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Stephen Shay and Victoria Summers have done an excellent job in commenting on the international implications of the various proposals to replace the U.S. federal income tax with a consumption tax.[1] In particular, as compared with previous discussions, Shay and Summers have made significant contributions in comparing the relative merits of destination- versus origin-based proposals, and in dealing with the complexities of applying the proposals to services in general and financial services in particular.[2]

So as not to repeat what has been said elsewhere on this topic, I will focus on three points, which may assist in situating the discussion into a broader context: (1) the role of simplification in tax reform proposals; (2) the historical context of the relationship of the United States to the international tax regime and its implications for tax reform; and (3) a best-case scenario for the outcome of fundamental tax reform and its implications.

I. THE ROLE OF SIMPLIFICATION

One of the most common criticisms of the current U.S. income tax regime is that it is terribly complicated. This complexity can be

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* Assistant Professor of Law, Harvard Law School. I would like to thank the participants in the Institute (especially my co-panelists, Stephen Shay and Michael Graetz), as well as Louis Kaplow and Alvin Warren, for their extremely helpful comments on this Comment.

1. *See* Stephen E. Shay & Victoria P. Summers, *Selected International Aspects of Fundamental Tax Reform Proposals*, 51 U. MIAMI L. REV. 1029 (1997).

2. For previous discussions of this issue, see Harry Grubert & T. Scott Newlon, *The International Implications of Consumption Tax Proposals*, 48 NAT'L TAX J. 619 (Dec. 1995); JAMES R. HINES, JR., *Fundamental Tax Reform in an International Setting*, *in* ECONOMIC EFFECTS OF FUNDAMENTAL TAX REFORM 465 (Henry J. Aaron & William G. Gale eds., 1996); STAFF OF JOINT COMM. ON TAXATION, 104TH CONG., DESCRIPTION AND ANALYSIS OF PROPOSALS TO REPLACE THE FEDERAL INCOME TAX, [1995] 82 Stand. Fed. Tax Rep. (CCH) No. 29, pt. 2 (June 15, 1995); Reuven S. Avi-Yonah, *From Income to Consumption Tax: Some International Implications*, 33 SAN DIEGO L. REV. 1329 (1997).

explained in part by the historical evolution of the Internal Revenue Code as a series of repeated attempts by Congress to close loopholes discovered by taxpayers, and in part by a desire to compromise between a pure income tax and a consumption tax (the so-called "hybrid" tax system). Both causes of complexity are said to be reduced by fundamental tax reform, the first by sweeping away much of the Code and starting on a clean slate, and the second by unequivocally opting for a consumption tax base.

The problem with this optimistic view of tax reform is that there are already signs that simplicity may not be achievable in a complex economy in which taxpayers are eager both to lobby for specific relief and to exploit loopholes. For example, the USA tax proposal,[3] even before going through the legislative process, is made significantly more complex by attempts to satisfy various interest groups (e.g., by ensuring a continued preference for state and local bonds) and attempts to prevent loopholes from arising (e.g., the provisions aimed at preventing taxpayers from deducting investments in the stock of corporations formed to hold assets that are ineligible for the deduction for savings).

Given that simplification is an important goal of tax reform, increased attention should be given to the issues of administrability and complexity in evaluating the various reform proposals. Specifically, in comparing destination- to origin-based taxes in the international context, one should focus on the superior potential of the former variety of consumption tax (such as the USA tax and the retail sales tax)[4] to address the transfer pricing issue. This problem continues to be a major challenge to the IRS and other tax administrations, as the current effort to develop advance pricing agreements makes clear. Under a destination-based tax, because imports are subject to tax, there is no incentive from the perspective of the U.S. tax system to inflate the prices of goods imported into the United States. Under an origin-based system like the Flat Tax,[5] on the other hand, there continues to be such an incentive because imported goods are fully deductible as business inputs and are not subject to import tax of any kind. For this reason, and for the reasons given by Shay and Summers, a destination-based tax is superior to an origin-based tax.

In addition, it is not clear why the United States has to "re-invent the wheel." As Shay and Summers point out, all other OECD members except Australia and many other countries have developed consumption

3. *See* USA Tax Act of 1995, S. 722, 104th Cong. (1995).

4. *See* National Retail Sales Act of 1996, H.R. 3039, 104th Cong. (1996).

