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POLICY BRIEF

PB 17-4 The Ryan-Brady Cash Flow Tax: Disguised Protection, Exaggerated Revenue, and Increased Inequality

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In its first week in office, the Trump administration sent mixed signals about whether it was prepared to endorse a proposal by Speaker of the House Paul Ryan and House Ways and Means Committee Chairman Kevin Brady to replace the corporate profits tax with a 20 percent tax on cash flow.[1] Their plan is aimed at lowering the statutory corporate tax rate, giving full immediate deductibility to new capital investment, and making the corporate tax "border adjusted"—exempting revenue earned by exports while subjecting imports to the tax.

On January 26 White House spokesman Sean Spicer stated that President Trump had decided to finance a wall on the Mexican border by imposing a 20 percent tax on imports from Mexico.[2] Spicer noted that such a tax could be imposed through the mechanism of the Ryan-Brady plan. White House Chief of Staff Reince Priebus responded to immediate criticism that such a tax would hurt consumers by indicating that the plan was just one of "a buffet of options" for financing the wall. Nonetheless, the possible linkage of financing the wall to the cash flow tax substantially escalates the chances that the proposal will be adopted.

The border tax adjustment (BTA) part of the plan is complicated—as President Trump earlier said. Nevertheless, despite the confusion sowed by the White House, the proposal remains a high priority for some in Congress. A major reason why Republican lawmakers continue to favor it is that it is designed to yield significant revenues—$100 billion a year by their estimates—which are crucial to the Republican pledge in Congress to enact tax reforms that make up for the lost revenues from tax cuts and do not widen the fiscal deficit.

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This Policy Brief argues that the Ryan-Brady proposal to replace the corporate tax with a 20 percent cash flow tax with no deductibility for imports but complete deduction of exports is misguided for several reasons.

First, it is protectionist, because it imposes the tax on the entirety of import value but only on the corporate profit component of domestic production, violating the concept of "like treatment" between imports and domestic goods. Second, a nonprotectionist version would involve a much lower rate and far lower revenues and, in principle, would have to vary sharply across sectors. Third, the tax would punish sectors particularly dependent on imports, especially the retail sector, automobiles, and oil refining. Fourth, the tax would be regressive, by shifting the burden to consumers

1. See the Ryan-Brady proposal, *A Better Way: Our Vision for a Confident America—Tax*, June 24, 2016, at http://abetterway.speaker.gov/_assets/pdf/ABetterWay-Tax-PolicyPaper.pdf.

2. Shawn Donnan, Demetri Sevastapulo, and Jude Webber, "White House weighs 20% import tax to fund US-Mexico border wall," *Financial Times*, January 26, 2017.

and away from the holders of corporate shares with respect to the traded part of production and consumption. Fifth, the tax is unlikely to induce a fully compensating rise in the dollar against other currencies such that imports would be no more costly (and exports no more profitable) than before.

Because of its protective structure, the proposal is likely to run afoul of rules against protection at the World Trade Organization (WTO), of which the United States is a signatory. Nevertheless, because the Ryan-Brady proposal continues to be a priority of Republicans in Congress, and in view of the Trump administration's mixed signals on the proposal, it is important for the public to understand its elements and the dangers they pose.

DISGUISED PROTECTION

The Ryan-Brady proposal for corporate tax reform calls for a shift from taxing corporate profits to taxing corporate "cash flow" on a basis of the "destination" principle. Implementing the destination-based cash flow tax (DBCFT) would require a "border tax adjustment" whereby no deduction would be allowed for imported inputs, and exports would be completely exempt from the tax—because the destination of the use of imports is domestic whereas that of exports is abroad.[3] Supporters of the proposal argue that the BTA would not be protectionist, because its use and the underlying destination principle are already well established in the case of the value added tax (VAT) used by most countries. However, as discussed later, the application of the BTA would be protection disguised by a supposed international precedent, because labor costs would not be deducted in applying the tax to imports but would be deducted in applying the tax to domestic production and sales. In contrast, BTAs for value added taxes must be set at the same rate as the value added tax, so that there is "like treatment" between imports and domestic goods.

