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U.S. considers border adjustable tax folly

One of the key separators between U.S. and European tax policy has long been the presence of value-added taxes. That might change thanks to a provision in the proposed blueprint that will serve as the starting point for corporate tax reform in the new U.S. Congress. If enacted, the fundamental change to U.S. corporate tax rates will also have significant implications for the international community.

VATs are efficient revenue raisers that enable bigger government, which is why it is all the more puzzling that Republicans are the ones whose actions might finally result in bringing a VAT to the United States. Republicans aren't proposing a VAT exactly, but one aspect of the blueprint put out last year by Speaker Paul Ryan and House Ways and Means Chairman Kevin Brady comes worryingly close, and is likely to lead to a straight VAT in the future.

The Ryan-Brady blueprint

After an election in which Donald Trump won the White House and Republicans maintained majorities in both the House and Senate, tax reform is looking more likely to happen than ever. Donald Trump issued a tax reform plan during his campaign, but the major legislative legwork is going to take place in Congress. And Congressional Republicans are likely to draw heavily on the Ryan-Brady blueprint released last year as they work to get tax reform quickly out the door.

The House blueprint contains many desirable, pro-growth provisions. It would replace depreciation with full expensing for most capital purchases, end the worldwide taxation of income, and lower rates to more competitive levels.

Yet included with these much needed reforms is a provision that has divided free market advocates, the business community and economists alike. The blueprint would convert the corporate income tax into a destination-based cash flow tax (DBCFT). It is "border adjustable," which the blueprint accomplishes by exempting revenue derived from exports from taxation and denying deductions for the cost of imports.

Full impact uncertain

Despite the apparent protectionist nature of the DBCFT, proponents insist that because much of the rest of the world uses border-adjustments in their VATs, it is neutral between domestic and foreign produced goods and thus an improvement over the present system. Some politicians also tout it as stimulating exports, but even those economists who otherwise support the DBCFT deny that would occur.

Proponents also suggest that price increases for consumer goods would be offset by increases in the value of the dollar relative to foreign currencies. That's uncertain at best. Real world data raises questions as to whether the theoretical assumption of perfectly efficient currency markets is warranted. Even if the dollar appreciated enough to offset higher consumer price tags, that would "deliver a sizeable hit to US residents' foreign wealth and could create risks of dollar-denominated debt problems abroad," according to Goldman Sachs.

Heading toward a VAT-tastrophe

Consumer price increases - which may or may not be offset by changes in the value of the dollar - and potential market disruptions to existing supply chains are problematic enough. But the real danger from the DBCFT is the likelihood that it will evolve into a straight VAT and enable bigger government for decades to come.

As proposed, the DBCFT is very similar to a VAT. The main difference is that the DBCFT allows for the deduction of payroll costs. But even that difference might not last.

It's highly dubious whether the DBCFT would be permitted under WTO rules. Historically, the WTO has made a distinction, whether justified or not, between direct and indirect taxes when it comes to border-adjustability. Rebates on direct (i.e. income) taxes are considered to be illegal export subsidies, while rebates on indirect (i.e. consumption) taxes are permitted. VATs, in other words, can be border adjustable while income taxes cannot.

The uncertainty regarding the DBCFT is due to the fact that it's an income tax that resembles a consumption tax base. The blueprint, however, is very clear that its authors do not consider it to be a VAT. If the WTO takes them at their word, the DBCFT is likely to be ruled impermissible.

Such a ruling would not simply be a lawmaker inconvenience. It could be the first domino to fall on the way toward seeing a VAT adopted in the United States. After all, the most likely solution for members of Congress facing a bad WTO ruling would be to make a few tweaks and turn the DBCFT into a VAT.

More worrisome still, there's no telling the partisan makeup or disposition of Congress by the time the WTO rules. If the left is back in power, the result could be a nightmare scenario where the U.S. corporate tax environment becomes more like that of Europe, with both income and consumption taxes.

Diminished competition

Whether the DBCFT is adopted doesn't just matter to the United States or those doing business with America. One of the primary reasons for adopting a DBCFT, according to its many left-leaning academic supporters, is the fact that it would relieve politicians from pressure to lower rates in the future. Because it is destination-based, in other words, there's no chance for taxpayers to seek an alternative system should tax rates become too onerous.

That's bad for U.S. taxpayers, as it means the pressure of tax competition would no longer help keep politicians from pursuing their most avaricious fantasies. And if other nations follow suit, it would mean higher taxes all around.

The political fight

The DBCFT has already led to the formation of unusual political alliances. Proponents include some free market advocates who value a tax they see as less destructive than corporate income taxes, left-leaning academics who see potential to raise rates and make taxes more progressive once competition is eliminated, and protectionist politicians who either see it boosting exports or at least the ability to sell it to the public as if it does. The latter group includes Trump Chief of Staff Reince Priebus, who said the administration wants border adjustability "so that American jobs are protected," and House Ways and Means Chairman Kevin Brady, who says it is a "key part" of the tax reform plan and "going to stay."

Opposed to the change are other free market advocates who see danger in providing an efficient revenue engine for future government growth, along with a large group of retailers and other industries which rely heavily on imports and who fear their ability to remain profitable going forward. The free market advocates who oppose the change lament that the insistence of Republicans that the good pieces of the plan must be "paid for" amounts to premature surrender to the flawed, static scoring models -used by the Congressional Budget Office and the Joint Tax

Committee - which favor government growth and have long been used by Democrats to prevent pro-growth or government shrinking reforms. It's a departure from the precedent set by Ronald Reagan, who cut taxes and let revenues fall in the short run in order to grow the economy, and thus revenues, in the long run. By providing future elected officials an easy means to raise revenue, they also see it as trading long-term pain for only short-term gain.

The split in the business community creates an additional political obstacle to passage of corporate tax reform. There are almost always going to be winners and losers, but whereas businesses would otherwise support corporate tax reform practically in unison, the inclusion of border adjustments has led to a rift, primarily between importers and exporters. With Republicans barely holding a majority in the Senate and needing the support of a few Democrats to prevent a filibuster, a fractured business community could prove the difference between passage and failure.

Conclusion

It remains to be seen just how likely the DBCFT is to be adopted. It creates unnecessary political obstacles to reform by dividing the business community and free market advocates alike. The idea has not been thoroughly vetted compared to other key reforms under consideration, likely because Republicans probably did not foresee the extent of the electoral victory when the blueprint was being crafted. Now they have to deliver on campaign promises, and unfortunately, new administrations have limited time in which to get major agenda items done before the next campaign season begins. There is not much time left for lawmakers to come to their senses.

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