5. *See* Freedom and Fairness Restoration Act of 1995, H.R. 2060, 104th Cong. (1995); S. 1050, 104th Cong. (1995).

taxes in the form of a destination-based value-added tax ("VAT"). In an increasingly integrated world economy, it would certainly seem to make sense (if only to save on transaction costs by learning from the experience of others) to adopt a consumption tax similar to those adopted elsewhere in the world. Charles McLure, for example, has envisaged a world in which all countries have only a destination-based consumption tax.[6] As he points out, one of the major advantages in such a world would be ease of coordination and avoidance of double taxation in the absence of treaties that would result from uniform use of the destination principle. This "best-case" scenario is discussed further below, but for present purposes it should be noted that its administrative potential depends to some extent on the United States adopting a system that is compatible with those of other countries, such as the destination-based VAT. Whether such a tax should replace the income tax or, as in other countries, be added to it (perhaps, if one wanted to be revenue neutral and compensate for regressivity, with a significant increase in the income tax exemption) is a different issue.

II. The United States and the International Tax Regime

Michael Graetz and Michael O'Hear published a fascinating article on the history of international taxation, and specifically the U.S. role there.[7] Graetz and O'Hear describe how the "grand compromise" underlying the international tax regime, i.e., the decision to allocate the right to tax passive income primarily to residence countries and business income primarily to source countries, was reached in the 1920s both in the United States and in the international arena. They describe the leading role played in the formation of this compromise by the United States (through the unilateral adoption of the foreign tax credit in 1918), and specifically by T.S. Adams, who was a key advisor to the U.S. Treasury and who also played a major role in developing the League of Nations model treaty, which is the source of all later models and tax treaties.

On several other occasions, the United States has played a decisive role in shaping the current international tax regime by unilateral action. First, in the early 1960s, the United States adopted the Subpart F regime for limiting deferral for controlled foreign corporations to active income. This regime has since been copied by all other members of the OECD, including countries with an exemption system.[8] Second, in the 1960s

6. *See* Charles E. McLure, Jr., *Substituting Consumption-Based Direct Taxation for Income Taxes as the International Norm*, 45 Nat'l Tax J. 145 (1992).

7. Michael J. Graetz & Michael O'Hear, *The "Original Intent" of U.S. International Taxation*, 46 Duke L. J. 1021 (1997).

8. *See* Brian J. Arnold, The Taxation of Controlled Foreign Corporations: An International Comparison (1986).

and again in the 1990s, the United States played a decisive role in translating the arm's length standard for transfer pricing into detailed rules that have since been copied by the OECD and other countries.[9]

In all of the above instances, the United States has contributed to preventing both double taxation (in the first case) and zero taxation (in the second and third). But the United States can also play a less positive role. This is exemplified by the unilateral enactment of the portfolio interest exemption in 1984, which was deliberately designed to make the United States a tax haven for portfolio investment regardless of the effect on the international tax regime, and which was also followed by other countries.

Shay's and Summers' excellent discussion of the potential reaction by other countries to replacement of the United States income tax by a consumption tax should be placed in this historical context. From an income tax perspective, it most resembles the portfolio interest exemption, in that it would make the United States into a tax haven not just for portfolio interest, but for investments of any kind. If one assumes (as Shay and Summers do) that other countries would want to keep an income tax, such a unilateral move by the United States would be an invitation to a tax war, whereby those countries each attempt to capture the tax base forgone by the United States.[10] This would be the worst-case scenario, which would lead to an unraveling of the international tax regime and increase potential for double or zero taxation, with all the ensuing costs. It would be ironic if the United States were to play this role after having, as Graetz and O'Hear carefully document, contributed so much to the initial formation of a compromise in an area where compromise is notoriously difficult to reach.

III. THE BEST-CASE SCENARIO[11]

What, however, if McLure's scenario comes to pass, and all other countries simply abolish their income taxes and replace them with consumption taxes?[12] Certainly, it is conceivable that such an outcome would flow from unilateral United States action. Moreover, McLure identifies two major advantages to a world with no income taxes. The first is that from an efficiency perspective, both capital export neutrality and capital import neutrality could be achieved simultaneously, which

9. For a discussion of the U.S. role in the 1960s, see Stanley I. Langbein, *The Unitary Method and the Myth of Arm's Length*, 30 TAX NOTES 625 (Feb. 17, 1986); for a discussion of later developments, see Reuven S. Avi-Yonah, *The Rise and Fall of Arm's Length: A Study in the Evolution of U.S. International Taxation*, 15 VA. TAX REV. 89 (1995).

