the tax increase since their employees receive relatively low salaries but generally work in countries having high living costs and therefore receive large allowances. The smallest cost increase was estimated at $500 per employee by a charity with 150 Americans overseas. Others estimated the increase at $4,000 to $5,200 per employee, while the maximum estimate was $7,300 per employee, or $600,000 for an organization employing 82 Americans overseas.

These organizations expected to reduce overseas staff or to curtail programs in order to fund tax allowances for their remaining employees. Overseas programs of these organizations include disaster relief, school lunches, and agricultural development.

One organization expressed specific concern that the tax increase might hinder American leadership and participation in some development projects. It noted that Americans are reluctant to accept overseas employment because of the higher taxes and that foreign governments and multilateral lending institutions which fund development projects are very sensitive to the high cost of American employees and do not view payment of U.S. tax allowances as contributing to development.

IMPACT ON RELATIONS WITH OTHER COUNTRIES

Opinions of U.S. Embassy and host-government officials were varied as to the potential impact of the tax changes on U.S. relations with host governments. Officials in most of the countries surveyed indicated that the tax changes were not an issue of concern to the host government or that they had not discussed the issue with host government officials. In a few countries, however, some potential impacts were noted.

Embassy and/or host-government officials in the Philippines and Singapore (both are considered developing nations) recognized that a potential outflow of Americans due to the tax changes might result in increased job opportunities for citizens of those countries. However, they said that, if the tax changes actually discouraged U.S. investment in their countries, the changes would be detrimental to their long-range economic development goals.

Another type of concern was expressed by U.S. Embassy and/or host-government officials in Iran and Saudi Arabia. These countries' governments have extensive contracts with U.S. companies and, it was asserted, would view increased company costs due to the tax changes as direct payments to the U.S Treasury. Embassy officials predicted resistance by the Iranian Government, should contractors attempt to pass on such increased costs in the form of price increases. It was noted that some sort of retaliatory tax action could be taken by these host governments. Some Saudi Government officials believed the tax changes would reduce the U.S. presence in Saudi Arabia because U.S. firms would become less competitive; they pointed out that this could be detrimental to U.S. trade interests and predicted a possible adverse impact on long-term United States-Saudi relations.

Americans hold positions in Saudi education, banking and industrial development institutions. It was asserted

that some of them are threatened by the recent tax changes and that loss of these Americans would have a potentially adverse effect on U.S. trade and influence in Saudi Arabia. One example is a university which has been patterned on an American curriculum and whose staff has traditionally included more than 33 percent Americans. The tax changes reportedly caused a number of professors to leave and the unversity has been unable to recruit other Americans. The potential effect on U.S. interests is viewed as important by American and Saudi officials because the university's graduates have gained important leadership position in Saudi Arabia. Another example is the possible loss of some Americans acting as consultants and advisors to Saudi Government agencies and corporations. Some of these Americans plan to leave and the government, unable to recruit replacement Americans because of the tax changes, is turning to Europeans to fill the positions.

CHAPTER 7

OPTIONAL METHODS OF TAXING INCOME EARNED ABROAD

In anticipation of congressional action during 1978 to further adjust the tax treatment for overseas employees, many groups (both within and outside the Government) have developed and are advocating a variety of proposals for adjusting the existing incentive. These proposals fall into the following spectrum of options:

1. Taxing all earned income and overseas allowances.

2. Granting a partial tax break on foreign-earned income and overseas allowances by:

    a. Authorizing either full or partial deductions (for housing, education, extraordinary cost-of-living, etc.) (1) indexed to costs in the United States, (2) above an arbitrary limit, (3) by region or industry, or (4) other.

    b. Authorizing exclusions for all or some by (1) region or industry, (2) public sector vs. private sector, (3) charitable vs. profit-making institution, or (4) other.

    c. Authorizing tax credits for foreign taxes paid on all income or on non-excludable income or other.

3. Making foreign-earned income and allowances tax free.

Taxation of Americans working abroad is part of the continuing conflict among the tax policy objectives of raising revenue and achieving tax equity, tax simplification, and other special aims of public policy. In this chapter we review and evaluate the above primary

policy options in terms of these policy objectives. 1/ It is not our purpose to single out one option over others. That choice must be made by Congress in light of the objectives it selects. Our purpose is to assist congressional decisionmaking by analyzing the advantages and disadvantages of various alternatives.

Since objectives are likely to play an important part in choosing among options, this chapter begins with a discussion of the justifications that have been offered for excluding from taxable income any part of the foreign source earnings of Americans abroad.

POLICY OF TAXING WORLDWIDE INCOME OF U.S. CITIZENS

The United States is the only industrialized trading nation that taxes the worldwide income of its citizens, regardless of where those citizens reside. Most countries only tax the worldwide income of their residents, and domestic-source income flowing to nonresidents. If the United States adopted this residence principle of taxation, Americans residing overseas would pay no U.S. income tax on their foreign source earnings and there would be no requirement for a special provision like Section 911 to relieve them of tax.

We make no effort in this report to review the historic U.S. principle of taxing the worldwide income of all U.S. citizens wherever they live because to do so would greatly enlarge the scope of this report. Altering the basis of U.S. income taxation would have far-reaching implications that Congress would want to weigh carefully before acting. We assume here that Congress would prefer to avoid making such a fundamental change as adopting the residence principle of taxation and that if it decided to reduce taxes on foreign source earnings it would rather explore various ways of doing so within the context of the present income tax system.

1/ Analysis of the tax cost of various options has been limited. We were unable to secure access to IRS tax return data necessary to compare the tax cost of policy options until shortly before issuance of this report. (The General Accounting Office was authorized access to such data by Public Law 95-125, signed on October 7, 1977). We plan to issue a supplement to this report, in the spring, with estimates of the tax cost of various policy options.

EQUITY ARGUMENT FOR TAX RELIEF

Perhaps the most common justification for special tax treatment of foreign earnings involves the fairness of the Federal tax system. It is claimed that in some overseas locations the cost of Western-style living is much higher than the cost of living in the United States and that an income of a given size in American dollars commands a smaller quantity of goods than it would in this country. Some spokesmen for Americans overseas contend that the lower real value of overseas incomes should be reflected in the level of taxes imposed on such incomes. Thus, if an overseas income of $50,000 a year corresponds to a U.S. income of, say, $30,000 a year, both incomes should be taxed alike. Taxing the overseas income on the same basis as that of a U.S. income of $50,000 a year is considered unfair.

Those who hold this view stress that taxation should not be based on "income" from which the employee receives no economic gain and that in fairness only persons with the same real incomes--not the same money incomes--should be taxed alike.

This position would justify extending special tax treatment to all income received by Americans residing in high-cost locations abroad, even income they receive from sources within the United States. In other words, the distinction drawn between Americans at home and Americans abroad is based on differential opportunities for using one's income, however that income may be gained.

A similar argument compares certain basic personal living expenses, such as food and housing, of overseas taxpayers to business expenses that companies may deduct in computing their taxable incomes. Of course, personal living expenses are not now deductible from a taxpayer's adjusted gross income for tax purposes, but Congress no doubt takes account of their size when it legislates income tax rates. However, the living expenses that Congress has in mind are the normal expenses of Americans at home, not the extraordinary expenses of Americans living in high-cost locations overseas. According to this reasoning, lower tax rates should be imposed on Americans abroad who are required by high local costs of living to spend unusually large parts of their incomes on certain basic goods and services. This reasoning leads naturally to proposals to permit such Americans to deduct the part of their living expenses that exceeds the normal expenses of Americans at home.

All these arguments invite the objection that living costs vary widely within the United States too, yet no allowance is made for variations in the tax rate schedules. The differences in cost between some expensive overseas locations and a typical U.S. city can be very large. But the fact that unusually high costs of living within the United States do not entitle taxpayers to a reduction in tax probably makes it advisable to avoid being too generous to Americans working abroad.

COUNTER-ARGUMENTS

The preceding arguments emphasize the unfairness of taxing Americans who live and work in high-cost locations overseas as heavily as Americans receiving the same nominal incomes in the United States. This argument rests on the assumption that it is Americans abroad who bear the impact of high costs and high taxes. However, if they have alternative employment opportunities in the United States, they are likely able to shift the higher costs of living and working overseas (including the tax cost) to their employers, who in turn pass on such costs to customers.

Many U.S. firms employing Americans abroad pay wages specifically keyed to the difference between the cost of living in the overseas location and the cost in some city in the United States. But whether or not the salary and allowances take account of costs explicitly is probably irrelevant in the majority of cases. Most Americans abroad presumably are paid enough to compensate them for the higher costs they bear; otherwise they would not accept overseas positions. If so, it may be unnecessary to give an income tax reduction to overseas employees in high-cost locations to ensure that their after-tax incomes are large enough to cover the high living expenses and to have something left over. Market forces will tend to ensure that result. However, the competitive position of employers may be adversely affected if they must bear the added costs.

By the same token, it should not be assumed that a tax reduction given to Americans abroad will, in the long run, add to their after-tax incomes. A reduction will instead lower the costs to American firms of employing Americans overseas. If American companies face competitive conditions abroad, a decrease in their costs should be reflected in reduced prices to foreign customers and a subsequent expansion of U.S. sales abroad. Therefore, it probably matters very little to the standard of living of Americans abroad whether special tax relief is provided for them in the Internal Revenue Code.

