Destination Basis with Border Adjustment as Tax Policy and as Macroeconomic Policy

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The US corporate tax system is broken. A combination of high rates, a dysfunctional international system, and a narrow base lead to distortions in business investment and increased complexity. These are largely unforced errors that could be ameliorated with a reformed business tax system. But the benefits of a reformed business tax system, while meaningful, are not large enough to justify introducing new problems, making existing problems worse, or incurring substantial transition costs. This paper attempts to understand the problems with the current system and the magnitude of the potential benefits of reform—while also weighing these benefits against the potential side effects of reform.

The main tax reform proposal under consideration today involves shifting the taxation of international income from the current system based on the location of profits (or "origin" of production) to a system based on the location of sales (or "destination basis"). It has been championed by Alan Auerbach, Michael Devereux, and Helen Simpson (2010), incorporated in one of the reform plans put forward by former President George W. Bush's tax reform commission (President's Advisory Panel on Federal Tax Reform 2005), and more recently included in the House Republicans' "Better Way" tax plan (House Republican Conference 2016).

There is a strong tax policy logic for shifting to a destination-based tax with border adjustment. In particular, such a shift would move taxation away from taxing based on the location of reported profits, which can easily be distorted or shifted to avoid taxation (by shifting production, profits, or headquarters), to a base that is considerably less subject to change (the location of sales). If the current US tax system were based on the location of sales, it would be foolish to change to an origin-based system.

But discussions of tax reform have to start from today as the starting point, and not just focus on an ideal endpoint, so it is important to balance the tax policy benefits of a destination-based system against the

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costs of getting there. Those costs are real and could be quite large. They include the effects associated with complete or incomplete exchange rate adjustment, possible international reprisals, and long-run revenue impacts. Moreover, the magnitude of the policy benefits could go down and the magnitude of the transitional costs could go up, depending on how the reform is designed and implemented.

Ultimately, however, border adjustment, like all other building blocks of tax reform, cannot be fully assessed in isolation because some of the most important issues in tax reform are the overall level of revenue, the distribution of income, and how the different building blocks fit together—all of which depend on the entire plan and not any single component. While there is an argument for improving the business tax system, it is not strong enough for it to come at the expense of worsening the medium- to long-run deficit problem or worsening the distribution of income.

This paper first details ways in which the US corporate tax system is broken, including high rates and a narrow base. Second, it identifies the magnitude of these problems, finding them to be meaningful but not so large as to overwhelm other considerations. The third section describes the substantial transition costs—including the costs associated with exchange rate movements and trade reprisals—that also argue against certain elements of the proposed reform. The fourth and fifth parts focus on revenue levels and distributional issues, two critical areas that cannot be evaluated definitively absent a fully specified plan. The conclusion considers potential alternatives if destination basis and border adjustment are not ultimately included in US tax reform.

THE BROKEN US CORPORATE TAX SYSTEM

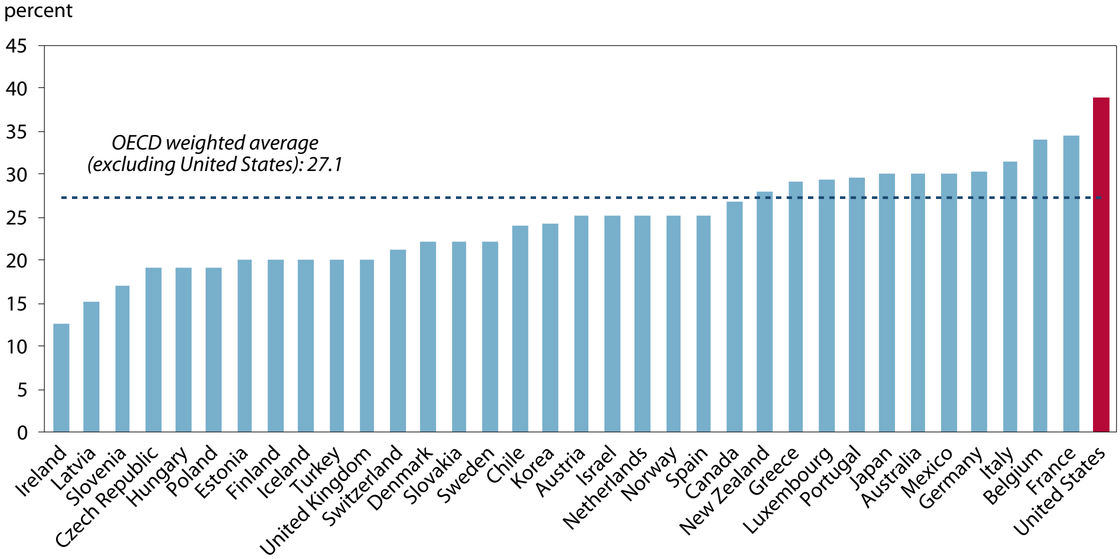
One indicator of the brokenness of the US tax system is that it has the highest corporate tax rate of any advanced economy, as shown in figure 1.

