Corporate Tax Reform: Time for Republicans to Show Us the Plan

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OVERVIEW

While much of the debate over the first few months of the Trump Presidency has focused on immigration, cabinet nominations, and Russian interference in the U.S. election, the push toward corporate tax reform may be building momentum.

With a growing number of President Trump's inner circle embracing Speaker Paul Ryan's proposed Border Adjusted Destination-Based Cash Flow Tax (DBCFT), the likelihood the concept will be included in a final tax reform package has jumped considerably.[1]

At the same time, the Ryan proposal has split the business community and drawn fire from some prominent Senate Republicans, raising questions as to whether Republicans can unite behind the Ryan approach – or, indeed, any tax reform proposal. Meanwhile, Democrats are keeping their powder dry, noting that, at this point, no one has actually seen a concrete proposal. It's time for Republicans to show us their plan.

PPI has long argued that fundamental corporate tax reform is urgently needed to boost economic growth and the global competitiveness of U.S. companies and workers. Despite broad agreement across the political spectrum that the corporate tax rate is too high and perversely gives U.S. firms incentives to keep revenues abroad, there's no consensus around how to pay for tax reform.

1 Anna Edgerton & Jennifer Jacobs, "Border tax breeds unlikely bedfellows: Ryan & Bannon," *Bloomberg News*, February 28, 2017

That's where Speaker Ryan's concept comes in. His cash flow tax is projected to raise more than $1 trillion – enough to reduce the corporate tax rate from 35 to 20 percent while cutting the rate for business partnerships to 25 percent.

It's called "border adjustable" because it would levy a 20 percent tax based on where goods are sold rather than where they are produced.[2] The cost of goods imported into the U.S. would be non-deductible and therefore subject to the 20 percent tax. Revenue from the sale of goods exported abroad would not be subject to the tax.

The Ryan approach bears some resemblance to a Value Added Tax (VAT) but appears to differ in some crucial respects. Many economists favor consumption taxes because they encourage investment and savings over spending, which should, in theory, lead to higher long-term growth. Like a VAT, the border adjustable tax is easy to collect because it taxes at the point of sale rather than the point of production. Some progressive commentators have also noted that, unlike a pure VAT, the Ryan concept could have a progressive distributional effect because it excludes wages and salaries from the tax base.[3]

Nonetheless, the cash flow tax is fraught with large uncertainties and a confusing rationale. Unless and until Republicans can produce an actual legislative blueprint, corporate tax reform will languish in the abstract realm of high concept. In the meantime, progressives ought to be asking plenty of hard questions about the House GOP approach.

Here are some key points progressives ought to keep in mind while awaiting a GOP plan:

It's just a theory.

Unlike a VAT, which is a known commodity because many advanced nations have one, the cash flow tax represents a leap into the unknown with the potential to wreak havoc on the U.S. economy. In fact, it seems to be a convoluted way to tax consumption while steering around many Republicans' oft-professed aversion to a VAT, which they see as a revenue machine for big government.

While many European countries have adopted border adjustment as part of their VAT systems, no country in the world has enacted a cash flow tax regime like the Ryan plan. No Member of Congress should be pressured into making a leap of faith before seeing actual legislation, subjecting it to rigorous and independent analysis, and thoroughly debating this untested proposal.

2 James R. Nunns, Leonard E. Burman, Jeffrey Rohaly, Joseph Rosenberg, Benjamin R. Page, "An Analysis of the House GOP Tax Plan," *Tax Policy Center*, September 16, 2016

3 Alan Auerbach, "A Modern Corporate Tax," *Center for American Progress & The Hamilton Project*, December 2010

No real trade benefit.

The Ryan plan appeals to “economic nationalists” in the White House (such as Steve Bannon) because, by taxing imports and exempting exports, it would presumably help close America’s trade deficit. The history of trade and international tax policy, however, suggests that our trading partners will respond in some way to a new U.S. business tax regime, such as further cutting their own corporate income taxes. The result being, over the long-term, the projected trade benefits will fail to materialize.

