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# The International Effects of the Adoption of a Consumption Tax in the United States

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# The International Effects of the Adoption of a Consumption Tax in the United States

ABSTRACT

*This Note concludes that through the adoption of a consumption tax the United States will benefit from both short- and long-term gains. This Note presents the advantages of consumption taxes and where relevant, discusses a specific consumption tax proposal—the Fairtax Plan. The Author responds to several critiques of consumption taxation, including whether consumption taxes are disproportionately placed on labor, the existence of efficiency gains, the international effects, increased black market activity, and cross-border tax arbitrage.*

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## I. INTRODUCTION

Historically, national governments structured their tax systems without accounting for international investment levels. Until recently, tax regimes were, by and large, a purely domestic issue, but as increased globalization dissolved barriers to free capital flows, the concerns of tax policy changed.[1] Modern advances in areas such as transportation and communication have helped free capital, an important part of any government's tax base, from its geographical roots. For instance, between 1973 and 1995, global capital transfers increased by a multiple of eighty.[2] The increasingly vast resources involved in the global market required a new understanding of tax policy.

As the prior century progressed, new technologies spurred policy changes worldwide, increasing the opportunities to invest abroad.[3] The Industrial Revolution led to advances in transportation technology, such as the railroad, spurring economic growth and increasing "incentives for capital formation, industrial concentration, international specialization, and for labor and capital migration."[4] Beginning in the 1970s, developed countries instituted policies that led to the drastic reduction of limitations on the international flow of capital.[5] Developing countries have changed their policies even more drastically; once suspicious of foreign investment, most developing nations currently view foreign investment as beneficial.[6] Changes in legislation continue to show an emphatic favoring of foreign investment: 93% of legislation in 2001 affecting international investment created more favorable conditions for investing.[7]

Increasingly mobile capital has raised concerns with some critics over the continued ability of governments to use traditional means of taxation.[8] Economic studies confirm that the combination of globalization, domestic economic stress, and budgetary imperatives

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1. ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT, HARMFUL TAX COMPETITION: AN EMERGING GLOBAL ISSUE 13–14 (1998), *available at* http://www.oecd.org/dataoecd/33/0/1904176.pdf [hereinafter HARMFUL TAX COMPETITION].

2. *See* Mitchell B. Weiss, *International Tax Competition: An Efficient or Inefficient Phenomenon?*, 16 AKRON TAX J. 99, 105, 107, 109 (2001).

3. ALEX EASSON, TAX INCENTIVES FOR FOREIGN DIRECT INVESTMENT 10–11 (2004).

4. C. Knick Harley, *A Review of O'Rourke and Williamson's* Globalization and History: The Evolution of a Nineteenth Century Atlantic Economy, 38 J. ECON. LIT. 926, 929–30 (2000).

5. EASSON, *supra* note 3, at 10.

6. *Id.* at 10–11.

7. *Id.* at 11.

8. Jack M. Mintz, *National Tax Policy and Global Competition*, 26 BROOK. J. INT'L L. 1285, 1286 (2001).

have led to reductions in worldwide tax rates on capital.[9] For example, as of April 2005, nine countries in Eastern Europe made themselves more attractive to global investment by lowering the rate of taxation on capital as part of a transition to a flat tax.[10] Lower tax rates on capital concern critics, such as Avi-Yonah, who worry that decreasing tax rates will lower government revenues, thereby constraining social expenditures that they deem beneficial.[11] Taxes on capital, however, *create* inefficiencies in capital accumulation and raise the relative price, and thereby reduce demand. Thus, this Note rejects the Avi-Yonah type concerns over tax competition and contends instead that the need for economic efficiency outweighs concerns about the ability of governments to maintain high levels of expenditures.[12]

The lowering of taxes on capital is a form of global tax competition, an issue which ties into a longstanding debate in the United States over whether the federal government should continue to use an income tax or adopt any of a variety of consumption tax proposals.[13] Under most consumption tax proposals seriously considered by Congress, capital is either lightly taxed or not taxed at all.[14] Compared to the current tax code—which taxes corporate capital returns at 35%—exempting such income, as this Note proposes, would be significant.[15] No major economy completely exempts investment from taxation,[16] and the adoption of such a policy by an economy the size of the United States has the potential to dramatically raise the level of tax competition.

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9. Duane Swank & Sven Steinmo, *The New Political Economy of Taxation in Advanced Capitalistic Democracies*, 46 AM. J. POL. SCI. 642, 651 (2002). *But see* Reuven S. Avi-Yonah, *Globalization, Tax Competition, and the Fiscal Crisis of the Welfare State*, 113 HARV. L. REV. 1573, 1576 (2000) (worrying that tax competition is threatening the solvency of countries that want to provide a social safety net).

10. *The Case for Flat Taxes*, THE ECONOMIST, April 16, 2005, Special Report, at 2. Countries that have adopted flat taxes include Estonia, Lithuania, Latvia, Russia, Serbia, Ukraine, Slovakia, Georgia, and Romania. *Id.*

11. Avi-Yonah, *supra* note 9, at 1576.

12. *See, e.g.*, Marianne Baxter, *Fiscal Policy, Specialization, and Trade in the Two-Sector Model: The Return of Ricardo?*, 100 J. POL. ECON. 713, 725–27 (1992) (describing the effects of distortionary taxation in two sector trade between two countries in a steady state model).

13. *See, e.g.*, Steven A. Bank, *The Progressive Consumption Tax Revisited*, 101 MICH. L. REV. 2238 (2003) (reviewing EDWARD J. MCCAFFERY, FAIR NOT FLAT: HOW TO MAKE THE TAX SYSTEM BETTER AND SIMPLER (2002)). *See generally* Alan Schenk, *The Plethora of Consumption Tax Proposals: Putting the Value Added Tax, Flat Tax, Retail Sales Tax, and USA Tax into Perspective*, 33 SAN DIEGO L. REV. 1281 (1996) (comparing various consumption tax proposals to the current U.S. income tax system).

14. *See generally* Schenk, *supra* note 13.

15. 26 U.S.C.S. § 11(b); 26 U.S.C.S § 1201(a)(2) (2005).

16. *Cf.* EASSON, *supra* note 3, at 35–36 (noting that some countries do provide exemptions for some passive investments).

With the advent of the global economy and increased tax competition, corporations and other investors use geographically fungible capital to lower their tax liabilities by moving their investments to low tax areas.[17] The potential for capital flight imposes constraints on the level of taxation, which, in turn, imposes fiscal discipline on governments.[18] Several normative economic studies have shown that the optimal tax rate on capital is zero, whereas the optimal tax rate on labor is positive, suggesting that the identifiable reduction of taxes on capital, through by tax competition, would provide worldwide benefits.[19] Discipline also may lead to reduced inefficiencies by forcing governments to streamline their tax systems.[20] Furthermore, in a more efficient market, investment will be allocated more productively, leading to worldwide welfare benefits in the long run.[21]

The thesis of this Note is that, should the United States replace its current tax system with a consumption tax, global benefits would outweigh global costs. Although the tax reform literature is thick, by concentrating on the international effects of a consumption tax, this Note takes a less traveled path. This Note makes an additional contribution by focusing on House Resolution 2525, nicknamed the "Fairtax Plan" by its supporters. The Fairtax Plan is a national sales tax proposal. It is an economically neutral non-cascading sales tax, under which only new goods and services are taxed.[22] The tax literature has not fully examined the Fairtax Plan, and this Note is an attempt to give a more complete analysis of the costs and benefits. This Note concludes that the adoption of a national sales tax will result in drastic change in international tax regimes and the global economy by lessening distortions and facilitating the efficient flow of international savings and investment.