In a recent report, the US Treasury focused on average effective tax rates across the G-7 countries (US Department of the Treasury, Office of Tax Analysis 2017). As figure 2 shows, the United States is roughly in line with other countries by this measure.

The combination of these two facts—relatively high statutory rates but a middle-of-the-pack average effective rate—does not imply that the tax system is just fine. Instead, it suggests that the problem with the existing system is not that corporations are greatly overtaxed in the United States but that they are badly taxed—with some paying rates that are too high, some paying rates that are too low, and in many circumstances simultaneously paying taxes on some activities that are too high and taxes on other activities that are too low (CEA 2015). In other words, what is needed is system-wide reform based on the premise that the tax system should be made more neutral with respect to business decisions, not simply more competitive through a simple reduction in statutory rates (Kleinbard 2014).

Another aspect of the US tax system is perhaps even more broken: the international tax system. Some refer to the US approach as a worldwide system, since corporations are taxed on income earned anywhere in the world so long as they are headquartered in the United States. But there is an important caveat: The United States only *pretends* to tax corporations on income earned anywhere in the world but gives them significant flexibility in deciding where income is earned and whether to even pay US taxes. This flexibility tends to result in exercised self-interest, which leads to what is arguably a "stupid territorial" system in which overseas corporate income is effectively untaxed. In fact, some estimates suggest that ending the pretense of taxing overseas income could even raise money because it would also end the ability of corporations to take

Figure 1 Statutory corporate income tax rates, 2016

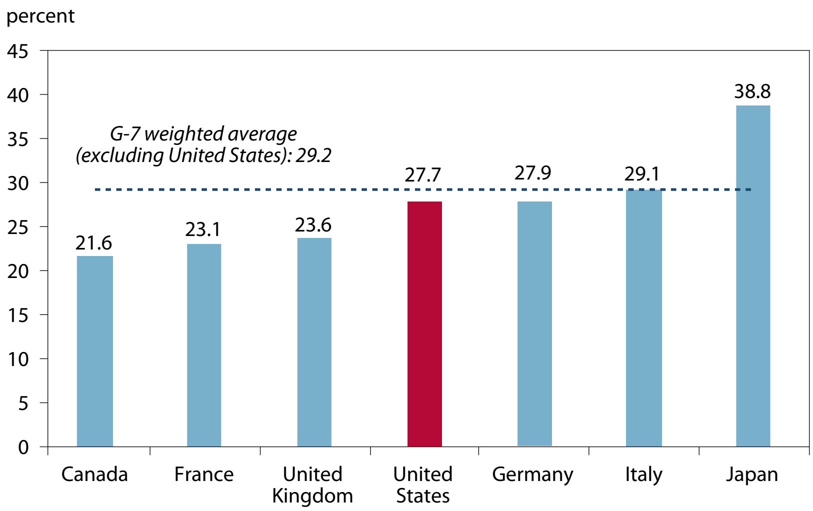


OECD = Organization for Economic Cooperation and Development

Note: Combined central and sub-central (statutory) corporate income tax rate given by the central government rate (less deductions for sub-national taxes) plus the sub-central rate. OECD average is calculated using gross domestic product (in current US dollars) in 2015 (latest year available for all countries) as weights.

Sources: OECD, national sources via Haver Analytics, and author's calculations.

Figure 2 Average effective tax rates in the G-7, 2006–09



Note: G-7 average is calculated using GDP (in current US dollars) as weights.

Source: Council of Economic Advisers (2015).

deductions associated with the costs of their overseas investment (Grubert and Mutti 2001).

Moreover, while the international system raises little or no revenue—and might even lose revenue—it still manages to create distortions. One manifestation of these distortions is the amount of profits that US-owned subsidiaries report in some low-tax countries, shown in table 1. In Bermuda, these profits total nearly 16 times that country's GDP, or 1,578 percent of GDP. In the Cayman Islands, these profits make up about 1,400 percent of GDP. These massive shares distract attention from countries like the Netherlands, where American-owned subsidiaries reported 15 percent of GDP—an extraordinary share of national income for the profits of US foreign subsidiaries alone, and another indicator of the brokenness of the US international tax system.

Table 1 US-controlled foreign corporation profits relative to GDP, 2010

Country	Percent
Bahamas	104
Bermuda	1,578
British Virgin Islands	1,009
Cayman Islands	1,430
Cyprus	13
Ireland	38
Luxembourg	103
Netherlands	15
Netherlands Antilles	25

Source: Council of Economic Advisers (2015).

