A Framework on Consumption Taxes and Their Impact on International Trade

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A Framework on Consumption Taxes and Their Impact on International Trade

The consumption tax is a word often heard when discussing tax reform; however, few discuss the specific implications of a consumption tax. Furthermore, it is even more rare to discuss the international effects of a consumption tax. This comment will provide a basic framework for the international considerations and consequences of a consumption tax. In part I, I will provide a terse definition of a consumption tax followed by part II which will begin the discussion on the characteristics of a consumption tax. Many of the examples in parts I and II are given in light of tax reform proposals in the United States; however, as part IV and V will show, these characteristics are not limited to the consumption tax in the United States.

In part III, I will provide a short discussion of proponents of the consumption tax in the United States, and in part IV, I will demonstrate the properties of both a destination-based consumption tax and an origin-based consumption tax. In reviewing both types of consumption tax, it is clear that there is a dilemma as to the effect consumption taxes have on international trade. Some economists predict that both destination and origin based consumption taxes have a net neutral effect on international trade. Other economists and tax analysts believe that the effect is not neutral. Part V will expand the analysis to four basic models of nations with competing and/or complimentary consumption based taxes. The models are then analyzed under interjurisdictional equity conditions, border control implications, and relocation of corporation problems. Lastly, section VI will impose the information from the previous analysis onto a model of the European Union. In conclusion, I will analyze what type of consumption tax or taxes gives the greatest advantage to the European Union and whether the tax advantage is permissible under the GATT.
I. The Consumption Tax

A consumption tax is a tax on spending or sales.\textsuperscript{1} This is in sharp contrast to the current United State’s income tax system. Under the consumption tax, outflows are taxed, while under an income tax, inflows are taxed.\textsuperscript{2} In other words, individuals are taxed by what they take from the economy, i.e. consumption, whereas under an income tax, individuals are taxed according to what they produce for the economy.\textsuperscript{3} Another crucial characteristic of a consumption tax is that it removes all investment spending from the tax base.\textsuperscript{4}

Consumption taxes come in many forms. A pure cash-flow expenditure tax, also known as a consumed income tax, applies a tax rate to total income minus saving.\textsuperscript{5} Usually the cash-flow expenditure tax is levied directly\textsuperscript{6} upon the individual and reported by the individual. Another form is the retail sales tax. This type of consumption tax is levied on the sales of goods and services.\textsuperscript{7} In practice, the retail sales tax is indirect because it is collected by the seller of the goods or services.\textsuperscript{8} Currently, many states have enacted this type of consumption tax. Between the extremes of both the cash-flow expenditure tax and the retail sales tax, is the third form of consumption tax, the VAT, or value-added tax.\textsuperscript{9} A VAT is levied on goods and services at each stage of production through the retail level; and is collected from the seller.\textsuperscript{10} A final example of a consumption tax is the flat tax. Under the flat tax, businesses pay taxes on their total sales revenue less the costs of material inputs,\textsuperscript{11} including wages and

\textsuperscript{1} Robert E. Hall & Alvin Rabushka, \textit{The Flat Tax}, \textit{TAX NOTES} 1, 18 (1995).
\textsuperscript{2} Id.
\textsuperscript{3} Id.
\textsuperscript{4} Id.
\textsuperscript{5} Hall & Rabushka, \textit{supra} note 1.
\textsuperscript{6} A “direct tax” is a tax demanded from the individual who is intended to pay it. JAMES J. FREEELAND ET AL., \textit{FUNDAMENTALS OF FEDERAL INCOME TAXATION} 15 (1998).
\textsuperscript{7} Hall & Rabushka, \textit{supra} note 1.
\textsuperscript{8} A “indirect tax” is paid by a person, usually the seller, who can shift the burden of a tax. JAMES J. FREEELAND ET AL., \textit{supra} note 6.
\textsuperscript{9} Hall & Rabushka, \textit{supra} note 1.
\textsuperscript{10} Id.
\textsuperscript{11} The costs of labor, materials, and other inputs purchased in the United States or imported to the United States would be allowable... as deductions for the business tax. Id. at 32.
investment goods.\textsuperscript{12} This is different from the VAT tax in that the VAT does not allow deduction for wages and salaries.\textsuperscript{13}

II. Characteristics of a Consumption Tax

The consumption tax has been deemed by its proponents as the cure for the federal income tax. Indeed, the consumption tax has many benefits. The cornerstone of a democratic and comprehensive tax is application of the same rate of tax to all similarly situated individuals.\textsuperscript{14} The current income tax has many opportunities for those earning the same amount to be treated differently. For example, the income tax may impose different tax liabilities on taxpayers with the same economic income depending on the source of that income.\textsuperscript{15} In addition, the federal income tax system treats expenditures differently depending on their purpose.\textsuperscript{16} In contrast, the consumption tax applies one rate to all expenditures.\textsuperscript{17}

It is important to note that a consumption tax of any type can become complex, if its structure is altered.\textsuperscript{18} For example, with political pressure, the flat tax could be changed to a multi-rate system.\textsuperscript{19} Though no longer a strict flat consumption tax, the multi-rate level would be more fair but more complicated.\textsuperscript{20} The VAT tax can also succumb to complications like those under the European VAT tax model which features numerous exemptions and multiple rates.\textsuperscript{21} If the consumption tax retains its simplicity, another benefit is its ability to prevent tax avoidance. The federal income tax avails savvy taxpayers the opportunity to escape tax. The consumption tax would treat everyone more equally.\textsuperscript{22}

