ALL ROADS LEAD TO VAT

COMMENTARY ON: *THE SAGA OF UNFULFILLED BUSINESS INCOME TAX REFORM* BY HARRY L. GUTMAN

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INTRODUCTION

Except for a small number of theorists who probably should have chosen mathematics as their profession, most tax policy experts I know in government and in private practice are motivated by a genuine desire to develop fiscal policies that will improve the welfare of society. To be effective at this often thankless task, these individuals must be proficient at two contradistinct sets of skills. First, they must have a broad range of obscure and highly technical knowledge, including a firm grasp of current and past tax laws (both domestic and foreign), a working knowledge of accounting and economics, and a familiarity with breaking developments in academic public finance literature. Second, they must possess a unique aptitude we can call political vision: they must have an amorphous sixth sense of what tax changes the public and interest groups will collectively find acceptable, and ultimately, they must understand whether these changes will be able to attract votes in Congress and avoid vetoes in the White House.

With his extensive experience advising private clients and governments, and his service to Congress as Chief of Staff of the Joint Committee on Taxation,

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Hank Gutman possesses that rare combination of technical skill and political experience that makes his commentary on the challenges of instituting a value-added tax (VAT) in the United States particularly thoughtful and pragmatic. Thus, the Article I have been asked to comment upon has great potential. But the challenges the author poses are also great. He is asking his readers to join the slim ranks of those willing to publicly support a VAT for the United States and to consequently risk the ridicule of appearing Pollyannaish in a political environment where Congress refuses to enact even mildly controversial measures.[1]

In order to take that giant step, we need answers to three questions—each progressively more difficult. First, is the VAT a good tax? Second, will the revenues from the VAT be put to good use? Third, as a political matter, is the VAT a feasible alternative for the United States in the foreseeable future? This last question is the most critical because, in a classic case of putting the cart before the horse, most of us in the tax community will not seriously examine the first two questions until receiving a favorable answer to the third. Remember, we are ultimately concerned with real-world solutions to real-world problems. Just as no engineer wants to develop a technically ingenious machine with no practical use, no tax expert wants to spend an inordinate amount of professional effort and reputational risk designing and promoting policies that have no chance of becoming law. But for a U.S. VAT to become reality, we must break out of the unproductive feedback loop of thought leaders not promoting a VAT simply because they doubt Congress would enact it. The political feasibility of a VAT will not spring from the earth spontaneously but, as Gutman concludes, will require leadership.

I. A GOOD TAX?

Taxes are mandatory extractions of money from the public by the government, so no tax is going to win any popularity contests. The job for makers of tax law is to devise the least unpleasant methods by which the government can collect revenue. We want taxes that are fair, that minimize interference with economic decision making, that are relatively inexpensive to administer, and that do not pile large compliance burdens on top of the inherent financial burdens. Gutman makes the case for a VAT on all these counts. When it comes to tax, it is easy to let details blur the big picture, so for this short commentary I will focus on the major features of a VAT that are of tantamount importance in the twenty-first-century globalized economy.

First, as a broad-based consumption tax, a VAT avoids the fundamental flaw of income taxation: the bias against saving and investment. This is particularly important at a time when saving for income security in old age and investment for productivity growth are critical challenges for the American economy. With a VAT, there is far less need for complex and inefficient targeted

1. On April 15, 2015, the Senate passed, by an 85–13 vote, a nonbinding resolution proposed by Sen. John McCain, R-Ariz., expressing opposition to the United States adopting a VAT.

investment incentives because the rate of tax on *all* new marginal investment is zero. In other words, the VAT already has the simplest and most efficient investment incentives hardwired into its structure.[2]

VATs are almost always imposed on a destination basis, meaning tax is levied where consumption—not production—takes place. This feature yields the second and third immensely attractive attributes of a VAT: a VAT causes businesses to become indifferent (for tax purposes) to the location of their production, and a VAT provides a tax that is largely immune to the profit-shifting techniques that plague the efficacy and efficiency of most business income taxes. In plain English, this means more jobs for American workers and less revenue leakage for the U.S. Treasury.