But even in the short term the supposed trade benefits of adopting a DBCFT are not likely to materialize. Let’s assume the advocates of the DBCFT are right and the value of the dollar does rise, allowing U.S. consumers to purchase just as many TVs and running shoes for the same number of dollars. What then happens to U.S. exports? As Steve Odland and Joseph Minarik point out, if the price of the dollar does appreciate, it will raise the price of our exports, unraveling the very trade benefit proponents of the tax are predicting.[4]

The trade benefits could also fail to materialize because the proposal could violate the principles of the rules of the World Trade Organization (WTO), of which the U.S. is a signee. Specifically, the elimination of the deduction for imported expenses (but not for domestic goods and services) could violate the national treatment principle of the WTO and rules of the General Agreement on Tariffs and Trade (GATT), while the taxable income exemption for export revenue could violate the WTO’s export subsidies agreement.[5]

A stiff tax hike on consumers.

In order to cut the corporate tax rate to a historically low level, the cash flow tax would shift a considerable tax burden onto consumers. In fact, the new 20 percent tax rate would be the largest sales tax hike in U.S. history and would radically change how the federal government taxes Americans. In addition, because so many states rely on sales and consumption taxes, the 20 percent rate could dampen consumer spending, which, in turn, would reduce revenues for state and local governments.

4 Steve Odland and Joseph Minarik, “The border adjustment tax is just another faux silver bullet,” *The Hill*, February 23, 2017
5 Martin Khor, “The Planned US Border Tax Would Most Likely Violate WTO Rules – Part 2,” Inter Press Service News Agency, February 17, 2017.

Higher prices on domestic and imported goods.

Proponents of the Ryan concept claim its impact on the price of imports would be negligible because, in theory, the U.S. dollar should appreciate by 25 percent, which should neutralize the 20 percent tax on imports and the 20 percent tax subsidy for exports. Yet we don't have enough information to know whether the Ryan proposal would lead to higher prices or lower company profits – or some combination of both. It seems clear, however, that the burden will fall heavily onto investors. And, if currency exchange rates don't adjust according to theory, consumers will pay a lot more for imported goods while companies that export could end up paying little or nothing in taxes. In reality, if you tax imports and, thus, raise their prices, then domestically produced goods will become more expensive as well.

The Trump administration's animus toward imports ignores the fact many products that are made in the United States include components manufactured abroad. Let's take the automotive industry as an example. A recent study showed that, with the exception of Tesla, the prices of all cars and trucks sold in the United States would rise under a cash flow tax – some by as much as $17,000. Another researcher has estimated that the proposed border tax could raise average prices in the U.S. by about 8 percent, or $2,500 per vehicle – enough to cut yearly sales by about 2 million.[6]

Not-so-level playing field.

One of the goals of corporate tax reform should be the leveling of the playing field both internationally and domestically. Yet, under the Ryan approach, some U.S. companies will be losers and others will be winners. Retailers, the automakers, as well as companies of all kinds that import components used in products that are then sold abroad are lined up against the bill because their goods will become more expensive and less competitive. Not surprisingly, companies that build products here and sell them either domestically or abroad are backing the proposal.

6 Ryan Beene and John Lippert, "Your Car Could Cost Up to $17,000 More With the Proposed Border Tax," *Bloomberg Markets*, February 6, 2017

In fact, some companies may be able to avoid paying any corporate income taxes at all. The United States' biggest exporter is Boeing, which sells 80 percent of its commercial airplanes abroad. And, even though it imports many components that are used in building its airplanes, its exports exceed its imports by a significant amount. Under the Ryan plan, the profits from Boeing's sale of exports will not be subject to U.S. taxes. And, although it will no longer be able to deduct the cost of its imports, the huge differential between its exports and imports would likely mean its commercial airplane business will become effectively tax free.

The Ball is in the GOP's Court

In control of both the White House and Congress, Republicans now have to show they can solve problems and get things done in Washington. Yet the stormy history of the Affordable Care Act – aka Obamacare – illustrates the pitfalls of passing major legislation on a strictly partisan basis. Washington urgently needs to reform corporate and business taxes, and, if that reform is to be lasting, it must rest on a stable political foundation of bipartisan support.

Before any serious deliberations over tax reform can get underway, however, Republicans must put a coherent plan on the table. So far, all they've offered is an untested theory that will either impose large tax burdens on investors, consumers and large swaths of the U.S. economy that rely on imports, or have a negligible effect on the U.S. trade deficit if, as Ryan's supporters predict, the dollar strengthens against other currencies.

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