The consumption tax might reflect a more accurate indication of an individual’s ability to pay because consumption is

\begin{itemize}
  \item \textsuperscript{12} Susan Wieler, Consumption Taxes: Do They Spur Growth?, 41 CHALLENGE 1, 5 (1998).
  \item \textsuperscript{13} "The flat tax removes wages and salaries from the business VAT and taxes them at the individual level instead." \textit{Id.}
  \item \textsuperscript{14} Deloitte & Touche “Consumption Tax” \textit{at} http://www.dtonline.com/TAXREF/trissue.htm#international (last visited October 29, 1999).
  \item \textsuperscript{15} \textit{Id.}
  \item \textsuperscript{16} \textit{Id.}
  \item \textsuperscript{17} \textit{Id.;} D\textsc{aniel} M\textsc{itchell}, The Fl\textsc{at} Tax 11, 17 (1996).
  \item \textsuperscript{18} Susan Wieler, \textit{supra} note 12, at 4.
  \item \textsuperscript{19} Deloitte & Touche, \textit{supra} note 14.
  \item \textsuperscript{20} \textit{Id.}
  \item \textsuperscript{21} Susan Wieler, \textit{supra} note 12.
  \item \textsuperscript{22} Deloitte & Touche, \textit{supra} note 14.
\end{itemize}
less variable over time than income. To demonstrate this idea economists point to an individual's ability to borrow and lend money when the individual wants. Thus, the timing of the receipt of income is not as indicative of the individual's ability to pay as is the consumption of goods.

A. Domestic Investment

One of the largest benefits of a consumption tax is its positive effect on savings. A country with a large percentage of savings will invest more in capital goods. More capital goods, such as better infrastructure, will make workers more productive. The expected effect is that the economy will be more efficient and produce more goods. In turn, the standard of living will rise.

A consumption tax taxes consumption and not savings; therefore, the consumption tax provides an incentive to save money for the future. The federal income tax does the opposite; it penalizes savings in the future. Studies show that nations with a consumption tax plan save more percentage of their total income than do people in the United States.

Many proponents of the consumption tax set their taxing rates below that which would be required to achieve the same revenue under the current income tax. The lower rate is based on the idea that given the chance, the savings incentive will increase investment and increase the real GDP (gross domestic product). However, if the savings increase does not materialize, the result will be a loss of revenue. For example, the Shelby-
Armey flat tax supports a tax rate of 17%.\textsuperscript{31} Most economists believe that a 17% tax rate would raise about 19% less revenue than the taxes it would replace.\textsuperscript{32} As explained above, advocates of the 17% flat tax expect the tax to stimulate the economy and increase output to a level that would produce the same revenues as those under the current system.\textsuperscript{33} Whether or not the amount of real GDP will rise to a sufficient level is uncertain. Most economists predict that output per capita will increase by approximately 4%, after ten years.\textsuperscript{34} However, saving and investment are dynamic elements and may not respond, especially in the short term, as the Shelby-Armey flat tax model predicts.\textsuperscript{35}

By definition, the consumption tax removes investment from the tax base.\textsuperscript{36} Many proponents of the consumption tax believe that the federal income tax double taxes capital gains.\textsuperscript{37} This occurs when income is earned by a business; it is subject to the corporate income tax.\textsuperscript{38} That same income is taxed, a second time, when it is distributed to shareholders.\textsuperscript{39} The abolishment of a federal income tax abolishes the tax on dividends. Not taxing dividends makes the decision to invest in stocks more appealing, thus, investment rises.\textsuperscript{40}

\textit{B. Administrative Efficiency}

The federal income tax is extremely inefficient.\textsuperscript{41} The inefficiencies of administering the federal income tax allow a large portion of American tax dollars to be spent on direct compliance costs (administration costs) and deadweight losses.\textsuperscript{42} Every dollar
spent complying with the federal income tax is a lost benefit to the American tax payer.

The federal income tax imposes two types of costs. The first is direct compliance costs: record keeping, learning about tax requirements, etc. Fifty years ago, the IRS estimated the compliance burden of individuals at 1.2% of federal tax revenues. In 1985, in a study conducted by Arthur D. Little, the estimate rose to a staggering 24.4% of income tax returns which equals $159 billion. More conservative estimates still come in at $100 billion. The second type of costs is indirect costs. Examples of indirect costs include a business that never formed because of high tax rates or elaborate reporting burdens. Another example of an indirect cost is when a dollar is put into a tax shelter instead of a productive investment. The exact amount of value lost to indirect costs is difficult to determine; however, intuitively, these costs are a loss to total output.

III. The Consumption Tax and its Implementors

There has been wide discussion in the Congress regarding tax reform. Many politicians are turning to consumption based taxes to achieve their political goals. Bills submitted to Congress that presented the consumption tax include the Schaefer-Tauzin-Chrysler National Retail Sales Tax (“National Retail Sales Tax”), the Nunn-Domenici “Unlimited Savings Account” tax (“USA” tax), and the Armey-Shelby “flat tax” (“Flat Tax”).

43. Id.
44. Id.
45. Hall & Rabushka, supra note 1, at 5.
46. In 1985, 24.4% of tax revenues equaled $159 billion. That is $159 billion earned by tax payers and spent by the federal government, not on programs to benefit the citizenry, but to administer the tax system. Data found in JAMES L. PAYNE, COSTLY RETURNS (1985) cited in Hall & Rabushka, supra note 1, at 6.
47. Hall & Rabushka, supra note 1, at 7.
48. Id.
49. Id.
50. The imprecision of these of indirect costs does not hinder economists from trying to reduce the cost into actual numbers.
51. Hall & Rabushka, supra note 1, at 8.
All proposals are designed to collect the same amount of revenue as currently received under the federal income tax. The characteristics of the tax proposals are varied. The National Retail Sales Tax proposes a 15% tax on gross payments for consumption in the United States of any property or service, no matter if the good or service is produced in the United States or in a foreign country. The tax would be collected by the selling business. The tax on imported goods would be paid by the consuming purchaser.

