Tax Adjustments at the Border

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In the tortuous path toward tax reform, both the Trump White House and Congressional Republicans have been tossing around the term "border adjustment tax," with proponents asserting that the adjustments they have in mind would protect American manufacturing, even as it generated big revenues to offset tax cuts elsewhere. U.S. retailers, for their part, are labeling it a tax on consumers — especially lower- and middle-income consumers — in hopes of smothering the baby before it can crawl.

Who's right? Arguably, neither side. Probably the easiest way to get a handle on what a border adjustment tax might actually do is to start with what border adjustments to taxation do now for other countries.

Border Adjustments Under a VAT

A value-added tax — think of it for the moment as a sales tax on steroids — is a major component of all of our big trade partners' tax systems. Under a VAT, a country taxes (most) consumer goods and services used within its borders. What differentiates a VAT from a made-in-USA–style sales tax is that the former imposes a tax on sales at all intermediate stages of production, rather than only at the final point of sale. VATs eliminate the problem of redundant taxation by allowing businesses to claim a rebate for taxes previously paid by its suppliers.

Export sales under VATs are "zero-rated," meaning that no tax is imposed on the value added by exporters, who can also claim credit for VAT paid on their purchased inputs. Importers, in contrast, are taxed on their sales and cannot claim credits because their foreign suppliers have not paid any VAT in the country of consumption. Border adjustability removes VATs collected at the early stages of production on goods and services that are exported and imposes a VAT on consumption of imported goods, effectively leveling the playing field between goods made at home and overseas.

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Border Adjustments Are Not Trade Barriers

President Trump and his economic spokesmen came to the erroneous conclusion that a country's border adjustability under a VAT amounts to an export subsidy, giving foreign competitors a leg up on U.S. manufacturers. Mexico, for example, has a 16 percent VAT that is adjusted at the border. In fact, the adjustment simply offsets what would otherwise amount to discrimination against Mexico's producers. Mexican consumers pay a 16 percent tax on their purchases, whether produced at home or imported. U.S. consumers pay no Mexican VAT, either on goods made in Mexico or goods made in the United States.

Retail sales taxes levied by states and localities in the United States treat traded goods the same way. New York imposes retail sales tax on goods consumed in New York, wherever they are manufactured, while goods made in New York and consumed outside of the state are exempt from the tax. By the same token, Federal excise taxes — yes, Uncle Sam still collects excise taxes on a handful of items — work the same way. U.S. consumers pay the same federal excise tax per unit of alcohol in Kentucky bourbon and imported scotch, while British consumers do not face the U.S. tax on bourbon exported to the UK. (Be assured, though, that Brits pay heavy taxes on booze, wherever it's made.)

Border Adjustments under the House GOP Plan

The Destination-Based Cash Flow tax (DBCFT) proposed by the House GOP is a form of VAT designed to look like the current corporate income tax. The House GOP levy resembles a VAT in three important ways. First, all capital costs would be deducted immediately from taxable income instead of being recovered over time through depreciation, as they would be under the current income tax. Second, interest expenses would not be deductible, as they are under an income tax. Third, export sales would be exempt from tax, while the cost of imported components and materials would not be deductible. Under the income tax, revenues from export sales count in calculating taxable profits, while import costs are deductible.

Bear with me on this: the DBCFT does differ from a VAT by allowing deductions for labor costs. Thus combining a standard European-style VAT with payroll tax relief and/or refundable tax credits for earnings would achieve the same result as a DBCFT. The DBCFT design reflects a desire by Republicans to achieve their policy goals, while being seen as reforming the corporate income tax instead of as substituting a tax with the dread label "VAT." (In the frequently quoted words of anti-tax lobbyist Grover Norquist, "VAT is a French word for big government.")

One has to sympathize a bit with Speaker Ryan's inclination to frame his proposal as corporate reform instead of a VAT. Border adjustments would remove the major problems we face today in taxation of multinational companies by taxing them based on where they sell their goods. Currently, companies can avoid the current corporate income tax by shifting investments and the reporting of income to lower tax foreign jurisdictions. Alternatively, they can merge with foreign corporations ("inversion," in the parlance of tax specialists) to become foreign residents and avoid U.S. taxes on repatriated profits.

Border adjustments would also raise significant revenue because the United States is currently importing about a half trillion dollars' worth of goods more than it exports. And this additional revenue could be used to help pay for lowering individual and corporate rates.

Problems, Perceived and Real

Border adjustments raise taxes on imports and provide tax rebates to exporters. But in theory, a uniform tax rate on imports and rebate rate on exports would not affect either the trade balance or the relative costs of importing and exporting firms because currency exchange rates would adjust to offset the effects of the taxes and rebates. What importers lost from higher taxes would be regained through lower dollar costs of their foreign purchases. And what exporters gained from the tax rebates would be lost because the competitive prices of their exports measured in dollars would fall by an equivalent amount.

Retailers dependent on imports and their allies on Capitol Hill, however, do not buy the theory. Senator Tom Cotton of Arkansas (home of Walmart) — opined that "some ideas are so stupid only an intellectual could believe them." Neither, for that matter, do export-dependent businesses, who are enthusiastic supporters of the DBCFT, presumably because they agree that the border adjustment would, after the dust settled, still reduce imports and stimulate exports and reduce competition from imports.

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This asset-value shuffle, it's worth noting, wouldn't necessarily please the current White House; foreign holders of U.S. Treasury securities (the largest of which is the government of China) would enjoy capital gains in terms of their own currencies, while developing countries that owe a lot of dollars to U.S. banks would find it harder to pay off their loans.

There are wheels within wheels to be accounted for here, too. Because export sales would be exempt from the tax, some profitable exporters would accumulate tax losses that they could not use. Meanwhile, other businesses could employ leasing transactions as well as mergers and acquisitions to shift reported profits from firms with positive taxable income to firms with tax losses. Finally, the World Trade Organization, which considers border adjustments acceptable trade practices under a standard VAT, might rule that the border adjustment under the DBCFT was an unfair trade practice because exporters would be receiving rebates for taxes they did not pay.

What It All Means

Uniform border adjustments are not trade barriers — a fact that both their supporters and opponents do not fully recognize. Border adjustments under the DBCFT would remove many of the worst problems of the current corporate income tax, but would have disruptive effects on exchange rates and asset prices, could lead to costly adjustments in firms' behavior as they seek to maximize the use of tax benefits, and would disrupt international trade if the practice were disallowed by the WTO. Oh, the tangled webs we weave…