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Time to Move Past the Proposed Border Adjustment Tax

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Abstract

The House Republican proposal to implement a border adjustment tax (BAT) is intended to remake the corporate income tax. A BAT would tax the full cost of imports and exempt exports. The new tax has divided prominent economists, tax experts, and industry groups between those who think the change is benign and those who see it as a harmful disruption. BAT proponents argue that the reform is part of a larger system of taxes that move the whole tax regime toward a domestic consumption base that does not double-tax savings and investment—a worthy goal that does not require a BAT. The BAT is a significant economic gamble, as it could change economic behavior in ways that may undermine other parts of broader tax reform. Without the BAT, the House tax reform blueprint outlines a very good tax plan that would encourage investment, job creation, and economic growth.

Key Points

- The border adjustment tax (BAT) on imported and exported goods is a controversial and economically risky proposal intended to remake the corporate income tax.
- A BAT would tax the full cost of imports, and exempt exports from the tax. To offset the trade and price distortions from the proposed 20 percent BAT, the U.S. dollar would need to appreciate by 25 percent.
- BATs have divided prominent economists, tax experts, and industry groups between those who think the change is benign and those who see it as a harmful disruption.
- BAT proponents argue that the reform is part of a larger system of taxes that moves the whole tax regime toward a domestic consumption base—a worthy goal that does not require a BAT.
- Without the BAT, the House tax reform blueprint outlines a very good tax plan that would encourage investment, job creation, and economic growth.

The House Ways and Means Committee recently held a long-anticipated hearing that focused on the proposed border adjustment tax (BAT). The controversial proposal to remake the corporate income tax has divided prominent economists, tax experts, and industry groups between those who think the change is benign and those who see it as a harmful disruption.

The House Republican Tax Reform Blueprint proposes to "border adjust" a reformed version of the corporate income tax.[1] Termed a destination-based cash-flow tax (DBCFT), the reform would, among other things, stop taxing revenues from exports and start taxing the cost of imports. Two prominent proponents of the tax have shown that under certain conditions, the end burden of the tax falls on Americans whose investments earn profits,

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wherever in the world those occur.[2] This is a change from the current U.S. system under which the corporate income tax falls primarily on domestic capital and labor.

Proponents of a border-adjusted corporate tax argue that the reform is part of a larger system of taxes that move the whole tax regime toward a less-distortionary domestic consumption base that does not double-tax savings and investment—a worthy goal. Conservatives should support a pure consumption tax with no corporate entity-level taxation. Any steps that Congress takes to move the U.S. toward such a system must be done carefully, without further institutionalizing elements of the current complex and opaque system that has multiple levels of taxation. In the context of the current tax debate, the border adjustment is not necessary for moving toward a consumption base that lowers the tax bias against savings and investment, while the implementation of the new tax would carry substantial economic risk.

House Blueprint: A Good Foundation for Tax Reform

The House blueprint outlines a very good tax plan that would encourage investment, job creation, and economic growth. The proposal lowers tax rates for individuals, businesses, and investors, includes full immediate expensing of capital, removes many special credits, deductions and exemptions, and simplifies those that are left. Unfortunately, the inclusion of the BAT introduces significant and unnecessary economic uncertainty.

The U.S. Would Be Unique with a Border-Adjusted Corporate Tax

Border-adjustment advocates claim that the U.S. is one of very few countries that do not border adjust their taxes.[3] While this is true, it wrongly conflates the corporate income tax with other taxes, such as the VAT, that are also collected at the corporate-entity level, but are analytically distinct because they are a separate tax system most often levied in addition to a country's corporate income tax. If the U.S. were to impose a DBCFT, it would be the only country in the world to border adjust a tax of this type.[4]

No BAT Needed to Eliminate the "Made in America Tax"

Border adjusting the corporate tax aims to remedy the current tax disadvantages faced by U.S. companies, or what some have termed the "made in America tax."[5] The additional tax burden on U.S. business is significantly a function of an unusually high corporate income tax rate assessed on worldwide income. By various measures, the U.S. consistently ranks as having one the highest corporate tax rates in the world.[6] The BAT is an overly complex solution to a simple problem; the U.S. corporate income tax rate is simply too high.

