A Tale of Two Tax Plans

What Trump and Ryan Get Wrong

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Republicans have long panned the U.S. tax system; now they have a plan to change it. In fact, two plans. The first comes from Congress, the second from the White House. The congressional "Better Way" plan, championed by Paul Ryan, the Speaker of the House, and Kevin Brady, chair of the House Ways and Means Committee, would create a business tax system that has never existed anywhere in the world. The White House plan would enact a massive tax cut, mostly for the wealthy.

Each plan aims to reform both the individual and the business parts of the U.S. tax system. But although the two plans offer similar rate cuts for individuals, the proposed reforms are very different on the business side. The White House simply wants to slash taxes for all businesses. The Ryan-Brady plan would convert the current corporate income tax into a border-adjusted cash-flow tax—a tax on consumption rather than on income. Tensions over this idea among Republicans and businesses are running high. Exporters, such as Boeing and GE, have lined up behind it, whereas retailers and importers, such as Target and Walmart, are lobbying hard to stop it in its tracks.

Although no official economic estimate of either plan is yet available, it is clear that the White House proposal threatens to explode the national debt and, as a result, impede economic growth. The Better Way plan is both more promising and more responsible than the White House's outline. Still, the Ryan-Brady proposal would likely increase the national debt, disrupt global trade, harm some American companies and benefit others, cause financial problems abroad by dramatically raising the value of the U.S. dollar, and lead to pervasive and costly uncertainty. In the end, the Better Way plan is too disruptive and too risky for the United States to adopt. Nonetheless, it points tax reformers in the right direction.

THE TWO PLANS

Congressional Republicans and the White House have a similar vision of individual income tax reform. Their plans would reduce the number of tax brackets from seven to three and lower the top rate. Both plans would repeal the estate tax, the alternative minimum tax, and the tax on investment income imposed by Obamacare. And both plans would expand the standard deduction. These reforms would increase the national debt by $3–$4 trillion over the next ten years. For comparison, the nation's entire debt stood at about $6 trillion before President George W. Bush's unfunded tax cuts of 2001 and 2003 and the wars in Afghanistan and Iraq took their financial toll.

Ryan and Brady propose to make up most of the lost revenue by eliminating all personal exemptions, deductions, and credits, except those for mortgage interest and charitable giving. The White House

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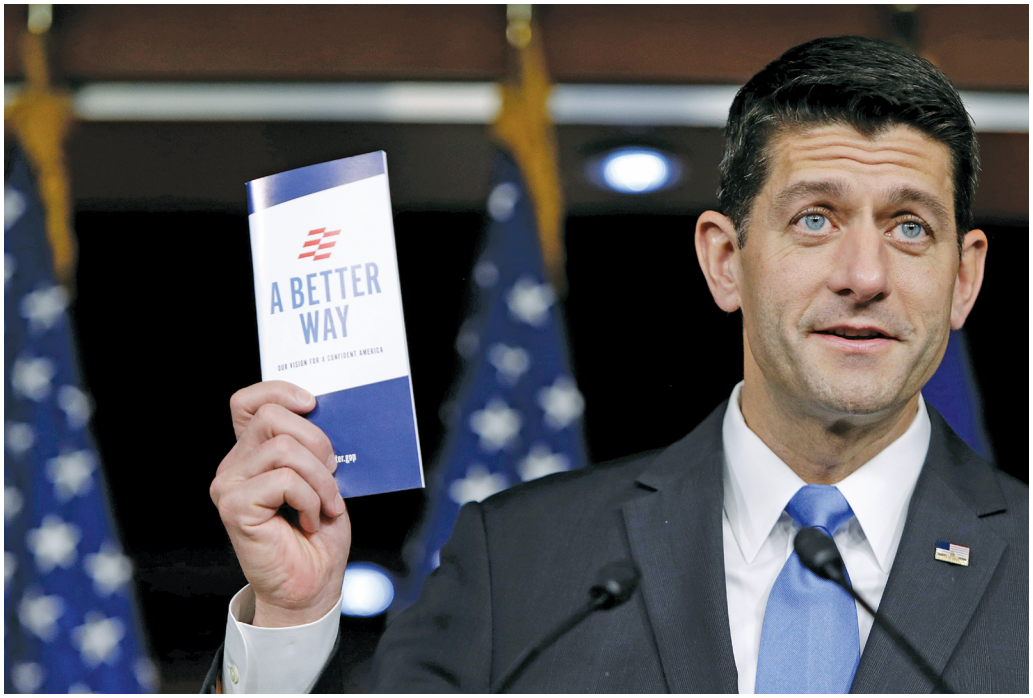

Taxman: Ryan discussing the Better Way plan with reporters, Washington, D.C., September 2016

GARY CAMERON / REUTERS

outline refers to repealing "targeted tax breaks that mainly benefit the wealthiest taxpayers" but does not specify which ones. In April, Treasury Secretary Steven Mnuchin said that one of these tax breaks would be the deduction for state and local taxes. Although the wealthy do benefit from that deduction, so do millions of middle-class voters. It remains to be seen whether President Donald Trump will accept the political cost of upsetting them. The same is true of taking away the personal exemptions that Ryan and Brady want to repeal.