Although this Note offers a solution to inefficiencies created by the current international system for taxing international flows of savings and investment, it recognizes that adoption of a consumption tax has tradeoffs, including a failure to remove cross-border arbitrage, thereby creating potential incentives to international organized crime. Furthermore, this Note recognizes that valid non-

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17. HARMFUL TAX COMPETITION, *supra* note 1, at 14.

18. Carlo Perroni & Kimberly A. Scharf, *Tiebout with Politics: Capital Tax Competition and Constitutional Choices*, 68 REV. ECON. STUD. 133, 134–35 (2001).

19. *See* Gian Maria Milesi-Ferretti & Nouriel Roubini, *Growth Effects of Income and Consumption Taxes*, 30 J. MONEY, CREDIT & BANKING 721, 723 (1998).

20. Perroni & Scharf, *supra* note 18, at 134–35.

21. *See id.*

22. Americans for Fair Taxation, Fairtax Frequently Asked Questions, http://www.fairtaxvolunteer.org/smart/faq-main.html#1, ¶ 1 (last visited Feb. 11, 2006); *see* Charles E. McLure, Jr., *Rethinking State and Local Reliance on the Retail Sales Tax: Should We Fix the Sales Tax or Discard It?*, 2000 BYU L. REV. 77, 82–88 (2000) (describing the ideal sales tax).

economic domestic concerns exist and, while not addressed in this Note, should be considered along with the potential adoption of a consumption tax.

Part II of this Note provides an overview of the international taxation of investment. This Part investigates basic concepts in international taxation and further develops the discussion of international tax competition. Part III describes the current international system and highlights the mass of inefficiencies and the need for radical reform. Part IV describes the benefits of consumption taxes, introducing the two dominant consumption tax systems and the relevant advantages of the Fairtax Plan. Because the Fairtax Plan has many of the general attributes of consumption taxation, this Note first addresses the attributes that the Fairtax Plan has in common with consumption tax plans. Finally, Part V addresses the critiques of consumption taxes and answers these critiques through the lens of the Fairtax Plan. This Part demonstrates how the criticisms of consumption taxes have been overstated

## II. OVERVIEW OF SOME PERTINENT INTERNATIONAL TAX ISSUES

### A. *Relevant Background*

World taxation systems can be separated into two generic groupings: territorial systems and worldwide residence systems.[23] Under a territorial system, income produced outside a country is not taxed.[24] Tax systems like the U.S. tax regime are based on worldwide residence. Thus, income earned by tax citizens, permanent residents, and corporations is taxed regardless of where it is earned.[25] Potential double taxation is addressed by either allowing a deduction or credit based on the amount of foreign taxes paid.[26] The United States gives domestic investors the option to choose to take either a tax credit or a deduction on foreign taxes paid.[27] Deductions and credits are limited.[28] If no limitations were in place, foreign nations could charge high taxes with the expectation that the U.S. government would reimburse U.S. corporations.[29]

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23. Charles L. Ballard, *International Aspects of Fundamental Tax Reform, in* UNITED STATES TAX REFORM IN THE 21ST CENTURY 109, 110 (George R. Zodrow & Peter Mieszkowski eds., 2002).

24. *Id.*

25. *Id.*

26. *Id.*

27. *See* 26 U.S.C. §§ 78, 275(a), 901(a) (2005).

28. *See, e.g.*, 26 U.S.C. § 904(a) (providing that total foreign tax credits cannot exceed the total tax liability in the United States).

29. Ballard, *supra* note 23, at 110.

Processes to relieve double taxation of international investment create incentives to manipulate the tax system, minimizing taxable income. Corporations, within limits, can decrease their tax liability by misclassifying income earned domestically as income produced by foreign sources.[30] For example, the limit of foreign tax credits can be increased by reclassifying income earned from the domestic production of export goods as foreign-source income.[31] Also, by transferring income to lower tax countries, total tax liability can be reduced.[32] For example, evidence indicates that corporations use transfer pricing to take advantage of Ireland's low tax rates, which provides significant tax savings.[33] Tax liability can also be reduced by manipulating interest-expense deductions.[34] Manipulation occurs when money is borrowed for a foreign business investment in foreign jurisdictions that do not allow the deduction of loan interest.[35] Because the United States allows the deduction of business loans, investors are incentivized to minimize their tax liability by shifting the loan interest to their U.S. source income.[36] The desire to minimize taxation can lead investors to make expenditures and investments that would be suboptimal in a taxless world.

Capital taxation also affects the form of international investment. Generally, a foreign investor can structure an investment to gain tax treatment as either a resident or a non-resident.[37] Assuming no investor-specific incentives, however, both residents and non-residents are generally taxed similarly on income generated within a country's borders.[38] Classification can matter, however, where differential tax rates make a particular classification tax efficient. For example, in the United States, firms can avoid taxation on foreign source income by reincorporating in another country that does not tax investment income. [39]

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30. *Id.* at 116.
31. *Id.*; *see, e.g.*, 26 U.S.C. § 863.
32. Ballard, *supra* note 23, at 116.
33. Frank Barry, *FDI, Transfer Pricing and the Measurement of R&D Intensity*, 34 RES. POL'Y 673, 677–78 (2005).
34. Ballard, *supra* note 23, at 117.
35. *Id.*
36. *Id.*
37. EASSON, *supra* note 3, at 37 (providing that the form of the investment affects the resident/non-resident determination).
38. Peggy B. Musgrave, *Consumption Tax Proposals in an International Setting*, 54 TAX L. REV. 77, 78–79 (2000) (providing that tax revenues from non-resident investors should be thought of as a lease payment, where the investor pays a fee to benefit from advantageous production factors within the host country).
39. Reuven S. Avi-Yonah, *International Tax as International Law*, 57 TAX L. REV. 483, 486–87 (2004).

