Taxing Consumption in a Global Economy

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The AEI Press
Publisher for the American Enterprise Institute
WASHINGTON, D.C.
1997

This study borrows extensively from Grubert and Newlon (1995). For comments on that paper, we thank Jay Mackie, Sheena McConnell, Barbara Rollinson, Joel Slemrod, Eric Toder, and Joann Weiner. Any views expressed here are those of the authors alone and should not be construed as reflecting the views or policies of the U.S. Treasury Department.

Available in the United States from the AEI Press, c/o Publisher Resources Inc., 1224 Heil Quaker Blvd., P.O. Box 7001, La Vergne, TN 37086-7001. Distributed outside the United States by arrangement with Eurospan, 3 Henrietta Street, London WC2E 8LU England.

ISBN 0-8447-7069-8

1 3 5 7 9 10 8 6 4 2

THE AEI PRESS
Publisher for the American Enterprise Institute
1150 17th Street, N.W., Washington, D.C. 20036

Printed in the United States of America

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Foreword

Economists, policy makers, and business executives are keenly interested in fundamental tax reform. High marginal tax rates, complex tax provisions, disincentives for saving and investment, and solvency problems in the social security program provide reasons to contemplate how reforms of the tax code and other public policies toward saving and investment might increase economic efficiency, simplify the tax code, and enhance fairness. Many economists believe that gains to the economy from an overhaul of the income tax or from a move to a broad-based consumption tax can be measured in the trillions of dollars. Most conventional economic models indicate a potential for large gains from tax reform.

While many economists agree broadly on the simple analytics of tax reform, they are in much less agreement on such key empirical questions as how much saving or investment would rise in response to a switch to a consumption tax, how much capital accumulation would increase under a partial privatization of social security, how reform would affect the distribution of taxes, and how international capital markets influence the effects of tax reforms in the United States. This lack of professional consensus has made the policy debate fuzzy and confusing.

With these concerns in mind, Diana Furchtgott-Roth and I organized a tax reform seminar series at the American Enterprise Institute beginning in January 1996. At each seminar, an economist presented new empirical research on topics relating to fundamental tax reform. These topics include transition problems in moving to a consumption tax, the effect of taxation on household saving, distributional effects of consumption taxes in the long and short run, issues in the taxation of financial services, privatizing social security as a fundamental tax reform, international issues in consumption taxation, distributional consequences of reductions in the capital gains tax, effects of tax reform on pension saving and nonpension saving, effects of tax reform on labor supply, consequences of tax reform on business investment, and likely prototypes for fundamental tax reform.

The goal of the pamphlet series in fundamental tax reform is to distribute research on economic issues in tax reform to a broad audience. Each study in the series reflects many insightful comments by seminar participants—economists, attorneys, accountants, and journalists in the tax policy community. Diana and I are especially grateful to the two discussants of each paper, who offered the perspectives of an economist and an attorney.

I would like to thank the American Enterprise Institute for providing financial support for the seminar series and pamphlet series.

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1
Introduction

A number of recent tax reform proposals would replace the U.S. income tax system with one based on consumption. Much ink has been spilled in analyzing the effects of such a change on incentives, distributional considerations, and compliance burdens, but the analysis is often placed in a closed-economy context. Our purpose in this volume is to lay out issues that arise from the fact that the United States has an open economy, with cross-border flows of capital, technology, and trade. Open-economy considerations raise new issues and can alter results implied by a closed-economy analysis.

Several variants on a consumption tax have been proposed, including the so-called flat tax, the unlimited savings allowance (USA) tax, a value-added tax (VAT), and a retail sales tax. A flat tax proposal modeled on the plan developed by Hall and Rabushka (1995) has been put forward by House Majority Leader Richard Armey. Under the flat tax scheme, individuals are taxed only on their wage income (including pensions), and businesses are taxed on their cash flow measured as sales less purchases, including capital purchases and wages. The USA tax, proposed by Senators Sam Nunn and Pete Domenici, actually consists of two separate consumption taxes. At the individual level, the USA tax imposes a consumed-income tax, that is, a tax on income less savings (plus dissavings).