At first, the two plans appear similar on the business side as well. Both reduce the tax rate for corporations and partnerships, and both exempt from taxation income that U.S. firms earn from foreign operations. But these similarities are misleading. The White House plan offers a historically large tax cut for all businesses, from GE and Goldman Sachs to hedge fund managers, doctors, lawyers, and other high-earning professionals. The Ryan-Brady plan offers an even more dramatic change: it would replace the current tax on corporate income with a consumption tax.

The rate cuts in both business tax reforms would result in lost revenue. Two nonpartisan think tanks—the Urban-Brookings Tax Policy Center and the Committee for a Responsible Federal Budget—have estimated that without offsetting measures, either proposal would add another $3–$4 trillion to the nation's debt by 2027, in addition to the $3–$4 trillion in debt from the tax cuts on the individual side.

Mnuchin and other administration officials insist that much of the lost revenue will be made up by economic growth. This is a fantasy. The conservative Tax Foundation, which tends to project optimistic growth resulting from

lower taxes, has concluded that the growth rate needed to pay for the White House's corporate tax cut alone is twice as high as the foundation can justify. Moreover, a major spike in the nation's debt would impede growth. As the debt skyrocketed, the government would be forced to spend an increasing share of its budget on interest payments. Businesses would have a harder time financing new projects once interest rates started to rise, as they inevitably would. This is not a pretty picture for any responsible policymaker, and especially for fiscal conservatives in the Republican congressional caucus.

Ryan and Brady have committed to keeping their tax reform revenue neutral, at least for now. Perhaps they and their colleagues will eventually accept modest long-term deficit increases, even though this would require the reform to expire in ten years because of current budgetary rules, just as the Republican tax cuts of 2001 did. Perhaps the official revenue estimators at the Joint Committee on Taxation and the Congressional Budget Office will become more optimistic about the economy's responsiveness to tax cuts. But no plausible economic forecast would project enough growth to offset the $3–$4 trillion shortfall resulting from the rate cuts in either version of the business tax reform. If Republicans want to produce lasting change in the U.S. business tax system, and if they are not prepared to gut the social programs on which most Americans depend, they will need to find a large, long-term revenue source.

They have three options to choose from. The first is a carbon tax. This tax has significant merits, but House and Senate Republicans voted on a non-binding resolution opposing the idea less than a year ago. The second is a value-added tax (VAT). Ryan and Brady have gone to great lengths to emphasize that the tax they propose is not a VAT. It's no secret why they have. Several recent Republican Party platforms have explicitly rejected a VAT. When, in 2010, the Obama administration's fiscal reform commission considered a VAT, 154 House Republicans signed a letter opposing the idea. The third option, Ryan and Brady argue, is the border adjustment feature of their plan.

The White House has not committed to any of these three revenue sources. "As of now," a spokesperson explained in April, "neither a carbon tax nor a VAT are under consideration." Nor does the White House plan mention border adjustment. Without new revenue, the plan's business tax reform would cause a slow-motion fiscal disaster.

The Better Way plan does include a significant revenue source. Its business tax reform is both more pro-growth and more fiscally responsible than the White House's outline. So the Better Way plan deserves serious consideration.

A BETTER WAY?

The Ryan-Brady plan would replace the existing 35 percent corporate income tax with a 20 percent tax on business cash flows. With two main exceptions, the new cash-flow tax would be true to its name: businesses would subtract their cash payments from cash receipts and pay tax on the remainder. The first exception would make things even simpler: businesses would ignore all interest, dividends, and capital gains.

The second exception would make the United States more business friendly. This is the so-called border adjustment, which would prevent businesses from

deducting payments for imports but would exempt from taxation export receipts. Under a border-adjusted cash-flow tax, a firm's tax liability would depend on where customers bought its goods and services, not on where the firm produced them. If a company wanted to sell to U.S. consumers, it would have to pay the new tax no matter where its headquarters, workers, or profits happened to be. So businesses would have no reason to move abroad in search of lower rates.