The USA tax is described as a "hybrid" consumption tax, imposed in part on businesses producing added value and in part on individuals. The business tax applies a flat-rate subtractive-method destination-based VAT. The subtractive-method VAT imposes a tax on the difference between sales and payments for inputs used in production (other than wages) in the period. Individuals would be subject to a graduated-rate personal consumption tax based upon the level of consumption.

The Flat Tax would impose a single-rate on business and individual tax bases. Businesses would be taxed on their gross receipts calculated as the sale of property or services minus the cost of business inputs, cash wages and retirement contributions. Dividends and interest would not be taxed and payments for compensation would be deductible. Individuals would be taxed a flat 17% rate on their wages earned in the United States, retirement contributions and unemployment compensation. A standard deduction would then be subtracted to yield taxable income.

56. Id.
57. Id.
58. Id.
60. Id.
61. Id. at 1036.
62. Id. at 1041.
64. Id. at 1044-5
65. Id. at 1045.
66. Id.
Not only are politicians interested in the consumption tax but so are the voters. The internet is bursting with groups intent on reforming the federal income tax. Those groups advocating a consumption tax include: Americans for Fair Taxation, Americans for Tax Reform, Citizens for Alternative Tax System, Citizens for Tax Justice, and Great American Taxpayer's Revolution.

IV. The Effect of a Consumption Tax on International Trade

Consumption taxes can be classified into two types: destination based and origination based. A tax based on the destination consumption tax principle imposes a tax on imports and provides a tax rebate on exports. Thus, a destination based tax system exempts consumption of its goods outside of the country. The rebate for domestic goods at the border is called a border adjustment. In comparison, the origination based consumption tax principle imposes a tax on goods leaving the United States while not imposing a tax on foreign imports into the United States. Thus, the tax is on all value produced in the United States no matter where it is consumed. An origination-based tax does not have a border adjustment. The majority of economists believe that border tax adjustments do not make any difference in the effect of both types of consumption taxes.

74. Border tax adjustments are required to free goods from sales tax upon leaving the exporting nation and to subject them to sales tax upon entering the taxing nation. Border tax adjustments differ from “border taxes,” such as import duties and export duties, which are imposed only on goods crossing interjurisdictional frontiers. Sijbren Cnossen, Coordination of Sales Taxes in Federal Countries and Common Markets, 9 CONN. J. INT'L L. 741, 742 (1994); Louis Lyons, Consumption Tax Could Mean Big Changes for Multinationals, TAX NOTES 1734, June 24, 1996.
75. Louis Lyons, Consumption Tax Could Mean Big Changes for Multinationals, TAX NOTES 1734, June 24, 1996.
A. Destination and Origination Based Consumption Taxes Are Neutral

Proponents portray the consumption tax as granting the United States the winning hand in the international trade game. They believe that a consumption tax will promote exports and discourage imports. A bias against imports has recently become an important political plank. Because of voter fear of jobs being lost to foreign countries, politicians have seized upon this opportunity to present the consumption tax because it appears to favor exports. However, under scrutiny, the consumption tax may not promote exports.

As stated above consumption taxes may be either destination or origination based. These two types of taxes must be examined separately. At first, exports appear to give the nation enacting the tax an advantage; however, under a destination tax system, imports and exports may be balanced. To demonstrate, the United States enacts a VAT of 20% on all goods. If a computer sells for $1,000, a domestically produced computer will be bought domestically for $1,200. A domestically produced and exported computer will receive a rebate, also known as a border adjustment, and be sold on the foreign market for $1,000. The foreign produced computer will be imported and taxed the United State's VAT. Then, the foreign produced computer will be sold in the United States for $1,200. The foreign produced computer that remains in the foreign country will be sold at its non-taxed price of $1,000. Thus, the prices on both sides of the border are equalized, and the United States export does not have a competitive price benefit.

An origination tax imposes a tax on goods exiting the United States while exempting foreign goods entering the United States. Using the same prices as above, examination shows that the

77. Id. at 13.
78. Id.
79. Id.
82. Id.
83. Id.
84. Id.
85. Id.; Louis Lyons, Consumption Tax Could Mean Big Changes for Multinationals, TAX NOTES, June 24, 1996, at 1734.
United States computer would sell domestically for $1,200. In the foreign market, the United States computer would sell for $1,200. However, the foreign computer sold in the United States and in the foreign market will a price of only $1,000 in both markets. These prices demonstrate a weakness for the United States product in both foreign and domestic markets. As demonstrated, switching to an origin based system would seem to disadvantage exports; however, many economists believe that this effect cannot survive. Some economists argue that under both destination and origination principles, the net effect is zero. This argument is based upon free floating exchange rates. If exchange rates between countries are flexible, one or both will adjust so that the dollar appreciates or devalues. Thus, the net effect is zero.

Economists who believe that destination and origination consumption taxes are neutral over time find that the net effect is neutral because currency exchange rates will function to eliminate any gains that may be received. Thus, over time the amount discounted to present value of net exports is zero. In other words, all foreign trade must be paid for in real dollars.

