NATIONAL CENTER FOR POLICY ANALYSIS

Effects of a Border-adjusted Corporate Tax

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U.S. firms pay the world's highest corporate tax rate — a federal tax of 39.1 percent combined with an average 4.1 percent state tax on profits from domestic sales, or foreign sales (when and if the profits are repatriated).[1] In contrast, the lower tax rate embedded in the prices of those goods produced in other countries and shipped to the United States often gives them a competitive advantage, whether due to other countries' lower value-added taxes (VAT) or much lower corporate tax rates.

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House Speaker Paul Ryan and other Republican House members have proposed a lower corporate tax rate of 20 percent with a border adjustment.[2] A border-adjusted tax (BAT) would apply to profits on domestic sales and on imports, but would not apply to profits from U.S. exports to other countries. According to the House Republicans' tax plan, the BAT will "mean that it does not matter where a company is incorporated; sales to U.S. customers are taxed and sales to foreign customers are exempt, regardless of whether the taxpayer is foreign or domestic."[3]

Effect on Producers and Workers. Since U.S. producers would not pay the tax on profits from exports, the BAT will increase their efforts to sell goods and services abroad, and reduce the resources they devote to producing goods for the domestic market. The greater demand on domestic resources can be expected to increase producers' domestic prices, which is how Mr. Trump expects real wages to rise for U.S. workers.

Employers who depend on imports (say, retailers) can expect their sales to fall as a result of the BAT — or tariff increases — imposed to deliberately raise the retail prices of imported goods. The collateral damage will be a reduction in the market demand for workers in these disfavored industries.

Effect on Consumers. The higher prices U.S. producers *and* retailers must pay for their inputs from both domestic and foreign sources will drive up prices for consumer goods, undercutting any real wage increases for worker groups in the export industries that directly benefit, and reducing the real wages of workers in industries that do not experience an increased demand for their labor. Those workers would pay the higher prices generated by the BAT for the benefit of the "protected" worker groups.

Effect on the Dollar. Advocates for the BAT contend that the induced reduction in imports and increase in exports will cause the

dollar to appreciate on international money markets, with the dollar's appreciation in itself reducing import prices for Americans — supposedly, marginally increasing their real incomes. That cannot be the case. If it were, the BAT would not likely achieve the advertised effects of reducing imports and increasing exports. The BAT might as well be shelved.

If the BAT has the intended effects on imports and exports, then we have to believe that many of the prior mutual benefits of international trade will be lost and production costs around the globe will go up. The result: a necessary reduction in aggregate real income, but one that is unequally distributed. Some U.S. firms and workers would gain, but other worker groups would lose more than these gains. The most that could be said for the impact of the dollar's appreciation is that it will dampen the increase in the prices Americans will pay for foreign goods, slightly moderating any decline in Americans' real wages.

Effect on Tax Complexity. The BAT conflicts with another ambitious goal of the Trump administration and congressional Republicans: to reduce the complexity of the U.S. tax code, which adds to firms' production costs and reduces their competitiveness. The BAT will likely greatly increase the tax code's complexity for many U.S. firms whose supply chains extend across the globe (consider Apple and Ford). The differing degrees of integration of these firms' production processes often make identification of "American-made" and "foreign-made" arbitrary; thus, volumes of tax rules would be required to define and tax "domestic" and "foreign" profits.

Effect on Efficiency. There is a bigger problem with the BAT proposal: It doesn't pass the "smell test" of efficiency and fairness. For example, under the proposal a firm in Indiana that produces a good for export will receive a tax-rate cut on its sales. Consumers in foreign countries will see the price of that good decrease and, consequently, may buy more of it. But if that same Indiana firm produces a good for sale in Montana, it will receive no corporate-tax concession, which means that American consumers will pay more for the firm's American-made goods than foreigners.

Even Americans who buy goods from firms that do not export at all can be expected to pay higher prices. Why? Again, as noted, if exports are broadly encouraged by newly created tax advantages, more of scarce U.S. resources will go into the production of exports. Fewer resources will then be available to produce everything else Americans want to consume, resulting in a concomitant increase in those goods' prices.