The new tax would have a lot in common with the most widespread consumption tax in the world: the VAT. A VAT also taxes all business cash receipts and grants relief for cash payments. Most countries also make their VATs border adjusted, taxing imports and exempting exports. The major difference between the tax in the Ryan-Brady plan and a VAT is that the former allows businesses to deduct wages whereas the latter does not. This difference makes the new tax less regressive than a VAT, but it does not change their essential similarity.

If it sounds strange to say that a tax paid by businesses would be a tax on consumption, think of a sales tax. The government receives sales tax proceeds from businesses, not consumers. Yet a sales tax is clearly a tax on consumption. It is based on the total value of goods and services a person consumes each year. The same is true of a VAT and the proposed cash-flow tax.

STICKER SHOCK

The plan's raison d'être is to stimulate the U.S. economy. Businesses prefer to write off the cost of their capital investments as fast as they can. Today, they must deduct these costs gradually over multiple

years; the Better Way plan would allow them to do so in the same year they made the investment. This change would encourage companies to buy more machines, build more factories, and hire more workers. And thanks to the border adjustment, businesses would want to make their investments and hire their workers in the United States rather than overseas.

The blueprint that Ryan and Brady released in June 2016 predicts that abolishing the corporate income tax would allow the United States to "leapfrog many of its trading partners" in competing for business. Of course, the United States would also add a new cash-flow tax on consumption. But more than 160 countries levy similar VATs, so the United States would simply be joining the club.

Unfortunately, this bright picture ignores several large dark spots. To start, the plan's effect on economic growth is uncertain. So far, two think tanks have evaluated it and come to different conclusions. The Tax Foundation decided that the plan would lead to significant economic growth. The Tax Policy Center concluded that the plan would have a much smaller effect. None of the government agencies that produce official estimates of the economic impact of proposed tax reforms has yet weighed in. But the Tax Policy Center's model is similar to those used by the government agencies. So it is reasonable to conclude that although the plan would probably increase U.S. GDP and employment, the improvements would likely be moderate at best.

At the same time, the two think tanks agree that cutting the corporate tax rate from 35 percent to 20 percent and replacing the tax on corporate income with a cash-flow tax would result in the loss of trillions of dollars in revenue in the next ten years alone.

The plan's proponents say that this is where the border adjustment would come to the rescue. Recall that this provision taxes imports and exempts exports. The two think tanks estimate that because the United States has a large trade deficit, a 20 percent tax on net imports would raise about $1.2 trillion over the next ten years. That revenue, plus the strong economic growth that Ryan, Brady, and the Tax Foundation optimistically project, would cover the shortfall.

This $1.2 trillion in border adjustment revenue is unlikely to materialize, however. Both the Tax Foundation and the Tax Policy Center ignored the fact that businesses would find ways to avoid paying a significant proportion of the new taxes. The plan's proponents emphasize that the existing methods of shifting profits abroad to avoid taxation would make no sense if the plan were enacted. They're right. But although the old tax planning would cease, new planning would proliferate. In fact, the new system would strengthen the incentives to game the tax rules. Right now, if Google shifts a $10 profit on a $100 sale to a foreign subsidiary, the U.S. parent company reduces its U.S. taxable income by $10. Under the Better Way plan, if Google figured out how to make its $100 domestic sale count as an export, it would reduce its U.S. taxable receipts by the entire $100.

The plan's supporters point out, correctly, that similar incentives exist today under all border-adjusted VATs. What they miss, however, is that those VATs exist alongside corporate income

taxes, which makes gaming the system more difficult. Because the Better Way plan is unique in abandoning the corporate income tax altogether, it would give rise to entirely new tax-avoidance opportunities.

Creative minds are already hard at work finding the loopholes. If Congress passed the Ryan-Brady plan, companies would figure out how to convert non-deductible payments for imports into deductible domestic expenses and taxable domestic sales into tax-exempt exports. All these strategies would reduce the government's tax haul. The economist Brad Setser has estimated that corporate profits currently shifted offshore to avoid taxes account for as much as 40 percent of the U.S. trade deficit, or about $200 billion. If companies were even half as successful at avoiding taxes under the new regime, some of the $1.2 trillion in border adjustment revenue would not materialize.

THE DOLLAR PROBLEM

Another reason to doubt the $1.2 trillion number is the likely effect of the border adjustment on the value of the U.S. dollar. The Better Way plan would cause the dollar to rise, although it is not clear how fast or by how much.