The United States is one of just a few countries that attempt to tax the worldwide income of domestically headquartered businesses. One of the most appealing features of the BAT is that it replaces the worldwide system, removing the current tax disadvantage for businesses that want to headquarter in the U.S. However, a simpler solution is a traditional territorial tax system, where foreign-sourced income is exempt from U.S. taxation.[7] While the

1. Office of the Speaker of the House, "Tax Reform Task Force Blueprint—A Better Way: Our Vision for a Confident America," June 24, 2016.
2. The tax falls on extra-normal or economic profits. Alan J. Auerbach and Michael P. Devereux, "Cash Flow Taxes in an International Setting," Said Business School *Working Paper* No. 2015-3, June 20, 2015, https://eml.berkeley.edu/~auerbach/Auerbach%20Devereux%202-25-17.pdf (accessed May 24, 2017).
3. Chairman Brady Opening Statement at Tax Reform Hearing on Increasing U.S Competitiveness and Preventing American Jobs from Moving Overseas, May 23, 2017, https://waysandmeans.house.gov/chairman-brady-opening-statement-tax-reform-hearing-increasing-u-s-competitiveness-preventing-american-jobs-moving-overseas/ (accessed May 24, 2017).
4. Other countries have consumption taxes, such as VATs, that are border adjusted, but the labor deduction in the destination-based cash-flow tax makes the proposed tax distinct. "Experiences with Cash-Flow Taxation and Prospects," European Commission *Taxation Paper* No. 55, May 2015.
5. House Ways and Means Committee, "Ending the Made in America Tax," https://waysandmeans.house.gov/madeinamerica/ (accessed May 24, 2017).
6. Adam N. Michel, "The U.S. Tax System Unfairly Burdens U.S. Business," Heritage Foundation *Backgrounder* No. 3217, May 16, 2017, http://www.heritage.org/taxes/report/the-us-tax-system-unfairly-burdens-us-business.
7. For a description of how the two systems differ, see Kyle Pomerleau, "A Destination-Based Business Tax Isn't Exactly the Same as a Territorial Business Tax," Tax Foundation, November 23, 2016.

ultimate goal should be the elimination of the corporate income tax, significantly lowering the rate and moving toward a territorial system are good reforms within the context of the current debate.[8]

More Revenue Not Required

The border-adjustment provision in the House blueprint should be recognized for what it is: a new source of revenue. Prominent advocates of the reform seem to agree that the BAT is not necessarily a pro-growth provision, but a revenue raiser.[9] Some argue that the BAT is desirable in and of itself because it is a simpler and less intrusive way to subject all consumption in the U.S. to the same tax rate. But the BAT is not the only way to tax domestic consumption and it is certainly not the best solution, since it has significant real-world implementation difficulties that are not always recognized.

Washington is stuck in a paradigm that forces all tax reform to be revenue neutral. However, systemic deficits and growing debt are not the product of insufficient tax revenue, but of uncontrolled spending. The ever-present constraint of revenue-neutral tax reform is dangerous. It forces Congress to make a false choice between otherwise pro-growth tax reform tied to additional revenue raisers, such as the BAT, and no reform at all. If Congress is serious about addressing the debt, tax reform should be paired with sustainable spending reform.[10]

BATs: Opening the Door to Bigger Government

Notwithstanding any commitments to smaller government made by current political leadership, the BAT lays the groundwork for future governments to expand Washington's reach. First, the proposed BAT is essentially a VAT with a deduction for wages, which are already taxed through the payroll and income tax. If the wage deduction is removed or phased out, the U.S. will be left with the economically destructive combination of a VAT layered on top of the income tax similar to what many European countries use to fund their large and burdensome governments.

Pressure to remove the wage deduction could come from a number of sources. Most immediately, international legal challenges through the World Trade Organization could lead to its removal. Further, a future U.S. Congress could phase out part of the wage deduction to facilitate a desire to raise additional revenue.[11] Although this may seem unlikely as businesses would strongly oppose the tax increase, it could be easy to make the political case that most other countries have a VAT without a wage deduction and it is time for the U.S. to have one, too.[12] Finally, to the extent that destination-based taxes can limit global profit shifting, the new tax will limit the pressures of global tax competition. Without the pressures of tax competition to keep tax rates low, future policymakers will inherit an irresistible source of additional tax revenue, allowing them to more easily raise taxes on future generations.[13]

The Risk of Economic Distortions and Imperfect Policy Design

The economics of this new tax proposal are poorly understood and the subject of academic disagree-

8. A majority of the implementation problems associated with the corporate income tax, VATs, and destination-based cash-flow taxes are a function of trying to tax businesses. Lowering the corporate income tax does not remedy these problems, but would significantly lessen the pressures on income sourcing, expense allocation, and intercompany pricing rules.