HOW SERIOUS ARE THE CONSEQUENCES OF THE BROKEN US TAX SYSTEM?

While the US corporate tax system contains a large number of unforced errors, it is the magnitude of the consequences of those errors that is important for assessing reform proposals that entail tradeoffs in the form of adjustment costs, distributional impacts, and potential changes to revenue levels.

One consequence of the US corporate tax system could be that it reduces the *quantity* of investment. The United States does indeed have a problem with too little investment—but this has happened despite the already low cost of capital, and it is doubtful that an even lower cost of capital would help. Moreover, it is difficult to lower the cost of capital without reducing overall corporate tax revenues—which would mean helping to ameliorate an issue with the corporate tax system while greatly exacerbating another issue, the medium- and long-run deficit.

A more real and fixable consequence of the US corporate tax system is its impact on the *quality* of investment. To the degree that tax rates vary across different activities, investment decisions are sometimes made for tax reasons instead of what is most economically efficient, thereby distorting the allocation of capital. Currently, as table 2 shows, the United States taxes investment in different sectors at highly variable rates, ranging from a 10 percent for utilities to 27 percent for wholesale and retail trade. Meanwhile, the US tax rate on equity finance investment is the highest of any of the advanced economies, and the tax rate on debt finance investment is the lowest—leading to over-indebtedness and financial fragility—and the tax rate on corporations is higher than the tax rate on pass-through businesses.

The US international tax system also distorts the geographic location of investment. Grubert and Altshuler (2013) provide examples of effective rates under a 30-percent tax rate for an American company investing in the United States. If, instead, the company invested in a low-tax country, it would actually face a negative effective tax rate, since it could take advantage of immediately deducting expenses associated with that investment and never pay taxes on the income. If the company were to invest in a high-tax country, it would face an effective rate of 13 percent. These differentials thus distort how companies allocate capital across countries. Notably, they diverge not just from the premise that profits worldwide should be taxed at the US rate (30 percent in this example) but also are significantly below what the company would pay under an effective territorial system (which would be the local tax rate in this example).

Table 2 Effective US corporate tax rates

	Percent
Average effective actual rate	
Utilities	10
Wholesale and retail trade	27
Effective marginal tax rates on new investment	
Equity–financed	35
Debt–financed	–5
Corporate business	29
Pass–through business	24
Hypothetical:	
In the United States	30
In a low–tax country	–24
In a high–tax country	13
Business	27
Owner–occupied housing	–2

Sources: Department of the Treasury (2017); Council of Economic Advisers (2015).

Finally, perhaps more consequential than any of these distortions is the fact that the effective tax rate on owner-occupied housing is –2 percent as compared to a 27 percent tax rate for business investment, a disparity that encourages overinvestment in housing relative to productive capital.

To illustrate the magnitude of reforms to address these and other distortions in the tax system, table 3 presents estimates from the Treasury Department for two thoughtful proposals for tax reform from a commission formed by President George W. Bush (US Department of the Treasury, Office of Tax Analysis 2006). The first proposal was a simplified income tax in the classic mold of "broaden the base, lower the rate" that was projected to raise the level of output by 0.9 percent in the very long run, an effectively imperceptible increase in annual growth rates. The second proposal was a "Growth and Investment Tax"—a cash flow tax with destination basis and border adjustment that is similar to the House Republican "Better Way" blueprint. Treasury found this would add at most 0.2 percentage point to the annual *growth* rate in the first decade and 1.4 to 4.8 percent to the annual *level* of output over the long run.

The second set of estimates in table 3 are derived from a more stylized model by Altig et al. (2001). Under their model, a proportional consumption tax could potentially significantly increase output. However, this assumes a completely proportional tax without any exemptions and the same rate for everyone—making the proposal dramatically less progressive than even a flat tax would be. Even more important, much of the output gains

Table 3 Select estimates of the effect of tax reform on the level of national income

		Percent increase	
Source	**Policy change**	**Short-run**	**Long-run**
Treasury (2006)	President's Advisory Panel on Tax Reform		
	Simplified income tax	0.0–0.4	0.2–0.9
	Growth and investment tax	0.1–1.9	1.4–4.8
Altig et al. (2001)	Stylized Revenue-Neutral Tax Reforms		
	Proportional consumption tax	6.3	9.4
	Flat fax with transition relief	0.5	1.9

Note: Time period for short-run effects is the average effect in the first decade for Treasury (2006) and is the effect in the fifteenth year for Altig et al. (2001). Long-run effects reflect estimates of the change in the steady-state level of output.

would be generated by the fact that a consumption tax confiscates a portion of the old capital in the country, in part by rescinding future allowances for depreciation that firms have already incurred.