If the new tax is border adjusted, businesses will not be able to deduct payments for imports as they currently do. So currency markets would expect importers, such as Walmart, to raise prices to pay the extra tax, causing consumers to buy less and Walmart to import less. Fewer imports would mean fewer dollars would be sent abroad. At the same time, exports would become tax free. So markets would expect exporters, such as GE, to cut prices given the benefit of their new U.S. tax savings and to sell more abroad. To pay for those exports, foreigners would need to buy more dollars. These trends would cut the supply of dollars overseas while raising the demand for them. As a result, the dollar would strengthen.

If the dollar rose by precisely 25 percent, the border adjustment would create neither an import tariff nor an export subsidy, even though it would seem to do both. U.S. importers and exporters would see no change in their profits, and U.S. consumers would see no difference in prices. This is the plan's intended result. According to economists backing the plan, the border adjustment is aimed at attracting businesses to the United States, not at creating trade barriers.

To illustrate the point, imagine that the dollar and the euro were at parity and Congress implemented the cash-flow tax without the border adjustment, so companies could deduct payments for imports just as they can today. Say Walmart bought a ten euro shirt from Greece for $10 and sold it in the United States for $11. The net cash flow would be $1, a 20 percent tax on that cash flow would be $0.20, and Walmart would be left with $0.80. Now imagine that Congress enacted the border adjustment, making payments for imports nondeductible. If the dollar rose by 25 percent, one euro would be worth only $0.80 (and $1 would be worth 1.25 euros). Now, Walmart would spend $8 (rather than $10) to buy the same ten euro shirt and sell it in the United States for $11, as before. Walmart would owe a 20 percent tax on the entire $11, not just its net cash flow. Nevertheless, as before, this would leave Walmart with $0.80 in cash ($11 from the sale minus $8 for the shirt

and $2.20 in tax). Walmart would now pay $2 more in taxes but would spend $2 less on buying the shirt from Greece, given the stronger dollar. The same logic would hold for exporters: the stronger dollar would force businesses to lower the prices of their exports, offsetting the savings from the lack of a tax.

It is unlikely, however, that the dollar would appreciate by as much as 25 percent. Such a jump would make the world's reserve currency more expensive than it has been in decades. This would spell trouble for many foreign borrowers. Foreign governments, banks, businesses, and individuals with dollar-denominated debts must buy dollars in order to make principal and interest payments. In 2015, emerging-market economies owed almost $4 trillion in dollar-denominated liabilities, according to the Bank for International Settlements. In Mexico, Russia, and Turkey, dollar-denominated debts, excluding those owed by banks, amounted to between a fifth and a quarter of each country's GDP. A large rise in the value of the dollar would do serious damage to these borrowers and others like them. The result would be credit downgrades, defaults, and all sorts of fiscal pain. Foreign central banks and governments would almost certainly step in to support their currencies and resist the rise in the dollar.

Moreover, about 20–30 percent of U.S. imports are priced in dollars. Those prices may take time to adjust, especially in the long-term contracts that are common in global supply chains. The existing evidence measuring the effects of changes in VAT rates on other countries' currencies is scant and inconclusive. For all these reasons, many experts, especially those outside of academia, believe that the plan would cause the dollar to appreciate significantly, but by less than 25 percent.

If this partial adjustment took place, then in the example above, Walmart would pay more in extra tax than it would gain from a stronger dollar, causing the company to raise prices for U.S. consumers. The picture would be reversed for exporters, such as GE, which would save more from the tax exemption for exports than they would lose from charging lower prices to foreign buyers. So it is not surprising that GE is pushing the plan hard, whereas Walmart, U.S. automakers, and other importers are fighting it tooth and nail. These companies recognize that a partial dollar adjustment would create an import tariff and an export subsidy.

The plan's likely protectionist effects have already put other countries on high alert. In March, *Der Spiegel* reported that German Chancellor Angela Merkel intended to discuss the "protective tariff" resulting from the plan with Trump. That was only the beginning of the international opposition. The border-adjusted tax in the plan would almost certainly violate the rules of the World Trade Organization. European countries are already preparing their WTO case against the United States, and they might retaliate with their own tariffs even before the WTO reached a decision. The trade expert Chad Brown has estimated that if the United States lost at the WTO, it would face trade sanctions as high as $385 billion a year.

This potential disruption in trade throws yet more doubt on the projected $1.2 trillion in border adjustment revenue. That estimate assumes that the United States would continue to run large trade

deficits, something the plan's protectionist effects make less likely. So not only would the border adjustment create winners and losers and lead to trade disputes; it would also fail to generate the revenue that Ryan and Brady are relying on to defend their plan's fiscal responsibility.

