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COMMENTARIES

INCOME VS. CONSUMPTION TAXATION: DOMESTIC AND INTERNATIONAL REFORMS

Gary C. Hufbauer[*]

I. INTRODUCTION

Any reader would be gratified to find so eminent a scholar as H. David Rosenbloom improving on ideas that the reader himself advocated nearly a decade ago. Today, I am the lucky reader. In 1992, Joanna M. van Rooij and I authored *U.S. Taxation of International Income: Blueprint for Reform.*[1] Among other recommendations, we advocated an exemption system.[2] It would be an exaggeration to claim that our analysis has had a modest impact. But in matters of tax policy, patience is required.

More voices are now joining the chorus for a modified territorial or exemption system. A year ago, Harry Grubert and John Mutti authored a paper pointing out that an exemption system actually could *increase* Treasury revenues.[3] Michael Devereux and R. Glenn Hubbard show that the old neutrality paradigms lose their punch when economies of scope and scale are considered.[4] With Mr. Rosenbloom on board, the intellectu-

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1. GARY CLYDE HUFBAUER & JOANNA M. VAN ROOIJ, U.S. TAXATION OF INTERNATIONAL INCOME: BLUEPRINT FOR REFORM 135-36 (Instit. for Int'l Econ. 1992).

2. *See id.*

3. Harry Grubert & John Mutti, *Dividend Exemption Versus The Current System for Taxing Foreign Business Income*, American Enterprise Institute Tax Policy Seminar (Oct. 29, 1999) (on file with the author).

4. Michael P. Devereux & R. Glenn Hubbard, *Taxing Multinationals*, Ameri-

al case for reform is gathering steam.[5]

At the beginning of the new millennium, we can accordingly take a small measure of satisfaction that ideas are crawling in the right direction. What I want to do in the remainder of these comments is contrast the recommendations offered by Mr. Rosenbloom with tax policy ideas I have argued elsewhere.[6]

II. INCOME VS. CONSUMPTION TAXATION

The overarching policy choice, long debated among tax professionals, is between income taxation and consumption taxation. I come down on the side of consumption taxation. My choice is justified both by inter-generation equity (our generation should not be imposing a huge Social Security/Medicare burden on the next), and by international equity (the richest Organisation for Economic Cooperation and Development (OECD) country should not be draining in excess of $400 billion annually from the world savings pool).

At the domestic level, in economic terms (if not in labels or law), a consumption tax is approximated by a wage tax with a savings allowance. At the international level, consumption taxation is aligned with the concept of residence taxation—using the term "residents" to refer to humans, not paper entities, like corporations and partnerships.

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can Enterprise Institute Tax Policy Seminar (Feb. 19, 1999) (paper dated Jan. 11, 1998) (on file with the author).

5. H. David Rosenbloom, *From the Bottom Up: Taxing the Income of Foreign Controlled Corporations*, 26 BROOK. J. INT'L L. 1525 (2001).

6. *See* HUFBAUER & VAN ROOIJ, *supra* note 1. *See also*, Gary Clyde Hufbauer & Carol Gabyzon, *Fundamental Tax Reform and Border Tax Adjustments*, *in* POLICY ANALYSES IN INTERNATIONAL ECONOMICS (1996) [hereinafter Hufbauer & Gabyzon]; Gary Clyde Hufbauer, *Tax Policy in a Global Economy: Issues Facing Europe and the United States*, *in* RESPONSES TO GLOBALIZATION IN GERMANY AND THE UNITED STATES (Carl Lankowski ed., 1999) [hereinafter Hufbauer 1999a]; Gary Clyde Hufbauer, *World Trade After Seattle: Implications for the United States*, *in* INTERNATIONAL ECONOMICS POLICY BRIEF NO. 99-10 (1999) [hereinafter Hufbauer 1999b]; Gary Clyde Hufbauer, *A Critical Assessment and An Appeal for Fundamental Tax Reform* (Institute for International Economics), *at* http://www.iie.com (last visited March 11, 2000) [hereinafter Hufbauer Appellate Report].