In contrast, with a flat tax and transition relief—and it is almost politically inconceivable that congressional tax reform would not have some type of transition relief with built-in graduated rates—the output effects are closer to half a percentage point of GDP after a decade and 1.9 percent of GDP in long-run steady state. It is important to note that these estimates are from a stylized, best-case version of reform that does not have the sort of carve-outs and exemptions likely in real-world reforms.

THE TAX POLICY LOGIC FOR DESTINATION BASIS WITH BORDER ADJUSTMENT

To appreciate the tax policy logic underlying destination basis with border adjustment, it is important not only to review misleading or false arguments for destination basis but also to understand why all origin-based approaches to reforming international taxation have substantial shortcomings. While destination basis raises a number of tax policy issues, it should be assessed compared to the alternatives—all of which have even greater issues.

Some Flawed Arguments for Border Adjustment

The idea of destination basis with border adjustment has suffered at the hands of many of its proponents. Some arguments for border adjustment are either fallacious or weak. The first is that everyone else is doing it, so the United States should too, in order to boost competitiveness. While politically appealing, economists advocating the idea have largely eschewed this argument on the grounds that the exchange rate would (at least eventually) adjust and thus offset any direct effects on the after-tax price of exports or imports (Auerbach and Holtz-Eakin 2016).

A second argument for destination basis, that it is a necessary part of a cash flow and consumption tax, has gotten more traction among some economists. Many economists are convinced that a consumption tax is the right base and that a cash flow tax is one way to implement it. Regardless of one's view on this issue, however, the question of whether to implement a consumption tax with destination or origin basis is a separable issue. In fact, most of the leading consumption tax proposals to date have not had this feature. Hall and Rabushka's *Flat Tax* (1985) did not have destination basis. David Bradford (2004) gave thoughtful consideration to this question and did not include destination basis in his proposed X-tax, a variant of a flat tax. And Carroll and Viard (2012) provide a book-length argument for a consumption tax and included a chapter that, after weighing the pros and cons, ultimately came down in favor of origin basis instead of destination basis.

A third argument is that border adjustment raises substantial budget revenue, a potentially important motivation for congressional support. As described in more detail below, this argument is fallacious and is in fact one of the most important arguments *against* adopting destination basis and border adjustment.

The Limitations of Origin-Based Approaches to International Taxation

A fuller understanding of the benefits of destination basis with border adjustment comes from understanding the flaws in the other approaches to taxing the overseas income of US companies. In particular, the concept of neutrality is relatively straightforward when it comes to the tax rates on investments in different sectors or financed in different manners—the tax system should equalize the tax rates. But in the international area there are conflicting goals for neutrality that cannot be simultaneously and perfectly resolved through any particular origin-based international taxation system.

For example, an ideal tax system would obey "capital export neutrality" (Musgrave 1969). A company can build a factory in either the United States or China; in an efficient system, the factory should be located where it makes the most economic sense, not where it makes the most sense for tax purposes. There are many fundamental economic reasons why a company might locate a factory in China, but to the degree that it does because Chinese tax rates on production are lower leads to an inefficient allocation of capital. Capital export neutrality can be achieved by a worldwide tax system that taxes multinationals at the US rate wherever they earn income in the world, with a credit against the tax they paid abroad to avoid double taxation. Under such a system, companies decide the location of production based on economic and not tax reasons.

However, there are also concerns about something that Desai and Hines (2003) have called "capital ownership neutrality." In this scenario, the best location for a factory is another country, say China—whether because it is serving the local market or because of lower labor costs—and no policy is going to change that fact. Given this, should that company be a subsidiary of a US multinational or of a multinational based elsewhere? Here, the ideal system is one where, regardless of nationality, the factory's owner pays the Chinese tax rate but not anything beyond that. Otherwise, if the American company pays anything more in US taxes than, say, a British company pays in UK taxes, the British company will have a competitive advantage (since the British company can have more efficient global supply chains that are undistorted by taxation). Capital ownership neutrality thus demands a territorial system, the exact opposite of the worldwide system demanded by capital export neutrality.

A third important element is where company profits are located and, in particular, whether they are attributed to the United States or to a low-tax country in for example the Caribbean. Here neither a worldwide system nor a territorial system is perfect. Worldwide taxation does remove the incentives around transfer pricing, debt stripping, location of intangibles, and so forth, because no matter where in the world profits are earned, US companies pay their taxes in the United States. Except there is one problem: Companies would love to move their headquarters out of the United States to get out of that system.

A territorial system poses the opposite problem. Under a territorial system companies do not mind where their headquarters are located, and there is no reason not to leave them in the United States—especially when the United States is so generous and lenient in its enforcement of interest stripping, location of intangibles, and (to some degree) transfer pricing.