At the business level, the USA tax imposes a subtraction-method VAT; that is, tax is paid on sales less purchases, where purchases include capital purchases but not wages. Various VAT plans have been proposed, perhaps most notably the detailed plan offered by Representative Sam Gibbons. Support for a federal retail sales tax has been expressed by, among others, Representative Bill Archer, chairman of the House Ways and Means Committee, and Senator Richard Lugar.

For our purposes, it is generally not necessary to go into many of the specific details of these plans. Most of the international issues we present can be illustrated in the context of two generic types of flat rate consumption taxes, which differ only in the treatment of exports and imports. The first is a destination-basis consumption tax, in which exports are exempt from tax and imports are taxed (that is, there are border tax adjustments). The USA business tax (and most VATs), a consumed-income tax, and a retail sales tax are all examples of consumption taxes that are imposed on a destination basis. The second is an origin-basis consumption tax, in which exports are taxed and imports are exempt (that is, there are no border tax adjustments). The flat tax is an example of an origin-basis consumption tax. We will discuss the significance of this distinction below. In many places the discussion focuses on the business components of the consumption tax proposals.

The next chapter of this volume summarizes key features of the proposals important to the analysis. The following chapters analyze the implications of the plans for the activities of multinational companies (MNCs), international capital flows and trade, tax avoidance opportunities, and the complexity of international tax provisions, transition incidence, and the reactions of other countries. The last chapter presents some conclusions.

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Key Features of the Plans

The Tax Base

All the proposals considered here have consumption bases. The flat tax and USA business tax, for example, are essentially both subtraction-method VATs in that purchases of goods and services are immediately deductible, including capital expenditures. The flat tax differs from the typical consumption VAT only in that wages are deductible at the business level and taxable at the personal level. The USA individual tax is a consumed-income tax in that the consumption base is arrived at by deducting from (including in) income a measure of net new saving (dissaving).

The principal significance of the consumption base is that an investment in the United States earns the pretax rate of return to capital. For a tax rate of t, a dollar's worth of capital can be bought with $1–t$ dollars because it is immediately deductible (that is, it is expensed), and each year the investment will pay $1–t$ of its cash flow after tax. The expensing of the capital invested and taxation of the cash flow occur at the business level under a flat tax or subtraction-method VAT and at the individual level under a consumed-income tax. Because the present value of the cash flow from a dollar invested at the margin should be equal to a dollar, the value of the expensing is just equal to the present value of the tax on the future cash flow from a dollar invested at the margin, and there is no tax on the return to new capital at the margin. There is tax on inframarginal, above-normal returns because the present value of the tax on the future cash flow will exceed the value of the initial deduction. An investment project that is worthwhile in the absence of the tax, however, will remain worthwhile with the tax, and the choice among investments would not be affected by the tax.

By contrast, under an ideal income tax, in which depreciation allowances match economic depreciation, marginal as well as inframarginal returns to capital would be taxed. Under such a tax, returns to capital would be taxed only once, either at the business level or at the individual level. The current U.S. tax system departs substantially from this ideal income VAT. There is a classical corporate income tax in which equity income is taxed once at the corporate level and then again when distributed at the personal level. Interest income is taxed, if at all, only at the personal level, since it is deductible at the business level. Depreciation allowances are not necessarily related to economic depreciation, and nominal, rather than real, interest is taxed. There are also substantial tax-favored sectors, including owner-occupied housing, tax-exempt entities such as pension funds, and the state and local government sector, which benefits from being able to issue tax-exempt bonds. And noncorporate business is also taxed more favorably than corporate business.

Given these complications, it cannot be presumed that much tax is paid on capital income. In fact, in an analysis of 1983 data, Gordon and Slemrod (1988) estimated that the United States collected very little revenue from the taxation of capital income. Even so, they did find that some revenue was collected, their results may have been partially attributable to cyclical effects, and the 1986 Tax Reform Act significantly narrowed the scope for the tax arbitrage that allowed capital income to escape tax or, in fact, to be tax favored.[1] Consequently, we shall assume that the current U.S. tax system does impose some tax on capital income; however, the complications we have outlined above will prove important in analyzing the effects of the proposals on capital flows.

