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CONSUMPTION TAX REFORM IN AMERICA: UNDER THE RADAR – BUT UNDERWAY

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The Trump Administration has successfully introduced major income tax reform in the US. There has been extensive media coverage of these important reforms which are significantly focussed on providing corporate tax relief for large transnational US companies.

But what about reform of consumption taxes – the taxes which apply when Americans purchase goods or services?

As it happens, the US is a striking outlier when it comes to taxing consumption.

In almost all developed economies – and many still developing economies (for example, China) – a Value Added Tax (VAT) is a key part of the public revenue landscape. VAT is called a Goods and Services Tax (GST) in many countries but the operating principles are the same.

With a VAT, tax is paid, from the outset, at each point of any production process. A rebate system is built in for each producer within the value-adding chain. Eventually the consumer pays the full VAT upon final purchase. From a public revenue viewpoint a VAT is very effective. Tax is collected as soon as the first sale to the next-in-line in a given production process occurs. Moreover, a VAT is significantly self-enforcing as producers able to claim a rebate report all the relevant cost figures to which the VAT applies in full to the tax authorities.

The US does tax consumption but mainly through a set of older style, single application, State level retail sales taxes. These vary widely from State to State. They are measurably inefficient compared to a VAT and easier to evade.

There has been debate in the US for some time about the need to introduce a VAT. Movement has been close to zero. Puerto Rico - not a State but an *unincorporated territory* of the US - planned to introduce a VAT in 2016 as it tried to deal with a recent debt crisis but the VAT was repealed before it took effect.

This lack of progress is not surprising. Proposals to introduce a new VAT always give rise to intense debate. This has happened in New Zealand, Canada and Australia prior to their applying GST regimes in 1986, 1991 and 2000, respectively. And we should not forget that the US, despite planning and debate stretching back over 200 years, has not been able to agree on moving to a comprehensive metric system of basic measurement – a beneficial reform with no inherent *black-cloud* .aspects of the sort which typically over-shadow tax reform proposals. (In 2018, the US was listed as only one of seven countries worldwide not to have formally adopted the metric system for weights and measures. Other included, Myanmar (Burma) Liberia and several US associated micro-nations in the Pacific.)

If formal VAT reform is going to happen in the US, it will require a combination of resolute leadership able to create political will and probably a serious public revenue crisis.

The current rather remarkable President of the US is certainly resolute. And, as we will see, the US is arguable already caught within a serious public finance crisis. It is, though, a boiled-frog crisis (place a live frog in very hot water and it will immediately jump out – place a live frog in cold water and slowly raise the temperature and the frog will remain put until it is cooked to death).

President Trump is strong on break-through policy-making. Suppose he took the view that a VAT might be a rather good way to help rebalance the massively indebted US budget system (which is true, as it happens). Donald Trump contemplates announcing that he is going to push for a VAT in the US. Within a pico-second, shrewd politician that he is, he would work out that this would make him about as a popular as a rattlesnake in a lucky-dip: no thank you – a tremendously bad idea.

Yet, thanks to Trumps' trade war on China, in particular, the US may be about to experience a massive sample of just what a new, very large consumption tax will taste like.

The US has imposed three rounds of tariffs, so far, on Chinese goods imported into America. In July and August this year, the US imposed a 25% tariff on a total of US$50 billion worth of Chinese imports. From September 24, 2018, the US imposed a fresh tariff of 10% on a further US$200 billion of US imports from China alone. This latest tariff is set to rise to 25% from January 1, 2019 unless some new trade deal is negotiated between the US and China. This would take the total of Chinese imports to the US subject to a 25% tariff to around US$250 billion.

Plans are afoot to apply US tariffs to another US$267 billion of Chinese imports if President Trump cannot force China to make concessions which he is prepared to accept (but which remain loosely specified). If implemented, this will take the total value of Chinese imports subject to US tariffs to over $500 billion.

The result is sure to be a significant tax-based lifting of sticker prices across a huge range of goods being sold in the US. The US today depends on China to supply lower cost, decent quality consumer goods on a massive scale.

This is a type of *stealth-bomber* consumption tax: consumers are told this is all part of a master plan to *Make America Great Again*. They are not, however, told that they, the consumers, have to pay the Federal Government a great deal to take on this project. In essence, the message to US voters from Donald Trump is: *I talk – you pay*.

President Trump has let the cat out of the bag to a degree with comments noting with warm approval how much extra revenue will now flow into federal coffers from the new tariffs. He has also occasionally, but tellingly, spoken of the need to reduce Washington's huge public debt load.

The President is right to be concerned about the debt level. The Congressional Budget Office (CBO) put the National Debt (of the Federal Government) at US$16 trillion in 2018 - equivalent to 76% of annual GDP. The CBO is forecasting this figure to rise to US$29 trillion by 2028 - equivalent to 96% of GDP. This would be the highest debt level since World War II. The CBO says that a significant component in this huge debt increase (over 12%) arises directly from those recent Trump income tax cuts (noted above) combined with increased Federal Government spending under the current administration. This debt-lift is calculated *after* allowing for the offsetting effect of higher economic growth in the US.