A. Tax Administration

In terms of tax administration, as Mr. Rosenbloom points out, it is relatively easy to tax human residents on their wages or consumption, and relatively hard to tax paper entities on their income. That is a major reason why social security and value added taxes are becoming more important in the fiscal revenues of OECD countries.

B. "Termites"

Vito Tanzi frets about the "termites" set loose by globalization that are eating away at tax systems.[7] Mr. Tanzi's analysis is correct, but he should not worry. The "termites" are first and foremost eating away at capital income taxes and taxes on paper entities.[8] These are insects of "creative destruction" (borrowing Schumpeter's term), laying waste to outmoded structures, not destroying valuable edifices of tax architecture.[9] Fortunately, there is very little prospect of massive international tax cooperation that would eradicate these particular termites.[10]

C. Basic Reform vs. Twisted Steps

As David Bradford argues, ideally the United States should jettison its present complex income tax structure and replace it with Professor Bradford's own X-Tax, or the Simplified USA Tax proposed by Representative Phil English (Republican from Pennsylvania).[11] Basic reform would have the virtues of simplicity, efficiency, and transparency. Unfortunately, as the recent election campaign revealed, neither the White House nor Congress is about to embrace sweeping tax reform. Instead, the United States is finding its way through a maze; groping towards consumption/wage taxation on a residence basis, and away from income taxation of paper entities in a series of twisted steps. In another 10 or 15 years, when addi-

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7. Vito Tanzi, *Globalization, Technological Developments, and the Work of Fiscal Termites*, 26 BROOK. J. INT'L L. 1261 (2001).

8. *Id.*

9. *Id.*

10. *See* Hufbauer 1999a, *supra* note 6.

11. David F. Bradford, *Blueprint for International Tax Reform*, 26 BROOK. J. INT'L L. 1449 (2001).

tional steps have been taken, it should be possible to rationalize the system (without massive distribution consequence) along the lines of the X-Tax or the Simplifed USA Tax.

III. DOMESTIC STEPS

Most of the twisted steps through the maze concern the domestic tax agenda, with only tangential international consequences. It's worth recalling the most important of these.

A. Deferred Taxation of Capital Gains and Reinvested Earnings

Important steps, taken at the inception of income taxation, are the taxation of capital gains only when realized and the taxation of dividends only when corporate earnings are distributed. Together, these provisions ensure that the taxation of reinvested earnings and appreciated capital can be long deferred. Taxes deferred long enough begin to look like taxes forgiven. Those who intend to save rather than spend can adjust their portfolio holdings accordingly.[12]

B. Pension Plans and IRAs

A more recent step is the rise of private pension plans and Individual Retirement Accounts—taxed only when income is drawn and consumed. Total assets held in various pension plans (excluding Social Security) are equal to about 100 percent of U.S. GDP. The annual untaxed savings, calculated at a modest return of about six percent, are huge and growing.

C. Death Tax Reform

The 106th Congress came very close to death tax reform. The issue is no longer whether to reform death taxes, it is simply a matter of how large an estate can be passed free of death taxes. If estates up $3 million are exempted from death taxes, and if carryover basis rules are applied to transferred property, that would represent another step towards consumption taxation.

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12. Savers can buy shares (or real estate) that pay low dividends (or rents), and they can hold their assets for long periods. Home ownership is a major form of untaxed saving for American households.

D. Expensing R&D

Since the 1940s, taxpayers have been permitted to expense research and development outlays. With the rising importance of technology in the capital asset base of U.S. firms, this embedded legislation has become more important. While physical assets are subject to depreciation rather than expensing, relatively short service lives (depreciation periods) are permitted for information technology equipment. With the right leadership, the U.S. Treasury could shorten the service lives for other kinds of equipment.