### B. *WTO Rules*

Taxation does not occur in a vacuum and tax policies can be influenced by rules that lie outside of the tax code. At the international level, trade rules promulgated under the World Trade Organization (WTO) can affect domestic tax policies by setting the ground rules for the international trade of goods.[40] The main obligation of the WTO is to encourage nondiscrimination, meaning that the WTO seeks to minimize and eliminate trade barriers.[41] For example, under most circumstances, the WTO requires members to award certain trade benefits to all other WTO members.[42]

More relevant to tax policies are the WTO rules regarding border adjustments, which provide favorable taxation rules under certain circumstances. Border adjustments occur when a country repays a taxpayer the amount of previously paid domestic taxes on exported goods.[43] The rules regarding border adjustments, however, do not allow border adjustments for all types of taxation. WTO rules allow border adjustments for indirect taxes, which are taxes that are not focused on a particular person, but instead are focused on an action, such as consumption.[44] WTO rules, however, do not allow border adjustments to be made for direct taxes, such as income taxes, which are focused on individuals.[45] Consequently, some advocates believe that, under GATT, countries that use direct taxation suffer a competitive disadvantage relative to countries with indirect taxation because of the inability to waive the domestic tax burden on exports.[46] Some estimates of the cost reduction afforded by border adjustments are as high as 25 to 30%.[47] Therefore, these advocates believe that because of the lower tax burden, businesses located in countries using an indirect taxation regime are more attractive to foreign investment and savings than businesses within countries using direct taxation.[48]

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40. WTO, GATT and the Goods Council, http://www.wto.org/english/tratop_e/gatt_e/gatt_e.htm (last visited Feb 11, 2006).

41. Yariv Brauner, *International Trade and Tax Agreements may be Coordinated, but not Reconciled*, 25 VA. TAX REV. 251, 266 (2005).

42. *Id.*

43. Laura Dale, *The Economic Impact of Replacing the Federal Income Tax with a Federal Consumption Tax: Leveling the International Playing Field*, 9 CURRENTS: INT'L TRADE L.J. 47, 47 (2000).

44. *Id.* at 50.

45. *Cf. id.* (direct tax is the converse of an indirect tax).

46. *Id.;* General Agreement on Tariffs and Trade, Oct. 30, 1947, 61 Stat. A3, 55 U.N.T.S. 187, art. III.

47. Dale, *supra* note 43, at 52.

48. Malcolm Gillis et al., *Indirect Consumption Taxes: Common Issues and Differences Among the Alternative Approaches*, 51 TAX L. REV. 725, 740–41 (1996).

The efficacy of modifying tax laws to allow exporters to make border adjustments is subject to debate. One side of the debate, often cited in the literature, argues that tax laws should not be changed. Supporters of this argument note that border tax adjustments do not have long-term effects on competition because assuming perfectly general tax regimes, competitive advantage will be eliminated by the movement of exchange rates, thereby eliminating any cost advantage gained by a change in the tax burden on internationally traded goods.[49] More specifically, the currency subjected to direct taxation will depreciate relative to the currency from a country using indirect taxation, thus eliminating any competitive advantage.[50]

Exchange rates do not immediately change in response to changing economic circumstances, preventing markets from eliminating the advantages gained should the United States adopt a consumption tax. Economic data suggest that "exchange rates are . . . persistent," having "half-lives . . . of four to five years".[51] The implication of this data is that at least short-term economic benefit can be gained from switching from a personal income tax to a general consumption tax.

## III. INEFFICIENT MARKETS

Attraction of foreign investment is not a zero-sum game and can benefit both capital-importing countries and capital-exporting countries.[52] Capital-importing countries benefit from increases in investment capital, tax revenue, employment, and the "introduction of new skills and technology."[53] Capital-exporting countries can expect returns on the investment in "the form of repatriated profits, intellectual property royalties and similar payments."[54] Returns on foreign capital investment have become more important as globalization has increased the flows of transnational investment; in 2004, investors globally invested almost ten trillion dollars of foreign

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49. *Id.* at 742–43; Alan J. Auerbach, *The Future of Fundamental Tax Reform*, 87 AM. ECON. REV. 143, 144 (1997); Harry Johnson & Mel Krauss, *Border Taxes, Border Tax Adjustments, Comparative Advantage, and the Balance of Payments*, 3 CAN. J. ECON. 595, 601 (1970).

50. Gillis et al., *supra* note 48, at 741.

51. Michael B. Devereux, *Real Exchange Rates and Macroeconomics: Evidence and Theory*, 30 CAN. J. ECON. 773, 795 (1997).

52. EASSON, *supra* note 3, at 12–13. *But see* Joel Slemrod, *Tax Principles in an International Economy*, *in* WORLD TAX REFORM: CASE STUDIES OF DEVELOPED AND DEVELOPING COUNTRIES 11 (Michael J. Boskin & Charles E. McLure, Jr. eds., 1990).

53. EASSON, *supra* note 3, at 14.

54. *Id.* at 13.

direct investment.[55] Despite research consistently showing that governmental interventions into the free market create bad results, legislatures consistently ignore the warning.[56]

A common concern is that tax competition will cause a "race to the bottom, reducing the amount of tax revenue, and therefore, reducing the supply of public goods below the optimum amount."[57] In response to this perceived threat, the Organization for Economic Cooperation and Development (OECD), a non-governmental organization encompassing thirty countries that addresses economic issues, attempted to use its market power to force alleged tax havens—usually smaller developing nations, into changing their tax structure—with the threat of sanctions or the cancellation of trade treaties.[58] Although so far ineffective, individual OECD members have threatened the cessation of all financial ties with non-complying nations.[59]

The root of the tax competition debate is largely a matter of conflicting social policy preferences. For example, one point of view represented by Charles Tiebout, a mid-twentieth century economist, hypothesized that competition makes government "more efficient and more responsive to the needs and desires of their residents," and thus tax competition is desirable.[60] Tiebout's insight into governmental competition continues to have adherents and embodies a preference for efficiency. It also provides a philosophical counterpoint to authors, such as Professor Avi-Yonah, who disfavor tax competition because it might affect the ability of governments to spend as they desire, potentially endangering European type social models.[61]

From a government's perspective, tax incentives can bring economic gains to specific countries, but countries that win a bidding war for foreign investment can discover that gains can be

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55. U.N. Conference on Trade and Development, World Investment Report, FDI Database, http://www.unctad.org/sections/dite_dir/docs/wir2005_outstock_en.xls (run search for outflows, by home region and economy, 1970–2003).

56. *See* EASSON, *supra* note 3, at 85.

57. John Douglas Wilson, *Trade, Capital Mobility, and Tax Competition*, 95 J. POL. ECON. 835, 836 (1987).

58. Akiko Hishikawa, *The Death of Tax Havens?*, 25 B.C. INT'L & COMP. L. REV. 389, 401–02 (2002); Benjamin R. Hartman, *Coercing Cooperation from Offshore Financial Centers: Identity and Coincidence of International Obligations Against Money Laundering and Harmful Tax Competition*, 24 B.C. INT'L & COMP. L. REV. 253, 264 (2001).

59. Hartman, *supra* note 58, at 263–64.

60. Julie Roin, *Competition and Evasion: Another Perspective on International Tax Competition*, 89 GEO. L.J. 543, 545 (2001); Charles M. Tiebout, *A Pure Theory of Local Expenditures*, 64 J. POL. ECON. 416, 416, 424 (1956).