A possible way to ameliorate but not fully solve these tensions is a "minimum tax" system that immediatley taxes overseas income at some rate between zero (a territorial system) and the US rate (a worldwide system). Instead of getting one margin exactly right and another margin badly wrong, this system would make smaller errors on all margins—which likely is better than the current system, pure territorial or pure worldwide—but still leaves a lot to be desired (Treasury 2017).

Table 4 summarizes the pros and cons of these various systems in terms of their distortionary effects on the location of production, the ownership of subsidiaries, the location of profits, and the location of corporate headquarters. In all of these cases, the current system gets it wrong—but there is no perfect alternative in the origin-based paradigm that has dominated international tax reform discussions until recently.

Table 4 Pros and cons of selected tax systems

Tax system	Where to locate production	Who owns a given subsidiary	Where to report profits	Where to locate headquarters
Current: Deferral	×	×	×	×
Origin-based				
Territorial	×	✓	×	✓
Worldwide	✓	×	✓	×
Minimum tax	✓/×	✓/×	✓/×	✓/×
Destination-based				
Border adjustment	✓	✓	✓	✓

Source: Author's calculations.

How Destination Basis Minimizes Distortions

The argument for destination basis is that rather than taxing aspects of business that are relatively more responsive to taxation—like the location of production, the location of ownership, and where profits are reported—the tax system should instead impose taxes on things that are relatively unresponsive to taxation. In particular, if sales are taxed, the location of sales is unlikely to change dramatically—a company will not sell a car in China instead of in the United States, since it can continue selling in both places.

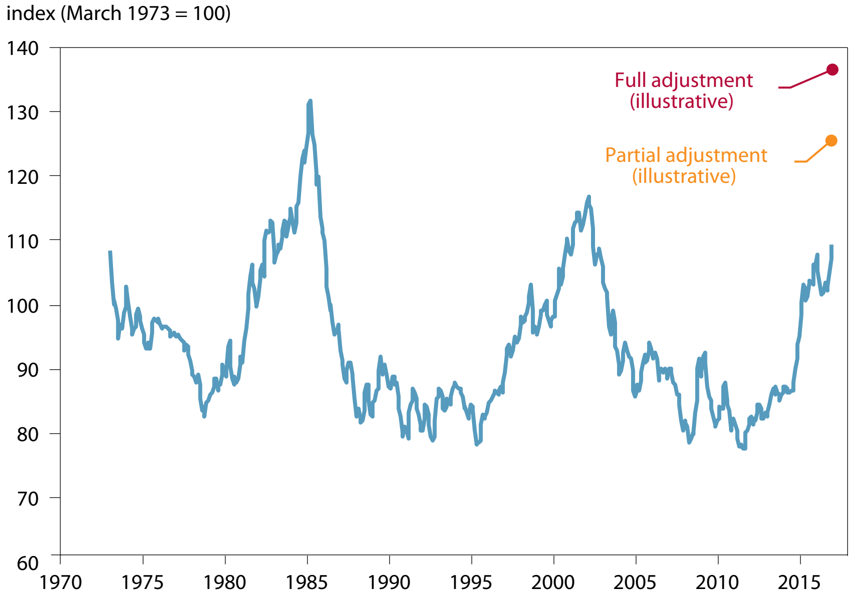
As a result, shifting to destination basis achieves neutrality on all of the important dimensions in a way that origin-based systems fail to do. There is no reason to shift production, ownership, reported profits, or headquarter locations in a system that does not use any of these as the basis for taxation. So these decisions would not be distorted, except to the degree that the continuation of origin-basis territorial systems by other countries leads to an ongoing incentive for companies to shift reported profits to the United States, knowing that such profits would not face taxes here under a destination-based system and would also escape overseas taxation as well.

To be sure, destination basis raises a number of tax policy issues. These include dealing with: (1) direct sales to consumers via the Internet, tourists, and retirees, as well as how to assess where services are consumed; (2) the fact that more firms will have unrecoverable losses because export revenue is excluded; (3) the impact on the global tax system given the incentive to shift income to the United States; and (4) the treatment of financial transactions, a particularly thorny issue. None of these issues is fatal; any tax system—and certainly the current US system—has a set of issues along these lines, and none are large enough, at least on tax policy grounds, to change the strong presumption in favor of shifting to a destination basis system.

POTENTIALLY LARGE ADJUSTMENT COSTS: EXCHANGE RATE AND TRADE RESPONSE

If the United States had a destination-based tax system, it would certainly be worth sticking with it. But transitioning to such a system may involve substantial costs, and it is worth weighing such costs against the benefits of the system.

Figure 3 Real trade-weighted dollar (major currency index)



Sources: Federal Reserve Board and author's calculations.