IV. INTERNATIONAL STEPS

The most important of the numerous twisted steps on the international agenda is deferral of "active" income earned by U.S. controlled foreign corporations. Deferral, coupled with the hideously complex foreign tax credit system, means that the United States collects very little tax revenue on the business activity of U.S. firms operating abroad. That is how it should be. The United States benefits from economies of scope and scale, importantly including networking economies, made possible by the vast reach of global corporations. When U.S. residents sell their shares in the parent corporations, or collect dividend and interest income, they are liable for tax. U.S. tax revenues on U.S. multinationals, realized through the individual income tax system, are huge. Again, that is how it should be.

But many more international steps need to be taken. In the analogy of the maze, the United States remains pretty close to the starting point on the international agenda. In his excellent paper, Mr. Rosenbloom has pointed to some of the steps that need to be taken. I will highlight others.

A. Exemption in Appropriate Cases

A major step towards simplification, and placing international taxation squarely on a residence basis, is the outright exemption of the foreign income of U.S. controlled foreign corporations engaged in active business in countries with a "normal" tax system. Mr. Rosenbloom advances an imaginative exemption proposal. I think the Rosenbloom proposal is a great starting place. With a push from the U.S. Treasury, it should gather bipartisan support in the Ways and Means Committee and the Senate Finance Committee.

Elsewhere, I have recommended that exemption should be conditioned on the observance of appropriate environmental and labor standards.[13] This idea will shock tax purists. However, it seems to me that tax carrots are a far better way of addressing environmental and labor abuse abroad than trade sanctions—an approach endorsed by many Congressional Democrats and World Trade Organization (WTO) opponents.

B. Foreign Portfolio Income

Foreign source portfolio income (including capital gains) is already large, and will multiply in the next few decades. United States pension funds invest only five percent of their assets in foreign securities, even though foreign securities represent about 50 percent of world wealth.[14] Over the next three decades, the percentage might rise to 20 percent. Moreover, if the United States adopts a more responsible attitude towards pension funding (moving towards a fully funded system and away from the pay-as-you-go approach), pension assets could reach 150 percent of GDP, instead of the current 100 percent figure. Putting these two pieces of arithmetic together, foreign portfolio investments might reach 30 percent of U.S. GDP and annual income (calculated at a 10 percent return, including capital gains) might reach three percent of GDP. This income will be an important source of consumption expenditure.

As Mr. Rosenbloom correctly points out, countries where portfolio investments are made derive substantial benefits from U.S. capital. The reason they can get away with taxing a good thing is the foreign tax credit. The tax receipts, by and large, come straight from the U.S. Treasury. The United States should put a stop to this nonsense, as Mr. Rosenbloom advocates, by only permitting a deduction, not a credit. Joanna M. van Rooij and I endorsed a deduction approach,[15] and we wel-

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13. Hufbauer 1999b, *supra* note 6.

14. The five percent figure is an understatement of the extent of foreign participation by U.S. pension funds, because U.S. multinationals (heavily represented in the S&P 500) derive about 50 percent of their earnings from foreign operations. U.S. pension funds invest heavily in S&P 500 firms, and thereby indirectly invest in foreign assets.

15. HUFBAUER & VAN ROOIJ, *supra* note 1, at 66-68 (advocating that taxes on

come Mr. Rosenbloom to the club. We would add that the deduction only should be permitted if the U.S. Treasury determines that the source country has implemented a reasonable system for reporting portfolio dividends and interest to the United States.

C. Imports of Goods and Services

The biggest hole in consumption based taxation is that, under the present U.S. income tax system, imports of goods and services are not taxed. The way to cure this defect, staying within the confines of the corporate income tax, is to disallow a deduction for goods and services purchased from foreign vendors. This change would require a revision of WTO rules, which embody an archaic distinction between "direct" and "indirect" taxes. The WTO Code on Subsidies and Countervailing Measures allows a destination-based border tax adjustment for the "indirect" taxes, like the value added tax and sales taxes, but not for "direct" taxes, like the corporate income tax.[16] It's time to end this distinction once and for all.