Some classes of Americans overseas are unable to pass on increased costs of living or increased taxes to their employers. These include Americans who are self employed; Americans who have joined local labor markets overseas and who possess no skills that command a premium price over the skills of local workers; and employees of non-profit organizations. These Americans have few spokesmen representing their interests in the United States. An increase in U.S. taxes may indeed be borne largely by them rather than by their employers or their employers' customers.

PRINCIPLES TO BE CONSIDERED

Let us suppose that Congress decides to grant some kind of tax relief to Americans abroad. Before considering what form the relief might take, we offer here some principles against which any proposal should be judged.

1. The provisions should be expressly designed to achieve their intended purpose. If the purpose is to compensate for taxpayers' high costs of living overseas, they should take into account only costs that are indeed higher. If they are intended to provide an incentive for employing Americans overseas, the reasons for the incentive should be spelled out and the provisions designed to focus the incentive where it will be most effective.

2. The provisions should not encourage excessive consumption of particular goods and services, especially those likely to be of foreign origin, since an important reason for the tax relief is to improve the U.S. balance of payments.

3. The tax relief given should not depend on the form in which compensation is paid; for example, it should not be contingent upon an employer's designating part of the employee's compensation as a housing allowance or cost-of-living allowance or on whether the compensation is paid in cash or in kind.

4. The relief provisions should accomplish their purpose in the simplest way possible, be easy for taxpayers to understand, and be as simple as possible for the Internal Revenue Service to administer.

POSSIBLE FORMS OF TAX RELIEF

If Congress decides that tax relief is warranted for Americans overseas to offset high local living costs, there are several ways in which relief can be granted. The most direct method of tax relief would be to allow taxpayers to deduct expenses deemed to be excessive. This could also be the most complicated method because of the difficulty of determining what constitutes excessive expenses. The simplest method would be to maintain the present flat exclusion; but this would also be the most inequitable, since it ignores the taxpayer's actual living costs. A middle way (in both complexity and equity) would be to adopt some form of indexing to take into account the average cost-of-living differences between the United States and various foreign locations--either by indexing the compensation received by the taxpayer or by allowing an exclusion indexed to cost differentials for specific countries or areas.

Deductions for excessive expenses

The idea behind this approach is to go directly to the perceived problem--the excessive expenses themselves. If compensation for additional expenses has caused income to become unreasonably inflated, then deducting the amount of these additional expenses will reduce income to the range of real incomes that the tax rates were designed to cover.

In concept, nothing could be simpler; in practice, this approach tends to be impossibly complex. The problem is in determining excessive expenses without inviting abuses. Allowing a deduction for reimbursed expenses (or in-kind payments) not only encourages altering compensation plans for tax-avoidance purposes but also discriminates against the self-employed and against employees whose compensation must be set in some other way for non-tax reasons. Floors are needed to determine what is excessive; ceilings are needed to avoid encouraging too much consumption of foreign goods. (Even with a ceiling, some encouragement of foreign consumption will occur for persons who would have spent less than the

ceiling in the absence of the tax subsidy.) Many different limits for various areas, income levels, and family situations may place an intolerable burden on both taxpayers and the IRS. Too few differences in limits makes the deduction very little better than a general exclusion.

The alternatives discussed below for several of the possible deductions are designed to suggest the problems of maintaining simplicity and equity that we believe the deductions approach inevitably creates.

Housing costs

Housing seems to be a very large part of almost all household budgets and is probably the most inflated cost in most areas. Dealing with the cost of housing would go a long way toward solving the expatriates' tax problems.

If only excessive housing expenses are to be allowed as a deduction, the deduction must have a floor. The floor usually suggested is a percent of income related to the average part of income spent on housing in some area of the United States. Housing allowances for overseas employees are usually computed by U.S. employers in this manner.

To illustrate, if housing expenses in excess of 20 percent of gross income were deemed excessive, it would be relatively simple to allow the portion in excess of 20 percent as a deduction. A person whose income totaled $65,000 and housing expenses $25,000 would be entitled to a deduction of $12,000. In principle, this deduction is somewhat small, since it should be keyed to the income that the person would receive if housing costs were not excessive. In this example, if local housing had not been more costly than housing in the United States (in t[illegible] t more than 20 percent of income had to be spent on [illegible]sing) the taxpayer would have received an income [illegible] $50,000 and housing would have cost him $10,000. [illegible]refore, the true excess housing expenses the taxpay[illegible] presumably should be entitled to deduct is $15,000, [illegible]her than $12,000.

Setting a reas[illegible]ble ceiling is also a problem. An arbitrary dollar li[illegible] would encourage excessive consumption (or excessive [illegible]cing) of housing in areas for which the ceiling was too [illegible]gh and would be unjust in areas for which it was too lo[illegible] The alternative is to have the

Secretary of the Treasury prescribe limits for various areas, based on local average housing costs. This information will necessarily be inadequate, extremely expensive to compile, or both.

An alternative that takes these problems into account would allow a deduction in computing adjusted gross income equal to the excess of the actual cost of shelter and utilities over the latest cost of "shelter" in Washington, D.C., published in the Bureau of Labor Statistics "Annual Costs of Higher Budget for a 4-Person Family". Washington was chosen as the base because it is also the base for the State Department's cost-of-living indexes (and therefore for most private employers' indexes). Washington costs also approximate the national average for metropolitan areas. The "Higher Budget" was chosen because about one-half of U.S. overseas employees would fall into the income range implied by that budget. An upper limit on the deduction would be necessary. It could be made equal to the excess of the State Department's Quarters Allowance over the floor prescribed above. For those areas determined to be inadequately measured by the State Department's survey, different ceilings could be set. Tokyo is certainly one such area, along with others not covered at all by State.

This provision could be further simplified by empowering the Secretary to rule that in-kind housing that was not extravagant or unreasonable should be included in an employee's gross income at the value that would afford him the maximum de[illegible]n. The only addition to the employee's adjusted gros[illegible]e would therefore be the excess of the deduction floor [illegible] the employee's payments for the housing. (This would avoid the problem of valuing in-kind housing.)

There are a number of locations in the world, according to State Department indexes, where housing costs are higher than in the United States but other living costs (apart from education) are lower. There are virtually no places where the opposite is true. Even when both exceed U.S. costs, it is usually housing that is the most inflated.

Another approach would be to allow an unlimited deduction for actual shelter and utility costs for foreign residents, but otherwise tax all remaining income and allowances at the normal U.S. rates. The deduction could be unlimited (except, perhaps, limited to the amount of "earned income") on the assumption that there is a natural limit to what most Americans living abroad would

want to spend on essentially temporary housing. It could be further presumed that the subsidy element (the portion of income that would have been spent on housing in the United States) would adequately cover most other additional costs of employment abroad. This would not be as inequitable to U.S. residents as it sounds, since most Americans also receive some housing subsidy through the tax code, either as homeowners (mortgage interest and property tax deductions) or as renters (the various provisions that make the ownership of rental housing "tax loss" operations).

The principal inequity would be in those cases where housing was not a serious excess cost of living abroad, but such instances are apparently uncommon. One advantage would be the elimination of the need to value in-kind housing; it need not even be reported.

Employer-provided lodgings

Under Section 119, lodgings provided on the premises for the convenience of the employer are not considered income to the employee. If provided off-premises, however, they are considered income, even if the employer requires this arrangement because it is cheaper for him than providing housing allowances. The "income" imputed to the employee from this arrangement is the local market value of the housing, which is often far more than the employee would have paid in the United States.

This is part of the general problem of additional housing costs, and we believe it should be solved through one of the options previously discussed. If this is not done, however, this part of the problem could be solved by deleting "on the premises" from Section 119, at least for foreign employees. Whether "on the business premises" must be the precise location where the employee is on duty is often a difficult question for the Internal Revenue Service and the courts to answer. For example, it might not always be clear whether the location of group housing and meals provided employees of an overseas construction contractor was actually "on the business premises."

Education of dependents

Tuition and school fees paid to primary and secondary schools attended by dependents are not costs normally found in the budget of an average U.S. family. Thus, any education expense due to overseas employment could be considered

excessive. A wide range of costs are possible, however, so some upper limit is appropriate.

The simplest approach would perhaps be a deduction for actual expenses, with a flat ceiling, as in the House version of the Tax Reform Act of 1976.

Alternatives that would add to equity (and complexity) would be to

1. vary the ceiling by geographic area, based on average costs or State Department educational allowances;

2. allow additional ceilings for room and board (and perhaps transportation) for areas where no acceptable local school is available.

The Secretary of the Treasury could be empowered to rule that a reasonable level of employer-provided schooling would be considered within the limits and its value need not be reported.

Other current expenses

Living costs other than housing and education are usually lumped together for reimbursement purposes. The State Department publishes indexes of these costs (as compared to Washington, D.C.) on which State and most private employers compute post differentials and cost-of-living allowances.

The deduction of the difference between actual expenses and some U.S. standard is obviously not one of the choices. Even if it were possible to establish "base" costs for myriads of items or categories (to determine what expenses were "excessive"), few taxpayers would be willing or able to keep the necessary records. All that has really been proposed in this area is a deduction based on average costs (or on reimbursements). This deduction, then, represents the differences in average living costs (other than housing and education) between the foreign areas and some U.S. area or areas.

The State Department and private indexes apparently attempt to compare the cost of an average U.S. standard of living with that of an average American living abroad. It is difficult to decide how valid this comparison is.