61. *Compare* Perroni & Scharf, *supra* note 18, at 134 (asserting tax competition can "raise welfare"), *with* Avi-Yonah, *supra* note 9, at 1629 (finding that tax havens endanger social programs).

nonexistent. The theory is that, in a bidding war, countries face an increased risk of overestimating the benefit of attracting the foreign investment by bidding too much.[62] Any welfare gained by attracting foreign investment would therefore be spent as it is gained.

Although the taxation of investment creates income for a governmental entity, such taxation also acts as a disincentive for investment.[63] Would-be investors will substitute untaxed uses on their income for the investment, thereby reducing the level of investment below what would have existed if there was no tax on investment.[64] Because investment would be below the free-market equilibrium, a deadweight loss greater than the amount of governmental tax revenues would be created.[65] Basic economics provides that a dollar now is worth more than a dollar in the future. Therefore interest has to be paid to encourage investors to delay the consumption of current dollars. Because taxes reduce an investor's rate of return, the savings rate is necessarily lower than the savings rate under a tax system where investment is not taxed. The use of distortionary taxation thereby provides relative gains but destroys potential economic gains.

Although tax competition has lowered the taxation of capital, this Note hopes to draw a distinction between general tax reductions and specific tax incentives. Specifically-tailored tax incentives result in two types of inefficiencies.[66] First, investors and savers are induced to allocate assets based on the tax incentives rather than on the most productive use of the assets.[67] Second, competition between those who receive incentives and those who do not receive incentives is distorted.[68] By increasing waste, these efficiency losses necessarily offset part of the gains tax competition creates through lower capital tax rates.

Tax incentives can also cause harm in more indirect ways. Incentives, for instance, can lead to a waste of governmental revenue. While incentives attract investment and savings that would otherwise not occur in a country, they also unnecessarily benefit

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62. *See* Clayton P. Gillette, *Business Incentives, Interstate Commerce, and the Commerce Clause*, 82 MINN. L. REV. 447, 451 (1997).

63. David F. Bradford, *The Case for a Personal Consumption Tax*, *in* WHAT SHOULD BE TAXED: INCOME OR EXPENDITURE 75, 96 (Joseph A. Peachman ed., 1980).

64. *See* John K. McNulty, *Flat Tax, Consumption Tax, Consumption-Type Income Tax Proposals in the United States: A Tax Policy Discussion of Fundamental Tax Reform*, 88 CAL. L. REV. 2095, 2105 (2000) (describing how an individual might replace leisure for work under high income taxation, although recognizing that income taxation may cause a reverse effect and individuals might work harder to increase income to reach the level of income the individual would have had without an income tax).

65. *Id.* at 2106.

66. EASSON, *supra* note 3, at 107.

67. *See id.* (applying idea to investment).

68. *Id.*

investment and savings that would have occurred in a country without an incentive, a phenomenon referred to by economists as the redundancy rate.[69] Assuming that countries wish to use tax revenues effectively, redundant tax expenditures conflict with this goal by paying an investor to invest unnecessarily.[70] To reduce the amount of public monies wasted, countries can tailor tax incentives to benefit only the investors that are thought to need the incentive to invest.[71] The international allocation of investment is inefficient. In a taxless world, decisions on capital allocation are based on the expected returns to an investment. Taxation, however, can introduce other factors into the decision-making process. Compared to a taxless world, favorable taxation attracts capital to less productive uses.[72] For example, favorable taxation can incentivize investments that would not otherwise be made. At the international level, differing tax rates can affect the "flow of goods and services, of factors of production, and the choices of individuals to reside and consume in one country or another."[73] By altering such preferences, differential taxation can change the pattern of trade by influencing the placement of production facilities, the flow of financial capital, and the movement of labor.[74] Tax incentives create an overall loss to social welfare because the benefits gained through tax incentives do not completely offset the efficiency costs. The coordination of worldwide taxation can create fiscally neutral taxation where investment decisions would not be affected by tax policy.[75] For example, neutrality could be achieved if every country adopted a retail sales tax.[76] Although tax coordination might be economically beneficial under some circumstances, other types of coordination can insulate governments from tax competition, thereby removing a limitation to government budgets.[77]

Increasing globalization provides countries the increased ability to make economic gains through the use of comparative advantage.[78] Comparative advantage assumes that countries will focus on

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69. *Id.* at 75–76.

70. *Id.* at 75. The redundancy rate can be reduced by targeting tax incentives, which in turn increases the distortionary effects. *Id.* at 76.

71. *See id.* at 106.

72. Michael J. Graetz, *Taxing International Income: Inadequate Principles, Outdated Concepts, and Unsatisfactory Policies*, 26 BROOK. J. INT'L L. 1357, 1381 (2001) (describing the definition of global efficiency used by Peggy Musgrave).

73. Peggy B. Musgrave, *International Coordination Problems of Substituting Consumption for Income Taxation, in* TAX POLICY IN THE GLOBAL ECONOMY 415, 418 (2002).

74. *Id.*

75. *Id.* at 419.

76. *Id.* at 427.

77. Ballard, *supra* note 23, at 124; *id.* at 421.

78. Mintz, *supra* note 8, at 1293.

economic activities that provide the greatest returns.[79] Thus, by focusing on their respective comparative advantages, two countries can maximize their combined economic outputs.[80] By providing tax incentives to attract international savings and investment, countries reduce the welfare benefits provided by comparative advantage. As previously noted, tax incentives can induce private actors to alter their investment behavior.[81] Behavior modification comes at a cost, however, because tax policy creates an inefficient allocation of resources where the relative costs of producing goods are changed.[82] Changes to the relative cost of production can make the production of tax-favored goods relatively more profitable than in a tax-free world. Thus, distortionary tax policies can incentivize investment in tax-favored activities at the expense of the most productive investment that would occur in the tax-free world.[83] Because relatively more resources are used to produce tax-favored goods, the excess resources used—called deadweight loss—are wasted, resulting in an overall loss of wealth.[84] At the international level, distortionary tax policy can create "dramatic, permanent shifts in the international pattern of specialization and trade."[85] Elimination of distortionary tax policy would lead to a worldwide increase in wealth.

More concretely, empirical evidence provides that international investment is highly elastic and therefore greatly influenced by tax differentials.[86] A cross-sectional study by Grubert and Mutti of five-hundred multinational corporations with locations in sixty countries shows that, in both the short and long term, low taxes are the most significant factor in explaining the locations of multinational investment.[87] The study concludes that 19% of worldwide capital is allocated in response to taxes, signifying the existence of large worldwide welfare losses.[88] The movement of such vast amounts of capital to tax incentives is another indication of the need to reduce losses to inefficiency through the adoption of an economically-neutral general tax such as a general sales tax.

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79. *See id.* at 1293.

80. *Cf.* ADAM SMITH, WEALTH OF NATIONS, IV 2.10–2.22 (1776) (arguing that "by opening a more extensive market . . . [foreign trade encourages participating countries] to augment [their] annual produce to the utmost, and thereby to increase the real revenue and wealth of the society.").