Effect on Imports and Exports. Proponents of the border-adjusted corporate tax and other trade restrictions complain that Mexico, China and others have a history of subsidizing their exports through government handouts and currency manipulations — presumably a tried-and-proven policy road to riches — because greater exports mean (supposedly) more plants, more jobs and higher real incomes for all. But in a world of scarce resources, encouraging exports must come at the expense of other goods produced.

"Real income" is ultimately defined not by the count of dollars earned but by what the dollars can buy. Thus, government policies that reduce the availability of goods and services simply undercut real incomes. Instead of countering the misguided real income-destroying policies of export subsidies, the Trump administration should do the opposite: Encourage other countries to subsidize their exports to the United States (if they are foolish enough).

The BAT proposal appears solidly grounded in the proposition that exports are necessarily good (for future economic prosperity), while imports are bad. But the exact opposite proposition carries far more economic weight. Imports expand the array of goods produced for domestic consumption and production. Exports do the opposite. Which should we prefer?

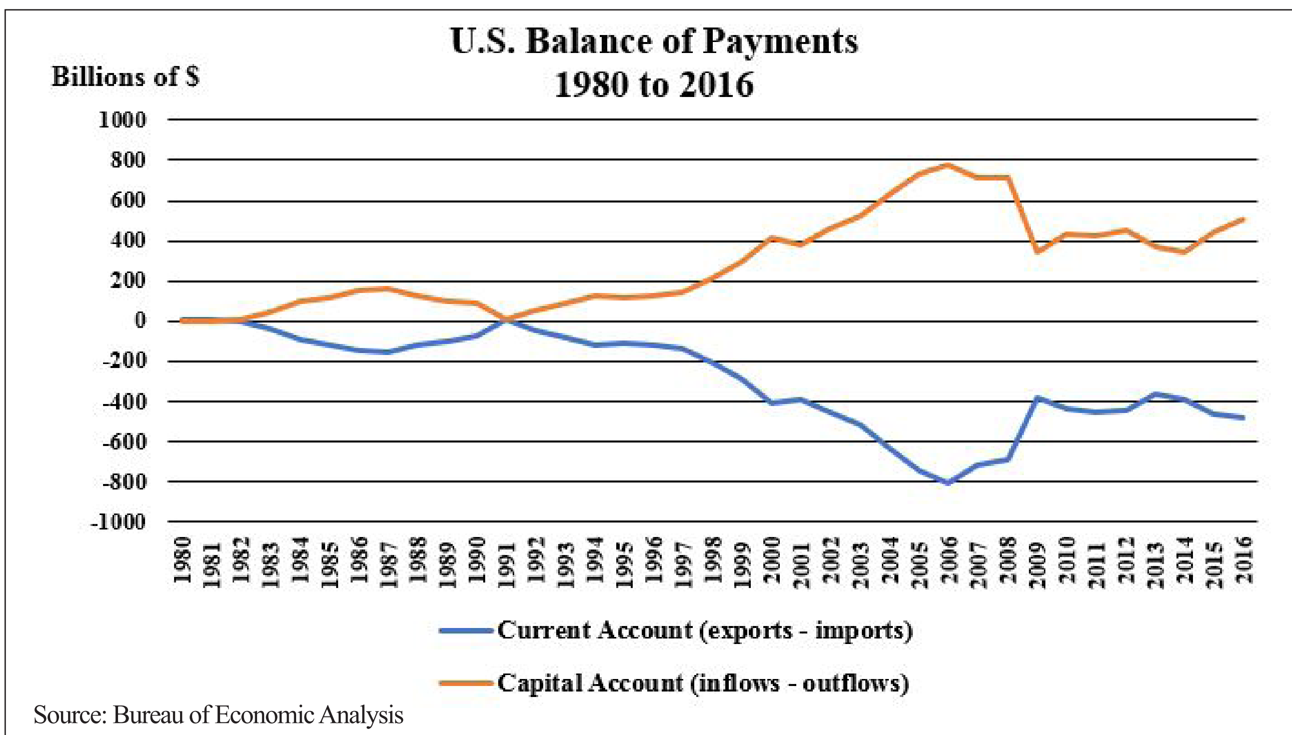
Effect on Trade Deficits. Though imports (and a trade deficit) may seem to be a consequence of the country's inability to compete, that is not necessarily the case at all. U.S. firms seeking to sell their goods and services constantly compete with each other, as well as foreigners, in international markets. But firms also have investment opportunities to sell in the form of stocks and bonds, real estate and whole companies, as well as intellectual property rights. Americans selling these investment opportunities compete for foreign buyers with their fellow citizens who have goods and services for sale.