The first cost is the exchange rate adjustment associated with the shift to a new system. In theory, adopting border adjustment should lead to a complete and instantaneous adjustment in the exchange rate, such that the price of imports and exports does not change (Feldstein and Krugman 1990, Auerbach 2017a). The argument for full and immediate adjustment is that if the economy was in equilibrium before, then with exchange rate adjustment it can stay in the identical equilibrium—something that is not inconsistent with past experience with value-added taxes, according to Freund and Gagnon (2017). For example, assume the current exchange rate is 100 Japanese yen per $1. Assuming a new system with a 20 percent corporate rate and border adjustment goes into effect, the dollar would appreciate by 25 percent, so $1 would buy 125 yen. After this adjustment, $1 buys 125 yen worth of imports, which after the de facto 20 percent US border adjustment tax would be worth the same 100 yen that they were worth before the tax and exchange rate appreciation.

Such an exchange rate adjustment, however, would be massive compared to past historical experience, as shown in the "full adjustment" case in figure 3. Moreover, the actual exchange rate appreciation should be even larger if the plan succeeds in raising domestic investment and if the plan is deficit-financed (thus lowering net national savings). Such a massive exchange rate change could have repercussions for global markets, including a substantial increase in the value of US assets held by foreigners like Japan and China and a substantial reduction in the value of foreign assets held by the United States—a loss estimated at between $2 trillion and $4 trillion for a policy change of this magnitude (Carroll and Viard 2012, Auerbach 2017b). In addition, the exchange rate change would increase indebtedness for foreigners with US dollar-denominated borrowing, which could affect financial stability.

Alternatively, it is possible that the exchange rate would not adjust fully, at least not immediately. This could be for any number of reasons: Most global trade is denominated in dollars and prices are sticky;

exchange rate markets are dominated by vast portfolio flows that outweigh trade flows; many countries fix their exchange rate against the dollar; financial markets may operate irrationally; or rational financial markets may expect the policy to be reversed. Partial adjustment could attenuate some of these asset and debt revaluation effects but would create another set of problems—a substantial set of sectoral winners like aerospace and losers like retail (Cembalest 2016).

The most likely scenario is something approximating complete adjustment in an orderly fashion in a relatively short period. But if there is even a 15-percent chance that this does not occur, then the risks for sectors like retail are substantial. Moreover, this raises significant political economy concerns. If these concerns result in exempting certain sectors, for example oil refining, from border adjustment, an entire new set of distortions and loopholes would be introduced into the tax system—precisely the opposite of what reform is supposed to accomplish.

The second set of issues is the expected response by other countries, which in part depends on whether the proposal is legal under World Trade Organization (WTO) rules, a topic analyzed extensively by Hufbauer and Lu (2017). But other countries need not wait for the WTO to license a response and could retaliate against the United States unilaterally, a response that could total more than $100 billion annually, according to Bown (2017).

According to economic logic, there is no reason that destination basis with border adjustment should be illegal under WTO rules or the subject of a trade reprisal, as it is economically equivalent to a VAT with a wage subsidy and border adjustment—identical to the system in countries around the world. In practice, however, a retaliatory response may be legal under WTO rules and could happen regardless. Moreover, the likelihood of the response goes up to the degree that border adjustment is marketed as a subsidy for exports and a penalty for imports—which is precisely how many politicians have described it. Additionally, if there are extensive sectoral exemptions—like oil refining—that would further lend the appearance of a targeted support for favored industries rather than a neutral tax policy, lending further impetus to a large negative trade policy response.

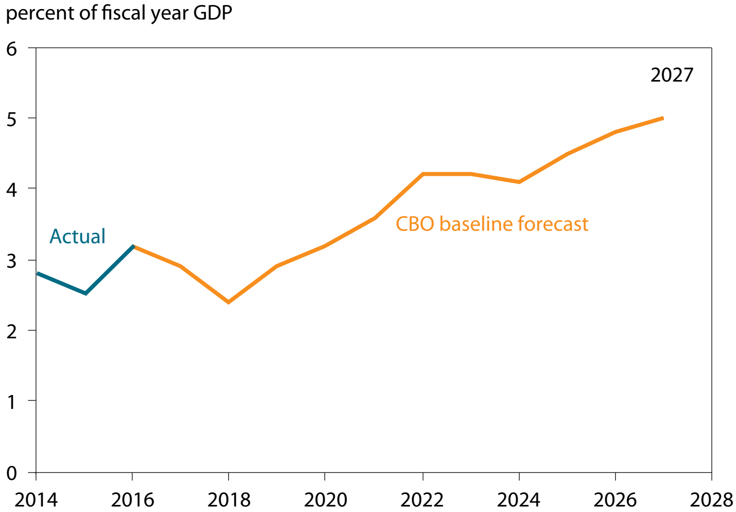
DESTINATION BASIS COULD WORSEN THE LONG-RUN DEFICIT

In evaluating any tax reform, it is important to assess its impact on the long-run budget deficit. Although the deficit is currently at the relatively manageable level of about 3 percent of GDP, as shown in figure 4, it is expected to rise to 5 percent of GDP in the next decade—a much more worrying level. While dealing with this longer-run deficit may not be the most immediate policy priority, at a minimum it is worth ensuring steps are not taken that would make it any worse.