II. WILL VAT REVENUES BE PUT TO GOOD USE?

If a VAT is ever going to fly politically, the public must understand that its revenues will do more good than harm. What can the government do with the big pot of money a VAT can raise? Some conservative ideologues would reflexively answer: nothing good. I disagree and argue strongly to the contrary, notwithstanding the rampant waste that exists throughout the federal bureaucracy and the inefficient design of numerous economic policies by Congress. Specifically, I believe Gutman has correctly identified the two ways VAT revenue can best be put to use: (1) stabilization of the growing federal debt, and (2) a leapfrog reduction in the statutory corporate tax rate from the highest in the developed world to one of the lowest—from the current federal statutory rate of 35% to 15%.[3]

While Congressional Budget Office (CBO) estimates are invariably inaccurate due to exogenous and unpredictable events, and there is some nonzero probability that the U.S. government's fiscal mess could right itself without major governmental action, the odds are slim. Barring a spurt of productivity growth from new technology and the long-term maintenance of our currently rock-bottom interest rates, our aging population and advances in costly medical technology make it almost certain that it is a matter of time before U.S. debt and interest rates on government bonds spiral out of control. That is, unless major corrective action is taken.[4]

The corporate income tax, which has always been an awful tax in theory, is now, with jobs and profit clearly shifting out of the United States, manifesting its flaws for all to see. The corporate tax stifles innovation and much needed productivity-enhancing investment. It encourages corporate leverage at a time

2. Expensing the cost of investment sets the marginal effective tax rate on equity-financed investment to zero. Expensing with debt-financed capital drives the marginal effective tax rate on new investment below zero. Additional investment incentives are justified if expenditures, such as those on research and development, generate positive externalities.

3. *See* Harry L. Gutman, *The Saga of Unfulfilled Business Income Tax Reform*, 89 TEMP. L. REV. 267, 278–80 (2017).

4. *See generally* Martin A. Sullivan, *Cloudy CBO Budget Forecast Shrouded in Uncertainty*, 152 TAX NOTES 443 (2016).

when the world's financial system remains on shaky ground. It encourages profit shifting to low-tax countries. It encourages production shifting to low-tax countries. It has large administrative and compliance costs. It discourages dividends. It encourages share repurchases. It encourages retention of accumulated earnings in tax havens. It encourages corporations to move their legal residence out of the United States.

Given Republicans' deep-seated intransigence to any tax increases, it is understandable that some VAT advocates, in the interest of not immediately closing off discussions with conservatives, have developed revenue-neutral plans where all VAT revenues are used to lower other taxes. The VAT approach originally proposed by Professor Michael Graetz,[5] and adopted by Senate Finance Committee Member Benjamin L. Cardin (D-Md.),[6] shuns use of VAT revenue for deficit reduction. Instead, their approach would use the bulk of VAT revenue to reduce income taxes by greatly increasing the standard deductions so that tens of millions of individual taxpayers would no longer have to itemize deductions. With the remainder of the revenue, they would, like Gutman, drastically reduce corporate tax rates to around 15%.[7]

Make no mistake, the Graetz-Cardin approach is an extremely attractive alternative to current law, and it deserves serious consideration—especially given its huge potential to simplify the taxation of individuals and to enhance the competitiveness of U.S. business. While this approach would mark the most monumental overhaul of U.S. tax law since World War II, the drawbacks are that it sets aside our biggest fiscal problem and ignores a once-in-a-lifetime opportunity to effect desperately needed change—to strike while the iron is hot. Why go through this enormous effort if tax reform is not going to address *the* fundamental flaw of our system—its inability to raise enough money to support an aging population? It would be like the Union fighting and winning the Civil War without abolishing slavery.

With that in mind, how much deficit reduction would be required to stabilize the long-term debt-to-GDP ratio? According to the latest CBO analysis, if deficit reduction started in 2017, we would need a combination of spending cuts and tax increases equal to 1.7% of GDP (about $330 billion in 2017) in order to stabilize the debt-to-GDP ratio at its current level (75%) over the next three decades, through 2046. If the reduction started in 2022, that figure would increase to 2.1% of GDP.[8]

How expensive is it to cut the corporate tax rate from 35% to 15%?

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5. MICHAEL J. GRAETZ, 100 MILLION UNNECESSARY RETURNS: A SIMPLE, FAIR, AND COMPETITIVE TAX PLAN FOR THE UNITED STATES 62–67 (2008).