Of course, Congress and several administrations can be faulted for lagging exports and surging trade deficits: Serial budget deficits have produced a lot of government bonds for sale. One can attribute trade deficits to hawkers of government bonds who have been able to offer foreigners better deals than U.S. exporters of goods and services. If the Trump administration increases federal budget deficits, as seems likely, the federal government will issue even more bonds. The Trump administration and Congress must remember that trade deficits are largely offset by capital inflows. [See the figure.]

Effect on Capital Flows. Imports seem to suggest to the Trump administration that the U.S. economy is not competitive, but the inflow of capital (attributable at least in part to U.S. imports) suggests quite the opposite: The economy is sufficiently competitive for investors around the world to see better odds for their entrepreneurial bets in the United States than elsewhere in the world — even where workers are paid much lower wages.

The Trump administration and congressional Republicans must understand that they are highly constrained in a world of "quicksilver," footloose capital. They cannot choose tax rates, especially for taxes that fall heavily on capital, without considering the effect on firms' location decisions. The BAT proposal implicitly acknowledges capital mobility consequences, but its structure is a throwback to when policymakers anointed economic "winners" and "losers" (hidden within a labyrinth of complicated corporate tax rates and rules) without regard to the aggregate economic consequences.

Effect on Politicians. Politicians and policymakers are ill-suited for picking winners and losers through a BAT, tariffs or other protectionist policies. They ply their trade in the streets of the capital. They have scant knowledge of the critically important technical and market details of various business operations that are scattered through all corners of the country and globe, and they will never be able to grasp those details well. Politicians and policymakers will also likely be overwhelmed by hordes of claimants pleading at their office doors for special governmental treatment on taxes and market protections, which means they will likely seek to make their jobs manageable by listening mostly to existing, politically established claimants, especially those with large lobbying coffers. They also will likely overlook, or just short-change, many firms and industries that don't exist today or are nascent; meaning future growth could be diminished.



Source: Bureau of Economic Analysis

Conclusion. In the not-too-distant past, governments everywhere could blithely set tax rates without much concern that their capital base (and jobs base) would erode. No longer. Too much critical modern capital (especially in digital form) is highly mobile across national boundaries. Far too much of U.S. firms' foreign-generated profits can be held offshore until the U.S. government get theirs its tax system right.[4]

The Trump administration must accept the obvious: U.S. corporate tax rates are too high for the "market conditions" federal and state governments face globally. It must bite the bullet and lower the country's corporate tax rates (finding other ways to replace the lost revenues or trim expenditures).

Why have policymakers avoided this obvious solution and instead become immersed in the tangled web of the BAT? *Wall Street Journal* columnist Holman Jenkins offered an incisive explanation: "When it comes to the politics of tax reform, a vital principle is always to inject a big disruptive element into the mix. That way members of the House and Senate tax-writing committees can be assured a fundraising bonanza from threatened business and taxpayer groups."[5]

Threatened businesses and taxpayers buy off politicians who plan tax reforms that will harm them and favor others. Proposing simple, easily understood tax reform would deny politicians fundraising opportunities for the next election. As it is, a BAT could be expected to crowd planes flying into D.C., full of lobbyists with carry-ons full of campaign contributions.

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Notes

1. Kyle Pomerleau and Andrew Lundeen, "The U.S. Has the Highest Corporate Income Tax Rate in the OECD," Tax Foundation, January 27, 2013. Based on data from the OECD.
2. See U.S. Congress, House, Ways and Means Committee, "Built for Growth: A Better Way Forward on Tax Reform," June 2016, pages 27–29.
3. Ibid.
4. For an extended discussion of the growing constraints of "quicksilver capital" (both real and financial capital) on government policy discretion, see Richard B. McKenzie and Dwight R. Lee, *Quicksilver Capital: How the Rapid Movement of Wealth Has Changed the World* (New York: Free Press, 1991).
5. Holman W. Jenkins, Jr., "What's Behind the Border Tax Kabuki?" *Wall Street Journal*, February 17, 2017.