The ability of exchange rates to change in response to a destination based tax (leaving destination and origination consumption taxes neutral) is demonstrated in the following example. First, a United States computer company ships 1 million computers for $1,000 each to France. The total amount received is $1

86. Deloitte & Touche, supra note 14.
87. Id.
88. Id.
89. Louis Lyons, supra note 75.
90. Id.
91. Id.
92. A fully adjustable exchange rate is a freely floating exchange rate. Freely floating exchange rates are allowed to fluctuate in the open market in response to changes in supply and demand. ROGER ET AL., ECONOMICS TODAY 787 (1994).
93. Stephen E. Shay & Victoria P. Summers, supra note 56.
94. Louis Lyons, supra note 75.
97. Id.
98. Id.
A French water bottler sells 1 billion bottles of water to the United States for $1 each.\textsuperscript{99} The French bottler receives $1 billion.\textsuperscript{100} The federal government then taxes the United States company a 25\% federal income tax.\textsuperscript{102} The United States company pays $250 million to the federal government and retains $750 million.\textsuperscript{103}

Now suppose, the federal government decides to enact a 25\% destination based VAT.\textsuperscript{104} The tax is imposed on water entering the United States and rebated on all computers leaving the United States.\textsuperscript{105} At first glance, it appears that the United States computer company will receive an advantage over foreign companies.\textsuperscript{106} However, a second look shows that water companies will increase prices to $1.25, in order to offset the consumption tax.\textsuperscript{107} Computers sold in the United States will increase to $1,250 to offset the consumption tax. The general price level in the United States will increase by 25\%. The United States computer manufacturer will still sell his computers for $1,000 in France; however, when the $1 billion is spent in the U.S. it will only purchase $750 million in goods (because of the 25\% price increase).\textsuperscript{108}

For facility, the above example utilizes price; however, the underlying dynamic is currency rates.\textsuperscript{109} Using the same analysis, suppose the American computer manufacturer sold a computer for $5,000 francs ($1,000 = 5,000 francs).\textsuperscript{110} After the VAT, the

\begin{footnotesize}
\begin{enumerate}
\item \textsuperscript{99} Id.
\item \textsuperscript{100} Lee A. Sheppard, \textit{The Consumption Tax: Tax Protectionism}, \textsc{Tax Notes} 13, 15 (1995).
\item \textsuperscript{101} Id.
\item \textsuperscript{102} Id.
\item \textsuperscript{103} Id.
\item \textsuperscript{104} Lee A. Sheppard, \textit{The Consumption Tax: Tax Protectionism}, \textsc{Tax Notes} 13, 15 (1995).
\item \textsuperscript{105} Id.
\item \textsuperscript{106} Id.
\item \textsuperscript{107} Id.
\item \textsuperscript{108} To understand the concept of spending $1 billion while only purchasing $750 million in goods, one must understand that the changing exchange rates leads to a decrease in the value of the dollar. Thus, in period one an individual may pay $1 dollar and receive $1 of real value in the form of goods or services. Then, in period two, after the dollar has devalued, an individual will pay one dollar but will receive less than $1 in real value. For more of an explanation on this topic, see William A. Mceachern, \textit{Economics} 163 (1997); Lee A. Sheppard, \textit{supra} note 97.
\item \textsuperscript{109} Id.
\item \textsuperscript{110} Id. at 14.
\end{enumerate}
\end{footnotesize}
exchange rate will adjust so that 5,000 francs are only worth $750 ($750 = $5,000 francs). After the VAT, the franc is weaker than the dollar. Thus, when the computer manufacturer brings its income back into the United States, the income will only buy $750 of goods (as compared to the $1,000 before the VAT). "The American bottled-water importer will be laying out the same dollars for inventory—the exchange rate adjustment having compensated for the tax."

The preceding examples are very useful tools in examining the effect on currency rates from a consumption tax. One problem remains, throughout our analysis we assumed that the price of the VAT may be passed onto the consumer. Here, analysts assume that consumers will bear the VAT when all prices are raised relative to each other. Only if wages increase in the same amount, will the consumer bear all of the VAT. Economic theory predicts that wages will rise in response to the increase in the price of goods.

The above example is based upon destination principles; however, the majority of economists believe the same will occur under an origin based consumption tax. Leading economist Alan Auerbach and most economists agree. One reason for agreement is that foreign investment will be the same under both destination and origination principles. Under the origination principle, investments abroad will receive a deduction. However, the deduction will be equal to the taxes paid on the returns from investments abroad. Thus, whether or not exports are rebated (whether destination or origination tax is adopted) is

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111. Id.
112. Id.
113. Lee A. Sheppard, supra note 104.
114. Id.
115. Elasticity, price sensitivity, will not play a role in this analysis because prices are rising as a whole. If some prices increased relative to others, then elasticity of prices would be important. WILLIAM A. MCEACHERN, ECONOMICS 394 (1997).
116. Lee A. Sheppard, supra note 104.
118. Lee A. Sheppard, supra note 104, at 15.
119. Alan Auerbach testimony in front of the Senate Finance Committee held April, 1995 quoted in Lee A. Sheppard, supra. note 104, at 15.
120. Id.
not of importance.121 Both types of consumption taxes will result in the same level of foreign investment.122 As stated by Auerbach:

Though investments abroad receive a deduction, the tax benefit of this deduction is equivalent in present value to the taxes that will be paid in the future on the cash flows that the investment generates. As a result, it is not particularly important whether foreign investments are made under and origin-based or destination-based value added tax.123

Two treasury economists, Harry Grubert and T. Scott Newlon support the proposition that origin based consumption taxes are neutral. They state that an origin based tax is equivalent to a destination based tax because both imports and exports must be paid for in real dollars.124 "An origin-based tax amounts to the prepayment of tax on U.S. investments abroad, because in real terms foreign investment is financed by exports and return on investment is in the form of imports."125

The crux of Grubert and Newlon's argument rests upon all trade being paid for in real dollars; however, in practice, many nations have a trade deficit. With a trade deficit, a nation is putting payment of imported goods off into the future. When a trade deficit occurs, exchange rates of the trading nations may not adjust and the destination and origination based taxes will not be neutral. In the next section, theories of the destination and origination consumption tax as non-neutral are advanced.126

