Dr. Robert F. van Brederode
126 Sherman Hill Road, C11
Woodbury, CT 06798
860-921-1973
Herrundhund@charter.net
robert.vanbrederode@nyu.edu

Commission on the
21st Century Economy
c/o Mr. Gerald Parsky, chairman
915 L Street, 8th Floor
Sacramento, CA

Woodbury, 22 september 2009

Dear Mr. Parsky,

It is my pleasure to herewith submit some general comments on the Commission's VAT proposal, triggered by remarks made by my esteemed colleague professor Richard Pomp in his memos 'Why I Think We are Heading in the Wrong Direction' and 'Will The Net Business Receipts Tax End Up As An Income Tax?' I will limit my comments to certain topics where I believe my expertise may add some value and it is not my intention to discuss every detail of your legislative proposal.

By way of an introduction I am attaching my CV and List of Publications. In short, I am a tax lawyer educated in Europe with over 25 years of experience in VAT, practicing on both sides of the Atlantic. Formerly a partner with PricewaterhouseCoopers, leading the Netherlands VAT practice and a professor of tax law at the Erasmus University, School of Economics, I am currently in solo practice from Connecticut and an adjunct professor at New York University, School of Law. I am one of the relative few people who actively combine academics and consulting in the field of consumption taxes.

1) Elimination of the Corporate Income Tax

The Corporate Income Tax (CIT) does not align well with the irreversible trend of globalization and the enhanced mobility of labor and capital. It is a misconception to believe that corporations actually pay the tax. The tax burden is either shifted forward in the prices of the goods and services produced, or shifted backwards to the labor and capital factors. Shifting forward is increasingly more difficult in an open global economy, and a business operating in a country that relies more on direct tax than on indirect tax for generating the revenue needed to fund the public sector find themselves at a competitive disadvantage, because direct taxes cannot be rebated under current WTO rules where indirect taxes can. With Japan, the US has the highest CIT rate in the world. It is significant and indicative in this respect that traditionally high tax countries in the EU all have reduced their CIT rates. In the US, state CITs are levied in addition to the federal CIT which magnifies the negative effect on competitiveness. A shift from direct tax to indirect tax is, therefore, a natural one, unless we would intend to eliminate the export sector of our economy.

For that reason, I support the Commission in its courageous proposal to eliminate the State CIT.

I disagree with my colleague where he states that the CIT is in fact a progressive element into the tax system that taxes shareholders. Where shifting forward is only possible to a very limited extent, the CIT will likely be shifted backwards. Shifting backwards to the capital factor has its limitations as well, because it would make a Californian company less attractive to investors and, in the long run, would reduce a company's ability to raise sufficient capital. Most economists believe that the CIT is for the most part a tax on labor. Contrary to Mr. Pomp's statement, eliminating the CIT would not constitute a tax cut for the privileged few.

Also, it follows from the above, that the Commission is not inconsistent in retaining the personal income tax and eliminating the CIT as Pomp suggests.

2) Regressivity of the Net Receipt Tax

The idea that the VAT is regressive has grown into an axiom. As a result, everybody seems to be mimicking platitudes to demonstrate their alignment with what is currently held to be politically correct. Something along the line of the character of the deputy chief of staff in the drama series the West Wing: "a VAT is wrong because it is regressive, which means that the poor pay more tax than the rich."

But is it true?

Measured as a percentage of income, it is generally true, primae facie, that low income groups pay more tax than higher income groups. That is simply so, because low income households will spend all their income and higher income households have the ability to save. However, with the exception of the very rich, saving is in fact postponed consumption. Poor and rich are not only relative classifications, most people cannot be categorized in the same group all their lives. Most people start within the category of low income group, reach their peak in income around middle age and have to do with less again when they enjoy retirement. Therefore, arguably, it is more correct to look at the effect of a tax over the lifetime of an individual than over an arbitrary selected time capsule. Based on annual tax incidence, a VAT is regressive; based on life cycle incidence, a VAT is proportional. I do not consider regressivity to be a valid argument against VAT.

3) Border Tax Adjustments under the NBRT

Pomp is correct that there is only limited experience in the US with a net receipt tax, since Michigan introduced it only in 2008. However, Japan has a direct subtraction VAT (which is the same) since April 1989. Pomp claims that under such a tax it is impossible to tax importations and rebate tax upon exportation, unlike the European style credit invoice method VAT. Let me just say that Japan does both: it taxes imports and is able to relieve exports from the tax burden. Pomp is simply wrong in his statement that such in impossible.
Taxing imports poses a constitutional challenge, but I don't see why this cannot be overcome by reversing the liability for the import VAT to the (business) recipient as is done in the EU.

Under a typical subtraction VAT, the taxable base is calculated by subtracting procurement or input from sales or output and apply the tax rate to the difference; (output – input)t. In a simple example: if total sales are 100 and total procurement is 50, at a tax rate of 10%, the tax due would be (100 – 50)10% = 5. Exports are exempt by first deducting export sales from total sales before applying the formula. Thus, if exports are 10: [(100-10) – 50]10% = 4.
Only in the case of a net exporter, should an actual refund be paid out. Pomp claims that such a refund cannot be calculated. I don't see why not. A net exporter has no taxable output, but would still retain his right to deduct inputs. Thus: [(100-100) – 50] 10% = (5).