10. For a more elaborate discussion of this scenario, see Avi-Yonah, *supra* note 2.

11. As will become clear, this refers to the best one can hope for, not the best we would want.

12. *See* McLure, *supra* note 6.

would require uniformity of rates, if all investment income were taxed at a zero rate. The second, which McLure first pointed out, is that in a world with only destination-based consumption taxes, double taxation would be automatically avoided without the need for an elaborate tax treaty network.

Thus, there are definite advantages to this best-case scenario. However, there may also be costs in terms of what Peggy Musgrave calls "inter-nation equity," i.e., the allocation of the tax base among countries. Currently, most countries tax both income and consumption. Consumption taxes are levied by both developed and developing countries under the destination principle on domestic consumption (indeed, it would be very hard for most countries to tax foreign consumption). Income taxes are levied, in the case of passive income, by residence countries, which tend to be developed countries (because developing countries find it difficult to tax passive income earned by their residents abroad). In the case of active income, the tax is levied at source by both developed and developing countries. Thus, for developing countries, taxing active income at source is *the* major source of revenue other than the domestic income and consumption of residents, which tend to be relatively limited.

The fundamental difference between an income and a consumption tax from this perspective is that a country imposing an income tax would apply it to both production and consumption, because international rules allow taxing active income at source, and the source of active income includes where the product is produced or the service rendered. A consumption tax, on the other hand, applies only to consumption, not to production. But the current distribution of consumption and production vary significantly; consumption is highly concentrated in developed countries, while production, because of the constant search by multinationals for less costly production locations, is much more evenly spread between developed and developing countries. Because of this phenomenon, a universal switch to a consumption tax could result in significant reductions of the taxing jurisdictions of developing countries.

In more concrete terms, the fundamental issue for each country is whether it will be able to maintain the same revenue level with a consumption tax that it now usually achieves with a combination of income and consumption taxes. The answer is likely to be "yes" for the United States, because the absence of a federal consumption tax means that tax reform can relatively easily be revenue-neutral, with one tax replacing another, although the impact on state retail sales taxes is unclear. The answer is also likely to be "yes" for a country like Japan, which relies heavily on income taxes despite the existence of a low (three percent, scheduled to rise to five percent) consumption tax.

Revenue neutrality will be harder to maintain in European countries, because they already levy consumption tax with double digit rates (sometimes above twenty percent), and revenue neutrality may require VATs with rates of forty percent or more.[13] Whether such rates of VAT are politically feasible, given the perception of regressivity, remains to be seen, but the potential at least exists, because consumption levels are relatively high.

In the case of developing countries, however, revenue neutrality will be extremely hard to maintain. Even currently, the elite of such countries tend to consume abroad, and because of the low overall income of the general population, domestic consumption is relatively limited. It is hard to imagine such countries switching to a consumption tax, forgoing their ability to tax production, and yet maintaining revenue neutrality.

It may be argued that nothing would prevent developing countries from maintaining income taxes even if the developed ones were to abandon them in favor of consumption taxes. But this ignores the reality that developing countries will find it extremely difficult to attract investments if they alone tax investors on their income. In addition, in the absence of an income tax treaty network and coordinated international efforts to combat transfer pricing, it is difficult to see how developing countries could unilaterally enforce an income tax on multinational businesses without cooperation from developed countries.

A likely outcome of a global shift to consumption taxes, thus, would be the maintenance of revenue neutrality in the United States and Japan, and perhaps in European nations (although in the case of the latter, an overall reduction in government revenues seems more likely), but a significant reduction in revenues by developing countries, at least until consumption levels in the developing world caught up with current levels in the developed world. The main beneficiaries from such a shift would likely be multinationals operating in developing countries (and the suppliers of capital, if the general assumptions about the incidence of the corporate tax are correct). These multinationals currently pay some tax on their production activities in developing countries, if only in the form of withholding taxes on their dividends and royalties (since taxation of operating income may be minimal because of enforcement difficulties and tax competition). Whether such a shift of resources from governments to multinationals is likely to benefit the population of the

13. This may also be true in the United States unless the consumption tax has no exemptions (a highly unlikely scenario).

countries involved is debatable. In any case, the proponents of fundamental tax reform in the United States and elsewhere should address these types of questions, which have not been the focus of much attention in the tax reform discussions to date.