Goodbye to All That?: A Requiem For the Destination-Based Cash Flow Tax

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“Packages” vs. fundamental particles

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

E.g., X-tax = (a) flat-rate VAT + (b) wage-tied rebate, up to a ceiling. Typically also paired with (c) repeal of existing income taxes (and payroll taxes? And estate/gift/inheritance taxes?)

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 can undermine clear thinking about distinct choices.

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

But it's truer still of the destination-based cash flow tax (DBCFT) that has been much discussed in recent years.

What is the DBCFT?

In the U.S., depending on the version (e.g., Auerbach 2010 vs. the June 2016 House Republican "Better Way"), it has at least 3 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.

House Republicans, but not Auerbach, would also, e.g., have taxed positive net interest income.

Particular versions of the DBCFT

Any specific DBCFT proposal, while having multiple components, can reasonably be evaluated as a whole.

E.g., one may conclude that it is either better or worse than prior law, alternative proposals, etc.

But the fact that it's a package makes discussing it, as a single "thing," more obfuscating than clarifying.

And the impetus for so treating it can reflect conceptual error.

Conceptual Error in DBCFT Debate

Suppose one asked: Should countries have (1) VATs **OR** (2) origin-based corporate (or business) income taxes?

This is an ill-framed question for 2 reasons:

(1) It's possible to have both – as nearly all developed countries (apart from the U.S.) do.

(2) The issues re. each depend on other fiscal system attributes.

E.g., merits of origin-based corporate income tax depend on how individuals are otherwise taxed. (DBCFT vs. X-tax.)

The right questions to ask, part 1

(1) Should one have a VAT? (And if so, at what rate?)

U.S. impetus for a DBCFT reflects difficulty of enacting VAT directly – although it might well feature in a political "Pareto deal."

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.

I've discussed this joke/paradox elsewhere (& suggested that political risk aversion is a key element).

The tricky U.S. path to a VAT

Easier to enact a U.S. VAT if it can be subbed in for an existing fiscal instrument.

A VAT's optics can resemble those of a corporate income tax – although its economic substance is closer to that of a payroll tax.

In politics, optics vastly outweigh economic substance.

Hence, Republicans can propose VATs (a la the "Better Way" & Ted Cruz's "business flat tax"), since they dislike corporate income taxation.

But if Democrats tried to sub it in for the payroll tax (e.g., for tax rate & transition incidence reasons), it wouldn't be seen as the "same tax."

The right questions to ask, part 2

(2) Should the origin-based corporate income tax rate go to 0?

DBCFT proponents note its ill effects on investment & corporate residence incentives, the difficulty of determining source, etc.

But suppose the individual side (at least, for much other income) remains the same.

Note corporate income tax as backstop for the individual income tax, issues of how to integrate the two, etc.

And an origin-based corporate income tax can have advantages, too – e.g., taxing resident owner-employees on outbound rents (if not otherwise done sufficiently).

Is 0% too low?

Many would say it *is* too low (e.g., Toder-Viard & Altshuler-Grubert, in recent U.S. business tax reform debate).

Whether one agrees or not, *that's what we should be discussing*.

It isn't helpful just to ask whether origin basis or destination basis is "better" – or to focus just on o-basis downsides.

And it needn't be an either-or question! ("VAT **or** corporate income tax?")

DBCFT proponents asked how best to tax business income. They should have asked *how best to optimize the overall fiscal system.*

The right questions to ask, part 3

(3) Should the VAT be modified to have a wage deduction?

As proponents agree, this isn't a standalone fundamental feature.

Auerbach et al (2017, 16): "[I]ntroducing a VAT … & reducing labor income taxes at the same rate would have equivalent economic effects to those of the DBCFT."

But combining the VAT w/ a wage deduction (rather than lowering labor income taxes directly) can -> gratuitous legal/administrative problems.

Consider, e.g., NOL problems & WTO / treaty compatibility.

Moving towards destination basis?

This panel's title ("Moving Developed Economies Towards a Destination Basis") jumps the gun a bit.

Under an ability to pay concept – underlying both income & consumption taxation – sensible results require looking at individuals' ***WW*** income or consumption, as the case may be.

(For individual-level consumption taxes, David Bradford called this the "tourism problem.")

Individual-level taxes of one kind or another are indispensable if one wishes to use rate graduation.

The need to integrate the two levels

The case against WW taxation of corporate income (taking income taxation as given) rests on the meaninglessness/manipulability of corporate residence.

And once WW taxation is rejected at the entity level, use of the destination basis has advantages.

But one still ought to think through the interactions between individual-level & entity-level taxes …

… reinforcing once again the inadequacy of an analysis that is confined to the stand-alone design of entity-level taxation.

Whither the DBCFT?

Outside the U.S., I have never seen the point to discussing the DBCFT (rather than discussing VATs, origin-based income taxes, & labor income tax rates).

In the U.S., it seemed to have promise as a trick to ease VAT adoption (albeit, arguably at the cost of lowering origin-based income tax rates too much).

But again, the trick didn't work.

I am hoping that future tax reform debate will return to more intellectually fruitful & transparent – or else, comprehensive – channels. (E.g., VAT + demogrant + inheritance/gift tax?)