Many in Congress have stated their intention that tax reform be revenue neutral. Even if that were the case, however, the reform could still worsen the long-run deficit. One reason could be if the baseline for assessing revenue neutrality were shifted, for example, to assume that certain expiring tax breaks were made permanent—a shift that would lock in a higher path for the deficit than that shown in figure 4. A more fundamental issue, especially in considering border adjustment, is that the long-run revenue effects may differ substantially from the short-run revenue effects.

In particular, three elements of the proposed "Better Way" tax reform would have systematically different short-run and long-run revenue effects. The first is a one-time "toll charge" on overseas earnings that would raise revenue within the budget window but not beyond it. The second is a shift to expensing of business

Figure 4 Federal budget deficit as share of GDP



Source: Congressional Budget Office.

Table 5 Plausible illustration of long-run fiscal effects
(net present value, percent of GDP)

	Ten years	Permanent
Border adjustment	0.4	0.0
Portion of rate reduction financed by border adjustment	–0.4	–0.4
Net fiscal impact	*0.0*	*–0.4*

Sources: Nunns et al. (2016); Bureau of Economic Analysis, National Income and Product Accounts; OASDI Trustees (2016); author's calculations.

investment, which would have a larger cost in the budget window (because of the immediate value of expensing) than in the long run (because many of the lost depreciation deductions would fall outside the budget window). These two elements would largely offset each other.

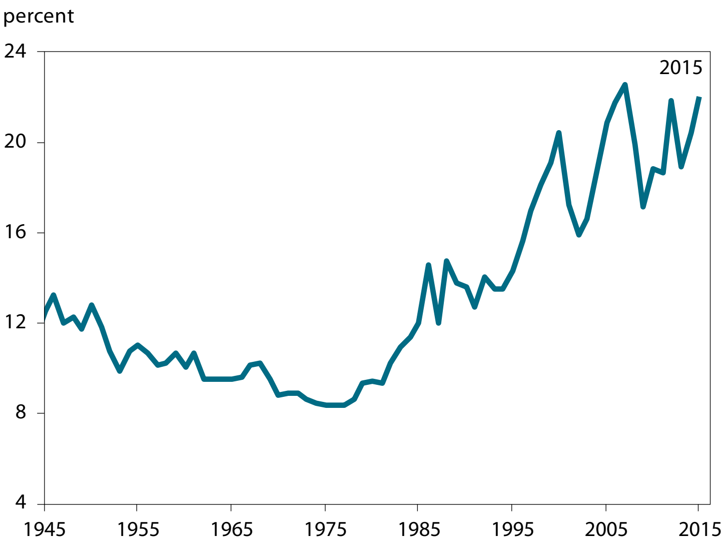
But the third way in which the short- and long-run revenue effects would be systematically different is border adjustment, a change that is quantitatively much larger than either of the other revenue shifts. The Tax Policy Center has estimated that border adjustment would raise $1.2 trillion, or 0.4 percent of GDP, in the budget window because the United States is currently running a trade deficit of about 3 percent of GDP, so the effective 20 percent tax on imports would raise more than the effective 20 percent subsidy on exports would cost (Nunns et al. 2016). But the United States is unlikely to be able to run trade deficits of this magnitude indefinitely without becoming unsustainably indebted to the rest of the world. And if the trade deficit narrows or reverses, then so would the revenue associated with border adjustment. That is why, unlike many of the issues surrounding destination basis (where there is significant debate), there is broad agreement that border adjustment would not actually raise any additional long-run revenue (e.g., Viard 2009).

Moreover, to the degree that border adjustment is used to pay for permanent tax rate reductions, then the net effect will be to raise the long-run deficit. Table 5 illustrates how the border adjustment component of the plan exactly offsets a portion of the rate reductions in the plan, both with a gross fiscal impact of $1.2 trillion, or 0.4 percent of GDP over ten years. (This is about a 10 percentage point reduction in the corporate rate.) But in the long run, if border adjustment raises zero revenue in net present value, then that portion of the tax reform plan will increase the long-run deficit by 0.4 percent of GDP. To put that in context, such an increase is one-third of the projected 1.2 percent of GDP deficit in Social Security and Medicare Hospital Insurance over the next 75 years (Medicare Trustees 2016; OASDI Trustees 2016). The actual impact could be larger or smaller than this estimate. If US holdings of foreign assets consistently earn a higher return than foreign holdings of US assets, this consideration would diminish and allow the United States to return long-run trade deficits. On the other hand, US repayment of $8 trillion in current debt to the rest of the world requires a trade surplus in net present value, and border adjustment would lose money over the long run.