81. EASSON, *supra* note 3, at 64–65.

82. Baxter, *supra* note 12, at 729.

83. Avi-Yonah, *supra* note 9, at 1604.

84. *Id.*

85. Baxter, *supra* note 12, at 734.

86. Harry Grubert & John Mutti, *Do Taxes Influence Where U.S. Corporations Invest?*, 53 NAT'L TAX J. 825, 835 (2000).

87. *Id.* at 831.

88. *Id.* at 835.

## IV. NEEDED CHANGE? A CONSUMPTION ALTERNATIVE

Most of the world's consumption taxes are a form of a value-added tax (VAT).[89] Generally implemented, a VAT is a single tax paid at each stage of production, calculated by subtracting the value of purchases from the value of sales.[90] A VAT is not a general tax; rather, there are usually many businesses exempt from paying VAT.[91] More specifically, there are two generally recognized exemptions to the VAT: one is for items legislatively exempted, and the other is for tax credits to offset VAT payments made during earlier stages of production.[92] A credit is provided for exported items because the typical VAT is a territorial system whereas exports are sold extraterritorially.[93] By providing an export credit, policymakers hope to make goods more competitive abroad. As noted above, although currency values adjust in the long run to cancel out any competitive advantage, evidence indicates that in the short run, instituting a border adjustment should create a short–run competitive advantage for the United States.[94]

The adoption of a consumption tax will benefit the United States because it will induce positive behavioral changes at the international level. Behavioral economics posits that the income tax is perceived as penalizing hard work, punishing ambition, and constraining freedom.[95] In contrast to an income tax, consumption taxes encourage saving and investment.[96] Other related features of a consumption tax include a broad tax base and increased simplicity that will reduce the drag of inefficient compliance costs.[97] The actual behavioral results of tax reform are highly debated and economic

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89. Arnold C. Harberger, *Principles of Taxation Applied to Developing Countries: What Have We Learned?*, *in* WORLD TAX REFORM: CASE STUDIES OF DEVELOPED AND DEVELOPING COUNTRIES 25, 27–28 (Michael J. Boskin & Charles E. McLure eds., 1990).

90. MICHAEL J. GRAETZ, THE DECLINE (AND FALL?) OF THE INCOME TAX 199 (1997).

91. Harberger, *supra* note 89, at 30.

92. Hunter R. Clark, Amy Bogran & Hayley Hanson, *The WTO Ruling on Foreign Sales Corporations: Costliest Battle yet in an Escalating Trade War Between the United States and the European Union?*, 10 MINN. J. GLOBAL TRADE 291, 311–12 (2001).

93. *Id.*

94. Musgrave, *supra* note 73, at 420–21.

95. Frank E. Guerra & José Luis Barrios Ramos, *Analysis of the Effects of a Consumption Tax in Puerto Rico*, 42 REV. D.P. 1, 6 (2003); Marjorie E. Kornhauser, *The Morality of Money: American Attitudes Toward Wealth and the Income Tax*, 70 IND. L.J. 161 (1994).

96. Federal Reserve Board, Testimony, Chairman Alan Greenspan, The Tax System (Mar. 3, 2005), http://www.federalreserve.gov/boarddocs/testimony/2005/ [hereinafter Greenspan Testimony].

97. *Id.*

models do not provide consistent predictions, but some general observations can be made. For example, under any consumption tax proposal currently under serious consideration, businesses would no longer have to pay taxes on income earned outside the United States and foreign investment would no longer be taxed.[98] In addition to reducing administrative costs of businesses and investors, a consumption tax would eliminate business and investors concerns about repatriated profit, which are taxed under the current system.[99] Most consumption tax proposals would only lightly tax capital and would incentivize shifting income from high tax areas to the United States.[100] Domestic taxation problems, however, would be created under certain consumption tax proposals, such as the VAT, because, internationally, income is not defined consistently.[101] Businesses would pressure Congress not to recognize certain types of income as foreign source income where foreign countries are not likely to recognize the income as such, allowing certain income-producing activities to go untaxed.[102]

In contrast to the VAT-style taxation of business inputs, sales taxes, as implemented in U.S. states, are focused on the sale of goods.[103] As applied in the United States, sales taxes are not general taxes. Individual states usually exempt the sale of services, food, housing, and clothing from sales taxation.[104] State governments also vary their intrastate rates of taxation, which increases the costs of administering the system.[105] Furthermore, as noted earlier, regarding income taxation, providing tax-favored status (such as exemption on any good or service from taxation) shrinks the tax base, which requires higher levels of taxation to collect a particular amount of tax revenue.

The use of a national sales tax as proposed in the Fairtax Plan is a better system than traditional state sales taxes. As with all consumption taxation systems, savings and investment are exempt from taxation.[106] But rather than applying to the sale of all goods, the Fairtax Plan only applies to the sale of new goods and services.[107] Secondary market transactions are exempt from taxation, thereby preventing double taxation.[108] Unlike the current U.S. tax system,

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98. Ballard, *supra* note 23, at 119.
99. *Id.* at 120.
100. *Id.* at 121 (predicting that all else equal, low capital tax rates in the United States would incentivize transfer-pricing schemes).
101. *Id.* at 123.
102. *Id.*
103. GRAETZ, *supra* note 90, at 199.
104. *Id.* at 200.
105. *Id.* at 205.
106. Americans for Fair Taxation, *supra* note 22, ¶ 28.
107. *Id.*
108. *Id.*

the Fairtax Plan does not grant taxpayers any exemptions from the sales tax on finished new goods and services.[109] Because the Fairtax Plan taxes services, it is broader than the typical state sales tax, which does not tax services. Business inputs, which include "business to business purchases for the production of goods and services," are not subject to taxation.[110] By only taxing retail goods and services, the lack of disclosure caused by embedded taxes on purchases of goods and services is eliminated.[111] Embedded taxes result from the taxation of businesses, which pass the costs of taxation onto the owners, consumers, or employees either through lower profits, higher prices, or reduced employee wages.[112] With the VAT, taxes are embedded in all non-exempt goods. To the extent that taxes are borne by consumers, removing taxes on business inputs, a feature of the Fairtax Plan, makes consumers aware of the full extent of the governmental tax burden.