121. Id.
122. Id.
123. Alan Auerbach testimony in front of the Senate Finance Committee held April, 1995 quoted in Lee A. Sheppard, supra. note 104, at 15.
125. Id.
126. Before advancing, it should be noted that Some advocates of a VAT, use the theory, that destination and origination consumption taxes are neutral, to their benefit. The advocates of the VAT oppose the corporate income tax because, in their words, it discriminates against imports. The discrimination exists because exports cannot be rebated under GATT (General Agreement on Tariffs and Trade). They then argue in favor of a neutral system like the consumption tax where exports can be rebated. For economists who believe destination and origination consumption taxes are neutral, currency exchange rates are the guiding force, the federal income tax is just as neutral as a consumption tax. In addition, border rebates (on exports) may be fully consistent with the GATT as long as they do not discriminate against imports or provide over-rebates on exports. In theory there is no discrimination against imports after a border adjustment; however, statistical evidence to support this
B. Destination and Origination Based Consumption Taxes Are Not Neutral

Economic theory holds that the effects of a destination based system and an origination based system are equivalent if the exchange rate and domestic price adjustments are taken into account. However, a destination based system and an origination based system are long run outcomes that depend upon efficient financial institutions and flexible interest rates. Without the flexibility, interest rates may not be able to neutralize the effects on imports or exports. Those economists who do not trust in the flexibility of exchange rates believe that destination and origination based consumption taxes are not neutral.

Often exchange rates are not flexible. "In the short run, prices and exchange rates are less than perfectly flexible, and a change from one principle to another affects a country's competitive position in the real world." Under imperfectly flexible exchange rates, there will, at best, be a time lag and, at worst, the time will never arrive before the relative prices of goods is restored. Thus, analysts cannot rely on exchange rates to take up the slack.

Second, tax policy is politically motivated and influenced by special interest groups. "A general tax levied at a uniform rate on all goods and services has no counterpart in the real world." Because of political pressure, different rates are applied to different goods. Here, the choice of a border tax adjustment scheme is imperative if the relative price levels that exist under a comparative advantage system are to remain intact. In addition, other international inefficiencies may prevent the restoration of relative prices. For example, net transfer payments or capital flows from one nation to another would disrupt the adjustment

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theory is presently absent. Indeed, this evidence would be extremely difficult to exact. Lee A. Sheppard, supra note 104, at 13.

128. Id.
129. Id.
130. Id.
132. Id.
133. Id.
process.\textsuperscript{134} Also, uniform exchange rates, instituted by national reserve banks, could prevent the required adjustments.\textsuperscript{135}

V. Models for Nations Trading Under Consumption Tax Systems

A destination or origination based consumption tax's dynamics are difficult to control; however, the problem increases exponentially when many separate nations are involved. To predict the outcomes of trade between nations, I analyze the results of trade between two independent nations. The nations are paired according to the four possible outcomes that result from our two types of consumption taxes.

In the following analysis, four models of international trade between nations adopting either the destination or origination consumption tax are presented. First, consider Nation 1 which implements an origination tax and Nation 2 which implements a destination tax.\textsuperscript{136} A $150.00 good is produced in Nation 1. With a 15\% consumption tax, the producer pays $22.50 in taxes. The good is then 0 rated as it is imported into Nation 2.\textsuperscript{137} Once received by Nation 2, $50.00 of value is added. Then the good is sold with a consumption tax of 15\%. The tax dollars received equal $30.00. Of the $30.00, $22.50 is owed to Nation 1 and $7.50 belongs to Nation 2. The primary breakdown under this system is that Nation 1 must rely on Nation 2 to reimburse the producer in Nation 1 the $22.50. If reimbursement does not occur, the producer in Nation 1 will be double taxed on the value it produced.

The second model involves an origination based consumption tax in Nation 1 and an origination based consumption tax in Nation 2.\textsuperscript{138} Nation 1 produces a good valued at $150.00. Nation 1 collects taxes of $22.50. Nation 2 imports the good and adds $50.00 of value. When sold, the good will be taxed 15\% on the

\begin{itemize}
  \item \textsuperscript{134} Id.
  \item \textsuperscript{136} Integrated Text Sixth VAT Directive (1992).
  \item \textsuperscript{137} The importance of 0 rating is to safeguard the principles of a destination based consumption tax. Exports are exempt. \textsc{Ben TERRA} \& \textsc{Peter WATTEL}, \textsc{European Tax Law} 126 (1993).
  \item \textsuperscript{138} Opposite of Integrated Text Sixth VAT Directive (1992). Currently, there is no real world example of one origination based system trading with another.
\end{itemize}
$50.00 of added value.\textsuperscript{139} Thus, Nation 2 will collect $7.50. Here all value is captured in the country which produced the good.

In the third model, Nation 1 enacts a destination consumption tax.\textsuperscript{140} Nation 1 produces $150.00 of goods. The goods are then 0 rated and imported into Nation 2.\textsuperscript{141} Nation 2, an origination based system, adds $50.00 of value to the good and sells it. The origination tax in Nation 2 only taxes the $50.00 of added value; therefore, the $150.00 of value is lost to both tax systems.

Model four shows a good flowing from one destination based system to another.\textsuperscript{142} In Nation 1 a good is produced worth $150.00. The good is then imported, at a 0 rate, into Nation 2, also a destination based system, and $50.00 of value is added.\textsuperscript{143} The good is then sold for $200.00. At a consumption tax rate of 15%, $30.00 is collected in tax.\textsuperscript{144} All $30.00 is kept by Nation 2’s government. Nation 1 loses all tax revenue to Nation 2.