For example, it is routinely argued that domestic servants are a necessity in undeveloped countries (and some developed ones); the State Department indexes are said to include this as a cost in some foreign areas. To some extent, domestic servants substitute for the convenience marketing and labor-saving devices available in the United States which, however, also take more of the taxpaying family's own time and effort. How comparable such life-styles are is a question the Congress will have to answer.

If allowance is to be made for other living costs, the most straight-forward method would be some form of indexing. For example, reduce total compensation received in the foreign location by the amount spent on housing and education and by income and social insurance taxes paid. Multiply the remainder by the ratio of the difference between the State Department's cost-of-living index in the foreign location and the cost-of-living index in the United States to the cost-of-living index in the foreign location. The product would be the allowable "cost-of-living" deduction.

To meet the objection that such a method might allow a deduction for income not actually spent on excessive living costs, the deduction might be based on average costs, determined by the Secretary of the Treasury on the basis of indexes and an average (or assumed) level of compensation. (A recent Senate bill proposed the salary of grade 12 step 1 in the Government GS salary chart.)

In either case, the Secretary would have to prescribe indexes or amounts for areas not covered by the State Department indexes.

Moving expenses

The present deduction for moving expenses (allowed by Section 217 of the Internal Revenue Code) affords a reasonable deduction for the actual cost of transporting household members and goods and for the cost of meals and lodging for household members enroute. It also allows deductions for "house-hunting" trips, meals, and temporary lodging for 30 days at the new location and expenses of disposing of the old residence and acquiring a new one. These deductions are limited to a total of $3,000, of which no more than $1,500 can be for the house-hunting trip and temporary quarters.

For persons allowed to exclude income under Section 911, the IRS has required that moving expense deductions be prorated between excluded and nonexcluded income. Thus, the deduction for foreign moves has been limited.

If the general exclusion is replaced by a set of specific deductions, moving expenses would presumably become fully deductible. In fact, if the purpose of relief for foreign-earned income is to reduce the effects of inflation on compensation, there is no reason why the moving expense should be considered related to a general exclusion.

The present deduction for foreign moves, even if allowed in full, may not be altogether appropriate. Expatriate groups have argued that 30 days is not long enough to relocate in a totally unfamiliar environment and that moves abroad for only a few years often involve the storage of household goods as a major expense. On the other hand, persons locating abroad for only a few years are less likely to sell their homes or buy foreign homes, so most of the expenses of disposing of old residences and acquiring new ones probably do not apply. Also, most of them probably would not be making separate house-hunting trips.

The moving-expense deduction could be broadened to include the full cost of moving abroad. It could be expanded to include the storage costs of household goods for some limited period. (This is presently allowed, without limit, for military personnel.) The limit on temporary quarters might be expanded to 60 days, and the $3,000 limit allowed for any combination of house-hunting trips, temporary quarters, and expenses of changing residence.

A related problem raised by expatriate spokesmen is the capital gains tax on the gains from selling a residence. If the gains are reinvested in another principal residence within 18 months, the tax is deferred. If a person sells his principal residence when going abroad, however, the proceeds are seldom reinvested since few Americans buy homes abroad. They are therefore subject to the capital gains tax.

One way to alleviate this problem would be to start the 18-month period when the taxpayer returns to the United States. To avoid abuse, it could be required that the capital gains tax be paid in the year of sale,

with a provision for claiming a refund should the taxpayer return to the United States within a limited period (say, 6 years) and buys a new principal residence within 18 months.

Deductions for Government employees

The position of the U.S. Government civilian employee stationed overseas is different from that of the private sector employee, both in fact and under tax law. Government employees receive free housing or an allowance to cover all housing costs (not just excess costs), free education or an educational allowance for their children, moving expenses, and a certain amount of home leave and other travel. They receive cost-of-living allowances for high-cost areas and are allowed discount shopping in Government exchanges where available. For special hardship posts, they may receive allowances for separate homes for their families and "hardship" pay. Except for the hardship pay, all of these allowances are currently nontaxable under Section 912 of the Internal Revenue Code.

This is, of course, similar to the "deductions approach" discussed earlier, but the position of the Government is unique in this case; it is both tax collector and employer. The Government as promulgator of tax rules can trust the Government as employer to set reasonable limits on its compensation programs, so the tax law need not worry about setting such limits. Also, the Government's direct compensation program is not as flexible as that of most private employers. The full housing allowance, commissary privileges, and freedom from additional taxes are offered in lieu of a private employer's overseas premium pay and tax equalization programs. Except for the allowances, Government employees, by law, have the same pay scales overseas as in the United States.

The discrepancies between Sections 911 and 912 are sometimes perceived as inequitable, so it might be worthwhile to make Government employees subject to the same tax rules as their private sector counterparts and to amend the compensation laws to allow the payment of the necessary premiums for foreign service (including any additional taxes).

General exclusion

The unavoidable complexities and/or unintended incentives in the deductions approach make the simple exclusions of the pre-1976 law seem more attractive.

The compromise in the 1976 Tax Reform Act has little to recommend it. The $15,000 maximum exclusion is too small for areas of extremely high costs where relief is most needed and too much where living costs are no greater or considerably less than in the United States. Moreover, the $15,000 is taken "off the bottom," leaving the large allowances and in-kind payments of high cost areas to be taxed at the higher rates, as if they represented huge increases in real income. Converting this exclusion to a credit, as suggested in the Joint Committee on Taxation staff study of simplification proposals, would not alter this effect.

If a general exclusion for all income earned abroad by nonresident citizens is to be retained, it should be made simple, taken off the top, and be large enough to dampen the effects of the graduated rates on inflated incomes. Such an exclusion would be a windfall to many who do not bear the higher costs but still not be enough for some since to lessen the windfall effect it would not be set to cover the highest possible costs. The virtue of simplicity, however, makes a general exclusion worth considering.

Indexing

Some of the simplicity of the general exclusion could be retained and greater equity achieved by providing a mechanism for variable exclusions tied to living costs. An index of foreign living costs could be used to provide an exclusion amount for each area, or it could be used directly to index the foreign income of each taxpayer and reduce it to its equivalent U.S. level.

The exclusion amount could be indexed by allowing the Secretary of the Treasury to calculate an exclusion for each index area, based on some standard level of compensation. The base salary of a GS-12 in step 1 (currently $21,883), rounded to the nearest $1,000, could be used. (GS salary levels are not actually indexed to living costs, but they are based on surveys of comparable jobs in the private sector and so will generally move up as the domestic cost of living increases.) The exclusion would

be calculated as an amount equal to that base salary multiplied by the percentage by which costs in the foreign area exceed U.S. base costs (rounded to the nearest $200). This would provide a windfall to those whose salaries are less than $22,000 and penalize those whose salaries are more than the (foreign equivalent of) U.S. base amount. But it would be simpler than the deductions approach and more equitable than a flat exclusion.

The taxpayer's total compensation could be directly indexed. Total compensation would be multiplied by the reciprocal of the index (which could be published by Treasury) and the result treated as total taxable compensation for U.S. income tax purposes. This approach indexes the premium pay and other overseas allowances not directly related to living costs. Therefore, it does more than merely allow for these costs. At the same time, it is relatively simple for taxpayers and might be more easily perceived as equitable by U.S. residents (because of its direct attack on inflated incomes).

There are two difficulties in the indexing approach. One is the index itself, which could be very difficult for Treasury to supply. Existing indexes of foreign costs generally do not include housing. The other is timing. The index would necessarily be at least a few months out of date when announced. Further, it would have to be proclaimed at the beginning of the year. So, by the time the return was filed, the index could be 2 years old or more.

Employees of charitable organizations

In the Tax Reform Act of 1976, employees of U.S. charities working abroad were treated as a separate category and allowed a $20,000 (rather than $15,000) annual exclusion. It was argued that increased taxes on employees merely increased the costs to the charity and that the loss of the U.S. exemption could trigger an increase in foreign taxes also, since in some countries such as Bangladesh the exemption from local tax was predicated on the U.S. tax exemption.

Since the latter justification is unique to charities, and since it was considered persuasive in 1976, the Congress may wish to continue a special exemption for employees of charitable organizations no matter what other action it takes.

Treatment of foreign income taxes

The foreign tax credit alone, with no additional exclusion or deduction, satisfies the "international norm" of avoiding double taxation of the same income. In effect, it allows the country of residence to take the first tax bite, and the United States takes only the amount by which the U.S. tax exceeds the foreign tax. If the foreign tax is larger, a carryover (back 2 years and forward 5 years) is allowed to other taxable years.

The interaction of the foreign tax credit with the earned income exclusion has been a problem. In the past, all foreign taxes, even those on income not subject to U.S. tax, were usable for the credit. The Tax Reform Act of 1976 required that foreign taxes be prorated and only that portion attributable to nonexcluded income was allowable as a credit. The objective was to prevent a double benefit--both exclusion and tax credit--related to the same income. The approximate $3,000 maximum benefit of the exclusion is reduced to the extent of any foreign tax on the $15,000 exclusion, as explained on page 48. Since the full foreign tax credit could be more valuable in high-tax countries than the exclusion, the Act also allowed individuals to "elect-out" of Section 911, claiming the full credit rather than the exclusion.

The most liberal treatment for foreign taxes, and probably the simplest to administer, would be full credit with no limitation. This option has the undesirable feature of subsidizing very high foreign tax rates to the extent taxpayers would be able to claim a foreign tax credit against U.S. tax on U.S.-source income.