Consumption taxes are more efficient than income taxes and increase the aggregate amount of savings and investment, resulting in long-term welfare benefits. Though consumption taxes—as with any tax—negatively affect a country's economy, the negative effects are substantially less than those under an income tax.[113] Despite differences in the estimates of aggregate benefits, most economic models show that consumption taxes create fewer distortions than income taxes.[114] For example, one of the distortions created by income taxation and addressed by consumption taxation is the disincentive to save.[115] Negatively stated, income taxes encourage spending because income taxes punish savers by lowering rates of return on investment.[116] In contrast, by exempting savings and investment from taxation, consumption taxes encourage saving and investment, the existence of which is necessary for economic growth.[117] Therefore a transition from an income to consumption tax reduces the tax burden on growth and welfare, setting the stage for economic growth.[118]

If the United States changed its tax structure to a consumption tax, foreign investment would increase in the short run. Foreign investors would want to benefit from zero taxation on the return of

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109. *Id.*
110. *Id.*
111. *Id.*
112. *Id.*
113. Milesi-Ferretti & Roubini, *supra* note 19, at 739.
114. *Id.* at 723.
115. *Id.* at 732.
116. *Id.*
117. *Id.*
118. *See id.* at 739 (reiterating the assumptions and variables of the model used).

their investment, thereby increasing the real return on investments in the United States.[119] Professor Dale Jorgenson's model shows that a consumption tax would create an increase in investment of 4.9%, in real terms, relative to investment rates under the U.S. income tax.[120] The investment increase, however, is estimated to decline over a period of ten years, until the relative investment advantage is completely eroded.[121]

Although the economic benefits from adopting a consumption tax are eventually lost, the short-term influx of investment into the United States would instigate change of its borders. The United States is a large country both economically and demographically, and as such, is more attractive to foreign investment relative to smaller countries with similar and sometimes more advantageous tax codes.[122] For instance, some studies suggest that following a unilateral change to a consumption tax like the Fairtax Plan, the increased investment in the United States would cause Europe to lose an estimated five percent of its capital stock.[123] A unilateral change by the United States will put downward pressure on all countries to lower their taxation of investment and savings.[124] Countries that do not respond to the competitive pressure will risk a capital flight similar to that which occurred when the United States eliminated the withholding tax on foreigners in 1984.[125]

## V. CRITICISMS OF CONSUMPTION TAXES AT THE INTERNATIONAL LEVEL

### A. *Consumption Taxation may be Unfairly Biased Toward Immobile Sources*

One criticism of consumption taxes is that they are unfairly biased toward immobile sources such as labor.[126] Some critics argue that because a sales tax is necessarily predicated on spending, immobile taxpayers—such as the poor—are disproportionately

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119. Guerra & Barrios Ramos, *supra* note 95, at 7.

120. Dale W. Jorgenson & Peter J. Wilcoxen, *The Long Run Dynamics of Fundamental Tax Reform*, 87 AM. ECON. REV. 126, 127 (1997).

121. *Id.*

122. Andreas Haufler & Ian Wooten, *Country Size and Tax Competition for Foreign Direct Investment*, 71 J. PUBLIC ECON. 121, 136 (1999) (providing that, all things equal, firms prefer to locate foreign productive assets in larger countries due to the larger available market).

123. Enrique G. Mendoza & Linda L. Tesar, *The International Ramifications of Tax Reforms: Supply Side Economics in a Global Economy*, 88 AM. ECON. REV. 226, 238 (1998) (assuming a 29% consumption tax).

124. *Id.* at 244.

125. Avi-Yonah, *supra* note 9, at 1576.

126. *Id.* at 1613.

affected because the purchase of necessities takes up a larger percentage of their disposable income as compared to the rich, who have more disposable income and are able to save more and accumulate even more wealth.[127] Critics are also concerned about the danger of placing excessive taxes on labor, finding that high taxes correlate with low job creation, a disincentive to work, and the driving of consumption overseas.[128] At the international level, concern over the taxation of immobile sources is a partial repackaging of the apprehension over international tax competition and the global decline of taxes on savings and investment—the so-called "race to the bottom." The argument assumes that because countries are frightened of losing foreign savings and investment, they will be less likely to tax capital and the tax burden, once borne by capital, will be shifted to labor.[129] As a result, because labor cannot be taxed without limit, tax revenues will be smaller and will not equal the amount needed to equal governmental expenditures, and in traditionally high tax countries will endanger the "social consensus" regarding the importance of the welfare state.[130]

Assuming the criticism above is completely valid, its applicability would be reduced through the adoption of the Fairtax Plan, which includes no exemptions on the consumption of new goods and services.[131] A broad tax-base ensures the lowest possible tax rate by spreading the tax burden and reducing the distortionary and anti-growth effects of high consumption taxation.[132] By reducing distortion, the Fairtax Plan will enable the United States economy to grow at an increased rate.[133] Distortion is reduced because the Fairtax Plan is a general tax, which does not tax-favor the consumption of any new good or service.[134] Furthermore, the focus on immobile sources is deceptive because implicit in the argument is that taxes paid on savings and investment will not ultimately fall on the consumer. This assumption is incorrect. Not only do such taxes fall on business owners, they are passed down to consumers and workers through higher prices and lower compensation.[135]

The idea that consumption taxes truly shift the tax burden from capital to labor is overstated. As previously noted, the incidence of

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127. *Id.* at 1624.

128. *Id.* at 1578.

129. Michael A. Livingston, *Blum and Kalven at 50: Progressive Taxation, "Globalization," and the New Millennium*, 4 FLA. TAX REV. 731, 742 (2000).

130. Avi-Yonah, *supra* note 9, at 1578.

131. Americans for Fair Taxation, *supra* note 22.

132. Greenspan Testimony, *supra* note 96.

133. *Id.*

134. Americans for Fair Taxation, *supra* note 22, ¶ 1.

135. *See, e.g.*, Richard Dusansky, *The Short Run Shifting of the Corporation Income Tax in the United States*, 24 OXFORD ECON. PAPERS 357 (1972).

capital taxation also falls on labor and consumers; support for this theory has existed for over fifty years.[136] Corporate taxes passed on to workers cause double damage because workers, in addition to receiving lower pay, pay the corporate tax again at the retail level. The approximate level of tax shifting is uncertain, with estimates of tax shifting ranging around 30% in the 1950s to estimates of businesses passing on 100% of their tax burden in the 1970s.[137] Even assuming the most conservative estimate of corporate tax shifting is correct, tax shifting exists at substantial levels. Although some concern about shifting the tax burden to labor is reasonable, the criticism as generally expressed is hyperbolic.

### B. *Are Efficiency Gains a Myth?*

Some academics question the estimated efficiency gains of consumption taxation.[138] For example, Professor Julie Roin argues that the literature generally supports the idea that both income and consumption taxes share the same base, and that the difference between the two is that only two types of capital are favored under a consumption tax: (1) the riskless real return, which is the interest rate equivalent to the interest rate provided by a riskless asset; and (2) the inflation premia, which is the extra interest paid by a borrower to account for expected inflation.[139] Because the tax bases are similar, the only existing efficiency gains would be in the re-taxation of accumulated capital, which already would have been taxed under an income tax.[140]

To support her argument, Professor Roin cites Professors Bankman and Fried, who found that little is gained from switching to a consumption tax because new capital investment continues to be taxed in three out of five categories.[141] The categories of financial capital are: (1) riskless real returns, (2) inflation premia, (3) marginal returns to risk, (4) supernormal returns, and (5) returns on human capital.[142] In their analysis, Bankman and Fried assume an ideal

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136. *See, e.g.*, B. U. Ratchford et al., *The Role of Corporate Taxation—Discussion*, 44 AM. ECON. REV. 535, 535 (1954). Ratchford notes a theory that there is a minimum amount of tax that is born by the corporation that is not shifted. *Id.* at 536.