Real versus Financial Transactions

The flat tax, the USA business tax, and consumption VATs in general use what is called an *R* base (for real, as distinct from financial, transactions), a terminology used in the 1978 Meade committee report.[2] Under an *R*-based tax, sales of goods and services are taxed, and purchases of goods and services are deductible; but financial transactions, including the payment and receipt of interest and dividends, are ignored. This arrangement creates an issue, familiar to those who have studied the VAT, concerning the taxation of banks and other financial intermediaries.[3] In the context of this volume, one implication is that while interest is not deductible from the U.S. tax base, it will still be deductible in countries that retain an income tax.

The USA individual tax is an example of an (*R*+*F*)-based tax, in which real and financial transactions enter the tax base. Under an (*R*+*F*) base, net increases (decreases) in financial assets are taxable (deductible). In the context of debt, then, cash receipts from borrowing (a borrower's proceeds from the issuance of new debt or a lender's receipts of interest or principal repayments) are taxable, and cash payments from borrowing (a borrower's interest payments and repayments of principal or a lender's new loans) are deductible. McLure and Zodrow (1995) have proposed a consumption tax system that is the reverse of the USA tax in that the business-level tax is on an (*R*+*F*) base, while the personal-level tax is on an *R* base.[4]

Nondeductibility of Interest

Under the flat tax, the USA business tax, and all VATs, interest expense is not deductible at the business level, and interest income is not taxed. In a purely domestic context, this change is innocuous to the extent that the elimination of interest deductibility is compensated for by the elimination of tax on interest income. But the increase in tax from the loss in interest deductions may actually far exceed the tax saving from exemption of interest income, because so much interest income is not taxed under current law. Consequently, such a change would substantially increase the tax burden on debt-financed business investment. In an open economy, the shift to interest nondeductibility becomes even more significant because foreigners are already exempt from U.S. tax on portfolio interest. Because they derive no benefit from any personal-level exemption, foreigners would reduce their holdings of U.S. debt if the adoption of these proposals produced any tendency for U.S. interest rates to decline.

Treatment of Foreign Income

Under the current U.S. tax system, U.S.-resident individuals and businesses are subject to tax on their foreign income. In the case of income earned by foreign subsidiaries of U.S. multinational corporations, U.S. tax is generally not imposed until the income is distributed to the U.S. parent company as a dividend; this policy is known as deferral. At the time of income repatriation, a credit against U.S. tax liability is allowed for any foreign taxes paid directly on foreign income, for example, dividend withholding taxes. For dividend distributions from controlled foreign subsidiaries, U.S. MNCs also receive a foreign tax credit for underlying foreign corporation taxes on the income out of which the distribution is made. The foreign tax credit is limited to the amount of the U.S. tax liability on foreign income, so that any foreign tax in excess of that amount cannot be used to reduce other U.S. tax liabilities. Within limits imposed by separate "baskets" for different types of foreign income, excess foreign tax credits from one source of foreign income can be used to offset U.S. tax liability on other foreign income; this is sometimes called cross-crediting.

Under R-based consumption taxes such as the flat tax and the USA business tax, foreign interest and dividends, as well as the foreign earnings of U.S. MNCs, are exempt. Under (R+F)-based consumption taxes such as the USA individual tax, all interest and dividend receipts are taxed, but investment in both foreign and domestic assets is deductible, so that capital income is untaxed at the margin whether its source is foreign or domestic.

A business-level income tax could also exempt income from direct foreign investment, as is done in a number of other countries. Income from passive, or portfolio, foreign investment, however, could not realistically be exempted without leading to substantial erosion of the taxation of capital income.

Royalty receipts from foreign licensees are in a category distinct from interest and dividend income from foreign sources because they can be thought of as payments for the export of an intangible asset, just as lease payments from a foreign lessee to a lessor of U.S. machines are payments for the export of those machines. Under current tax law, receipts of royalties from abroad are included in foreign-source income, but, in principle, they could be included in domestic income under an income tax, as is income from the export of goods under current law generally.[5]

Based on this reasoning, the taxation of royalties should be consistent with the choice of destination or origin basis.[6] Royalty receipts from abroad should be exempt under the destination basis, and royalty payments to foreigners not deductible. Conversely, under the origin basis, all royalty receipts should be taxable and all royalty payments deductible.

Border Tax Adjustments

As we noted in the introduction, consumption taxes can be characterized as being either on a destination basis or on an origin basis, which describes the way imports and exports are treated. Under a destination-basis tax, exports are exempt from tax, and imports are taxed. Examples are the business component of the USA tax, a retail sales tax, and a cash flow consumed-income tax. Under an origin-basis tax, exports are taxed, and imports are exempt from tax. The flat tax is on an origin basis.