The proposal envisions a flat rate of 20 percent (to replace the present loophole-ridden 35 percent rate). Laffer Curve enthusiasts[4] hope the lower rate would pay for itself by stimulating more economic activity. Moreover, because the United States has an annual trade deficit of about $500 billion, supporters anticipate that the change would raise revenue—by implication, by $100 billion per year, enough for them to claim it would substantially offset revenue losses from other tax cuts. A key objective of the approach is to eliminate the incentive for US firms to use transfer pricing and corporate inversions to locate profits abroad where the corporate tax rate is lower. More fundamentally, the change would partially shift corporate taxes from a production base to a consumption base, a long-term goal of those who judge that the current system is biased against saving and investment. However, such a shift would occur only with respect to the externally traded part of production.

A fundamental question about the DBCFT is whether it amounts to outright protection. After all, if it imposes a 20 percent tariff on all imports, and gives a 20 percent differential incentive to exports as opposed to all other activities, the effect would seem close to outright import protection and export subsidization, which the United States and other countries have forsworn in international trade agreements. Nor can it be said that the BTA simply levels the playing field with domestic products, because labor and other domestic costs would be deducted from the cash flow tax base for the good produced domestically whereas the entire value of the imported product would be subject to the tax.

To transform the proposal into a nonprotectionist tax, it would be necessary to allow the same structure of deductions for imports as for domestic sales. To avoid protection, the import must be subjected to the same tax as the domestically produced good. If the tax is a sales tax, the import should face the same sales tax as the domestic good. But if the tax is a cash flow tax, which allows deduction of domestic purchases of inputs, capital expenditures, and labor costs, then a wide disparity arises if corresponding deductions are not allowed for the imported good.

EXAGGERATED REVENUE AND INCOMPLETE EXCHANGE RATE OFFSET

The cash flow tax is supposed to be a substitute for the corporate profits tax, and as such just the corporate profit content of imports should be subject to the tax and just the corporate profit content of exports should be exempted from the tax in border adjustment. But the economywide division of income between profits and labor costs is approximately 30 to 70 percent. As a consequence, the cash flow tax would avoid being protectionist only if on average 70 percent of import value (the estimated labor content) were deducted from the tax base. Similarly, only 30 percent of the export value (namely, the corporate profit content) would be deducted from exports in calculating the tax base. The effect would be to shrink the rate of the tax on the trade deficit from 20 percent to about 6 percent, reducing revenue from about $100 billion to about $30 billion annually even if there were no reduction in the $500 billion annual trade deficit.

3. Auerbach and Holtz-Eakin (2016) provide perhaps the leading analysis of the proposal.

4. The Laffer Curve is a theory developed by supply-side economist Arthur Laffer to show the relationship between tax rates and the amount of tax revenue collected by governments. The curve is used to illustrate Laffer's main premise that the more an activity such as production is taxed, the less of it is generated. Likewise, the less an activity is taxed, the more of it is generated (see www.investopedia.com/terms/l/laffercurve.asp).

Advocates counter concern about the protective effect by arguing that there would be no competitive advantage considering that the proposed tax would induce appreciation of the dollar. The proposition is that any initial curb to imports would mean less demand for euros to buy French wine (for example), and any initial stimulus to exports now cheaper in euros would increase demand for dollars to buy US exports, so the dollar would appreciate relative to the euro (and other currencies). Economists like to buttress the argument of induced exchange rate appreciation by invoking the national accounts identity whereby the trade deficit is merely the excess of domestic investment over domestic saving.

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But the determination of protection turns on "like treatment," which dominates any considerations about induced exchange rate effects. Moreover, the induced exchange rate effects would likely be less than fully compensating. There are two major problems with the postulate of automatic exchange rate offset.