Apart from this pivotal debt predicament, the US is facing massive problems with currently unfunded, growing liabilities within two key welfare programmes: Medicare and Social Security. These unfunded obligations are presently calculated at around US$45 trillion according to the US Government Accounting Office (GAO). When added to the current national debt, total funding obligations which need to be met exceed $US60 trillion, today. These obligations are continuously rising. The GAO says that the US is on a fiscally unsustainable path.

Still, could the tariffs lead to on-shoring of competitive US manufacturing on a significant scale? Do not hold your breath.

Henry Hing Lee Chan argued in the IPP Review recently, that an analysis of the US trade figures so far, post tariff imposition, shows poor indications that substitute sources can step up to the plate - either through alternative non-Chinese offshore suppliers or through commencement of production onshore (see, *"Trade Wars Are Good and Easy to Win": US July Trade Data Says Otherwise*, https://ippreview.com/index.php/Blog/single/id/797.html). Henry Chan goes on to make several important points. First Chinese supplied goods are intertwined in global supply chains. Next, Chinese goods dominate supply across a range of key wholesale and retail supply chains in the US which indicates that US domestic production is uncompetitive or there is no local production. His view, with which I agree, is that it is likely that China will continue to export heavily to the US and that the tariff costs will simply be added to sticker prices and passed through to consumers.

If the on-shoring of manufacturing currently done in China were to gather momentum it would need to overcome two clear US local challenges: finding people, today, in America willing to do such jobs; and, assuming this could be resolved, training enough such persons to impart the skills needed for the relevant work. It follows, frankly, that any successful on-shoring is likely to rely as heavily as possible on using AI (Artificial Intelligence) enhanced robot-based manufacturing.

Although the circumstances are somewhat different, Australia offers a cogent example of what happens when high tariffs attempt to hold out still highly competitive offshore competitors. In the 1970s, the Japanese first seriously began selling cars offshore in Australia. Australian tariffs and other special taxes added around 100% to the landed cost of those cars before they got to the showroom. They still sold swiftly and, soon enough, very swiftly. Australians saw that, despite the massive trade-sales taxes, they offered excellent value for money compared to local products. The last of the Australian-based car-makers closed fairly recently.

The impact of this potentially vast new American tax will be felt by consumers. This will not be not sharply evident until after the US mid-term elections in November this year. But it will bite well before 2020 (if all current plans proceed) when Donald Trump plans to seek re-election.

To get a feel for the impact, consider the following figures. The total amount of all State and local sales tax revenue in the US was recently estimated to be around US$545 billion. Fully implemented, as threatened, the *additional* tariff-based consumption tax would collect over $US120 billion in additional revenue annually. This amounts to an increase in existing sale taxes rates of around 21%. These are large numbers.

Who knows, the US may collectively say, okay, we can live with the impact of this new federal impost on our wallets. And who knows, this stealth tax may yet lay the groundwork for finally arguing successfully that the US needs to adopt a VAT.

Beyond the US, estimates of lost annual global GDP arising from the US instigated trade war range up to US$500 billion. What may be the long term impact on the global standing of the US cannot be predicted with any precision. President Trump's new appointee to the US Supreme Court, Brett Kavanaugh, did recently use an expression which has resonance here, however. As he responded to harsh questioning during heated sessions of the relevant US Senate Committee, he noted that, "What goes around, comes around".

In any event, it is understandable that President Trump (a man who is familiar with the experience of gambling) may feel he has put himself in a *heads-I-win, tails-you-lose* position. If, after applying this quite immense tariff pressure on Beijing, China backs down and says *what do you want?* – he can exultantly declare victory. China looks very unlikely to do this, however. But never mind, in that case, President Trump can relish how those rivers of tariff revenue flowing into the Washington Treasury can help fix America's long-term, debt-driven existential public revenue disorder. That is until voters realize just what a profound change has been implemented within America's consumption tax regime.

In 1688, "The Glorious Revolution", in what we now know as the UK, saw William and Mary become King and Queen of England and Scotland, with crucial support from Parliament. The previous King, James II of England, was forced to abdicate. In 1689, the "Bill of Rights" was passed as part the agreed compact between William and Mary and Parliament. This was, in essence, a Bill of Rights for Parliament (not a general Bill of Rights). Arguable its single most important provision, which applies to this day in many Parliaments across the British Commonwealth, is that the King may impose *no* taxes – only Parliament can impose taxation.

It is intriguing how President Trump's executive imposition of taxation through tariffs highlights a pivotal aspect of perceived bad governance which the Bill of Rights set out to prevent.

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