A second option would be full credit limited to the amount of U.S. tax on foreign earned income. (Taxes not currently creditable could be carried back or forward.) That was the basic treatment of foreign income taxes prior to the Tax Reform Act of 1976. It caused some administrative difficulties with the limitation and carryover provisions, but was simpler than current law.

A third option--and present treatment--would reduce the tax credit to the extent that foreign taxes were allocable to income not taxed (excluded) by the United States. As previously noted, this treatment of foreign taxes has the effect of reducing the value of the Section 911 exclusion, whether the exclusion is retained in its

current form or changed to a set of cost-of-living deductions. It adds to the complexity of administration, and would be even more complicated if it were combined with an approach that allows deductions for excessive expenses.

A fourth option, although not viable, would be elimination of the foreign tax credit. This option would clearly not be equitable, as it would subject individuals to double taxation on their foreign incomes. In high-tax countries with progressive tax rates, the combined U.S. and foreign incremental tax rate for a single taxpayer could exceed 100 percent on a taxable income as low as $35,000.

Other forms of relief

So far, the options discussed have focused on the problem of adjusting for inflated foreign incomes. As noted earlier, however, employers benefit from the special treatment of income earned abroad, and perhaps the country as a whole does too. It may be that these benefits to foreign trade and U.S. foreign policy are considered better justifications for tax subsidies than the removal of the disincentives discussed above.

Export trade covers more than just the export of goods; many Americans export their services. These include the activities of construction and engineering firms, professionals practicing abroad, and teachers in foreign schools and universities. Because of high U.S. standards of living, their services tend to be expensive. The U.S. practice of taxing worldwide income can make them even more expensive. If their continued presence abroad is considered desirable, tax subsidies of some sort may be warranted.

U.S. companies that export goods frequently find the presence of U.S. sales and service representatives abroad effective in increasing or maintaining sales. They pay premiums to induce their U.S. personnel to locate abroad. Tax subsidies for overseas income are, in effect, used to reduce their costs of exporting. Therefore, Section 911 is actually a subsidy for exports (but legal under international agreements, which a more direct subsidy might not be).

Thus, special treatment of income earned abroad can be viewed as a legitimate and desirable subsidy to U.S. exports and the U.S. "presence" on the international

scene. If this view is accepted, some additional options are possible.

For an explicit incentive, the amount of the subsidy is perhaps more important than the form it takes. From the legislators' point of view it can be seen as a type of appropriation allocated among the recipients so as to give the maximum results.

Incentive devices

The easiest solution might be to ignore the allocation problem (in the interest of simplicity) and return to a flat general exclusion taken off the top (with all allowances fully taxable).

This approach has a number of drawbacks. It would be wasteful since it would apply to areas where much less incentive would be sufficient. It would be of no benefit in areas where foreign taxes were high enough to offset all U.S. taxes and of limited benefit in areas where costs were very high. If worldwide inflation continues, the exclusion would have to be increased periodically to maintain its effect. But its simplicity makes it an alternative worth considering.

An indexed exclusion could also be designed as an incentive. A minimum amount to be excluded could be provided by law. The Secretary of the Treasury could be empowered to prescribe larger amounts, proportional to living costs, for areas with living costs higher than those in the United States.

Allowing deductions for extraordinary expenses plus exclusions of $20,000 to $25,000 would presumably be the nearest thing to returning to the pre-1976 situation (at least for employees who were then excluding reimbursed expenses and in-kind housing from income). It has been argued that this is the only way employees living in construction camps would perceive any tax incentive, since presumably most of their free housing would be excludable from income under Section 119 as being for the convenience of the employer. Extending the deduction for extraordinary expenses to those who are not reimbursed entails, of course, an additional revenue loss. Thus, the total cost could be somewhat higher than current estimates.

It has been suggested that the exclusion approach could be made more effective as an incentive if it were targeted for specific activities that were considered desirable. The 1976 law changes provided a targeted exclusion for employees of U.S. charities. An exclusion for construction workers was suggested later by a task force on the subject. However, by the time the list was expanded to include everyone potentially promoting U.S. trade, culture, or presence, there would probably be so few left out that the process would not be worth the trouble.

The incentive question is basically a matter of degree. Anything that reduces taxes is an incentive. Thus, any of the options discussed in this chapter would serve as incentives, compared to doing nothing or to doing something less generous.

Residency and physical presence tests

The present complex and stringent tests for qualifying for Section 911 benefits date from the time when temporary stays abroad could result in large tax benefits. Their purpose was to prevent tax avoidance by working overseas merely to reduce or eliminate U.S. income tax. Under the present $15,000 exclusion and the options that tie tax benefits to actual or average excess expenses, large tax benefits and tax avoidance by short stays abroad are unlikely. Consequently, under existing law the stiff residency and physical presence tests do not serve their original purpose.

It might be well to consider the qualification rules along with the other provisions of Section 911. If the present limited exclusion is continued or one of the limited options adopted, the rules could be changed to allow the benefits (properly prorated) for any stay abroad of more than 6 months, providing the stay was a condition for earning income.

Performing artists and professional athletes are often considered special problems, so they could be required to meet more stringent tests. However, a general exclusion of $15,000 taken off the bottom, or provision for differences in living costs would not usually produce any significant tax benefits (compared with staying in the United States), so it may not be worth the added complexity.

Subsidies to employers

The subsidy effect of this tax expenditure program could be explicitly directed to trade promotion by giving it to the employers rather than to the individual employees. Firms meeting specified criteria as export trade companies could be allowed tax credits (or given direct subsidy payments) for part of the costs of keeping their employees abroad. This could be in lieu of or in addition to tax relief for the employees, depending on the amount of subsidy desired.

This would make it easier to account for the cost and perhaps easier to evaluate its effectiveness, as well as direct the money explicitly toward the export trade industries.

It would have the disadvantages of (1) offering no assistance to Americans self-employed or employed by foreign companies, (2) perhaps being perceived as less equitable than relief for employees, and (3) possibly violating the export subsidy provisions of the General Agreement on Tariffs and Trade.

Because of the equity and international implications, we have not pursued this option, but if trade is the principal concern, it might be kept in mind.

CHAPTER 8

CONCLUSIONS AND MATTERS FOR CONSIDERATION OF THE CONGRESS

In deciding on whether and how to further modify Section 911 incentives, policymakers are confronted with

- --a deteriorating U.S. international economic position;
- --the limited number of policy instruments available for promoting U.S. exports and commercial competitiveness abroad; and
- --a high degree of uncertainty about the relative effectiveness of policy instruments in effect for promoting these aims.

We believe an essential need exists for regular evaluation of the effectiveness and cost of Section 911 incentives, comparison of such results with the actual or potential results of alternative means of promoting U.S. exports and commercial competitiveness abroad, and reporting the comparison regularly to the Congress. Also, promotion of commercial competitiveness and exports is an appropriate objective which Section 911 incentives should be used to support until an evaluation system is established and more effective policy instruments identified.

The United States is the world's largest producer of manufactured products. For many years, it generated most of its raw materials and consumed most of the products it manufactured, exporting less than 7 percent of its gross national product. But the United States is running out of raw materials and increasingly must import raw materials at higher costs to operate its factories. These increased imports must be paid for by increased exports or by increases in net repatriated profits on foreign investments. Thus, the United States must remain competitive. To do so, it is essential to maintain a large force of U.S. citizens abroad to promote and service U.S. products and operations.

In the 1970s, for the first time in this century, the United States had a deficit trade balance. Moreover, foreign investment in the Nation is increasing faster than U.S. investment abroad. These trends underline the

importance of identifying and implementing public policies that have the greatest potential for enhancing the Nation's international economic position and focus attention on the following issues.

--How can Government policy and resources be used most productively 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 incentives?

--How significant are the benefits of having a large force of U.S. citizens abroad influencing world economic affairs and representing the U.S. system of values and culture?

LIMITED POLICY INSTRUMENTS AVAILABLE

The United States has placed great reliance on the private business sector to maintain its leadership positions in international commerce without large-scale assistance or intervention on the part of the Government. The latter's role has traditionally consisted of programs to (1) acquire and disseminate foreign commercial intelligence, (2) encourage and facilitate private trade promotion activities, (3) negotiate with other governments to attain a favorable trade and investment climate, (4) provide last-resort financing for certain classes of exports through the Export-Import Bank and the Commodity Credit Corporation, (5) provide political risk insurance for overseas investments, and (6) limit foreign purchases for Government activities through "Buy American" policies. In addition, the Government has supported international commerce with certain tax measures, including the foreign-earned income exclusion, the DISC program, foreign trading company programs, and deferral of tax on undistributed earnings of U.S. foreign subsidiaries.

In recent years, however, the U.S. financial position has deteriorated while that of some major competitors has strengthened. A new international monetary system predicated on floating exchange rates has developed, but uncertainities exist concerning its full effect. Little in the

way of new programs has emerged to strengthen the U.S. international financial position. Direct measures for support of exports are limited by commitment to a free trade policy and participation in the General Agreement on Tariffs and Trade. At the same time, the longer term effectiveness of some tax incentives, which are not so limited, needs to be ascertained.

NEED FOR ESTABLISHING A SYSTEM FOR PERIODIC EVALUATION

The Congress is not routinely informed of the effectiveness or cost of overseas employment tax incentives. In fact, nobody has ever evaluated their effectiveness or the economic impact of changes in the incentives. Accordingly, at the time the law was amended in 1976 it was not clear what effects the changes would have.