The first has to do with the "national accounts identity" argument whereby there could be no change in the trade balance because there would be no change in the underlying excess of investment over saving.[5] Those who invoke this identity to infer that exchange rates must fully adjust are forgetting that a second equation must also be balanced at the same time: the equation showing the response of exports and imports to the price variable (through the exchange rate and changes in import tariffs) as well as the foreign income variable for exports and the domestic income variable for imports (Cline 1994, 28–39). There is no presumption that the I-S equation is strictly determinative (exogenous) and the trade-price-income equation must be strictly residual (endogenous) through a fully responsive exchange rate appreciation. For example, when import prices start to rise, consumption of imports tends to fall. With less consumption, saving will tend to rise, so the "S" in the national accounts identity will change. Similarly, with incipient increases in exports (given preferred tax treatment) and incipient reductions in imports (given the new tax), output would tend to rise, and by residual, saving would tend to rise, for example from saving of higher profits.[6]

Second, and perhaps even more important, with capital mobility exchange rates are determined at least as much by financial market conditions as by trade changes, and probably more so. As a consequence, the exchange rate may be driven much more by relative interest rates and other financial influences than by recent trends in the trade balance. If other countries were to follow the US lead in introducing the DBCFT, moreover, some could be tempted to use exchange market intervention to thwart potential appreciation of their currencies.

SECTORAL WINNERS AND LOSERS

Once one casts doubt on the automatic exchange rate offset, it becomes apparent that shifting from the present corporate profits tax to the DBCFT could be very disruptive to several sectors of the US economy. Consider retail trade, where a high proportion of sales are of imported goods (especially for apparel and footwear). The new 20 percent tax on the imported wares would be a huge cost, which would wipe out thin profit margins unless the dollar price of the imports fell by enough to leave the price to the consumer unchanged. Or consider the internationally integrated structure of manufacturing relying on global supply chains (such as imported components in automobiles). Or consider the imported content for petroleum refining. Unless the exchange rate offset is nearly complete and prompt, the effects on such sectors would be severely adverse.

Incomplete exchange rate offset would indeed lead to some improvement in competitiveness and some reduction in the trade deficit. Although that outcome would cheer supporters (especially if a lower trade deficit were to dissuade the president from otherwise attacking trade with punitive tariffs on China, Mexico, and perhaps others), the eroding trade deficit would correspondingly erode the expected revenue from the tax on the trade deficit. More broadly, the damage done to entire business plans and supply chains would make this mechanism an extremely inefficient means of curbing the trade deficit.

These same considerations, moreover, clarify that the revenue associated with nondeductibility of imports does

5. From the product flow side of national accounts, $Y \equiv C + I + G + X - M$, where Y is output, C is consumption, I = investment, G is government spending, X is exports, and M is imports. From the factor income side, $Y \equiv C + S + T$, where S is saving and T is taxes. Subtracting the second equation from the first and rearranging, $I - S = M - X$.

6. That is: in the first instance, with Δ indicating change, $\Delta Y = \Delta X - \Delta M$. If consumption, government spending, and investment remained unchanged, then by residual, $\Delta S = \Delta X - \Delta M$.

not come as manna from heaven. The illusion of windfall revenue reflects the paradox that with complete exchange rate offset, consumers would pay no more for imports net of the tax than before. But instead, the revenue is to a large extent obtained from an excessive levy at the destination that overstates the net cash flow being taxed, essentially treating the entirety of the import value as pure profit and subjecting it to a corporate profits tax in the name of destination collection rights. So it is evident that rather than manna, the revenue represents a loss imposed on foreign suppliers and domestic users (corporate purchasers of components from abroad or households buying imported goods). This loss does not vanish, even if it is largely imposed on foreigners in the case of nearly complete exchange rate offset.

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MISLEADING VAT-BTA PRECEDENT

Advocates of the DBCFT will argue that it is no more protectionist than the corresponding framework in which value added taxes are applied with border offsets. Suppose a European country has a VAT of 15 percent. An import otherwise not subject to a tariff must pay the 15 percent on entry. Otherwise the import would not be subject to the same tax as the domestic good. Similarly, an exporting firm obtains a rebate of the 15 percent VAT on its exports. Most countries have this system, and it has long been sanctioned by the General Agreement on Tariffs and Trade (GATT) and the World Trade Organization (WTO). But there is no comparable problem of identifying the theoretically deductible component of the import, because when an imported good arrives at the border, it is safe to assume that its entire value constitutes the sum of value added of all stages of production that went into it. In contrast, a border adjustment tax on essentially corporate profits would prima facie be overstating the relevant tax if it treated the entirety of the import value as (foreign) corporate profit, making no deduction for costs of production.

