

The Rise and Fall of the Destination-Based Cash Flow Tax: What Was That All About?

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Oceans apart?

U.S. tax system (& broader fiscal system): highly distinctive by global standards.

Only OECD country with no VAT/GST. Unusually high statutory rate (whether or not effective rate) in corporate income tax.

Greater reliance on income taxation -> an unusually progressive tax system – but a not very progressive overall fiscal system.

Structure raises concerns about the U.S. tax system's marginal deadweight loss & sensitivity to tax competition.

International issues are central – inversions, base erosion, unrepatriated earnings, etc.

The distinctive turn that wasn't

2016-17: U.S. briefly seemed poised to do something apparently more distinctive still.

That is: become the only country in the world with a “destination-based cash flow tax” (DBCFT).

While *formally* off-the-charts unique, this would have made the U.S. tax system *substantively* more like the rest of the world.

The DBCFT is basically a VAT (plus wage deduction) in lieu of the entire existing U.S. corporate income tax.

So its adoption would have (a) in effect given us a VAT, and (b) moved our statutory corporate income tax rate from near the top to the bottom (i.e., 0%).

Yet the distinctiveness would have mattered

The DBCFT was nonetheless an odd way to go about making the U.S. tax system substantively more like that in other countries.

E.g., putting the wage deduction inside the VAT courted WTO sanctions plus violation of dozens of tax treaties.

The DBCFT also raised a # of distinctive technical concerns. E.g.:

- loss refundability in light of the wage deduction,
- treatment of financial sector, if no corporate income tax,
- coordinating its interactions with the remaining individual-level (origin-basis) income tax.

So why consider doing it this way?

The DBCFT rose as a political option for quirky reasons, then fell for obvious (& foreordained?) reasons.

These reasons are worth reviewing briefly – but the backstory is more important in the long run.

It concerns the political unavailability of the obvious, more direct approach to making the U.S. tax system more like others.

Why not just (1) adopt a VAT like everyone else?, (2) lower the corporate rate, whether or not to 0, and (3) decide what further changes all this required?

DBCFT story first – then to the backstory.

Rise of the DBCFT, part 1

In U.S. academic tax literature, the #1 topic for 45 years has been: Should we wholly replace the income tax with a progressive consumption tax?

E.g., via the X-tax (subtraction method VAT + wage deduction; tax wages at progressive rates that top out at the business rate).

The X-tax might be either origin-basis or destination-basis.

Alan Auerbach: proposes replacing just the corporate income tax w/ the *d-basis* version of the *business level* part of the X tax.

And the DBCFT is born.

Rise of the DBCFT, part 2

House Republicans in 2016 anticipate losing presidential election, but keeping Congress.

They want a new approach to anchor debate – without believing it could actually be enacted any time soon! DBCFT fits the bill.

Post-election, Speaker Ryan & tax committee chair Brady note estimates that the d-basis feature would raise \$1T in the next 10 years (due to trade deficit).

While just a temporary fiscal benefit, myopia reigns in budgeting.

So they deem it the magic bullet for procuring a permanent tax cut without *actually* raising anyone's taxes by \$1 trillion.

Trade issues

Optical benefit of the DBCFT: it looks like a protectionist tariff, though it actually isn't.

It actually should increase U.S. investment – but not from border adjustment as such.

Rather, from eliminating the origin-based U.S. corporate tax.

This does, however, imply surrender in the battle over taxing outbound rents (such as from IP) that are generated by U.S. people working in the U.S.

The currency issue

Lots of debate re. how fast the U.S. \$ would appreciate, thereby saving importers from getting hammered by non-deductibility.

In theory, adjustment is immediate – but no good historical precedent; theory says more about the equilibrium than the path.

Gets messier still if one starts thinking about traders anticipating adoption (or post-WTO repeal).

DBCFT-caused dollar appreciation would cause a one-time wealth transfer, from Americans to foreigners, estimated to exceed \$6 trillion – but no one in the U.S. seems to care!

Fall of the DBCFT

The DBCFT swiftly draws punishing fire from all sides.

--Hard to explain to the public,

--Trump Administration isn't sure what to think or do,

--Democrats opposed, so no bipartisan buy-in,

--Experts largely skeptical (unless done slowly & carefully, which seemed unlikely),

--Importers strongly opposed.

Plus, the background of the Ryan/Trump healthcare clown show.

Backstory: Why not just enact a 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.

But 4 key points about the current U.S. tax policy debate:

- 1) Most (on both the left & the right) could support the VAT if irreversibly embedded in a particular broader “package.”
- 2) Huge disagreements between the left & the right about what that package should be!
- 3) Each side may view the VAT as making the *other* side’s package potentially even worse.
- 4) No current prospects to enact an avowed VAT.

An over-exposed (but under-analyzed) joke about the VAT

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.

I believe it has a rational underlying cause (more on this shortly).

VAT: can't live with it, can't live without it

It's generally agreed that VATs induce less marginal inefficiency than income taxes ...

... especially if one starts from high income tax rates and no VAT.

VATs' regressivity in isolation can be overcome if used to fund healthcare, education, infrastructure, etc.

“Money machine” claim – as distinct from the greater-efficiency claim – has been disputed, & could be addressed institutionally (earmarking, reporting, etc.).

So, what could possibly be the problem?

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.

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.

E.g., Republicans keep tiptoeing up to it, as in the DBCFT debate (more on this shortly).

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 both the left's & right's 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."

Rather, it's about 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 discreet charm of the VAT*

Since each side likes (as well as dislikes) something about VATs, they keep cropping up in reform proposals, even if unnamed.

DBCFT is just one example – consider also Ted Cruz’s “business flat tax” (accurately if inelegantly described by Marco Rubio as a “VAT tax” [sic]).

Republicans find it easy to camouflage VATs, by subbing them in for corporate income taxes.

It’s structurally harder for Democrats to disguise VAT proposals, if they’re committed to preserving corporate income taxation.

*With apologies to Graeme Cooper, who thought of this title first (although he changed it to “discrete”) .

What is likely to happen?

In the current Congress, Republicans seem unlikely to do more than enact tax cuts that might have to be temporary.

Probably to be done without structural changes (requiring losers as well as winners) that could reasonably be labeled “tax reform.”

Modest moves towards a VAT-ish model (such as greater use of expensing) are possible.

But, limits on interest deductibility? I’ll believe it when I see it.

The tax cuts would just kick the can down the road given (a) larger fiscal gap, (b) lack of bipartisan buy-in.

A VAT can't happen, but has to happen

The U.S. fiscal gap reflects that nearly all voters want more gov't spending than Republicans want (or Democrats dare) to fund.

Recall the controversy around Obamacare repeal, since taking away 24 million people's insurance was politically awkward.

Note aging population, healthcare, retirement security, military-industrial complex, education & childcare, infrastructure, etc.

Hard to see how this gets addressed without a VAT. Herbert Stein's Law: "If something cannot go on forever, it will stop."

But also hard to see how the U.S. would actually get to the VAT (or, e.g., a carbon tax).

A closing irony?

Perhaps the U.S. will finally enact a VAT when it's no longer part of "best fiscal practice" but has become obsolete.

VATs are already being undermined around the world by the rise of the digital economy.

As was noted in the U.S. DBCFT debate, it's hard to border-adjust if imports and true exports are hard to observe.

Suppose, meanwhile, that assets become ever-harder to hide, and ever-easier to value. A shift back towards income & even wealth taxation?

With the U.S., given plutocratic capture of its political system, once again being the chief outlier?