To enable the Congress to improve its oversight of Section 911, we believe a system should be established for evaluating and periodically reporting to the Congress the effectiveness of these incentives. If the Congress decides it is necessary to promote U.S. exports and competitiveness abroad, these evaluations should include comparisons with alternative fiscal instruments.

Past efforts to address the relative effectiveness of Section 911 incentives have been hampered by a lack of reliable information about its revenue costs. For example, during congressional deliberations over the Tax Reform Act of 1976, the revenue effect of proposed changes to Section 911 was significantly underestimated. The Treasury Department estimated that the changes would result in additional tax revenues of $45 million a year. Now Treasury estimates additional revenues of $228 million a year. The earlier estimate was based on an analysis of income tax returns filed for tax year 1968; the latest estimate is based on an analysis of 1975 tax returns. Had a periodic evaluation system been in operation, better estimates based on more current tax returns--perhaps from 1973 or 1974--would have been available in 1976.

Policymaking has also been hampered by the absence of an analysis of the effectiveness and economic effects of the Section 911 incentives. Although these incentives have been in effect for more than 50 years they have never been carefully evaluated. Consequently, policymakers cannot

be sure to what extent the incentives have benefited the Nation. Uncertainty will persist until their effects have been carefully appraised.

Suggested evaluation measures

To promote better analysis and improved congressional oversight, we believe the Congress should require the Depart- of the Treasury, in consultation with the Department of Commerce, to regularly evaluate the effects of Section 911, including comparisons with alternative fiscal instruments that might be more effective.

We also believe that the Congress itself should communicate its needs and priorities to those responsible for conducting the evaluations. This communication would help to ensure that Treasury evaluations were cost-effective and pertinent to congressional oversight. In view of the diversity of issues raised during the debate on changes to Section 911, such interaction would help to ensure that evaluation efforts were focused where they would be most productive.

MATTERS FOR CONSIDERATION OF THE CONGRESS

To enhance its oversight of the tax incentives for U.S. citizens employed abroad, we recommend that the Congress spell out specifically what it expects the incentives to achieve and require the Department of the Treasury in consultation with the Department of Commerce to:

--Periodically evaluate the effectiveness of the tax incentives in achieving these objectives.

--Compare the tax incentives 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 evaluations regularly to the Congress.

Appendix III contains language for including this requirement in Section 911 of the Internal Revenue Code and further analysis of the nature, scope, and timing of such evaluations.

We believe that serious consideration should be given to continuing Section 911-type incentives, at least until more effective policy instruments are identified and implemented.

COMPARATIVE COST-OF-LIVING INDEXES IN 40 MAJOR FOREIGN AND U.S. CITIES (Washington, D.C. = 100)

Cost-of-living indexes available in the public and private sectors are based on particular assumptions and raw data; no one index is without imperfections or can be called the "correct" one. The overseas indexes provided by the Department of State reflect expected consumption habits of Americans in various countries. The U.S. indexes recomputed from the Department of Labor's indexes reflect a "higher budget". The overseas indexes exclude costs of housing and education; the U.S. indexes take them into account. As shown below, there is greater variance in the overseas indexes than in the U.S. indexes. Moreover, if the costs of housing and education were included in the overseas indexes, some of them would be even higher, given the magnitude of these costs in many countries. Finally, the overseas indexes include only major cities (usually the capitals) and the costs of maintaining an American standard of living in remote areas may vary from costs in these cities.

Overseas (note a)	April 1977 index	United States (note b)	Autumn 1976 index
Tokyo	165	Anchorage	135
Geneva	158	Honolulu	122
Frankfurt	150	New York	120
Brussels	147	Boston	118
Paris	142	San Francisco	103
Riyadh	137	Milwaukee	102
Caracas	136	Philadelphia	99
Djakarta	126	Detroit	98
Rome	123	Los Angeles	97
Hong Kong	120	Baltimore	96
Tehran	118	Chicago	96
Tel Aviv	114	San Diego	96
Canberra	112	Cleveland	95
Rio De Janeiro	111	Denver	93
Ottawa	111	Kansas City	93
Singapore	111	Seattle	93
Madrid	106	Indianapolis	91
London	102	St. Louis	90
Manila	88	Dallas	86
Mexico City	78	Houston	86

a/ These cities are in countries having the greatest numbers of Americans claiming exclusions in 1975.

b/ The cities are those in Labor's indexes which have the largest populations, except for Anchorage, which is included because it represents the extreme of cities in Labor's index.

U.S. EXPORTS AND FOREIGN SUBSIDIARY SALES FOR COUNTRIES WITH OVER 1,000 AMERICANS CLAIMING SECTION 911 (note a)

	U.S. exports (millions)	Sales of U.S. affiliates (millions)
Canada	$ 21,759	$ 78,484
United Kingdom	4,525	45,860
West Germany	5,194	38,102
Iran	3,242	7,842
Australia	1,816	13,647
Japan	9,565	17,778
Saudi Arabia	1,502	(b)
Brazil	3,056	13,121
France	3,031	26,100
Switzerland	1,153	13,676
Mexico	5,144	7,713
Singapore	994	(c)
Indonesia	810	6,444
Italy	2,867	14,516
Belgium	d/2,427	d/13,263
Venezuela	2,243	11,968
Spain	2,161	4,945
Philippines	832	2,420
Israel	1,551	(c)
Hong Kong	808	(c)
Peru	904	999
Thailand	357	(c)
Netherlands	4,183	14,204
Bahamas	208	4,077
Greece	450	(c)
Colombia	643	1,698
Nigeria	536	2,019
Taiwan	1,660	(c)
South Africa	1,302	5,308
Total	$ 84,923	$344,184
World Total	$107,652	$458,310

a/ All data is for 1975, the most recent year for which consistent data is available.

b/ Suppressed to avoid disclosure of individual company data.

c/ Not available; data reported regionally, not by country, in these areas.

d/ Belgium and Luxembourg.

RECOMMENDED LEGISLATION REQUIRING THE PERIODIC EVALUATION OF TAX INCENTIVES FOR CITIZENS EMPLOYED ABROAD

RECOMMENDED LEGISLATIVE LANGUAGE

Section 911 of the Internal Revenue Code (26 U.S.C. 911) is amended by adding the following as subsection (f) and redesignating the existing subsection (f) as (g):

(f) Information and evaluation for the Congress. - For the purpose of providing information that will aid Congress in carrying out its oversight responsibilities, the Secretary shall prepare and transmit to the Congress, through the President, no later than 18 months after the end of each even-numbered calendar year beginning calendar year 1978, a report that evaluates the effectiveness of the provisions of this section. The specific information to be included in the report shall be developed by the Secretary after consulting with the House Committee on Ways and Means, the Senate Committee on Finance, and the Secretary of Commerce and shall include, but not be limited to, the following:

(1) a detailed description of the manner in which the provisions of this section have been administered, including a summary of major problems encountered in their administration;

(2) the number, countries of residence, occupations, and other pertinent characteristics of persons claiming the benefits of this section and the pertinent characteristics of the employers of such persons;

(3) the revenue and economic effects of the provisions of this section;

(4) an evaluation of the appropriateness and effectiveness of the provisions of this section, including their impact on the Nation's international economic position;

(5) a comparative analysis of this section with alternative fiscal instruments designed to achieve similar objectives; and

(6) recommendations for additional legislation where warranted.

ANALYSIS

1. Information on administration of the tax provisions.

This information would include an explanation of how Treasury has translated the legislative intent and statutory requirements of Section 911 into operation. It could include a description and evaluation of Treasury rulemaking, tax collection procedures, audit activities, and enforcement efforts, as well as discussions of any other subjects, such as judicial decisions, that affect the implementation of the law.

2. Descriptive statistics on persons claiming the benefits of Section 911 and on their employers.

This information, which could be gathered from Federal income tax returns, would describe the universe of individuals who benefit from Section 911 and their employers--their countries of residence, occupations, and salaries, for example, and the nationalities of their employers. The data would be required for estimates of the revenue effects of both the actual and alternative provisions.

3. Analyses of the revenue and economic effects of the incentives.

These analyses would be undertaken to ascertain the actual effects of the provisions on revenue collections and the response to the provisions by individuals and firms. Although some of the required information could be obtained from tax forms, other data could only be collected by special surveys. Evaluating the effects of Section 911 on the hiring practices, compensation patterns, pricing decisions, and competitive behavior of firms employing Americans abroad would require special data-collection efforts.

In conducting these analyses, it would be appropriate for analysts and policymakers to work together to (a) identify important questions concerning the impact of Section 911 that could be answered by special studies and (b) ensure that the studies are carried out both expeditiously and at reasonable cost.

4. Evaluations of appropriateness and effectiveness.

These evaluations would require the Treasury Department to interpret the information developed under the previous three headings. Evaluations of appropriateness would require expert interpretation and judgment by Treasury of the importance and value of the economic and other effects of the provisions. Conclusions about effectiveness would require comparisons of results with policy objectives, such as enhancing the U.S. international economic position.

5. Analyses of alternative fiscal instruments.

These analyses would directly support policy deliberations by comparing the effectiveness of the Section 911 provisions with those of alternative instruments, such as the various tax options mentioned in chapter 7 of this report and such other instruments as direct Government outlays or subsidies, trade fairs, trade exhibits, and Domestic International Sales Corporations.

Much would be gained if analysts and policymakers agreed on the kinds of alternatives to be examined, evaluation criteria to be used in the comparisons, and particular policy questions to be addressed.