This problem is one of the reasons for the distinction in GATT between acceptance of the BTA for indirect taxes but rejection of the BTA for direct taxes. The VAT is a sales tax that is sophisticated in avoiding double counting at successive stages of production. It is an indirect tax. Economists have tended to postulate that "the GATT distinction between rebates on direct and indirect taxes lacks a sound theoretical basis" (Mutti and Grubert 1984, 303).[7] Perhaps on such grounds, the advocates of the DBCFT appear to judge that the United States could make a good case for its acceptance under international trade rules, even though past similar US efforts associated with relief on direct taxes for exports have been ruled GATT-illegal (the Domestic International Sales Corporation or DISC, Foreign Sales Corporation or FSC, and Extraterritorial Income, or ETI). But the long-standing distinction between direct and indirect taxes in the GATT likely has more theoretical justification than some economists have acknowledged. In particular, the distinction is relevant because it is linked to the inherent ambiguity and difficulty of verifying the foreign cost structure, when considering a direct corporate tax with BTA, as opposed to the unambiguous magnitude of the indirect tax levied on a like good.

LIKELY ADOPTION BY OTHER COUNTRIES

If the DBCFT is adopted, a few years down the road the WTO will likely rule that it is illegal, just as in the previous incarnations of special export treatment. It is difficult to see how a multi-year period of uncertainty would help corporate investment decisions. And if the WTO accepted the approach, the question would then be, who's next? If the word goes out that the WTO accepts a regime that at least in the initial partial equilibrium instance penalizes imports and favors exports, then other nations would line up to adopt it, following the lead of the United States.

Canada and Mexico could be among the first, as they would be the most affected because of their high bilateral trade with the United States. China might do so, and of course the issue of exchange rate intervention (and the thwarting of the exchange rate offset) could then once again become prominent. The European Union could do so as well. Even though the European Union relies heavily on the VAT with border adjustments, European economies also impose substantial corporate taxes that they would likely convert to the cash flow variant adopted by the United States.

Other key economies, such as Brazil and Korea, might also find it attractive to supplement their tax regimes with DBCFTs. If the US structure of the DBCFT is not improved by allowing deductibility of labor costs for the imported good, then such an improvement would likely be absent in

7. Similarly, Hufbauer and Gabyzon (1996, 2) call the GATT distinction between border adjustability for indirect taxes but not direct taxes "outmoded."

the regimes of those countries that copied it.[8] US exports to these countries would then become fully subject to the 20 percent (or similar) tax rate. Moreover, if all countries converted their corporate taxes to the DBCFT, then one of the arguments of supporters would not be attained, because it would be impossible for the currencies of all countries to rise in real terms simultaneously.

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INCREASED INEQUALITY

Replacing the corporate profits tax with the DBCFT is also regressive with respect to distributional equity. To the extent that shareholders currently bear the burden of the corporate tax, their income and wealth levels are most affected. The bottom half of US households hold only 1 percent of wealth (CBO 2016). The middle class tends to hold wealth in housing, not corporate shares. So it seems safe to say that shareholder wealth is held heavily by the upper brackets of the income and wealth distributions. For products with a high import content and relatively little domestic production content, the proposed tax is mainly a new tax on consumption of imported goods. For exports, the DBCFT eliminates the corporate tax. Overall, the DBCFT shifts the burden of taxation from production to consumption with respect to the part of activity that crosses the border.[9]

Middle- and lower-income groups spend proportionately more on consumption than those at the top of the distribution, especially of imports, which tend to be the cheaper goods at Walmart. Shifting the tax composition from production to consumption is thus doubly regressive: It reduces the tax on corporate shareholders at the top of the wealth distribution, and it increases the tax on consumption of imported goods purchased proportionately more by those at the bottom of the income distribution. To justify replacing the current corporate tax with the DBCFT it would be necessary to demonstrate major welfare costs arising from production distortions under the current corporate tax structure that more than outweigh the regressive effects of the replacement.