6. In the waning days of the 113th Congress, Senate Finance Committee member Benjamin L. Cardin, D-Md., introduced the Progressive Consumption Tax Act of 2014, S. 3005, 113th Cong. (2014).

7. In the 104th Congress, Senators Sam Nunn, D-Ga., and Pete Domenici, R-N.M., introduced the USA Tax Act of 1995, S. 722, 104th Cong. (1995), which included a subtraction-method VAT as a replacement for the corporate income tax.

8. *See* CONG. BUDGET OFFICE, THE 2016 LONG-TERM BUDGET OUTLOOK 5, 128 fig.1-3, 129 Box1-1 (2016), http://www.cbo.gov/sites/default/files/114th-congress-2015-2016/reports/51580-ltbo-one-col-2.pdf [http://perma.cc/EJ42-GCT9].

According to the latest CBO baseline forecast, corporate tax revenues will average approximately 1.7% of GDP in the future.[9] This puts the cost of the proposed corporate tax reduction at just about 1% of GDP.

Combining these two rough estimates, we would need a VAT that would raise approximately 3% of GDP to effectuate Gutman's plan for deficit reduction and a corporate rate cut. Of the more than one hundred VATs now in place in the world, New Zealand, with its minimal tax preferences and exceptions, probably has the most ideal VAT. The country's tax base equals approximately two-thirds of its GDP.[10] In the rest of the world, typical VAT bases fall between 30% and 40% of GDP.[11] Net tax revenue gains will usually amount to less than the taxes imposed upon typical VAT bases because rebates to lower-income households will be necessary to maintain low-income progressivity and, as economists Eric Toder and Joseph Rosenberg correctly point out, imposition of a VAT would reduce revenues from other taxes.[12] Taking this all into account, a realistic rule of thumb is that any U.S. VAT that Congress would pass is likely to raise approximately 0.2% of GDP for every 1% increase in the VAT rate (including net grants to raise progressivity and offsetting reductions in other taxes).[13]

This implies a 15% VAT rate in order to make Gutman's vision a reality. But that is not the end of the story. There are economic effects to be considered. Modest growth effects can be expected from downsizing the corporate tax, which will, among other salutary effects, induce a shift in jobs and profits into the United States. Further, there could be additional economic growth because of the accompanying reduction in federal borrowing (which crowds out private investment). On top of all this, there could be added benefits from the reduction of uncertainty about future taxes and deficits.[14]

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9. The CBO has provided "10-Year Budget Projections" and "Long-Term Budget Projections," that demonstrate this 1.7% figure. *See Budget and Economic Data*, CONG. BUDGET OFF., http://www.cbo.gov/about/products/budget_economic_data#2 (last visited Feb. 15, 2017) [http://perma.cc/5GD8-KZXG] (providing historical budget data).

10. *The New Zealand Tax System and How It Compares Internationally*, TAX POL'Y INLAND REVENUE, http://taxpolicy.ird.govt.nz/publications/2011-other-bim/2-new-zealand-tax-system-and-how-it-compares-internationally (last visited Feb. 15, 2017) [http://perma.cc/4T8H-KQCS]; Dody Tsiantar, *Why the U.S. Can Learn from New Zealand When It Comes to Taxes*, FORTUNE (Apr. 13, 2010, 4:46 PM), http://archive.fortune.com/2010/04/13/news/economy/new_zealand_vat.fortune /index.htm [http://perma.cc/H9PK-3CD8].

11. William G. Gale & Benjamin H. Harris, *A VAT for the United States: Part of the Solution*, *in* THE VAT READER 64, 66 (Tax Analysts ed., 2011).

12. ERIC TODER & JOSEPH ROSENBERG, TAX POL'Y CTR., EFFECTS OF IMPOSING A VALUE-ADDED TAX TO REPLACE PAYROLL TAXES OR CORPORATE TAXES 12–14 (2010), http://www.taxpolicycenter.org/sites/default/files/alfresco/publication-pdfs/412062-Effects-of-Imposing-a-Value-Added-Tax-To-Replace-Payroll-Taxes-or-Corporate-Taxes.PDF [http://perma.cc/U25U-DGWD].