The four models show international trade between nations that can choose between destination or origination based consumption taxes. The following sections use the four models, and the international trading systems they represent, to predict the effect of those systems on interjurisdictional equity, border controls and multinational company location.

A. Interjurisdictional Equity

The phrase interjurisdictional equity refers to the concept that the country that produced the value should reap the tax benefits.\textsuperscript{145} If origination and destination based consumption taxes are neutral, then each of our models should yield perfect interjurisdictional equity.\textsuperscript{146} However, if exchange rates are not

\begin{itemize}
  \item \textsuperscript{139} Opposite of Integrated Text Sixth VAT Directive (1992).
  \item \textsuperscript{140} Integrated Text Sixth VAT Directive (1992).
  \item \textsuperscript{141} The importance of 0 rating is to safeguard the principles of a destination based consumption tax. Exports are exempt. \textsc{Ben Terra} & \textsc{Peter Wattel}, \textit{supra} note 137.
  \item \textsuperscript{142} \textit{See} Integrated Text Sixth VAT Directive, Art. 2 (1992).
  \item \textsuperscript{143} \textsc{Ben Terra} & \textsc{Peter Wattel}, \textit{supra} note 137.
  \item \textsuperscript{144} Integrated Text Sixth VAT Directive, Art. 2 (1992).
  \item \textsuperscript{145} There is also sentiment that interjurisdictional equity is not based upon who produces the value but who consumed the goods. Considering interjurisdictional equity from the standpoint of the producer creates incentive for governments to enhance production over consumption. Sijbring Cnossen, \textit{supra} note 128; Malcolm Gillis et al., \textit{Indirect Consumption Taxes: Common Issues and Differences Among the Alternative Approaches}, \textsc{Tax L. Rev.}, 725 (1996).
  \item \textsuperscript{146} Sijbring Cnossen, \textit{supra} note 127, at 745-6.
\end{itemize}
flexible and adjustment does not take place properly, then interjurisdictional equity will not be properly distributed during international trade.  

In addition, in the short run, before adjustment takes place, interjurisdictional equity will also not be distributed properly.  

To emphasize, unless exchange rates adjust and financial institutions allow that adjustment, the following will occur.

Utilizing model two explained above, when both nations adopt an origination based consumption tax, Nation 1 and Nation 2 each receive the tax on the value that each created.  

Hence, there is perfect interjurisdictional equity.  

To demonstrate, Nation A received $22.50 in tax revenue on the $150.00 of value it created, and Nation B received $7.50 in tax revenue on the $50.00 of revenue it created.

Under international trade between two destination based nations, model four, Nation 1 is subject to the institutions and fair trade practices of Nation 2. The sole tax collection occurs in Nation 2. Thus, Nation 2 holds the entire $30.00 of the tax. If the 22.50 owed to Nation 1 is returned, then Nation 1 will receive the tax on the value it created. However, and more likely then not, Nation 2 will retain the whole $30.00 leaving Nation 1 to obtain tax revenue through other means.

147. Id.

148. Id.

149. All models only control for the type of consumption tax. The outcomes are subject to change if different tax rates are imposes. For example, Consider an origination based consumption tax in Nation A of 10% and in Nation B of 20%. When Nation A exports its goods to Nation B, A's cars will have already have a 10% tax imposed by Nation A and B's cars will have the domestic 20% tax rate imposed. The different tax rates may lead to B's cars being favored because of their lower price.

Under a destination tax, the discrepancies in rates disappear. When Nation A exports its goods into Nation B, A's autos will be charged a tax rate of 20% and B's autos will be charged a tax rate of 20%. Under the framework presented above, the destination based system unifies the tax rate charged to each of the goods, from Nation A and Nation B; however, the 20% tax collected in Nation B does not represent who created the value. Thus, the analysis of the type of consumption tax is of utmost importance.

Malcolm Gillis et al., Indirect Consumption Taxes: Common Issues and Differences Among the Alternative Approaches, Tax L. Rev., 725 (1996); Sijbring Cnossen, supra note 127.


151. Most likely, the proper procedure will involve Nation 2 receiving the whole $30.00 tax subject to a $22.50 credit. See Integrated Text Sixth VAT Directive (1992).

152. More than likely Nation 1 will also retain the whole tax revenue of Nation 2's imports. However, interjurisdictional equity is only achieved when
Model one, an origin system trading to a destination based system, is of most detriment to the producers in Nation 1. Nation 2 will collect all of the revenue from the 20% tax. Note that the tax on $150.00 of the value was previously collected in Nation 1. Subjecting the good in Nation 1 to a 20% tax in Nation B, in fact, taxes the producer in Nation A twice on the $150.00 value. Double taxation is a severe burden on producers competing globally. To protect its producers, Nation 1 may strengthen its position if it changes to a destination based policy.

In contrast, model three, a destination system trading to an origin based system, allows the tax on the $150.00 of value to escape taxation. The destination based system in Nation 1 exempts the export. Nation 2, with an origination based system, taxes only the $50.00 in value added in Nation 2. Thus, Nation 2 collects $7.50 in tax revenue on the $50.00 in value, and no tax is ever collected on the $150.00 produced in Nation 1.

