

Tax Reform and the Border-adjusted Tax

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The tax reform idea that has received the most attention recently is replacing the corporate income tax with a cash-flow tax on domestic business — and imposing a tax on imports into the United States.



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The current personal and corporate tax system impose taxes on productive activities that contribute to economic growth, such as working, investing and saving. Consider dividends paid by corporations to shareholders: They are taxed at the corporate level, then taxed again at the shareholder level. On the other hand, our current tax system also subsidizes consumption and debt. Think of interest deductions on personal mortgages and corporate debt.

Taxes on corporations encourage firms to relocate to lower-tax jurisdictions. If they repatriate any profits back to the United States, they must pay the U.S. tax minus any taxes paid in the country of origin. Since the United States now has the second highest marginal corporate tax rate in the world, there is no incentive to repatriate. Instead, it is more profitable to locate production in a country with cheaper labor and lower taxes, and export goods to the United States.

Cash Flow Business Tax. A tax reform plan proposed by a House Republican task force in 2016 would replace the corporate income tax with a flat business tax of 20 percent. Among the features of the plan:

- Businesses would deduct (immediately expense) capital expenditures from revenues without a complicated depreciation schedule. Businesses could also deduct labor costs.
- Businesses could no longer deduct net interest payments on loans, ending the current tax code's bias in favor of debt over equity financing.
- "Pass-thru" businesses, such as partnerships, would also be taxed at a lower rate — putting them on a more equal footing with corporations.
- U.S. taxes on income from overseas investments would be eliminated.

These changes would make the tax system simpler and fairer, and would encourage economic growth by reducing the tax burden on capital investment. A hypothetical flat-rate corporate income tax was modeled for the NCPA by Senior Fellow Laurence J. Kotlikoff of Boston University. Dr. Kotlikoff found that replacing the current corporate tax with a flat 9 percent business tax would yield the same revenue and, according to Kotlikoff, "produce a rapid and dramatic increase in domestic investment, GDP, real wages and national saving."

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Border Adjustment of the Tax. The most controversial aspect of the Republican tax plan is a 20 percent tax on imported goods and services that excludes export revenues from the cash flow tax. This border-adjusted tax (BAT) would apply to all imported goods and services sold at retail or used as inputs for other domestic production [see the figure].

Border-adjusted taxes are nothing new. Most countries impose a “value-added” tax (VAT) — an excise tax added to each stage of a good’s production — but rebate the tax on exports. Exports are then taxed by the destination country. Ultimately, the total cost of the VAT is paid by the final purchaser (the consumer).

However, VAT rates vary widely — for instance, it is 8 percent in Japan, but 27 percent in Hungary — and the VAT is imposed in addition to corporate income taxes and labor taxes. The burden of these other taxes are incorporated into the prices of exports. The tax burden on an economy can be expressed in terms of government spending as a percentage of gross domestic product, which also varies widely — for instance, from 32 percent of GDP in South Korea to 58 percent in Finland, with the United States at 38 percent.

Thus, though Americans might claim other countries’ VAT rebates are export subsidies, they only partially compensate for the tax burden in the exporting country. Because tax burdens vary widely, a uniform tax on all U.S. imports will either overcompensate or undercompensate for the export subsidies of individual countries.

Exchange Rate Adjustments. There are concerns about the effect of a border-adjusted tax on consumer prices. On the surface, it appears the attempt to level the playing field between domestic and foreign producers would create another type of inequity, as

imported goods increase in price due to the tax and exported goods become relatively cheaper.

However, economist Martin Feldstein, among others, argues that as imports become more expensive to U.S. consumers, dollars flowing overseas from the sale of imports will become scarcer, driving up the demand for, and thereby the value of, dollars. Likewise, U.S. exports would become cheaper, allowing exporters to lower their prices. These scenarios combined would theoretically offset the tax on imports.

Economists Alan Auerbach and Douglas Holtz-Eakin say that if the import tax and “export subsidy” rates are equal, they would neither encourage nor discourage international trade. If that were to happen, there would be no net positive effect on the competitiveness of U.S. goods in world markets.

However, Senior Fellow David Ranson argues such an automatic adjustment mechanism is a myth, and the fact that the dollar “floats” does not imply it automatically offsets the effects of taxes or trade barriers. He agrees that if dollar appreciation fully offsets the tax, it would render the policy change pointless.

Conclusion. Replacing the corporate income tax with a cash-flow business tax would increase the after-tax return to capital investment, encouraging economic growth. In contrast, border-adjusting the tax does not appear to accomplish the purpose its proponents seek, while penalizing exports from some countries (and favoring others) and raising prices for consumers.

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