13. Gale & Harris, *supra* note 11, at 68.

14. The Organisation for Economic Cooperation and Development is now promoting the reduction of tax uncertainty as a major policy goal. *See* ORG. FOR ECON. COOPERATION & DEV.,OECD SECRETARY-GENERAL REPORT TO G20 FINANCE MINISTERS 12 (2016), http://www.oecd.org/ctp/oecd-secretary-general-tax-report-g20-finance-ministers-july-2016.pdf

I have necessarily left out a myriad of details that would affect the numbers, but ballpark, back-of-the-envelope calculations are appropriate to begin our journey. Based on Gutman's analysis, the United States should give serious consideration to adopting a broad-based VAT of between 12% and 14% to stabilize the national debt and to make the country's corporate tax one of the most competitive in the world.

III. IS THE VAT FEASIBLE IN THE UNITED STATES?

Where do we go from here? Allow me to suggest that the United States will adopt a VAT when U.S. tax reform enters its third stage. As explained below,[15] we have already completed the first stage, roughly spanning the five-year period from 2010 to 2014 when Congress, the White House, and experts in the tax community considered enacting the conventional type of tax reform that U.S. lawmakers had engineered in the mid-1980s. Now that our leaders acknowledge that such an approach is not possible, they are exploring less conventional alternatives. This puts us at the beginning of a second stage, which could be considerably shorter than the first.

A. Tax Reform 1.0—Attempting to Redo What President Reagan Did in 1986

The skyrocketing federal debt resulting from the financial crisis and the subsequent recession—the net federal debt rising from 35.2% of GDP in 2007 to 70.4% in 2012[16]—catapulted the need for bipartisan deficit reduction to the forefront of fiscal policy priorities. The main obstacle to achieving a "grand bargain" that would reduce the growth rate of the federal debt to sustainable levels was the Americans for Tax Reform pledge, by which most Republicans in Congress agreed never to increase taxes.[17] Any lasting plan must be bipartisan. And for any plan to be bipartisan, Republicans must be willing to accept tax hikes; otherwise, Democrats will not agree to spending cuts.

In a thinly disguised attempt to camouflage tax increases as tax reform, the National Commission on Fiscal Responsibility and Reform (referred to as the Simpson-Bowles Commission for its co-chairmen, former Senator Alan Simpson (R-Wyo.) and Erskine Bowles) in 2010 stressed that its tax proposals were Reagan-like reforms that broadened the base, lowered rates, and only incidentally raised additional revenue.[18] Most Republicans were not fooled and opposed the plan.

[http://perma.cc/YZV2-CC2J].

15. *See infra* Part III.A.

16. CONG. BUDGET OFFICE, THE BUDGET AND ECONOMIC OUTLOOK: 2016 TO 2026, at 217 tbl. F-1 (2016).

17. BOB WOODWARD, THE PRICE OF POLITICS 60 (Simon & Schuster 2013) (2012).

18. The presidentially appointed eighteen-member National Commission on Fiscal Responsibility and Reform released its final plan on December 1, 2010. Don Haider, *Simpson-Bowles: It's Back, and Better Than Ever*, BLOOMBERG VIEW (June 14, 2012, 6:31 PM), http://www.bloomberg.com/view/articles/2012-06-14/in-praise-still-and-again-of-simpson-bowles [http://perma.cc/K8Q5-G59J].

With the huge federal deficits that followed the recession, Republicans shifted their fiscal policy focus from tax reduction to revenue-neutral tax reform. The two most prominent examples of these efforts were the plans of Republican presidential nominee Mitt Romney during the 2012 campaign and the multiyear effort by Republican Ways and Means Committee Chairman Dave Camp of Michigan.

During the 2012 presidential campaign, Romney proposed a 20% cut in the top corporate and individual rates (then both 35%) to 28% to be paid for through the elimination of tax expenditures.[19] Though the Romney campaign provided little detail of his tax reform plans, subsequent independent analysis showed these reforms, particularly the individual rate cuts, would likely be unpopular with the majority of voters.[20]

Camp assumed the chairmanship of the Ways and Means Committee in 2011 and soon undertook a multiyear project culminating in the 979-page Tax Reform Act of 2014.[21] Though his plan eliminated and downsized dozens of tax breaks, he was only able to reduce the top individual rate to 35% and the corporate rate to 25%.[22] Moreover, the plan was not revenue-neutral outside a ten-year window because many of its corporate revenue raisers were timing differences whose gains faded over time.