As Professor Bradford points out,[17] the destination principle has the great advantage of diminishing the vexatious problems associated with transfer pricing. Who cares what price different subsidiaries of the same corporation charge one another for components and royalties if no deduction is allowed?

As Professor Bradford also points out, the destination principle applied to corporate purchases does not address the problem of "tourist purchases" abroad, including in this phrase normal tourists, e-commerce deliveries from foreign suppliers to U.S. residents, and U.S. citizens who chose to retire in low tax jurisdictions.[18] The tourist problem is one of Vito Tanzi's "termites." I do not worry too much about the tourist problem for the same reason that I do not worry about the mild disciplinary impact that Virginia's low tax rates exert on the District of Columbia and Maryland.

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foreign portfolio income should be deducted, not credited).

16. *See* Hufbauer & Gabyzon, *supra* note 6.

17. *See* Bradford, *supra* note 11.

18. *Id.*

D. Exports of Goods and Services

Thanks to prodding by the European Union (EU) in the notorious *Foreign Sales Corporation* case,[19] brought in the WTO, Congress is beginning to inch towards the destination principle applied to exports, and the exemption principle applied to the active business of U.S. controlled foreign corporations.[20] Applied to exports of goods and services, the destination principle simply means that receipts from foreign purchasers are not included in the corporation's taxable revenues. Again, this principle has the side virtue of diminishing the transfer price problem.

As I have argued elsewhere,[21] the *FSC* case was wrongly decided. However, good tax policy may come out of bad case law. Responding to the WTO decision, the 106th Congress repealed the FSC and in its place enacted extraterritorial income (ETI) legislation that exempts a certain amount of qualified export income from the tax base. The same legislation exempts a parallel amount of U.S. controlled foreign corporation income from the U.S. tax base—meeting the WTO standard of equivalent taxation of exports and foreign production.

The qualifying conditions in the ETI legislation, however, contain division-of-income rules that might not meet the "arm's length" standard, and domestic content rules that might not accord with the "national treatment" standard.[22] These aspects were not addressed in the original *FSC* decision, and it is not certain how they will be analyzed in the second round. If

19. United States—Tax Treatment for "Foreign Sales Corporations," Report of the Panel, adopted October 8, 1999 (WT/DS108/R), *available at* http://www.wto.org/gen_search.asp.

20. The origins of the *FSC* case had nothing to do with tax policy and everything to do with the European search for "bargaining chips" to trade against EU losses in the *Bananas* and *Beef Hormone* cases, and the prospective expiration of the agricultural "peace clause" in 2003. *See* European Communities—Regime for the Importation, Sale and Distribution of Bananas, Report of the Panel, adopted on September 25, 1997 (WT/DS27/R/USA), *available at* http://www.wto.org/gen_search.asp. *See also* EC Measures Concerning Meat and Meat Products (Hormones), Report of the Panel, adopted on May 20, 1996 (WT/DS26/R/USA), *available at* http://www.wto.org/gen_search.asp.

21. *See* Hufbauer Appellate Report, *supra* note 6.

22. The "arm's length" pricing standard, a tax concept, is adopted in the WTO Code of Subsidies and Countervailing Measures. The "national treatment" standard (equivalent taxation of imported and domestic products) was a basic principle of the original General Agreement on Tariffs and Trade (GATT), and was carried over to the WTO.

the WTO panel, however, rejects the new provisions because of their domestic content or division-of-income rules, the 107th Congress would have an opportunity to improve on the handiwork of the 106th Congress. If the WTO rejects the ETI legislation wholesale, the challenge will be even greater. In response, Congress could move further towards an exemption system for exported goods and services (*e.g.*, Bradford's X tax) and, at the same time, embrace Mr. Rosenbloom's proposals for exempting the income of U.S. controlled foreign corporations.