CORPORATE INVERSIONS AND PROFIT-SHIFTING

That brings us to a key motivation for the change: the concern that the current corporate tax is biased against domestic production. This concern reflects the US system of subjecting worldwide income to the corporate tax, rather than following the "territorial" approach used by most other countries. The only concession to territoriality in the US system is the permission to defer payment of tax on corporate income earned in subsidiaries abroad until the income is remitted to the United States, so that in effect only the first, lower tranche of the tax—that collected by the (lower-tax) host country—gets collected up front. Hence the popular notion that some $2 trillion or $3 trillion in corporate profits are "locked up" (or "stranded") abroad until we grant a remittance holiday, and that the result is a lack of investment and job creation in the United States. (Critics of such views point out that in recent years when corporations have had access to more funds, they have tended to spend them on stock repurchases rather than building new plants, but that is a separate issue.) The closely associated distortion is the problem of inversion, whereby a large US corporation merges with a small corporation in a low-tax country in order to relocate its domicile to that country. A prominent recent example is the medical device firm Medtronic, which in effect moved to Ireland, where the corporate income tax is only 12.5 percent.

There are more direct ways to address territoriality and inversion than wholesale discarding of the corporate tax and replacing it with the DBFCT. Inversion may already be in the process of being resolved. After tighter application of rules within the US Treasury, drug giant Pfizer scuttled its plans to carry out an inversion merger with the Irish-headquartered firm Allergan.[10]

Distortions caused by worldwide rather than territorial treatment include primarily the use of transfer pricing

8. For the cash flow tax applied to domestic goods, deductions would also be allowed for intermediate inputs, in addition to labor costs. At the level of the imported product, the cumulative value of intermediate inputs into the product imported can be seen as the sum of capital and labor costs at all of the successive stages of production, so it is the labor content that faces the tax asymmetry in the DBCFT between taxation for imports but deductibility for domestic goods.

9. The shift to the DBCFT, however, does not represent a shift from a production tax to a consumption tax more broadly. As shown in appendix A, if the firm has no exports or imports, the only change is that the full amount of fixed investment becomes deductible, depreciation is no longer relevant, and interest is no longer deductible. None of these three changes constitutes a shift from a production tax to a consumption tax.

10. Matthew Herper, "Merck CEO Ken Frazier Is Looking Smart for Avoiding a Tax Inversion," *Forbes*, April 6, 2016.

to shift profits to lower-tax locales. In the 1990s and early 2000s, the average rate of return on direct investment abroad by US firms was about 4.5 percentage points higher than the corresponding return on direct investment by foreigners in the United States (Cline 2004, 53). The tendency of US multinationals to use transfer pricing to book profits in their foreign subsidiaries appears to have contributed to this divergence. The Internal Revenue Service (IRS) could police transfer pricing practices more aggressively, perhaps with punitive fees where misallocations of profits and costs reach some fraud-like threshold. (Large recent legal fines on large banks for misleading marketing of mortgage-backed securities in the Great Recession and on Volkswagen for thwarting emissions tests could serve to concentrate the corporate mind if such a policy were adopted.) For example, simple "standard" allocations of costs and profits based on workforce or revenue shares in worldwide totals of a multinational could serve as limits on profit and cost allocations in the absence of special demonstration otherwise by the firm.

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Both inversions and profit-shifting abroad could be curbed by amending US law to place a floor on foreign corporate tax rates that qualify for the territorial deferral of taxes on US corporate income earned abroad. The permissible gap might be set at, for example, 10 percentage points, if the current US corporate tax is not cut. If the corporate tax is cut to 25 percent (with loopholes eliminated), then the allowed gap could appropriately be smaller, say 5 percentage points, such that only countries with corporate tax rates of 20 percent or more would qualify for the deferral. Effectively the amount of advantage from the partial bow to territorial treatment in the form of deferral would be constrained to a narrower band.