6. Recommendations for additional legislation.

This item is included in the event that the evaluations indicate that additional legislation is warranted.

Reporting timetable for the evaluation

In our opinion, it would be appropriate and practicable to conduct these evaluations every 2 years. The costs of processing and analyzing a sample of overseas income tax returns and preparing a formal report more frequently would probably not be justified by the value of the results. However, interested congressional committees could work out informal arrangements to keep themselves apprised of other evaluation efforts in order that the results of any special surveys or analyses might be made available for congressional deliberations.

The proper date for submitting the report to the Congress depends primarily on the time it takes the Internal Revenue Service to process a sample of overseas returns. In the past, it has taken IRS almost 15 months, and if it takes

as long in the future, 24 months after the end of the calendar year would be the earliest feasible due date for the report. Overseas returns must be filed by June 15, and Treasury analysts estimate from their experience that they would require about 3 months to prepare the report after receiving the processed sample of returns from the IRS. If the report is to be received early in a congressional session, as would be desirable, it should be submitted not later than 18 months following the end of every other calendar year. The 18 month timetable would require IRS to shorten processing time of the returns from 15 to 9 months. We believe IRS could do so if it gave the job a high priority.

HOUSING MARKET IN SURVEYED COUNTRIES

The substantial foreign and U.S. tax burden faced by U.S. citizens employed overseas is due in large part to the fact that all or most of the allowances they receive are taxable. Most significant among these is the housing allowance. Tax Court rulings of 1976, moreover, made housing provided by a company taxable at its fair market value in the host country.

Because of the significance of housing costs, we questioned individuals and companies extensively about availability, quality, and costs of housing occupied by Americans and viewed for ourselves the housing of several individuals in each country. In addition, in an attempt to corrobrate some of the information thus provided, we contacted U.S. and foreign Embassy officials, third-country company officials, and host-government officials knowledgeable of the housing situation for foreigners in their countries.

AUSTRALIA

Australia has no restrictions on foreign ownership of housing. Houses are generally smaller than those of the United States. Comparable-size houses are available, but at a higher cost than in the United States.

Monthly rental paid by individuals in our survey ranged from about $700 to $1,000 a month. Monthly utilities ranged from about $40 to $170, excluding telephone service which appeared to be more expensive than in the United States. Over two-thirds of the individuals stated that the housing quality was somewhat inferior to that in the United States; the others were of the opinion that it was about the same. Monthly rental costs for U.S. Embassy personnel in Sydney and Melbourne ranged from about $300 to $1,030.

BRAZIL

There is ample housing available in Brazil and no restrictions on foreign occupancy. Suitable housing is expensive, and apartments are the most common type of housing.

Individuals surveyed generally considered the housing quality somewhat inferior compared to that in the United States. Conveniences, such as air conditioners, heating,

and hot running water, are not standard and generally must be installed by the tenant.

A typical apartment has about 1,000 to 1,500 square feet of space and consists of two or three bedrooms, one full bath, living and dining area, small kitchen with no appliances or cabinet space, and small servant's room with bath. It rents from $750 to $2,000 a month, including condominium fees and utilities. Utility costs range from $25 a month for a 2-bedroom apartment occupied by a single adult to about $75 a month for a house occupied by a family of four.

Long-term rental contracts are rarely negotiated because of inflation, and in most cases rental contracts are subject to yearly increases in relation to the rate of inflation (approximately 40 percent in 1976).

HONG KONG

There is an adequate supply of Western-style apartments in Hong Kong, but they are expensive, and, in many instances, the occupant must furnish such basic items as light fixtures, carpeting, water heaters, appliances, and closets. Utilities are an additional cost. There is virtually no single-family housing because of the limited land area and high cost, so most American businessmen live in apartments. Charges are made for property taxes at rates computed on a percentage of the unit's fair market value (currently 18 percent).

For the past 7 years, the American Chamber of Commerce in Hong Kong has surveyed the housing costs of its membership. The 1977 survey, based on a 34-percent response from the membership, concluded that the average expatriate lives in an apartment of about 2,000 square feet at a cost of $1,419 a month including rates. In 1976, domestic premises held in the name of a corporation, government, or public body were removed from rent control. This change had an inflationary effect on housing costs as shown below.

Year	Average rent including rates	Rent index (percent)	Percent increase over previous year
1974	$1,008	100.0	--
1975	1,005	99.7	-0.3
1976	1,105	109.6	10.0
1977	1,419	140.8	28.4

Our survey and the U.S. consulate figures on rental costs for comparable housing appear to confirm the Chamber's housing survey results. Of 23 individuals surveyed, the average American in Hong Kong lived in a 3-bedroom unit with an average monthly rent including rates of $1,200. The U.S. consulate's average monthly rent excluding rates for recently leased 3-bedroom apartments was $1,440. U.S. Consulate personnel are in the process of renegotiating about 20 leases, and they expect increases of from 15 to 20 percent. Furthermore, they estimate rents will increase by 10 percent annually for the next 5 years.

Individuals surveyed generally agreed that the housing they occupied was slightly inferior to what they would be occupying in the United States. Basic to these opinions was the consideration that many individuals would be living in single-family homes in the United States.

Government-leased quarters are not subject to rates but, as for privately leased quarters, the apartments must be prepared for occupancy. In one case, preparation of the apartment cost $2,267 (including agency fee, installation of carpets, draperies, air conditioners, washer and dryer, stove, and refrigerator).

IRAN

In Iran, the availability and cost of housing vary according to geographic location, but housing is generally considered a major expense. The cost of housing has been affected by Iran's high inflation rate which, according to the U.S. Embassy, increased by about 34 percent in 1976. The Embassy noted that housing rentals in Tehran ranged from about $710 a month for a 2-bedroom apartment to $2,100 a month for a 5-bedroom house with an enclosed yard and swimming pool.

Our survey indicated that rent for a 3-bedroom dwelling ranged from a low of $360 to a high of $1,500 a month. The variations in rents appeared to be due in part to the dates and lengths of the lease agreements, geographic location, and special agreements between landlord and lessee.

The availability of adequate housing appears to be a problem everywhere. The consensus of the individuals surveyed was that housing was inferior to what they would have in the United States. Complaints included inferior construction, inadequate and undependable electrical power,

low-quality appliances, unsanitary sewage disposal, and use of bottled gas rather than gas lines.

Housing occupied by U.S. Embassy personnel included:

--A 3-bedroom apartment occupied by an Embassy staff member at an annual rent of $11,915. The lease was initiated in June 1977.

--A 5-bedroom house occupied by an officer at an annual rent of $17,021.

JAPAN

Western-style housing is very expensive in Japan and American executives generally consider it inferior to that occupied in the United States. Most Americans living in Tokyo live in apartments, because single-family homes are scarce and costly. Of 183 individuals surveyed by the American Chamber of Commerce in June 1977, 104 lived in apartments, mostly with two or three bedrooms.

The average cost of housing for Americans we interviewed in Tokyo was $1,520 a month, excluding utilities which averaged over $100 a month. These figures are slightly less than those indicated by the Chamber's survey; the average rent for 142 individuals responding was $1,850 a month, excluding utilities of $150 a month.

American businessmen paid considerably higher rent than that paid by the American Embassy. As of July 1977, the Embassy rented over 90 apartments containing one to five bedrooms for its staff at rents ranging from $400 to nearly $2,400 a month, with an average of $900 a month. Three-bedroom units comprised about one-third of the total units and rents averaged about $990 a month. Officials noted that the Embassy generally received more favorable rates than the business community because the Embassy has a strong position in the rental market.

Purchase prices for housing in Tokyo could be considered prohibitive, particularly for single-family dwellings. Several individuals we interviewed lived in private or company-owned, single-family homes, which were purchased before 1960. One individual stated that the current market

value of his single-family home was about $750,000, but he paid less than $100,000 for it in 1957. Condominium units are also extremely expensive. A new 2,100 square foot Western-style apartment with American-made appliances, carpets, heating, and air-conditioning, was selling for over $500,000 in November 1976.

Typical housing occupied by American businessmen and their families in Tokyo includes:

--A house occupied by a senior offical of a petroleum company (with a base salary of over $50,000 annually) has 2,600 square feet, is on a 3,900 square foot lot, and has three bedrooms. It is owned by the company, and has an estimated rental value of $3,000 monthly.

--A 3-bedroom apartment (plus den) occupied by a senior representative of a construction engineering firm has slightly over 2,000 square feet, and rents for about $2,400 monthly.

--A Japanese-style, 1-bedroom apartment occupied by a manager of an industrial products firm (with a base salary of about $15,000 in 1976) has about 420 square feet. It rents for $350 monthly plus $90 for parking.

MEXICO

Since 1976, the demand for adequate housing in Mexico has far exceeded the supply, resulting in increased costs. In certain cases, rents have increased more than 100 percent. The primary reasons for this situation are (1) the influx of foreign businesses, (2) fewer houses being built, and (3) the increasing population.

U.S. residents surveyed generally live in houses with three or four bedrooms. While the houses are generally spacious, most U.S. residents consider the housing quality inferior to that in the United States.

Foreigners and local nationals are generally charged the same amount for housing. Because of the difference in living standards, however, foreigners generally live in the higher rent areas. The cost range for housing during August 1977 was as follows.