CUI BONO?

The Better Way plan would also affect how wealth is distributed around the world and within the United States. For starters, the plan would significantly reduce American wealth. Again, the stronger dollar would be to blame. A foreigner holding U.S. dollars or dollar-denominated assets would receive a windfall from a dramatic rise in the value of the dollar. But a strong dollar would hurt Americans with investments denominated in other currencies, since these investments would lose value in proportion to the rise in the dollar. The economist Alan Viard has estimated that the gains to foreign asset-holders and losses to Americans would run into the trillions of dollars.

Things are less clear on the domestic front. The plan would repeal the existing corporate income tax, but it is unclear who exactly would benefit. "Corporations" is not a legitimate answer: these are legal entities, which cannot feel joy, suffer pain, or benefit from anything, tax cuts included. Most economists agree that the burden of a corporate tax is split between workers and owners of capital, but they do not agree on how much falls on each group. Estimates of the workers' share range from 20 to 70 percent. If the corporate income tax falls largely on workers, then abolishing it would benefit them. If it does not, they might gain little.

The effects of the cash-flow tax are not obvious either. Economists believe that the wage deduction would encourage businesses to pay their workers more. If it did, then the burden of the new cash-flow tax would fall more heavily on the rich than a VAT would. Yet economists simply do not know how wages would adjust. For all these reasons, even the plan's strongest supporters are cautious in predicting how it would change the distribution of income among Americans.

The list of problems that the Better Way plan would create is daunting, but its most immediate cost would be pervasive uncertainty. If the plan became law, retail prices would rise, but no one knows by how much. The Federal Reserve might try to curb the resulting inflation by hiking interest rates or do nothing. The plan would strengthen the dollar, but it is unclear how fast and how high the dollar would rise. Foreign governments and central banks would respond, but no one knows when or how. U.S. trading partners would bring a case against the United States at the WTO, but the organization can take years to decide such disputes. If the WTO imposed sanctions, the United States might pay them, change the tax, or withdraw from the WTO, perhaps setting off a trade or currency war.

On the domestic front, retailers would challenge the new tax in court. They have a plausible argument that the cash-flow tax would violate the U.S. Constitution. Such disputes would also take time to settle. Finally, Congress might reverse course. It would be easy to go back to the current corporate tax if the political winds shifted again. No one can say what effect all this uncertainty

would have on the U.S. or the global economy. But these questions should concern even the bravest reformers.

FIX IT, DON'T NIX IT

Ryan and Brady are right that the U.S. tax system badly needs change. The United States has the highest statutory corporate tax rate in the developed world. Congress should cut it. But lowering the corporate rate to 15 or 20 percent—below the rate in many other rich countries—would cost about $2 trillion in revenue over the next ten years. So Congress should make up this revenue elsewhere. It is time for the United States to join the rest of the world and enact a VAT.

Republicans have opposed a VAT for decades. They resist new taxes, and they worry that because taxpayers would notice a VAT increase less than they would an income tax hike, Democrats would raise the VAT rate again and again. Democrats are also reluctant to embrace a VAT, because it would fall more heavily on lower-income people. These are real concerns.

The Better Way plan, however, points toward a solution. In essence, the plan proposes a VAT with a wage deduction. Congress could achieve the same result by enacting a typical border-adjusted VAT while providing a direct tax credit to wage earners. This seemingly minor change would avoid many of the problems that the Better Way plan would cause.

A VAT would comply with all U.S. international trade and tax obligations. If Congress granted a tax credit only to lower-income, rather than all, workers, that credit plus a VAT would be more progressive than the Ryan-Brady cash-flow tax. This might appease Democrats concerned that the other part of the reform—a corporate tax rate cut—would benefit primarily the wealthy. Moreover, a VAT with a credit for only lower-income wage earners would generate more revenue than Ryan and Brady's proposed tax. This extra revenue, in addition to the revenue from a 15 or 20 percent corporate income tax, would allow Congress to impose a VAT at a rate significantly lower than the 20 percent proposed in the Better Way plan. This would mitigate the negative effects of a rising dollar.

Granted, the new VAT would be yet another tax. But perhaps Republicans would accept it as the price of cutting the corporate tax rate by roughly half while keeping their commitment to fiscal responsibility.

These ideas are not new. Several politicians, including Democratic Senator Ben Cardin of Maryland, have already turned similar suggestions into legislative proposals. These are the proposals on which policymakers should focus. Congress should improve, not abandon, the current system. In tax policy—as in life more generally—it rarely makes sense to reinvent the wheel.