A Requiem for the Destination-Based Cash Flow Tax

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“Packages” vs. fundamental particles

Widely-discussed tax instruments often are packages – willfully combining multiple rules at distinct margins.

WW tax = (a) tax FSI at domestic rate, (b) dollar-for-dollar reimbursement of foreign taxes.

<u>Territorial tax</u> = (a) tax FSI at 0%, (b) foreign taxes ≈ deductible.

<u>X-tax</u> = (a) flat rate VAT, (b) wage-tied rebate, rising up to a ceiling.

(Pure VAT, by contrast, is a “fundamental particle” if one is willing to amalgamate all of the goods that it uniformly taxes.)

Packages' pluses and minuses

Packages offer a convenient shorthand for compound proposals – and can be an indispensable political tool.

But they undermine clear thinking about distinct choices – as I've (futilely, albeit correctly) argued in the international realm.

This is even true of the X-tax – which might, e.g., be compared to a VAT + demogrant (in lieu of its rising wage-tied rebate).

Today I want to offer a mainly unfriendly requiem for another package: the destination-based cash flow tax (DBCFT).

“Mainly unfriendly”!?

Important to clarify what I mean by this. I could easily have supported a still broader package that included a DBCFT.

But it was fundamentally an attempted trick, in package assembly, that didn’t happen to work.*

There’s nothing as such wrong with tricks! And here it served reasonable aims (by obscuring controversial but possibly meritorious components).

So perhaps it’s too bad that the trick didn’t work.

Continued focus on the DBCFT as if it were a single thing, not a package, can impede looking clearly at the particles.

*This is not to say that the proponents thought of it as a trick! But if not, they should have as a matter of clear thinking.

What is the DBCFT?

For convenience, we can say it has 4 main elements:

(1) Enact a VAT,

(2) Lower the origin-based corporate income tax rate to 0,

(3) Put a wage deduction into the VAT,

(4) Add a tax on net interest income to the VAT. [As proposed on the Hill, as distinct from purer academic versions.]

Grading the DBCFT's elements

(1) Enact a VAT – I'm in favor, but the trick didn't work; why would countries that already have VATs bother with this?

(2) Lower the origin-based corporate income tax rate to 0 – Too low? Should discuss directly! Not either-or with the VAT!

(3) Put a wage deduction into the VAT – under-specified as a standalone feature; combining the two -> gratuitous problems (NOLs, WTO & treaty compatibility).

(4) Add a tax on net interest income to the VAT – peculiar & ad hoc. A function of packaging constraints, not deliberate design.

So here's my proposal: Let's (1) forget about the DBCFT as such, & (2) think seriously about each of the 4 elements.

Backstory: Why no US VAT?

No need for the DBCFT if could enact a VAT directly.

Then it would just be a question of what to do with/to the existing corporate income tax, given the new revenue source.

So why can't we have one? Consider Larry Summers' famous VAT joke.

The Summers joke

Larry Summers: No U.S. VAT because conservatives view it as a money machine, & liberals see it as a tax on the poor.

He added: We'll get the VAT when liberals figure out that it's a money machine & conservatives see that it's a tax on the poor.

The apparent paradox – why do both just see the "bad" thing from their standpoints? – has not been much analyzed.

So it's worth asking: Why has VAT enactment in the US been (for better or worse) such a prohibitively heavy lift?

Some reasons for the "heavy lift"

VAT enactment outside the U.S. hasn't always been so easy either. Usually requires strong motivation.

E.g., it has replaced gross-receipts taxes, or been a condition of EU membership, or responded to a fiscal crisis. And note IMF role.

U.S.: VATs much discussed in late 1970s. But then: Al Ullman, tax revolt, "Reagan revolution," rising U.S. policy exceptionalism.

But history alone doesn't explain its continued absence.

A missing Pareto deal?

Suppose we knew for sure what the U.S. tax system would look like *without* a VAT.

(Obviously, this requires assuming both fiscal sustainability & political stasis.)

Say we could also specify what the U.S. tax system would look like *with* a VAT, so long as the left & right could agree on the terms for introducing it.

Then there ought to be a set of Pareto-improving deals (from *rational* left & right standpoints) involving VAT adoption.

From reduced inefficiency, getting to cut capital income taxes, & getting to fund some added spending.

High transaction costs amid dissensus

When Pareto deals don't happen, look for the transaction costs.

Who would negotiate the deal? How assure its stability? How sell it to one's own supporters?

The U.S. has a huge ideological divide & open political warfare – both sides want to win, & think they still can.

Hard to agree to share the blame for introducing it - & recall that (for each side) a VAT might open the door to *worse* outcomes.

Cf. the ongoing chicken game re. how to address the fiscal gap – neither side wants to offer concessions prematurely.

Back to Larry Summers' VAT joke

Both sides know that a VAT both increases feasible spending & is regressive (compared to income taxation) as a standalone.

There's nothing new that they need to "figure out."

But there's risk aversion re. the downside if the *other* party gets to set the broader agenda.

Plus, the inherent political difficulty of selling it to voters when (a) neither side trusts the other, and (b) political actors on each side would have incentives to defect.

The VAT's U.S. future

Republicans may find it easier to camouflage a VAT, since they dislike the corporate income tax (and the two instruments are optically similar).

The analogous Democratic move – subbing it in for the payroll tax – is evidently an even harder lift.

"Can't live with it, can't live without it"?

Perhaps the US will finally get the VAT when it's ceased to be part of "best fiscal practice" due to intangibles, cross-border issues, & improved global information-sharing about wealth & income.