Apartment	1 bedroom	$220 to $310 a month
	2 bedrooms	$240 to $350 a month
	3 bedrooms	$310 to $480 a month
	4 bedrooms	$350 to $530 a month
House	2 bedrooms	$350 to $ 530 a month
	3 bedrooms	$440 to $ 880 a month
	4 bedrooms	$530 to $1,090 a month
	5 bedrooms	$660 to $1,310 a month

Housing costs were expected to increase during 1977 as housing availability becomes more critical.

THE PHILIPPINES

Adequate Western-sytle housing is available in Manila. Foreigners generally occupy large single-family units, many with private swimming pools. They are, however, expensive by U.S. standards and costs have risen substantially over the past few years.

Most foreigners live in the Makati area of Manila, which is near the business section. Since foreigners cannot own land in the Philippines, housing is rented. The residential area of Makati is divided into villages, each enclosed and guarded. Most homes are split-level or two-story dwellings close to shopping facilities. The houses are on small lots but are large and individually styled. They usually have three or four bedrooms, two baths, a servants quarters, and a modern kitchen. Very few apartments are available. Recently, a few large condominium-type apartments have been erected, but the initial rental prices are very high.

The individuals we surveyed paid an average monthly rent of $1,050. The range was from $340 to $2,000. These rents appear to be somewhat high in comparison to those of the U.S. Embassy-Manila, whose average rent for 150 housing units as of April 1977 was about $530 per month, with an additional $170 a month for utilities. The Embassy noted, however, that rents have increased 45 percent in each of the last 2 years and estimated increases of 25 percent for each of the next 2 years.

While Embassy personnel and private businessmen seem to live in comparable housing in the same villages, the U.S. Government gets more favorable rental rates. Embassy officials responsible for housing said this is true because:

--The U.S. Government is considered a favored tenant because it does considerable maintenance on the residences.

--The business community is generally willing to pay what is asked for housing.

It should be noted that the range of housing available is not as wide as that in the United States. Americans are forced to live either in one of the villages where most foreigners live or in housing similar to that occupied by local residents; there is no middle-class housing. Foreigners tend to seek housing in the villages and, as a Philippine Government official noted, they are driving up the rents of such housing, forcing local citizens to move out.

SAUDI ARABIA

Housing presents a substantial cost to employers in Saudi Arabia. Individuals surveyed described housing costs as "very high" and "outrageous." In short, there is an extreme seller's market.

Saudi Arabian law requires that on contracts above a certain size employers must provide housing for their employees to help ease the continuing shortage. Thus, employees are not given housing allowances as such but are provided with housing, often viewed as a condition of employment. Housing benefit plans vary from company to company.

--Some deduct a theoretical U.S. cost from an employee's salary and pay the difference.

--Housing may be free as part of the compensation package.

--Employees pay the first $500 or a similar amount, and the employer pays the rest.

We found no instance of a company paying the employee a sum of money and the employee house-hunting for his own best deal.

Discussions with company officials and individual employees generally support American Embassy analysis of the housing situation:

- --As a rule, there are few apartment or office buildings. For private firms, it has been necessary to rent villas and convert them into the desired arrangement of offices, family housing, or bachelor accommodations. The financial terms of leasing in Saudi Arabia are extremely arduous. Landlords, by and large, enjoy an extreme sellers' market. Customary practice is to require 2 to 3 years' rent in advance. Landlords almost never make renovations and provide no maintenance. These costs must be borne by the lessee.

- --The cost of family housing depends on the (1) annual rent and (2) cost of renovation. A firm setting up an operation in Riyadh in July 1975 paid $40,000 to $45,000 a year for attractive 3-bedroom villas. Two-bedroom villas went for $30,000 to $35,000 a year. Rates have gone up since then, and current annual rent for houses with three bedrooms would be about $50,000 to $60,000.

- --The amount of renovations depends, of course, on conditions of the house. Generally, any housing which becomes available requires air-conditioning and separate wiring to handle the air-conditioning load. One firm estimated it spent over $35,000 a house on such renovations in 1976. It is estimated that renovation costs range between $10,000 and $50,000.

- --The cost of bachelor housing depends on the type of facility chosen. For long-term employees, firms set up villas and divided them for bachelor accommodations. It is estimated that the annual cost per man per year would range between $12,800 and $15,000, assuming a villa accommodated four or five men.

Below are specific examples of housing costs for the companies interviewed.

- --A company leases 30 apartments in Jidda for workers on one contract and has purchased prefab homes for other workers. The cost

of each leased apartment (two bedrooms, 1,000 square feet of living space) is about $20,000 a year. The total cost per prefab home, including infrastructure for the compound, is about $160,000, with an expected life of 10 years. Annual cost for these homes with 1,200 square feet of living space, therefore, would be about $16,000.

--A company starting up in Saudi Arabia costed out its contract proposal on the basis of annual housing costs of $40,000 per family and about $13,300 per single worker.

SINGAPORE

Housing occupied by foreigners is distinctly different from that occupied by locals, primarily because housing acceptable to locals is not comparable to housing styles or sizes found in Western countries. As a result, foreigners elect to incur higher costs to approach a living standard close to what they would have in their home country.

Individuals surveyed lived in apartments and in semidetached and detached houses. The majority of the units were rented. Some companies and the U.S. Embassy own houses in Singapore. Due to a recent change in the law, however, foreigners can now only purchase apartments and these must be in buildings with six or more stories. More than 25 percent of the individuals surveyed believed that the quality of housing was somewhat inferior to that they would have in the United States.

Rents paid by foreigners ranged from $400 to about $1,600 a month. The price range in greatest demand is in the $400 to $1,000 a month range. Housing costs have been holding relatively steady as a result of overbuilding compounded by a decrease in demand brought about by a slowdown in the oil industry.

UNITED KINGDOM

The United Kingdom has a highly developed, complex housing market, with costs varying significantly throughout the country. In northern England, rents were described by one company as lower than average U.S. Midwest rents. In London, as in other large cities, the "neighborhood" is especially important in setting price.

The housing situation is an irritant to most individuals we interviewed. The major complaints centered on high costs and inferior quality compared to U.S. accommodations, especially in terms of room size and adequacy of heating, plumbing, and certain amenities. We believe it questionable, however, that housing costs in London exceed those prevailing in such U.S. cities as New York.

U.S. Embassy rentals in the summer of 1977 were as follows.

--A 3-bedroom unfurnished apartment in central London rented for $821 a month.

--A 2-bedroom unfurnished house in the London suburbs rented for $492 a month.

--A 4-bedroom partially furnished house in the London suburbs rented for $684 a month.

In London monthly rents for 2-bedroom apartments ranged from $450 to $700. Reasons for variances include location, size, and date of lease agreements. Cost data provided by some companies showed increases ranging from minimal to significant over the last few years. Embassy officials agreed that housing costs have risen dramatically, and they expected an additional 20 to 25 percent increase in 1977 because of increased demand, especially from Middle Easterners and oil companies, and lack of recent building and modernization.

VENEZUELA

The demand for housing far exceeds the available supply; the result is an inflationary rental boom. This is attributable to (1) the growing tendency for multinational corporations and banks to establish regional offices in Caracas, (2) an influx of foreign executives and technicians into Venezuelan firms, (3) a rapidly growing urban population, and (4) limited land upon which to build new housing.

Most individuals we surveyed occupy apartments. Housing quality and attractiveness is considered adequate and comparable to housing in Miami, Florida.

Housing costs are expected to increased a minimum of 30 percent annually because of inflation and because of a government limit on construction profits that reduces the potential for new housing. The cost range for housing during the summer of 1977 was as follows.

Apartment	2 bedrooms	$ 700 to $ 940 a month
	3 bedrooms	$ 940 to $1,170 a month
	4 bedrooms	$1,170 to $1,400 a month
House	4 bedrooms	$1,050 to $1,870 a month
	5 bedrooms	$1,290 to $2,100 a month

Since 1973, the housing allowance has about doubled for U.S. Government employees because of rising costs. It has increased from $3,440 to $8,700 for secretaries and junior officers and from $6,600 to $12,200 for most senior officers. Two more increases were expected during 1977.

Foreigners generally pay more for housing than local nationals because

--foreigners generally have higher living standards;

--most locals live in areas where the Venezuelan Government prohibits rent increases; and

--the general feeling among locals is that foreigners, especially Americans, are wealthy.

HYPOTHETICAL EXAMPLES OF TAXATION OF U.S. CITIZENS IN SELECTED COUNTRIES BEFORE AND AFTER 1976 TAX CHANGES

The following schedules demonstrate the varying effect of 1976 tax changes in selected countries. For the examples, we selected fictitious taxpayers--a single taxpayer, base salary $20,000, and a married taxpayer, three dependents, filing a joint return, base salary of $40,000. To their base salaries we added the value of various allowances at prevailing rates. We assumed these taxpayers had been overseas for at least a year prior to the tax year so that home leave and tax allowances were appropriate. The foreign tax liability was determined in accordance with the current income tax rates and definitions of each country; we did not attempt to adjust for any possible defects in tax administration.

In the schedules, the first column shows the tax computation following rules applicable in 1975, assuming that the taxpayer was not reporting his housing allowance as taxable income. The second column applies the same rules except that it assumes the taxpayer reports his housing allowance or overseas fair market value of employer-provided housing as taxable income in accordance with 1976 Tax Court rulings. The third column shows the tax computation following the Tax Reform Act changes in Section 911.