B. Tax Reform 2.0—The Search for Consumption Tax Options

From these efforts, Congress and the public (to the extent it paid any attention at all) learned two important lessons. First, although in the abstract everybody favors a simpler tax system, realistic individual tax reform had limited political appeal because rates could not be lowered without significantly trimming tax benefits that disproportionately helped the middle class—like the deduction for mortgage interest, the deduction for state and local taxes, the deduction for charitable contributions, and the exclusion for employer-provided health insurance.

Second, although there was broad bipartisan recognition that the United States needed to lower its corporate tax rate, there were numerous political and economic obstacles. We will only focus on three of them here. First, cutting business tax breaks to pay for corporate rate cuts would raise taxes on (mostly small) noncorporate businesses that would get no benefit from the corporate rate reduction. Second, many of the large tax expenditures that would have to be cut are, dollar for dollar, more effective investment incentives than rate cuts, so trimming tax expenditures to pay for rate cuts could actually hurt the economy.

19. *See* SAMUEL BROWN, WILLIAM GALE & ADAM LOONEY, TAX POL'Y CENTER, ON THE DISTRIBUTIONAL EFFECTS OF BASE-BROADENING INCOME TAX REFORM 2, 8 (2012), http://www.brookings.edu/wp-content/uploads/2016/06/01-tax-reform-brown-gale-looney.pdf [http://perma.cc/JNR7-VUED].

20. *See id.* at 6–8.

21. Chairman Camp introduced the Tax Reform Act of 2014, H.R. 1, 113th Cong. (2014), on December 10, 2014.

22. H.R. 1 §§ 1001, 3001.

Third, corporate tax expenditures disproportionately favor manufacturing. A revenue-neutral reform that broadened the base and lowered the rates would increase taxes on manufacturing at a time when most of Washington is striving to support domestic manufacturing. The bottom line is that the classic formula that produced the 1986 tax reform—"broaden the base and lower the rates"—will not work under current conditions.[23] Unlike in 1986, there simply are not enough politically vulnerable business tax breaks to cut in order to pay for a significant reduction in the corporate rate.

Given the failure of the conventional approach to tax reform that was embodied in the Camp plan, the current Ways and Means Committee Chairman Kevin Brady[24] has made it clear that an entirely new approach is necessary for tax reform progress. In a February 12, 2016 speech, Brady told his audience the following: "I am asking our committee to look at tax reform with fresh eyes, examining the whole range of tax ideas—consumption tax, cash flow tax, reformed income tax, and any other approach that will be pro-growth."[25] Except for the usual vague platitudes about promoting growth and simplification, Brady provided no indication of the shape tax reform should take, likely because—as is common at that point in the election cycle—presidential candidates were floating all types of plans. However, on June 24, 2016, House Republicans released a tax reform blueprint, the last of six parts of their *A Better Way* economic program intended to give voters a clear vision of their priorities in the next Congress.[26] Although many *details* remain sketchy, to his credit, Brady and the House Republicans made the following clear choices about the *direction* of House Republican tax policy.[27]

First, for those who still needed convincing, the *A Better Way* proposal confirmed that all hopes of a sweeping individual income tax reform were dead. The partisan plan only lowered the top individual rate to 33%.[28] Rates above 30% simply do not generate excitement in the Republican ranks, and without that grassroots energy, it is simply not possible to overcome the opposition of the well-organized groups whose tax breaks would have to be reduced to lower rates.

But at the same time Brady was effectively closing the door on significant individual tax reform, he was giving new life to business tax reform. Under the

23. Joseph J. Thorndike, *1986? Who Cares?*, TAX HISTORY PROJECT (Oct. 12, 2011), http://www.taxhistory.org/thp/readings.nsf/ArtWeb/D5459C3F90E078AD8525792F0054E618?OpenDocument [http://perma.cc/U8C8-8X4Z] (internal quotation marks omitted).

24. On November 4, 2015, Brady was elected the sixty-fifth Chairman of the Committee on Ways and Means after Rep. Paul Ryan (R-Wis.) resigned from the chairmanship to become Speaker of the House of Representatives.

25. Kevin Brady, Chairman, Ways and Means Comm., Keynote Address at the Tax Council Policy Institute Symposium (Feb. 12, 2016), http://waysandmeans.house.gov/brady-delivers-keynote-address-at-the-tax-council-policy-institute-symposium [http://perma.cc/JJJ2-46F9].

