The Daily Dish

The WTO and Tax Reform

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On Wednesday the Environmental Protection Agency (EPA) announced that they will begin their review of the Obama Administration's methane rule. EPA Administrator Scott Pruitt said that the review is simply the EPA "continuing to follow through with President Trump's Energy Independence Executive Order." The repeal of the methane rule was a part of President Trump's Energy Independence Executive Order which was signed in March.

Yesterday the Federal Communications Committee (FCC) voted 2-1 to reinstate the Ultra-high frequency (UHF) discount, thereby easing the restrictions on media ownership. Under the UHF policy, some television outlets "count less" toward the household limit for major broadcasters. The UHF discount was done away with in 2016 under the Obama Administration.

Eakinomics: The WTO and Tax Reform

The WTO is the World Trade Organization, which exists to support international trade. Tax reform is the permanent restructuring of the U.S. tax laws to transform the core economic growth. Yet one often hears that U.S. tax reform — the House Blueprint, in particular — will get nullified by the WTO. What is going on?

A danger to international trade is unfair subsidies on exports or protective tariffs or quotas on imports. To address these issues, the WTO's predecessor — the General Agreement on Tariffs and Trade or GATT — developed rules for "Subsidies and Countervailing Measures" (SCM) to identify and punish unfair trade practices. Since there is little practical difference between subsidizing an export and a targeted tax break for all exporters, it is inevitable that tax policy would get dragged into negotiations that led to the SCM agreement.

During the early postwar, the U.S. fully participated in these negotiations, but ultimately cut a bad deal. The SCM permits "indirect taxes" — those levied on a product like a sales or Value Added Tax (VAT) — to be "border adjustable"; that is, applied to imports but exempted for exports. As it turns out, VATs are the dominant tax used by many developed country competitors to the United States. In contrast, "direct taxes" — income or profit taxes — are not permitted to be border adjusted. The distinction between direct and indirect taxation is economically vacuous. I can be $100 poorer because of a sales tax or because of a tax on profits distributed by dividends or because of a income tax on my wages. There is no logic for one to be viewed a substantively different from the other.

Unfortunately, the existing WTO rules mean that when U.S. exports arrive in a VAT country, they bear the U.S. corporation income tax and are subject to the VAT because the U.S. cannot border-adjust its income taxes. Similarly, goods from a VAT country arrive in the U.S. exempt from the VAT (because of border adjustment) but cannot be subjected to the U.S. corporation income tax. The tax playing field is simply not level.

Enter the House proposal: a cash-flow tax. It is (roughly) calculated by looking at the difference between the value of revenues and the value of purchases from other businesses — i.e., value added — and then also subtracting off the value of employee compensation. It is also border-adjusted and therein lies the rub. Is this tax system simply another form of corporation income tax? Or is it simply a VAT with an additional tax break for domestic employment? Or is it something different altogether?

Many tax scholars side with the income tax interpretation, invoke the SCM rules on direct taxes and argue that it is a violation of the WTO rules to apply border adjustment. Others, especially among economists, argue that the WTO has already blessed border-adjustment of VATs and has no jurisdiction over whether a country provides tax-based labor subsidies

Personally, I think the right answer is that the meaningless direct-indirect distinction should simply be removed. WTO rules were not handed down in stone tablets on a mountain top. They were negotiated by member nations and are subject to re-negotiating. Regardless of whether or not the U.S. does tax reform in 2017, the issues raised by the House Blueprint will not go away in the 21st century and should be settled as soon as possible.