APPENDIX V

SAUDI ARABIA

	Single taxpayer			Married taxpayer filing joint return		
	1975 rules	1975 rules with Tax Court changes	Tax Reform Act rules	1975 rules	1975 rules with tax court changes	Tax Reform Act rules
Salary	$20,000	$20,000	$20,000	$40,000	$ 40,000	$ 40,000
Allowances (note a)	b/12,458	33,210	33,210	b/45,894	91,372	91,372
Foreign-earned income	32,458	53,210	53,210	85,894	131,372	131,372
Less exclusion	20,000	20,000	-	20,000	20,000	-
U.S. taxable foreign-earned income	$12,458	$33,210	$53,210	$65,894	$111,372	$131,372
Tentative U.S. tax	$ 2,281	$10,077	$19,140	$22,898	$ 45,409	$ 54,666
Less tax on exclusion	-	-	3,512	-	-	3,004
Net tentative U.S. tax	$ 2,281	$10,077	$15,628	$22,898	$ 45,409	$ 51,662
Income taxable by foreign country (note c)	$ -0-	$ -0-	$ -0-	$ -0-	$ -0-	$ -0-
Foreign tax--item 1	-0-	-0-	-0-	-0-	-0-	-0-
Foreign tax credit	-0-	-0-	-0-	-0-	-0-	-0-
Less reduction (note d)	-0-	-0-	-0-	-0-	-0-	-0-
Net foreign tax credit	$ -0-	$ -0-	$ -0-	$ -0-	$ -0-	$ -0-
Foreign tax credit carryover	$ -0-	$ -0-	$ -0-	$ -0-	$ -0-	$ -0-
U.S. tax--item 2	$ 2,281	$10,077	$15,628	$22,898	$ 45,409	$ 51,662
Total U.S. and foreign tax--item 1 plus item 2	$ 2,281	$10,077	$15,628	$22,898	$ 45,409	$ 51,662

a/

	Single	Married
Housing	$16,908	$30,420
Cost of living	2,544	5,904
Overseas premium	3,000	6,000
Eduation	-	10,740
Home leave	1,326	5,304
Hardship	4,000	8,000
R&R	1,588	2,676
Tax reimbursement	3,844	22,328
Total	$33,210	$91,372

b/ Does not include housing; tax reimbursements are smaller.

c/ No personal income tax in Saudi Arabia.

d/ Foreign tax credit reduced for taxes allocable to Section 911 excluded income (see p.47.)

APPENDIX V

JAPAN

	Single taxpayer			Married taxpayer filing joint return		
	1975 rules	1975 rules with Tax Court changes	Tax Reform Act rules	1975 rules	1975 rules with Tax Court changes	Tax Reform Act rules
Salary	$20,000	$20,000	$20,000	$40,000	$ 40,000	$ 40,000
Allowances (note a)	b/11,121	26,850	26,850	b/39,202	71,932	71,932
Foreign-earned income	31,121	46,850	46,850	79,202	111,932	111,932
Less exclusion	20,000	20,000	-	20,000	20,000	-
U.S. taxable foreign-earned income	$11,121	$26,850	$46,850	$59,202	$ 91,932	$111,932
Tentative U.S. tax	$ 1,930	$ 7,324	$15,960	$19,612	$ 35,932	$ 44,946
Less tax on exclusion	-	-	3,512	-	-	3,004
Net tentative U.S. tax	$ 1,930	$ 7,324	$12,448	$19,612	$ 35,932	$ 41,942
Income taxable by foreign country (note c)	$29,759	$31,628	$31,628	$73,754	$ 82,856	$ 82,856
Foreign tax--item 1	$ 6,501	$ 7,007	$ 7,007	$26,124	$ 30,220	$ 30,220
Foreign tax credit	$ 1,930	$ 7,007	$ 7,007	$19,612	$ 30,220	$ 30,220
Less reduction (note d)	-	-	1,542	-	-	2,115
Net foreign tax credit	$ 1,930	$ 7,007	$ 5,465	$19,612	$ 30,220	$ 28,105
Foreign tax credit carryover	$ 4,571	$ -0-	$ -0-	$ 9,209	-0-	-0-
U.S. tax--item 2	$ -0-	$ 317	$ 6,983	$ -0-	$ 5,712	$ 13,837
Total U.S. and foreign tax--item 1 plus item 2	$ 6,501	$ 7,324	$13,990	$26,124	$ 35,932	$ 44,057

a/	Single	Married
Housing	$13,860	$23,628
Cost of living	6,588	14,644
Overseas premium	3,000	6,000
Education	-	6,290
Home leave	1,362	5,448
Tax reimbursement	2,040	15,922
Total	$26,850	$71,932

b/ Does not include housing; tax reimbursements are smaller.

c/ Home leave and housing allowances not included in taxable income if a trip is taken a employee repays a portion of rental costs to employer.

d/ Foreign tax credit reduced for taxes allocable to Section 911 excluded income (see p. 47)

APPENDIX V

MEXICO

	Single taxpayer			Married taxpayer filing joint return		
	1975 rules	1975 rules with Tax Court changes	Tax Reform Act rules	1975 rules	1975 rules with Tax Court changes	Tax Reform Act rules
Salary	$20,000	$20,000	$20,000	$40,000	$40,000	$40,000
Allowances (note a)	b/ 9,216	13,380	13,380	b/25,964	32,600	32,600
Foreign-earned income	29,216	33,380	33,380	65,964	72,600	72,600
Less exclusion	20,000	20,000	-	20,000	20,000	-
U.S. taxable foreign-earned income	$ 9,216	$13,380	$33,380	$45,964	$52,600	$72,600
Tentative U.S. tax	$ 1,458	$ 2,530	$ 9,314	$13,034	$16,317	$25,280
Less tax on exclusion	-	-	3,512	-	-	3,004
Net tentative U.S. tax	$ 1,458	$ 2,530	$ 5,802	$13,034	$16,317	$22,276
Income taxable by foreign country (note c)	$33,380	$33,380	$33,380	$72,600	$72,600	$72,600
Foreign tax--item 1	$12,188	$12,188	$12,188	$35,167	$35,167	$35,167
Foreign tax credit (note d)	$ 1,458	$ 2,530	$ 5,802	$13,034	$16,317	$22,276
Foreign tax credit carryover	$10,730	$ 9,658	$ 6,386	$22,133	$18,850	$12,891
U.S. tax--item 2	$ -0-	$ -0-	$ -0-	$ -0-	$ -0-	$ -0-
Total U.S. and foreign tax--item 1 plus item 2	$12,188	$12,188	$12,188	$35,167	$35,167	$35,167

a/	Single	Married
Housing	$ 4,164	$ 6,636
Overseas premium	3,000	6,000
Education	-	2,436
Home leave	380	1,520
Tax reimbursement	5,836	16,008
Total	$13,380	$32,600

b/ Does not include housing.

c/ Items included in gross income were the same for both countries.

d/ The Limitation on Credit, which is the lesser amount of this item and of Total Foreign Taxes Available for Credit; therefore there is no Reduction for Taxes.

 APPENDIX V

HONG KONG

	Single taxpayer: 1975 rules	Single taxpayer: 1975 rules with Tax Court changes	Single taxpayer: Tax Reform Act rules	Married taxpayer filing joint return: 1975 rules	Married taxpayer filing joint return: 1975 rules with Tax Court changes	Married taxpayer filing joint return: Tax Reform Act rules
Salary	$20,000	$20,000	$20,000	$40,000	$40,000	$40,000
Allowances (note a)	b/ 7,310	19,382	19,382	b/23,528	53,018	53,018
Foreign-earned income	27,310	39,382	39,382	63,528	93,018	93,018
Less exclusion	20,000	20,000	-	20,000	20,000	-
U.S. taxable foreign-earned income	$ 7,310	$19,382	$39,382	$43,528	$73,018	$93,018
Tentative U.S. tax	$ 1,050	$ 4,447	$12,226	$11,916	$26,525	$35,489
Less tax on exclusion	-	-	3,512	-	-	3,004
Net tentative U.S. tax	$ 1,050	$ 4,447	$ 8,714	$11,916	$26,525	$32,485
Income taxable by foreign country (note c)	$28,204	$28,204	$28,204	$62,533	$72,676	$72,676
Foreign tax--item 1	$ 3,826	$ 3,826	$ 3,826	8,345	9,867	9,867
Foreign tax credit	$ 1,050	$ 3,826	$ 3,826	$ 8,345	$ 9,867	$ 9,867
Less reduction (note d)	-	-	1,098	-0-	-0-	839
Net foreign tax credit	$ 1,050	$ 3,826	$ 2,728	$ 8,345	$ 9,867	$ 9,028
Foreign tax credit carryover	$ 5,873	$ -0-	$ -0-	$ -0-	$ -0-	$ -0-
U.S. tax--item 2	$ -0-	$ 621	$ 5,986	$ 3,571	$16,658	$23,457
Total U.S. and foreign tax--item 1 plus item 2	$ 3,826	$ 4,447	$ 9,812	$11,916	$26,525	$33,324

a/

	Single	Married
Housing	$12,072	$20,268
Cost of living	2,640	5,880
Overseas premium	3,000	6,000
Education	-	4,968
Home leave	1,670	6,680
Tax reimbursement	-	9,222
Total	$19,382	$53,018

b/ Does not include housing and there were no tax reimbursements.

c/ Home leave not included in taxable income; housing included as 10 percent of total of other income items.

d/ Foreign tax credit reduced for taxes allocable to Section 911 excluded income (see p. 47)

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