In some respects, a destination-basis tax is easiest to analyze because it is a pure consumption tax, and more specifically, it is a tax on consumption in the United States. Exports, which are not consumed in the United States, are exempt from tax; and imports, which are consumed in the United States, are taxed. From that feature, many implications flow. One, which is discussed later, is the irrelevance of the transfer-pricing issue, because ultimately only final consumption in the United States is in the tax base. An origin-basis tax has a somewhat more complicated base, U.S. consumption plus net exports, because aspects of U.S. production (that is, exports) are included in the base and aspects of consumption (that is, imports) are excluded. As we will see, in some respects the two bases are equivalent, and in other respects they are not.

It is commonly believed that the border tax adjustments under the destination-basis consumption tax, the exemption from tax of exports, and the tax on imports act as incentives for exports while discouraging imports. We will attempt to explain why this apparently common-sense view is incorrect. But we should be clear what we mean when we say that the border tax adjustments, by themselves, do not confer a trade advantage. It is not that a switch from an income tax, including the corporate tax, to a consumption tax, of any type, cannot affect trade.

The tax on business under the income tax can clearly influence trade. The corporate income tax increases costs in the corporate sector (manufacturing, for example) relative to the noncorporate sector. Capital-intensive products are affected more than others. Accordingly, capital-intensive industries in the corporate sector will find their international competitiveness decline relative to more tax-favored sectors. A switch to a consumption tax, which does not tax capital on the margin, will obviously neutralize these tax-induced differences in costs.

Therefore, to focus on the consequences of the border tax adjustments alone, not the switch from an income tax, let us assume that a destination-basis consumption tax is enacted starting from a no-tax world. Alternatively, the new destination-basis consumption tax might be an "add-on" tax without other taxes being lowered.

Let us see how the decisions of consumers and producers are affected by the introduction of the destination-basis consumption tax. Are exporters any better situated than they were before the enactment of the tax? No, the exemption of exports will just get them to the position they were in before the consumption tax. The prices on exports they can offer are the same as before imposition of the consumption tax. Imposing a tax and then removing it does not leave them any better off in world markets.

What about the decisions of consumers? To them, the relative price of foreign goods and domestic goods has not changed. The destination-basis tax applies to all consumption, irrespective of where the goods were produced. U.S. consumers will, therefore, make the same choices between foreign and domestic goods as before the introduction of the tax. Accordingly, neither the prices of exports nor the U.S. demand for imports is affected by the destination-basis tax. No trade benefit is provided.

Now that we have seen that the enactment of a destination-basis consumption tax by itself is not an export incentive, we are in a better position to see whether switching from a destination-basis tax to an origin-basis tax makes a difference. Take an exporter who is considering selling one dollar more abroad. In real terms, the proceeds from those additional exports can be used for one of two purposes, to finance a dollar more of imports currently or to reinvest the dollar abroad. But if the dollar is invested abroad and the investment is at the margin, eventually it will finance imports with a present value of a dollar because a marginal investment should earn just a normal return. Accordingly, there is a simple equality between the value of the additional exports and the present value of the additional imports they will finance. That is,

increase in exports = present value of increase
in imports.

If we apply the tax rate t to both sides, we still have an equality,

t x increase in exports = t x present value of in
crease in imports.

On the left-hand side is the tax on the additional exports under the origin basis. On the right is the present value of the tax on the resulting additional imports under the destination basis. In present-value terms, the additional tax due to the increase in exports is identical under the two bases. Thus, the destination- and the origin-basis tax are equivalent for investment and trade decisions on the margin.

It is perhaps convenient to think of the origin-basis tax as a prepayment system compared with the destination-basis tax. The tax is prepaid on the exports going out. Eventually, a destination-basis tax collects an equivalent amount of tax on the imports financed by the additional exports.

The simple equality above for trade or investment with normal returns on the margin can be used to illustrate when the two bases are not equivalent. Consider, for example, the case in which U.S. investors have assets abroad before the consumption tax is enacted. In that case, under the origin-basis tax there is no tax on the consumption financed by the earnings on these assets abroad. There has been no prepayment of tax on the exports that financed the acquisition of these assets, and there is no tax on the imports coming in. But there is a tax under the destination basis because all U.S. consumption, including imports, is taxed. Thus, the destination and origin bases are not equivalent with respect to the initial cross-ownership of assets when the consumption tax is enacted.