The models demonstrate that where both nations have origination based consumption taxes the nation that produced the value receives the tax revenue. Thus, model two results in the best distribution of interjurisdictional equity. However, in practice, there are no examples of two nations with origination based systems conducting international trade. The best explanation for this phenomenon is the greed of nations to reap the most tax revenues possible. To increase tax revenues, nations switch to a destination based system. Once this occurs, the destination based nation receives revenue on value they did not create. In addition, the other, origination based system, must switch to a destination based system to protect its producers from double taxation. A tendency for each nation to change to a destination based policy may explain why model four is the equilibrium point for most of international trade.

there is a balance of trade. WILLIAM A. MCEACHERN, ECONOMICS 163, 83 (1997).
153. DANIEL MITCHELL, supra note 31, at 34.
155. Id.
156. Id.
157. Id.
159. Id.
B. Border Tax Adjustments

Usually imports and exports are freed from tax upon leaving the taxing nation and are then subject to sales tax upon entering the next taxing nation. These adjustments are called Aborder tax adjustments.160 In practice, because most consumption taxes are destination based,161 border tax adjustments are a mechanism used to implement destination based taxes.

Border tax adjustments are crucial in maintaining the tax scheme set out in models three and four. In both situations, $150 of value is created and exempted as it is exported out of the country. The exemption allows the tax to be levied at the Adestination” where the good is consumed.

Border adjustments are also crucial in maintaining the benefits of comparative advantage.162 Tax policy dictates that goods which can be produced at a lower price in one location should retain that lower price status in other markets.163 Thus, comparative advantage is an important concept. The cumulative worth of all goods produced under a system maintaining the comparative advantage of its producers will be greater than under a system that does not.164 Border adjustments help to keep the relative prices of goods the same in all markets in order to reap the benefits of comparative advantage.

The importance of border tax adjustments is also contingent upon whether one accepts the theory that destination and origination consumption taxes are neutral.165 If the tax is neutral, then the institution of border tax adjustments is unnecessary. The free floating exchange rates will adjust, leaving the dollar to vacillate to the appropriate strength or weakness.

160. Border tax adjustments are prohibited in the United States and Canada. A retail sales tax is preferred by the United States and Canada because it does not require a border tax. “Problems arise with out-of-state purchases of taxable goods, interstate mail order and other direct-marketing sales, and with border sales.” “To protect the revenue from the tax, U.S. states have to coordinate the levy of their RST's through mutual assistance agreements.” Stephen E. Shay & Victoria P. Summers, supra note 67.


162. Comparative advantage is the ability to produce something at a lower opportunity cost than other producers face. WILLIAM A. MCEACHERN, supra note 116, at 748-50; see also Sijbring Cnossen, supra note 152.

163. WILLIAM A. MCEACHERN, supra note 152, at 748-50; see also Sijbring Cnossen, supra note 127.

164. WILLIAM A. MCEACHERN, supra note 152, at 748-50; see also Sijbring Cnossen, supra note 127.

165. See generally Sijbring Cnossen, supra note 127, at 747.
However, even if destination and origination based consumption taxes are neutral, there are some practical reasons to institute border tax adjustments. First, there may be huge gains and losses for investors who prefer stability. The length of time and the amount of the exchange rate adjustment is uncertain. In that period of time when the dollar devalues, there would be significant windfall gains and losses to foreign investors in the United States and to American investors abroad. To avoid the possibly devastating financial consequences for important investors and to maintain stability in the United States and its financial institutions, border adjustments could be used. Once created, border adjustments would need to be maintained unless we chose to devalue the dollar at some time in the future.

A second theory supporting border tax adjustments when neutrality will result from origination or destination based tax, only emerges when nations utilize nonuniform tax rates. Under a destination system with border tax adjustments, the relative prices of domestically-produced and imported goods would increase by the same amounts, and the nonuniform tax rates would operate like a set of selective excise taxes on consumption goods. In comparison, under an origination system without border tax adjustments, the exchange rate adjustment discussed above would reflect the average rate of taxation. The result would be a set of selective production taxes.

Although somewhat complex, the above analysis demonstrates that, under nonuniform rates, the use of a border tax adjustment results in distortions to consumption. In contrast, not using border tax adjustments affects production decisions. Economic theory, and capitalism, prefer to distort consumption rather than production decisions. One reason is that it is
generally more efficient in the long run to distort consumption. A second reason is that politicians can use the resultant excise taxes on consumption to promote their agendas. For example, the nonuniform rates can promote basic foods, like bread, over goods that generate negative externalities, like tobacco.

C. Relocation of Corporations

A tax should not influence the decisions of corporations to relocate. However, multinational corporations will locate in the country that affords them the lower tax rate and the easier administrative process. The dilemma of relocation is also based upon whether destination and origination based taxes are indeed neutral. Those who predict neutrality will result believe that multinational corporations will not move off-shore. To prove their hypothesis, Harry Grubert and T. Newlon, treasury economists, point to the increase in foreign corporate investment and domestic investment that would result from a destination based consumption tax. Under a consumption tax, foreign corporate investment in the United States should rise. This is true even though the U.S. tax on foreign income would be repealed under a consumption tax. Grubert and Newlon state, A... expensing of deductible capital investment expenditures would cut the U.S. tax on normal returns to investment to about the same degree as the existing tax on returns to foreign investment." In other words, the tax on returns from investment would be the same no matter the source, domestic or foreign, for the return.

If destination and origination based consumption taxes are not neutral, then whether a nation adopts a destination or origination tax may ultimately effect the location of multinational companies. The best scenario for a multinational producer occurs

179. Id.
180. Sijbring Cnossen, supra note 127, at 747.
181. Hall & Rabushka, supra note 1, at 32.
183. Louis Lyons, supra note 75.
185. Id.
in model three. Where the producer is under a destination based system exporting to an origination based system, the multinational producer escapes paying taxes on the $150.00 of value it produces.

The worst situation occurs in model one. The multinational producer is under an origination based policy exporting to a destination based nation. The producer is subject to double taxation on the value it produces. The double taxation leaves little doubt that the multinational company will relocate to a destination based nation. The incentive to relocate supports the conclusion above that all nations must maintain interjurisdictional equity.

