Problems to Address

• Distortions Associated with Existing Systems
  – **Worldwide**: Inversions, International Competitiveness and (with deferral) Lock-Out
  – **Territorial**: Shifting Abroad of Profits and Activities

• Distortions of Investment and Finance
  – Income taxation raises the cost of capital
  – Interest deduction favors debt finance

• Complexity and Information Requirements
Two Elements of Proposal

• **Cash flow tax**
  – Meade Committee:
    • R base (real flows only), or
    • R+F base (real + financial flows)

• **Destination based**
  – Broadly, location of purchaser
    • Same approach as taken under existing VATs
    • Unlike VATs, aim is to tax business profits, allowing a deduction for labor expense
Steps to Reform

• **Cash flow tax:**
  1. Replace depreciation with immediate expensing
  2. Eliminate net interest deductions (R) or tax net borrowing (R+F)

• **Destination based:**
  3. Ignore foreign activities, as under a territorial tax
  4. But also effectively ignore cross-border activities, by having border adjustments offset business export revenues and import expense deductions
Why Cash Flow Taxation?

• Tax falls on economic rent, but not the normal return to capital
  – Does not discourage investment
  – Neutral between debt and equity finance

• Simpler to administer
  – No need to capitalize any expenditures or keep track of asset bases
Why Destination Based?

• No incentive for profit shifting
  – With cross-border transactions ignored, no change in US taxes from manipulation of internal transfer prices or strategic location of borrowing
  – Tax based on location of purchases can be avoided only to the extent that location of purchases can be manipulated

• Simpler to administer
  – Need information only on domestic transactions
Tax System Properties (1)

• No business-level tax on US-source income
  – Cash flow tax imposes no tax on expansion of investment
  – Destination basis ensures that no tax is imposed as a result of production in US; only location of purchasers matters
Tax System Properties (2)

• No incentive for government to reduce tax rate to attract business or profits
  – Shifting profits or activities to/from the US has no effect on a company’s US tax liability unless the location of its sales changes
Tax System Properties (3)

• System is equivalent to the combination of
  1. A broad-based consumption tax (e.g. a retail sales tax or a VAT)
  2. An equal rate subsidy to payroll

• Result is a tax on consumption from sources other than wages and salaries
Tax System Properties (4)

• System is highly progressive
  – Exempting wage & salary-based consumption overcomes the standard view of a consumption tax as regressive
  – Inability of companies to avoid tax through shifting of profits and activities eliminates current concern that the corporate tax is being shifted to labor
Tax System Properties (5)

• Self reinforcing incentives for adoption
  – If US adopts, then puts pressure on other countries to do so, to avoid shifting of profits and activities to the US
  – Unlike other approaches to “reform” that require coordinated adoption of rules and increased information sharing
Implementation Issues

• Taxing financial services
• Dealing with tax losses
• Revenue and transition
• Taxing natural resources
• WTO
Taxing Financial Services (1)

• How can we tax economic rent earned by banks and other financial companies?
  – VATs do not do this effectively
  – R base cash flow tax ignores financial transactions, and so would not capture financial rents

• R+F base captures financial rents, by including financial transactions in the base
  – Continue to tax/deduct interest, but also include net borrowing in the tax base
Taxing Financial Services (2)

• But R+F base involves greater complexity
  – All companies would need to keep track of financial transactions
  – Destination basis would require keeping track of whether financial transactions were with foreign or domestic companies, since cross-border transactions would be ignored

• But full R+F base not needed to capture rents
Taxing Financial Services (3)

• For transactions between domestic firms, tax consequences offset

• Example: bank loan to industrial firm
  – Lending by bank receives tax relief
  – Borrowing by firm is taxed
  – Firm’s interest & principal payments get tax relief
  – Bank’s receipt of such payments are taxed

• So, by netting can ignore financial transactions, e.g., use R base for transactions between domestic firms
Taxing Financial Services (4)

• All that is left to tax under the R+F base are financial transactions between domestic companies and domestic non-business taxpayers
  – Note: no need for financial companies to allocate nonfinancial costs, as all such costs would be deductible
Dealing with Tax Losses

• Increased likelihood that profitable firms would have losses
  – Example: a firm produces domestically for export; has deductible expenses but no taxable revenue

• Need improved methods of recovering losses
  – Carrying forward, even with interest, may not suffice, as pattern could remain over time
  – One simple approach would be to allow losses to offset other taxes, e.g., payroll taxes
Revenue and Transition

• Rough calculations (Auerbach 2010) suggest not a clear reduction or increase in revenue
  – These ignore border adjustments, which would increase revenues substantially in the short run
  – Extension beyond C corporations would increase revenue
  – Transition relief would reduce revenue
  – But revenue could be raised via a one-time tax on existing offshore earnings
Taxing Natural Resources

• In some instances, taxation based on source of income may still be attractive
  – Clear case: natural resource rents, for which source is readily identifiable
  – Destination based approach gives up tax on such rents, so a separate tax will be desirable if they are a large share of existing corporate tax base
  – Can still follow cash flow approach, but on an origin basis (e.g., Henry Review, Australia, 2010)
WTO

• WTO rules permit border adjustments under a VAT
• The destination based tax is equivalent to a VAT plus a equal-rate reduction in payroll taxes, both of which are WTO compliant
• Is the destination based tax WTO compliant?
  – Yes; it’s a tax on consumption
  – No; it’s a direct tax, not an indirect tax
Final Thoughts

• Tax competition, with falling rates, is likely to continue under existing system
  – A simple shift to territorial taxation does not help arrest this, nor does strengthening worldwide taxation

• The approach proposed here would shift the nature of competition from lowering rates to reforming tax systems