Again, the origin and destination bases are not equivalent when the prospective investment abroad will earn above-normal returns. In that case, the tax on the additional exports that finance the foreign investment is less than the present value of the eventual imports made possible by the investment abroad. The origin-basis tax will, therefore, be less, in present-value terms, than the destination-basis tax. U.S. investors expecting to earn an above-normal return abroad would prefer the origin-basis tax. (This is related to the question of how royalties are taxed under the origin basis.)

The two bases are also not equivalent if a U.S. resident earns income in the United States and goes abroad to consume. In that case, there is no tax on the consumption abroad under the destination-basis tax because the consumption goods are not imported into the United States. In real terms, this consumption abroad will be financed by U.S. exports, which are not taxed under the destination basis, since U.S. tax on exports is rebated at the border. So going abroad to consume escapes the U.S. consumption tax if it is on a destination basis. (A consumed-income tax, such as the USA individual tax, is an exception to this conclusion if U.S. residents continue to be subject to the tax even if they consume abroad.)

But an origin-basis tax will tax the consumption abroad because it has to be financed by U.S. exports, which are taxed under the origin basis. Thus, under the origin-basis tax, U.S. taxpayers obtain tax-free consumption only if they have been fortunate enough to take their capital abroad before the introduction of the consumption tax. Under the destination-basis tax, they have an incentive to take themselves abroad to consume.

3
Effects on Multinational Business

Multinational companies account for a significant proportion of cross-border trade and investment flows. The effects of moving to a consumption tax on the incentives faced by MNCs are therefore of considerable significance. In this chapter, we consider how moving to a consumption tax system would affect the decisions of MNCs regarding the location of production, intangible assets, the performance of R&D, and the financial structure of the multinational group. In examining the MNC decision on investment location, we implicitly treat investments as being equity financed.[7]

Location of Production by U.S. MNCs

Under most consumption taxes (including the flat tax, the USA business tax, a retail sales tax, or a VAT), the foreign income of U.S. MNCs would be exempt from U.S. tax. The question arises whether this exemption would make investment in low-tax foreign jurisdictions relatively more attractive than it currently is. This is the so-called runaway plant problem, wherein production is shifted to low-tax foreign jurisdictions. Although exemption of foreign income from tax would lead to incentives for U.S. MNCs to locate tangible capital in low-tax jurisdictions if the United States retained an income tax, the case would not necessarily be the same if a consumption tax were substituted for the income tax. In fact, switching to a consumption tax would result in a greater preference by U.S. MNCs for investment in the United States, even in most cases as compared with investment in low-tax countries.

Under an income tax, the exemption of foreign income from tax would provide MNCs with an incentive to invest in low-tax jurisdictions, because the low foreign tax would be the final tax on the foreign income. If, in contrast, foreign income were taxed as it accrued, providing a credit for the foreign taxes paid on the income, there would be no tax motivation for domestically based MNCs to invest in low-tax foreign jurisdictions because the same rate of tax (the home country rate) would be paid wherever the investment was located. In reality, the current U.S. system for taxing foreign income provides incentives that are somewhere in between the pure exemption system and the taxation of foreign income on an accrual basis. Although the foreign income of a U.S. MNC is subject to U.S. tax, because the U.S. tax is often deferred until the income is repatriated to the United States (and because foreign taxes are credited against the U.S. tax liability on an overall basis, allowing cross-crediting from high- to low-tax items of foreign income), the incentives for investment in low-tax jurisdictions can sometimes approach, or even be the same as, those under an exemption system.[8]

The major effect on U.S. MNCs of replacing the income tax with a consumption tax may therefore result from the elimination of tax on normal returns to new investment in the United States. That should lower the tax on U.S. MNC investment in the United States relative to investment in all foreign locations, whether high or low tax.

There would be some difference on this score between a destination-basis and an origin-basis consumption tax. Under a destination-basis tax, U.S. MNCs would face the same U.S. tax (only on above-normal returns) whether they invested at home or abroad because foreign investment