9. The Tax Foundation estimates that the border-adjustment tax will have negative 0.4 percent GDP growth. Doug Holtz-Eakin told CNBC that "all of those things [growth from tax reform] can happen with or without the adjustment at the border." Kyle Pomerleau, "Details and Analysis of the 2016 House Republican Tax Reform Plan," Tax Foundation *Fiscal Fact* No. 516, July 5, 2016, https://taxfoundation.org/details-and-analysis-2016-house-republican-tax-reform-plan (accessed May 24, 2017), and Doug Holtz-Eakin on border-adjustment tax, CNBC, 2017, video, https://youtu.be/ZEzaaCi7_MI (accessed May 24, 2017).

10. Romina Boccia and Adam N. Michel, "Pathways for Pro-Growth, Fiscally Responsible Tax Reform," Heritage Foundation *Backgrounder* No. 3219, May 25, 2017, http://www.heritage.org/taxes/report/pathways-pro-growth-fiscally-responsible-tax-reform.

11. Scott Lincicome, "Will House Republicans' 'Border Adjustable' Tax Plan Cause a Trade War? (Spoiler: Maybe Not!)," Cato Institute, January 23, 2017, and Gary Clyde Hufbauer and Zhiyao (Lucy) Lu, "Border Tax Adjustments: Assessing Risks and Rewards," Peterson Institute for International Economics *Policy Brief* No. PB17-3, January 2017.

12. This is similar to the argument being used right now to advocate for the BAT.

13. Citi Research, "Border Tax Adjustments Are Not Benign," January 13, 2017.

ment.[14] What is clear from the available evidence is that economists' models of how border adjustments affect trade flows, currency markets, consumer prices, and internationally held assets are imperfect; and if nothing else, a border adjustment in the context of the House blueprint presents unnecessary economic risks to the U.S. economy.[15]

Advocates of border adjustments rely on several simplified assumptions when making the case that the new tax will be non-distortionary. The two main assumptions are that the adjustment is uniform and permanently implemented, and that international currency markets fully adjust to offset the import tax. To offset the proposed 20 percent import tax and export subsidy, the U.S. dollar would need to appreciate by 25 percent.[16]

Because no other country has implemented a DBCFT, most analysis of this reform is overconfident and not properly caveated because it is either based on simplified academic models or other countries' experiences with border-adjusted VATs.[17]

Ongoing academic and policy debates are not settled on the long-run effects of a border adjustment in the U.S. context.[18] One can, however, learn some things with relative certainty: Currencies do not adjust as models predict, and will likely never fully offset the tax increase.[19] The most obvious reason is that some forms of trade cannot be effectively border adjusted. Tourism and travel, which account for 9 percent of U.S. exports and 4 percent of imports, are the most obvious examples.[20] Trade in sectors not covered by the BAT will be severely distorted, and trade in other sectors will be somewhat distorted.

This real-world departure from the academic models is the result of unavoidably imperfect policy design and other influences on currency markets. While a perfectly designed BAT may not constitute a tariff-like impediment to trade, an imperfectly implemented, real-world border adjustment will certainly distort relative trade flows, burdening some taxpayers, particularly the poor, more than others.[21] Research indicates that any BAT, even if well designed, will decrease total trade flows because the tax falls more directly on traded goods than on goods that do not interact directly with the border tax.[22] Such impediments to trade decrease economic efficiency and depress economic growth.[23]