Pomp points out several difficulties with cross-border services. Without proper design, economic distortions may occur. However, these problems are not new and have been resolved under the VAT in other countries, mainly by applying reverse charge rules. Exported services can be exempt to ensure a level playing field abroad and imported services can be taxed by shifting the liability to the recipient, which would not violate the Constitution and would avoid nexus issues.
The only remaining problem would be sales of goods and services from out of state directly to in-state private consumers. Shifting the tax liability to the consumer won't work as is proven by the low voluntary compliance of individuals with the use tax. There are existing models that tackle this issue, but in the US context any non-physical presence nexus standard will operate under the threat of the constitutional Damoclesian sword. But then, this is not different from the current situation under the sales and use tax.

4) Elimination of the State Sales and Use Tax

The NBRT partly serves to replace the current State Sales & Use Tax. Pomp is correct that the choice could have been made to improve the SSUT instead. VAT and retail sales taxes are close cousins and have the same economic effect in the sense that they are both taxes on private consumption if designed well. They are the response to the disadvantages associated with a gross receipt tax. Basically, under a GRT the effective tax rate of a product will depend on the length of the supply chain due to tax pyramiding. VAT solves that by allowing credit for either inputs (subtraction VAT/ Net Receipt Tax) or for the tax paid on inputs (Credit invoice method VAT which allows for the tax paid on inputs to be credited against tax due on output). Instead of tax credits, a RST provides exemptions for non-retail sales. In reality, the RST is to a large extent borne by businesses due to the incompleteness of the exemptions. To that same extent, the RST functions as a GRT with all the associated economic distortions. Improvement of the RST is an option of course, but I support the choice for a consumption that is more in line with the rest of the world, because that would also improve chances and effectiveness of international tax coordination and cooperation.

5) Is the NBRT a tax on Consumption or on Income?

This is a very important issue raised by professor Pomp. Generally, and I hope you forgive me for lecturing a bit, taxes are classified in terms of incidence as either direct or indirect and in terms of scope as product type, income type or consumption type. It does not require many modifications to change a tax from direct to indirect or vice versa, or from income type to consumption type or vice versa. In fact, value added is conceptually very similar to net income under the US corporate income tax. Pomp is certainly justified in cautioning against incorporating features into the NBRT which would make it resemble an income tax. The more it resembles an income tax the likelier it will be perceived and treated as such. Pomp rightfully pointed out the risk of any nexus provision to render invalid under PL 86-272. In addition, rebates of tax related to exports would become questionable under WTO rules and would likely trigger opposition from trading partners and lead to legal disputes and procedures.
If a consumption is to be introduced, it is best to keep its design as close as possible to the theoretical ideal model.

6) Why not the Credit Invoice Method VAT?

About 150 countries in the world, including all major US trading partners apply the credit invoice VAT. It has a proven track record of success, and a relative long history to allow a comparative best-practice study to select the design features most appropriate for California. There are four (4) main principle reasons why this VAT is universally preferred over the addition and subtraction VAT.

- The tax liability is attached to the transaction, which makes it superior from a legal and technical perspective

- The audit trail created by mandatory invoicing on a transaction basis
- It can accommodate multiple rates
- It is more practical because the tax liability can be calculated on a weekly, monthly, quarterly or annual basis.

In addition, under a NBRT businesses sell their product on a tax inclusive basis, i.e., they are assumed to raise their prices with the new tax. If before the introduction of the tax, a business total sales in a year are 100 and its total procurement is 50, a business must raise its prices with the taxes, e.g., 10%, and sell for 110 and will incur raised procurement costs totaling 55, thus paying tax over the difference of 45, being its value added. Tax shifting is assumed under a net receipt tax. Without it, the tax would be a business tax. The credit invoice method VAT offers a more visible mechanism for tax shifting, since the tax is added to the price. For that reason it is also more readily accepted as a consumption tax and be less vulnerable to inclusions of features that would clearly violate its character as such (see, supra, under 5).

Conclusions

Professor Pomp's main criticism lies in the lack of ability of the NBRT to accommodate border tax adjustments and the presumed regressivity of the tax. Neither of them are true. His defense of the CIT is rooted in a axiomatic belief in the moral superiority of income taxes, but does not reflect the economic reality of the 21st century with virtually open markets, including those of labor and capital, and increasing international competition. High corporate income taxes put US companies at a competitive disadvantage in foreign markets and strongly reduces the attractiveness of the US as an investment country.
It is imperative that the NBRT in its design remains close to the ideal theoretical model of a consumption tax. Otherwise, and I concur with my esteemed colleague in this respect, the risk arises of political pressure to accommodate certain interests via design features that do not belong in a consumption tax and which may trigger counter-productive and harmful consequences for California. A Credit invoice method VAT would serve California best, not only from a technical and practical perspective, but also because it is clearly the dominant tax of the 21st century and would align California fiscally with the rest of the world. Introducing such a VAT would also boost California's ability to participate in international tax cooperation and coordination efforts.

Sincerely,

Dr. Robert F. van Brederode
New York University, School of Law
International VAT Consultants