LONG RUN-IMPACT ON THE DISTRIBUTION FACING HOUSEHOLDS IS UNCLEAR

Finally, perhaps the most important consideration in any tax reform is how it affects income distribution—because these effects are likely to swamp any welfare effects of the aggregate changes in the economy (Furman 2016). This is particularly important given the high level of inequality in the United States, as shown in figure 5. (While the figure shows only the top 1 percent's share of income, the conclusion holds up under a wide range of conventional measures of income inequality.)

Figure 5 Top 1 percent income share, 1945–2015



Source: World Wealth and Income Database.

It is difficult to provide a confident prediction as to how business tax reform broadly, or destination basis with border adjustment in particular, would affect income distribution. The issue is both complicated by and dependent on a number of unknown factors: the direct incidence of taxes; the impact on the economy and before-tax incomes; the impact on labor, leisure, saving, and investment; and so forth. Moreover, if a tax cut is not paid for when it is first passed, it does not mean that it will never be paid for; it simply means that how it will be paid for is unknown—and much of the impact on households will depend on these future changes. Does Social Security get cut more to make up for this cut? Or do taxes on high-income households go up more to make up for lost revenue? The incidence of the tax reform as a whole will depend greatly on these future policy responses.

These are all difficult questions to answer, and they depend on the plan as a whole—not just on one piece of it, like border adjustment. If the proposal were a net-present-value tax reduction, the manner in which that deficit increase is eventually financed and repaid would swamp any of the distributional effects of the tax cuts themselves—and such long-run distributional effects would largely be adverse.

Finally, the entire theory behind a destination-based cash flow tax system is that the normal return to capital should not be taxed—since that distorts people's intertemporal consumption choices, reduces savings, and hurts the economy—but that supernormal returns, like returns to monopoly or oligopoly power, should continue to be taxed. According to its proponents, shifting to a consumption tax base constitutes a shift of taxation away from the normal return of capital and towards a supernormal return, since such rents are better captured by it—a change that is in some ways more progressive than the current corporate tax system. However, it is not clear why one would want to combine this type of change with the dramatic reduction in the tax rate contemplated by the Ryan-Brady plan, since that cut itself would be more regressive than simply reducing the corporate tax rate under the current system, where it applies to a blend of normal and supernormal returns. Under a consumption tax, cutting the tax rate would only be giving a windfall for investment that was made in the past, for monopoly power, and for luck, three things that do not need larger subsidies than they already get today.

CONCLUSION

The business tax system is badly in need of reform. It is possible to achieve reform in a way that is genuinely revenue-neutral over both the short run and the long run. It is possible to have an international tax system that either raises more revenue than the current system with the same distortions, or raises the same revenue with fewer distortions, or some combination of the two. But the United States cannot even begin to have a conversation about corporate tax reform without accepting the fundamental premise that the corporate tax problem will not be made better by making the deficit problem or income distributional problem worse.

Starting from that premise, one possible reform route would be to adopt something like the House Republican "Better Way" tax plan but without their proposed reductions in the corporate and the individual tax rates. The "Better Way" shifts to a consumption base for taxation, which eliminates all taxes on the normal return to capital. As a result the plan applies the corporate tax to just supernormal returns—including on past investments, luck, and market power. Taxing these is economically efficient and, conversely, cutting the tax rate on them is a pure windfall. Such a modification would preserve essentially all of the economic benefits of the plan without the costly and regressive reductions in the corporate and individual tax rates and without the large increases in the long-run deficit or reductions in progressivity that would occur under the current proposal. But the downside of this approach are the transition costs associated with border adjustment. Moreover, at a 35 percent statutory tax rate, the exchange rate would need to appreciate by 54 percent to make the plan sectorally neutral—a massive movement.

Alternatively, tax reform could be more conservative in the small "c" sense and adopt a broader tax base, a lower-rate type of plan along the lines of President Reagan's reform in 1986 and the tax reform frameworks put forward by President Obama and former House Ways and Means Chairman Dave Camp. These approaches would lower the corporate rate to the mid-to-upper 20 percent range, consistent with the statutory rate in other major economies, and pay for the change with some combination of reducing accelerated depreciation, haircutting interest deductions, ending tax preferences for pass-throughs, and closing other loopholes. On the international side, such an approach could retain origin basis but switch to a minimum tax along with base erosion rules to both ensure revenue collections while also minimizing distortions associated with repatriating income or producing overseas. Such an approach does not have the elegance or economic upside of proposals for a destination-based cash flow tax. But it would be an improvement on the current system without many of the substantial transition risks that potentially mar alternative proposals.

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