14. Reuven S. Avi-Yonah and Kimberly A. Clausing, "Problems with Destination-Based Corporate Taxes and the Ryan Blueprint," University of Michigan *Law & Economics Research Paper* No. 16-029, February 5, 2017, https://ssrn.com/abstract=2884903 (accessed May 25, 2017), and Auerbach and Devereux, "Cash Flow Taxes in an International Setting."
15. For a good summary of the available evidence, see Jason J. Fichtner, Veronique de Rugy, and Adam N. Michel, "Border Adjustment Tax: What We Know (Not Much) and What We Don't (All the Rest)," Mercatus Center *Policy Brief*, February 2017, https://www.mercatus.org/publications/border-adjustment-tax (accessed, May 24, 2017).
16. Kyle Pomerleau, "Exchange Rates and the Border Adjustment," Tax Foundation, December 15, 2016, https://taxfoundation.org/exchange-rates-and-border-adjustment/ (accessed May 24, 2017).
17. The simple model is explained and defended by Alan J. Auerbach in "Border Adjustments and the Dollar," AEI *Economic Perspectives*, February 2017, https://www.aei.org/wp-content/uploads/2017/02/Border-adjustment-and-the-dollar.pdf (accessed May 25, 2017).
18. University of Chicago Booth School of Business, Initiative on Global Markets Forum, "Border Adjustment Tax," http://www.igmchicago.org/surveys/border-adjustment-tax (accessed May 31, 2017), and Veronique de Rugy and Daniel J. Mitchell, "The Border-Adjustment Sleight of Hand," *The Wall Street Journal*, April 16, 2017, https://www.wsj.com/articles/the-border-adjustment-sleight-of-hand-1492366244 (accessed May 31, 2017).
19. Morgan Stanley, "Border Adjustability: How US Tax Reform Could Be a Boon for USD," December 19, 2016, and Citi Research, "Border Tax Adjustments Are Not Benign."
20. International Trade Administration, National Trade and Tourism Office, "U.S. Exports and Imports of Tourism," 2015, http://travel.trade.gov/outreachpages/inbound.general_information.inbound_overview.asp (accessed March 22, 2017); news release, "U.S. International Trade in Goods and Services," Bureau of Economic Analysis, March 2017, https://www.bea.gov/newsreleases/international/trade/2017/trad0317.htm (accessed March 22, 2017); and Heritage Foundation calculations.
21. Goldman Sachs, "US Daily: What Would the Transition to Destination-Based Taxation Look Like?" December 8, 2016.
22. Mihir A. Desai and James R. Hines Jr., "Value-Added Taxes and International Trade: The Evidence," unpublished working paper, January 2005, and Michael Nicholson, "Value-Added Taxes and US Trade Competitiveness," Forum for Research in Empirical International Trade *Working Paper* No. 186, July 2010.
23. Some proponents argue that destination-principle taxes are more efficient than origin-based systems. These claims are highly dependent on the assumptions used and the other variables in the tax system, as well as more complex political-economy considerations. Auerbach and Devereux, "Cash Flow Taxes in an International Setting," and Jason J. Fichtner and Adam N. Michel, "The OECD's Conquest of the United States: Understanding the Costs and Consequences of the BEPS Project and Tax Harmonization," Mercatus Center, March 2016.

It is not unreasonable to disagree about the effects of the BAT on currency markets and trade flows. Any fundamental tax reform will be disruptive as taxes change behavior. However, policymakers should acknowledge that the proposed BAT is a significant economic gamble, as it could change economic behavior in ways that may undermine some of the benefits of other parts of the reform.

There are many other issues not considered here, but ultimately just as important. These include: transition rules, decoupling of the state corporate income taxes, trade responses of other countries, the design of tax refunds for exported products, the tax treatment of financial transactions, and measuring intangibles.[24]

A Path Forward: Building Consensus for Tax Reform

In the context of the current tax reform debate, the economic risks of a BAT seem to outweigh the political benefit of promoting revenue neutrality. Notwithstanding tax reform, the nation is on an unsustainable fiscal path that requires entitlement and other spending reforms irrespective of any tax reform proposal.

To make the U.S. a more attractive place to do business, tax reform should include:

- **Reduced rates.** The House blueprint's proposed corporate income tax rate of 20 percent is a good start, although the 15 percent rate proposed by President Donald Trump would be better. The corporate income tax and entity-level taxation in general should ultimately be eliminated, but a federal rate as close to 12.5 percent as possible (the lowest in the Organization for Economic Co-operation and Development) would make America a leader in business tax rates.
- **Expensing.** Allow the immediate deduction of capital expenses in order to remove the tax bias against new capital investments and remove unnecessary complexity.
- **Territorial taxation.** Move to a territorial tax system under which the U.S. would not collect additional taxes on foreign-earned profits. Without a lower corporate tax rate, a territorial-only reform could face significant base erosion.

These three reforms, paired with reforms to the individual tax code, have the potential to dramatically increase new investment, wages, output, and jobs.

Regardless of one's ultimate view of the economics of border adjustments, it is clear that the current proposal is impeding an otherwise unified effort for tax reform. The tax code is badly in need of an update, and true reform is possible without the border tax distraction. Congress should move forward on reform without the BAT.

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24. A few of these items are surveyed by Fichtner, Rugy, and Michel, "Border Adjustment Tax: What We Know (Not Much) and What We Don't (All the Rest)."