137. Diran Bodenhorn, *The Shifting of the Corporation Income Tax In a Growing Economy*, 70 Q.J. ECON. 563, 563, 580 (1956); Dusansky, *supra* note 135, at 370.

138. Joseph Bankman & Barbara Fried, *Winners and Losers in the Shift to a Consumption Tax*, 86 GEO. L.J. 539, 539 (1998).

139. Julie Roin, *Competition and Evasion: Another Perspective on International Tax Competition*, 89 GEO. L.J. 543, 579 (2001) (citing Bankman & Fried, *supra* note 138, at 539) (assuming that most commentators believe a consumption tax will improve efficiency and the only argument is the amount of efficiency gains).

140. Bankman & Fried, *supra* note 138, at 566.

141. *Id.* at 542.

142. *Id.*

income tax, with full loss offsets, stable investment prices, and the ability to increase portfolio risk nearly costlessly.[143] Full loss offsets are where investors are allowed to deduct losses to investment from other income.[144] Given those assumptions, Bankman and Fried argue that when an ideal income tax is compared to an ideal consumption tax, the consumption tax will only avoid taxing capital investment related to the inflation premium and the risk premium.[145]

Bankman and Fried illustrate that under an "ideal" consumption tax or "ideal" income tax, some marginal investments are discouraged.[146] They provide that either tax system would increase the marginal cost of business, making some investments unprofitable that would otherwise be profitable in an untaxed world.[147] Although Bankman and Fried's criticism is accurate as applied to some consumption tax proposals, the Fairtax Plan avoids discouraging investment by exempting human capital from taxation.[148] By exempting business inputs, no difference in the level of investment would exist under the Fairtax Plan or in an untaxed world.[149]

### C. *World Reaction*

#### 1. Foreign Response: Potential Effect on Tax Treaties

Some critics, such as Avi-Yonah, are also concerned that switching to a consumption tax would negatively affect the United States because of the negation of tax treaties. Tax treaties form the core of international policy on taxation.[150] The system of tax treaties began in the 1920s and its main function is to eliminate double taxation.[151] Globally, there are more than 1,200 tax treaties.[152] The concern is that because consumption taxes do not tax income from savings and investment, double taxation would cease to be a concern, and therefore would cripple the global tax treaty system by making it irrelevant.[153] By withdrawing from the tax treaties, other countries can and will attempt to capture the tax revenue forgone by the

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143. *Id.* at 543.
144. *Id.*
145. *Id.* at 541–42.
146. *Id.* at 545–46.
147. *See* Bankman & Fried, *supra* note 138, at 545–46.
148. *See* Americans for Fair Taxation, *supra* note 22.
149. Bankman & Fried, *supra* note 138, at 545.
150. Avi-Yonah, *supra* note 9, at 1650.
151. Reuven S. Avi-Yonah, *From Income to Consumption Tax: Some International Implications*, 33 SAN DIEGO L. REV. 1329, 1329 (1996).
152. *Id.* at 1349.
153. *See id.* at 1349–50, 1353.

United States by taxing U.S. foreign investment multiple times.[154] Avi-Yonah argues that because capital, and therefore part of the tax base in a territorial system, will flow from other countries into the United States, countries will begin to tax worldwide returns on investment, transferring the forgone tax revenue in the United States into their own coffers.[155] He further argues that foreign countries are punished through losing investment to the United States as long as the additional taxation was only on the "windfall" profits provided to investors by the United States.[156]

Although it is difficult to predict the actions of foreign countries, concern over an international backlash is not warranted. While the "core function" of U.S. tax treaties *might* be superfluous, the existence of one variable is unlikely to predict another country's foreign policy.[157] Rather, the decisions of any government stem from a multitude of factors. For instance, a foreign county or bloc of countries might be too concerned about economic retaliation should they begin a "tax war." Furthermore, beginning a tax war based on the U.S. domestic policy is not justifiable because there is no international tax organization and no international law to give a foreign country input over another country's domestic taxation policy.[158]

2. Foreign Response: Foreign Changes at the Domestic Level

Professor Avi-Yonah believes that, should the United States act unilaterally in changing its tax system, there will be a negative international response, which has the potential to mute any long term advantage gained by the United States. Countries, especially those in Europe, will be concerned with the spillover effects of the United States' adoption of a consumption tax.[159] Worldwide, some countries will face pressure to stop taxing investment, while others will try to capture the extra investment income not taxed by the United States.[160] Countries will be able to capture the United States' source profits because residence countries retain the right to tax income that goes untaxed in source countries.[161] For example, the OECD has historically adopted norms to tax profits earned on investment and savings in low tax jurisdictions.[162] OECD member

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154. *Id.* at 1353.
155. *Id.* at 1347–48.
156. *Id.* at 1348.
157. *See id.* at 1329.
158. Avi-Yonah, *supra* note 9, at 1649.
159. HARMFUL TAX COMPETITION, *supra* note 1, at 14.
160. Reuven S. Ali-Yonah, *Comment on Grubert and Newlon, "The International Implications of Consumption Tax Proposals"*, 49 NAT'L TAX J. 259, 262 (1996).
161. *Id.* at 261.
162. *Id.* at 262.

nations in particular might avoid losing investment by capturing the United States' forgone taxes.[163] Professor Avi-Yonah suggests that by eliminating deferral and cross-crediting, any windfall gained by corporations investing in the United States will be eliminated, and investment incentives will return to pre-consumption tax levels.[164]

The incentive for tax avoidance will reduce the ability of other countries to capture the tax revenues the United States would forgo by switching to a consumption tax. Raising taxes will only raise the payoff and therefore the incentive to avoid taxation. Contrary to Avi-Yonah's position, investors and savers alike will change their investment behavior, structuring their assets to maximize exempt income in the United States and minimize taxes paid on investment and savings in other countries.[165]

The potential utility of more efficient international capital taxation is greater than the utility of accommodating the desire of other foreign government's to have inefficient tax systems. If foreign countries respond to the United States' adoption of a consumption tax by reducing their own tax rates, such an action would reduce the incentive of foreign corporations and foreign individuals to transfer assets to the United States.[166] Convergence of international investment taxation, due to competition rather than collusion, will create several mutually beneficial outcomes, including a worldwide increase in investment, reduction of resources spent on avoiding taxes, and the reduction of deadweight loss.[167] Thus, a worldwide increase in wealth would be earned.

### D. *Avoidance*

#### 1. Black Market

One source of black market activity is the manner and rate of taxation. Most economic studies find a material link between high taxes and high levels of black market activity.[168] Black market activity is economic activity completed in a manner that avoids tax or

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163. Avi-Yonah, *supra* note 151, at 1348.