26. TAX REFORM TASK FORCE, HOUSE REPUBLICANS, A BETTER WAY: TAX (2016), http://abetterway.speaker.gov/_assets/pdf/ABetterWay-Tax-PolicyPaper.pdf [http://perma.cc/V4UQ-JA7C].

27. *Id.*

28. *Id.* at 17.

Brady plan, the current corporate tax would be completely repealed and replaced with a destination-based cash flow tax—an idea offered as an option by President Bush's Advisory Panel on Tax Reform in 2005 but largely ignored except by academics.[29] The Reagan model used by Romney and Camp to reform the current corporate tax was out the window. Now, with the blessing of both House Speaker Paul Ryan and Brady, the powerful chairman of the tax-writing committee, the Republican majority in the House of Representatives have endorsed (in their *A Better Way* economic program) a destination-based cash flow tax—this pushes consumption taxation to the center stage of tax policymaking process.

There are four major differences between the current corporate tax and a destination-based cash flow tax, under the latter: (1) all cash outlays including investment in plant and equipment are no longer depreciated but are immediately deductible, (2) all interest expense (net of interest income) is not deductible, (3) only revenues from sales in the United States are included in the tax base, and (4) all costs of imported goods are no longer deductible. The first two features are what make the proposal a cash flow tax. The last two are why we call it destination based. In terms of its mechanics, this proposal is similar to a destination-based subtraction-method VAT except wages are deductible.

Since release of the proposal from President Bush's Advisory Panel on Tax Reform, suggestions for a destination-based cash flow tax have surfaced. Alan Auerbach proposed one in 2010.[30] Also, the destination-based cash flow tax was one of the two alternatives discussed at two recent conferences on corporate tax reform[31]—one at the Saïd School of Business at Oxford in the United Kingdom[32] and a companion conference sponsored by the Tax Policy Center in Washington, D.C.[33] Most participants at these conferences extolled the virtues of replacing the corporate tax with a destination-based cash flow tax. The benefits of this approach include: (1) a zero marginal effective tax rate on new investment (leaving only high-profit investment subject to tax), (2) the elimination of the corporate tax's bias in favor of debt financing, (3) the elimination of the incentive to move production out of the United States to low-tax countries, and (4) the elimination of the incentive to artificially shift profits out of the United

29. THE PRESIDENT'S ADVISORY PANEL ON FED. TAX REFORM, SIMPLE, FAIR, AND PRO-GROWTH: PROPOSALS TO FIX AMERICA'S TAX SYSTEM 162 (2005).

30. ALAN J. AUERBACH, CTR. FOR AM. PROGRESS & THE HAMILTON PROJECT, A MODERN CORPORATE TAX (2010), http://www.hamiltonproject.org/assets/legacy/files/downloads_and_links/FINAL_AuerbachPaper.pdf [http://perma.cc/UFU6-95WN].

31. The other policy alternative was a sales-based formulary apportionment. *A Corporate Tax for the 21st Century,* TAX POL'Y CTR., URBAN INST. & BROOKINGS INST. (July 14, 2016, 3:00 PM), http://www.taxpolicycenter.org/event/corporate-tax-21st-century [http://perma.cc/QQ7C-9RYM].

32. For materials from the June 27, 2016 Oxford conference, see *Summer Conference 2016: Corporation Tax for the 21st Century*, SAÏD BUS. SCH., U. OXFORD, http://www.sbs.ox.ac.uk/faculty-research/tax/events/summer-conference-2016-corporation-tax-21st-century [http://perma.cc/X7UY-QHD2].

33. For materials from the July 14, 2016 conference in Washington, D.C., see *A Corporate Tax for the 21st Century*, *supra* note 31.

States to low-tax countries.

All of these are hugely attractive benefits that should motivate Congress and President Trump to seriously consider a destination-based cash flow tax as proposed by Brady. But there is one enormous difficulty that stands in the way of adoption of a destination-based cash flow tax in the United States. According to trade experts, it is almost certain that a destination-based cash flow tax would put the United States in violation of World Trade Organization (WTO) rules.[34] This could spark retaliation by our trading partners, even a trade war. At a minimum, like the Brexit vote in the United Kingdom, enactment of a destination-based cash flow tax would begin a long period of uncertainty that could be damaging to the economy as new and unpredictable international arrangements are sorted out.