But it is important to distinguish between welfare-distorting and tax-avoidance problems when evaluating what is wrong with the current corporate tax structure. If one is focusing on revenue losses due to tax avoidance, then the more fundamental question of whether there is some degree of a Laffer Curve for the corporate tax probably becomes more important than worrying about transfer pricing.[11] One senses, however, that the true angst about the corporate tax has more to do with the fear that it is hollowing out American manufacturing by giving undue incentive for multinationals to locate plants and jobs abroad. On top of this concern is the view that the US fiscal approach relies too much on taxes on income and production and too little on taxes on consumption, and thereby curbs saving and investment.[12] But as noted, replacing the corporate tax with the DBCFT would shift taxation from production to consumption directly only in the traded component of production and consumption (although the indirect influences on investment location and profit allocation would work in this direction).

With respect to revenue, the corporate income tax generated about 4 percent of GDP in revenue in 1960, but revenue fell to about 3 percent of GDP by 1970, and since 1980 has been in the range of about 2 to 2½ percent of GDP (CEA 2016, 586; BEA 2017). In contrast, personal income taxes now raise about 8.5 percent of GDP in revenue. So even if the corporate tax revenue were increased by say one-fourth, the contribution to fiscal stability would not be enormous. By implication, the stakes in corporate tax reform for incentive effects on growth and structure of the economy are probably greater than those on the fiscal side.

CONCLUSION

Overall, the case for replacing the corporate income tax with the DBCFT is doubtful. If the change were to be adopted, it would be important to allow deductibility of a substantial portion of imports, based on stylized ratios of labor costs to total value by sector; otherwise the BTA would amount to protection. The existing system could be improved by more strict rules on inversions and more aggressive policing of transfer pricing. Other possible reforms (such as accelerated depreciation) may also be warranted. But as currently proposed, the DBCFT has great potential to wreak havoc in such sectors as the retail industry and automobiles. Moreover, a central premise of the reform, that there would be prompt and full exchange rate offset, is not well based in theory and does not account for the dominant role of financial markets in setting the exchange rate. The proposed system would cause uncertainty by inviting dispute in the WTO. In short, the problems and costs of the reform are likely to outweigh any potential benefits.

11. Note that using data on corporate tax rates and revenue in OECD countries for 1980–2005, Brill and Hassett (2007) find that the revenue-maximizing rate fell from 34 percent in the late 1980s to 26 percent by the early 2000s.

12. As postulated by Hufbauer and Gabyzon (1996).

APPENDIX A

SIMILARITIES AND DIFFERENCES IN THE CORPORATE PROFITS TAX AND THE DESTINATION-BASED CASH FLOW TAX

Let t be the tax rate, assumed equal in the corporate profits tax (CPT) and the DBCFT. Let Q be output value. Let W = wages paid to workers; INP = inputs into production; DEP = depreciation; INV = new capital investment; and INT = interest payments. Let the subscripts x, D, and M represent exports, domestic, and imported, respectively. With R as revenue from tax, and with cp and cf as subscripts indicating the CPT and the DBCFT, respectively, the two systems can be compared as follows:

$$R_{cp} = t\,[(Q_D + Q_x) - W - INP - DEP - INT] \quad (1)$$

The current corporate profits tax applies to the excess of total output value (output sold domestically plus output sold in exports) minus labor costs, the cost of nonlabor inputs, depreciation, and interest payments.

Under the proposed cash flow tax,

$$R_{cf} = t\,[Q_D - W - INP_D - INV] \quad (2)$$

Now only the domestically sold output is included in the tax base. The full labor cost is still deductible. However, only the domestic part of nonlabor inputs is deductible. Total nonlabor inputs equal domestic plus foreign: $INP = INP_D + INP_M$.

Subtracting equation (1) from equation (2), the change in revenue caused by the replacement of the corporate tax by the DBCFT will be:

$$R_{cf} - R_{cp} = t\,[INP_M - Q_x - INV + DEP + INT] \quad (3)$$

For firms that do not import any inputs or export any output, the only change in the tax revenue from the firm will be the new tax on interest paid (previously deductible but now nondeductible) and the immediate expensing of investment instead of its deductibility only over time in depreciation.

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