164. *Id.*

165. *Cf.* Harry Grubert & T. Scott Newlon, *The International Implications of Consumption Tax Proposals*, 48 NAT'L TAX J. 619, 641 (1995) (predicting that multinational corporations will shift profits to the United States and shift abroad debts that are tax deductible).

166. *Id.*

167. Dale, *supra* note 43, at 52.

168. Friedrich Schneider & Dominik H. Enste, *Shadow Economies: Size, Causes, and Consequences*, 38 J. ECON. LITERATURE 77, 82 (2000). There is a vast amount of literature about black markets and this Note only scratches the surface of the literature.

regulation.[169] While the central aspect of black market activity—trade—is not bad in and of itself, black markets are associated with outcomes that governments try to minimize, such as reducing tax revenues, narrowing the tax base, and acting as an outlet for organized crime. Rampant black market activity creates competitive pressure for others to avoid taxes to be able to offer the competitive lower price, which, in turn, lowers tax revenue.[170] The problems associated with black markets require more than strict enforcement of laws; curtailing black market activity requires a tax system that will reduce attempted black market activity by creating a perception of fairness.

Changing the U.S. tax code to a consumption tax will potentially create an increase in black market activity. Indirect taxes such as those under the Fairtax Plan provide incentives to sellers to undercut competitors by avoiding the sales tax.[171] Under the Fairtax Plan, the opportunity to reap large profits exists where the buyer and seller avoid the sales tax and split the tax savings between themselves.[172] Facing the danger of being undercut by black market activity, competition might become more difficult for non-avoiders.[173] Cigarette smuggling in the United States is a classic example of the incentive that consumption taxes give to black marketers. A case study completed in 1993 revealed that maximum variation in cigarette prices in the United States was 63.5 cents per pack and that as early as 1977, smuggling cost high-tax counties 391 million dollars.[174]

The possible incentive for black market activity should serve as a warning for legislatures to keep taxation of consumption at a broad base and as low as possible. While there are always compliance costs in enforcing a taxation system, it is essential to reduce enforcement costs by ensuring that the tax implemented is perceived as fair.[175] Perception is important because taxes perceived as fair have higher voluntary compliance than taxes perceived as unfair.[176]

The success or failure of tax systems correlates to the honesty of the taxpayer and the taxpayers' perceptions of the tax system.[177] Fair

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169. *See* John McLaren, *Black Markets and Optimal Evadable Taxation*, 108 ECON. J. 665, 665 (1998).

170. *See id.* at 670.

171. *Id.* at 667 (assuming a competitive and perfectly elastic market).

172. Guerra & Barrios Ramos, *supra* note 95, at 14.

173. *See, e.g.*, McLaren, *supra* note 169, at 668–70.

174. Bruce Bartlett, *Cigarette Taxes, Smuggling, and Revenues*, 63 TAX NOTES 1493, 1496 (1994).

175. Leo P. Martinez, *Taxes, Morals, and Legitimacy*, 1994 BYU L. REV. 521, 548–50 (1994).

176. *Id.*

177. Thomas Earl Geu, *Professor T.S. Adams (1873–1933) On Federal Taxation: Deja Vu All Over Again*, 10 AKRON TAX J. 29, 31–32 (1993) (relating the opinion of

tax laws promote a perception in the taxpayer that obedience to the laws is morally grounded, as is punishment for violating those laws.[178] Illustrating this principle is the fact that reported income in the United States' 70% tax bracket in 1917-1918 fell by 46% after a high tax rate was instituted.[179] This decrease was in large part attributable to the perceived unfairness and excessiveness of the tax rate.[180] Put differently, a tax system that is perceived as fair will result in fewer instances of tax avoidance. Should tax arbitrage become a serious problem, the United States could bear significant compliance costs.

## VI. CONCLUSION

Advocating change in the international norms of taxation requires recognition that taxation is about more than economic efficiency.[181] For example, the fairness of the tax burden played a large role in the different gradations of income tax in the United States.[182] The issue of fairness even played a role in League of Nations meetings on international taxation.[183] At the international level, however, given the increased mobility that globalization has given capital, esoteric notions of equity seem less relevant because of the high economic stakes.

This Note recognizes that there are many domestic issues that surround the adoption of a national sales tax. Consumption taxes dampen demand for the taxed goods and services; therefore, adopting the Fairtax Plan would result in a partial tradeoff, providing a preference for more investment and savings relative to more consumption.[184] Professor Michael Graetz noted that "if economic efficiency were the sole goal of tax policy, we would tax wages or consumption, but not income."[185] Although in the long run an efficient system of international taxation would leave everyone better off, Graetz's insight parallels an insight of John Maynard Keynes: "in the long run, we're all dead."[186]

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early income tax proponent Thomas Sewell, who helped shape the modern income tax system)

178. Martinez, *supra* note 175, at 550.

179. Geu, *supra* note 177, at 32.

180. *Id.*

181. Graetz, *supra* note 72, at 1392–93.

182. *Id.* at 1393.

183. *Id.* at 1394 (describing that rival economists Edwin Seligman and T.S. Adams both believed fairness to be a prime issue in international taxation).

184. Guerra & Barrios Ramos, *supra* note 95, at 10–11.

185. Graetz, *supra* note 72, at 1381.

186. *See* JOHN MAYNARD KEYNES, MONETARY REFORM 88 (1924).

A general problem with tax research is that it focuses on ideal models. Other than the VAT and a few versions of sales taxation, most of the ideal models advocated by economists and tax attorneys are untested and would certainly create unforeseen results. Further, as central governments have not shown the capability to resist tinkering with the tax system, ideal tax systems will assuredly not remain ideal.[187] The U.S. tax system has careened between the poles of economic efficiency and benefiting special interests, and lawmakers may very well find ways to subvert the benefits of the Fairtax Plan for short term political gain.[188] As noted by former Federal Reserve Chairman Alan Greenspan, reform of the U.S. tax code will require assessment of "tradeoffs between complexity, fairness, and economic growth."[189] The next step in analyzing individual tax proposals is to more thoroughly study the separate issues surrounding the Fairtax proposal.

Although contentious domestic issues remain, at the international level, the potential short- and long-term economic gains of adopting a consumption tax in the United States enormously outweigh the potentially negative aspects of its adoption. In particular, the Fairtax Plan addresses several of the valid criticisms of consumption taxation. Internationally, the United States' adoption of the Fairtax Plan will benefit other countries. By putting additional pressure on countries to reduce taxes on international savings and investment, assets will flow more like they would in a free market. Under the Fairtax Plan, the most productive investment opportunities will receive more assets, reducing waste caused by tax incentives. Although some countries, such as those in the European Union, are skeptical about changing the status quo, these states should and likely will ultimately embrace a system that will enhance their ability to create wealth.

*Matthew McMahan**

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187. *Cf.* Greenspan Testimony, *supra* note 96 (describing how the U.S. government changed the tax rates shortly after the 1986 tax reform passed).

188. *Cf. id.*

189. *Id.*

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