A disruptive dispute between the United States and other WTO members could be avoided if, instead of replacing the current corporate tax with a destination-based cash flow tax, the United States replaced it with a credit-invoice VAT, as Gutman recommends. It is well-established that a destination-based credit-invoice VAT does not violate WTO rules.[35] Moreover, replacing the corporate tax with a credit-invoice VAT would produce the same four significant economic benefits that would result from replacing the corporate tax with a destination-based cash flow tax (which was proposed by Brady). They are worth repeating given that any one of them would be a major accomplishment: (1) a zero marginal effective tax rate on new investment, (2) the elimination of the corporate tax's bias in favor of debt financing, (3) the elimination of the incentive to move production out of the United States to low-tax countries, and (4) the elimination of the incentive to artificially shift profits out of the United States to low-tax countries.

C. Tax Reform 3.0—Recognition of Value-Added Taxation as the Best Option

The preceding discussion raises a strikingly simple question that politicians and the public can readily understand: why replace the current corporate tax with the Brady-proposed cash-flow tax when we could replace the current corporate tax with a credit-invoice VAT that has all of the same positive features and would not result in any of the disruption and discord of violating WTO rules?

The answer to this pivotal question is that the United States suffers from an irrational, simplistic fear of value-added taxation. The most vehement opponents of a VAT oppose it mainly because it is efficient. Apparently they want taxation to be as painful as possible because voter discontent with taxes fosters political

34. *See, e.g*, GARY CLYDE HUFBAUER, FUNDAMENTAL TAX REFORM AND BORDER TAX ADJUSTMENTS, *in* 43 POLICY ANALYSES IN INTERNATIONAL ECONOMICS (1996); Wolfgang Schön, *Destination-Based Income Taxation and WTO Law: A Note* 2 (Max Planck Inst. For Tax Law and Public Fin., Working Paper No. 2016-03, 2016), http://papers.ssrn.com/sol3/Papers.cfm?abstract_id=2727628 [http://perma.cc/YX83-5E5A].

35. A credit-invoice VAT is an indirect tax on transactions (like a sales tax). A cash-flow tax and a subtraction-based VAT are direct taxes on taxpayers (like an income tax).

opposition to tax increases and thereby helps keep government small. But carried to its logical conclusion, this argument leads to the absurd result that bad taxes are necessary for good government.

Even if we assume that the majority of Americans desire a smaller government, deliberately designing a less efficient tax system is hardly the only way, and it is certainly not the best way, to achieve that goal. First, we know from experience that the "starve the beast" theory does not work: lowering taxes has not done much to decrease government spending but has done a great deal to increase government debt.[36] Second, a more burdensome tax system is inconsistent with the nearly universally proclaimed view that the United States should have a simpler tax system. Third, it is inconsistent with the nearly universally proclaimed view that the United States should have a tax system that promotes economic growth.[37]

Finally, and most importantly, the addition of a VAT to the U.S. tax system does not mean anti-tax conservatives in Congress and the White House would lose any of the considerable political power that allows them to keep downward pressure on *overall* federal taxes and spending. It is true that adoption of a VAT for the purpose of deficit reduction does lay bare their oft-stated claim that somehow the United States government can balance the budget by simply cutting spending. But barring some miraculous spurt of economic growth, it will become increasingly obvious over time to the public and to Republicans themselves that deficits cannot be eliminated entirely through spending cuts. The federal debt continues to grow, despite cuts in spending on defense and medical research, and there is no practical progress from either major party on addressing the growing shortfalls in the Social Security and Medicare trust funds.

CONCLUSION

While the exact timing depends on how quickly the government's fiscal situation deteriorates, at some point, Republicans will have to consider tax increases. Obviously this should be done in a manner that is consistent with the time-honored tax policy goals of promoting fairness, growth, and simplicity. As Congress searches through options it has thus far chosen to ignore, it will eventually realize that Gutman's or a similar plan is the logical choice.

36. *See generally* William A. Niskanen, *Limiting Government: The Failure of* "*Starve the Beast*," 26 CATO J. 553 (2006).

37. *See, e.g.*, Douglas Hotz-Eakin, *The Case Against the VAT*, *in* THE VAT READER 96, 98–99 (2011).