Models two and four require the multinational corporation to pay taxes on the value produced. The corporation is taxed equally no matter if it is located in Nation 1 or Nation 2. In theory, model four will also tax the multinational on value produced. However, practice must require the tax collected at the time of sale to be distributed back to Nation 1. One of the most convincing methods of ensuring that companies receive their fair share of taxes is to institute a VAT type of destination consumption tax. The VAT makes it difficult to cheat because of its simplicity: a flat percentage is paid out of every transaction. The VAT is essentially self-enforcing. To demonstrate, under a VAT, each level of production pays taxes on the value added to the product. Therefore, every subsequent producer monitors the proceeding producer. This ensures that the subsequent producer does not pay tax on value they did not contribute. Enforcement continues until the last transaction, that between the retailer and the customer.

Two safeguards exist against fraud by the retailer. The penultimate transaction is recorded; therefore, the retailer has only a limited ability to defraud. Any attempt to report much less than receipts received, will be caught by a watchful Internal

186.  For simplicity sake, consider the multinational company as the producer of the $150.00 value.
187.  Sijbring Chossen, supra note 127, at 745.
189.  Id.
190.  Id.
191.  Id.
Revenue Service. Another safeguard flows from the division of tax reporting among all levels of production. The retailer is only one in a chain of reporting enterprises, and therefore, pays only a small portion of the total tax. Fraud is possible but only with cooperation among companies within a complete line of production.

VI. What Is Best for the European Union?

The European Union operates under a destination based VAT system known as a deferred payment system. Under this approach, the compensatory import tax is not levied and imported goods are not checked physically at the border. Instead, the credit mechanism of the VAT is relied on to ensure that the first taxable person in the importing country implicitly pays the compensatory tax, since there is not offsetting credit. Deferred payment requires that the importer report the compensatory import tax within 8 days after the importation of the goods. By making the recipient liable for the tax on the goods, the VAT is enforced.

However, the European Union has long been contemplating a change to an origination based tax. This may be a good idea. In reviewing the four models, the best case scenario for inter-jurisdictional equity, border adjustment, and business location occurs when one origination based system trades with another origination based system. But, it is also true that, in practice, foreign trading partners do not adopt origination based taxes. It is in the best interest of the European Union to utilize origination based consumption taxes for intracommunity trading. Because the European Union can regulate trading with itself, it can realize all the benefits of origination based consumption taxes without

193. Id.
194. Id.
195. Id.
196. The principle of the deferred payment scheme was adopted in Article 23 of the Sixth Directive of the European Commission. The Integrated Text of the Sixth VAT Directive, Article 23 “Obligations in respect of imports” states: “As regards imported goods, Member States shall lay down the detailed rules for the making of the declarations and payments.”
In particular, Member States may provide that the value added tax payable on importation of goods by taxable persons or persons liable to tax or certain categories of these two need not be paid at the time of importation, on condition that the tax is mentioned as such in a return to be submitted under Article 22(4). Integrated Text of the Sixth VAT Directive, Art. 23 (1992).
197. Sijbring Cnossen, supra note 127, at 750.
198. Id.
having the strategic problem of a trading partner switching to a
destination based tax.

The European Union can then adopt a destination tax for
trade with foreign nations. This dual strategy enhances the
position of the European Union in global trade.

Only one obstacle may prohibit the adoption of a dual tax
policy: the GATT. Under the GATT 1994, international trade
practice cannot result in an export subsidy.199 Hence, the above
discussion on whether destination and origination based taxes are
neutral is the determining factor.200 If the tax is found to function
as an export subsidy, it will be allowed under GATT 1994 only if it
meets two conditions.201 The first is that it must be one of several
“indirect” taxes set forth in the Agreement on Subsidies and
Countervailing Measures.202 The VAT tax that is proposed for
intracommunity trade is allowed.203 However, at present, no
origination based systems are mentioned. The second condition
provides that an export subsidy will only be allowed if the rebate
on the export does not exceed the amount levied on the goods
sold for domestic consumption.204 Whether a dual tax policy will
favor exports over domestic goods sold will depend upon the tax
rates instituted under each system.205

In conclusion, whether the dual tax policy is prohibited by
GATT balances on whether or not destination and origination
based consumption taxes are neutral. The comment presents both
views on the neutrality of consumption taxes and demonstrates
that flexible exchange rates are the determining factor.

199. "The products of the territory of the contracting party imported into the
territory of another contracting party shall not be subject, directly or indirectly,
to internal taxes or other internal changes of any kind in excess of those applied
directly or indirectly to like domestic products." GATT art. 3, para. 2, of part II.
See also Stephen E. Shay & Victoria P. Summers, supra note 67; Within the
GATT, each member agreed to treat all member nations equally with respect to
trade. WILLIAM A. MCEACHERN, supra note 152, at 763.
201. Id.
202. Id.
203. Id.
204. Stephen E. Shay & Victoria P. Summers, supra note 67, at 1048.
205. In respect to the difference between a credit-invoice VAT and a
"subtractive-method" tax, “Adjustments could be made for inputs exempted or
taxed at different rates, but this would be extremely burdensome as each item of
tax paid would have to be tracked.” Id. at 1051. The same is not true for a dual
tax system. Exports would be treated differently from domestic sales. Inputs
would not need to be tracked.
In addition, the use of the four models of consumption tax in international trade provides important options for nations with developing tax policies. The four models distinguish possible scenarios for interjurisdictional equity, border adjustments, and company location. Thus, I concluded that the best option for the European Community is an origin based consumption tax for intracommunity trading and a destination based consumption tax for international trading.

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