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What Is a Border-Adjusted Tax?

Mark J. Mazur
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This year, Congress will consider what may be the biggest tax bill in decades. This is one of a series of briefs the Tax Policy Center has prepared to help people follow the debate. Each focuses on a key tax policy issue that Congress and the Trump administration may address.

In June 2016, House Republicans proposed a tax reform blueprint that would affect most of the tax code. The business component of the plan is generally referred to as a destination-based cash flow tax (DBCFT). The proposed DBCFT is composed of two parts. One part is a cash flow tax through which firms would immediately deduct the costs of all outlays (including the costs of investments in plant and equipment) and through which no deduction would be allowed for interest paid (equalizing the treatment of debt and equity financing). The second part is the destination-based (border-adjusted) tax, which has attracted much attention. With that system, firms effectively would be taxed on the value of goods and services they import into the United States (by not allowing a deduction for their costs) but not be taxed on the value of goods and services they export (by exempting these receipts from tax). This brief discusses the second part of the DBCFT, the destination-based part, which would be a striking departure from the way the United States currently taxes businesses.

Under current law, US-based firms can deduct their cost of goods and services purchased, no matter where the goods are produced, and include all receipts from sales of goods and services in the United States or abroad. Firms pay US income tax on their worldwide income, calculated as receipts minus deductions for purchases, with deductions for most investment goods spread out over time. However, they may defer paying US income tax on income earned by foreign subsidiary corporations until that income is distributed to the US parent firm as a dividend; a provision known as deferral. When the dividend is received, firms can claim a credit against their US income tax liability on income earned outside the US for income taxes paid to other countries.

HOW BORDER ADJUSTMENT WORKS

Under the proposed border-adjusted tax, goods and services sold abroad would be free of US taxes, but sales of imported goods and services, along with those produced domestically and sold in the United States, would be subject to the US tax. In other words, goods and services would be taxed based on where they are consumed, not on where they produced or the residence of the company that produces them.

Conceptually, a DBCFT is similar to a value-added tax (VAT), which is levied on the difference between a business's sales and its cost of inputs purchased from other businesses (which are also subject to a VAT). More than 160 countries currently impose some form of a VAT.

A DBCFT would differ from a VAT, however, by allowing firms to deduct the cost of labor. That may violate World Trade Organization rules that allow border adjustments for VATs but not for taxes on business profits that exempt wages. Proponents of a DBCFT argue that although it may formally resemble an income tax, it acts more like a consumption tax and therefore should be in compliance with World Trade Organization rules.

The border-adjusted tax in the DBCFT differs from an import tax or tariff. Such levies are normally imposed on individual products or countries (President Trump has even threatened to impose them on individual firms). In contrast, the border–adjustment tax proposed by House Republicans would apply to all imports and exports of goods and services conducted by businesses.

THE CURRENCY ADJUSTMENT MECHANISM

Critics claim that the border-adjusted tax would lead to higher prices for imported goods. That might be true in the short run if importers raise prices to cover the additional tax. But higher import prices would reduce Americans' demand for foreign currencies, while lower prices on tax-exempt exports would increase foreigners' demand for dollars. Both responses would push up the value of the dollar relative to other currencies.

In theory, exchange rates would adjust until the foreign currency prices of US exports (net of the tax savings from the exclusion for exports) and the dollar prices of US imports (including the additional tax created by the loss of deductions for imports) return to where they were before the tax was imposed. With full exchange rate adjustments, the border-adjusted portion of the DBCFT wouldn't affect the prices or aggregate amounts of either exports or imports.

PROBLEMS WITH THE THEORETICAL TEXTBOOK STORY

- *Timing of the Exchange Rate Adjustment.* Although the experience of other countries that have implemented border–adjust taxes suggests that exchange rates adjust to them quickly, that might not prove true for the proposed US tax, which is not just a modest change to a VAT rate. Even a short delay in currency adjustments would adversely affect US importers and consumers and benefit exporters.

- *Incomplete Exchange Rate Adjustment.* Many factors besides trade affect the value of the dollar relative to other currencies. Dollars are used throughout the world, both for exchanges and as stores of value. Although imposing a border-adjusted tax would put upward pressure on the value of the dollar, other factors could keep it from appreciating enough against other currencies to offset the tax completely. Moreover, world prices for some products—most importantly oil—are set in US dollars, not in the currencies of exporting countries. US consumers of oil and other dollar-denominated products would be adversely affected if the world price of those products did not fall by the full amount that the exchange rate of the dollar increased.

- *Delayed Tax Rebates to Exporters.* With the border-adjusted tax, exporters could expect to get tax rebates on the goods and services they sell abroad if their deductions for costs incurred in the United States exceed receipts from sales in the United States. But the proposed DBCFT would not allow firms to claim an immediate refund if their deductions exceed taxable receipts. Any delay in refund payments could adversely affect exporting firms and prevent full the exchange rate adjustments. And some exporters with permanently negative tax liability after the border adjustments may never get to claim the full amount of refund or rebate.

BENEFITS OF A BORDER-ADJUSTMENT TAX

Lawmakers who back a border-adjusted tax say it would reduce incentives for American firms to avoid taxes by shifting profits outside the US, it would raise new revenue to help pay for business tax rate cuts, and it would potentially lead to the creation of millions of jobs as US-based manufacturers expand export sales.

First, a border-adjusted tax would reduce incentives that exist under the current income tax for US companies to shift their US profits to low-taxed foreign subsidiaries, for foreign companies to shift the profits of their US subsidiaries out of the US, and for US companies to avoid US tax on the earnings of their foreign subsidiaries by becoming foreign companies (so-called inversions). A border–adjusted tax would remove the incentives to undertake these tax-avoidance measures because the amount of US income tax paid by businesses would be the same no matter where the products are produced or where the producing firm is legally domiciled. But although a border–adjusted tax would eliminate those incentives, they would create new incentives for firms to recharacterize domestic sales as exports and understate the value of imports, especially for digital transactions that don't require movement of physical goods.

As long as the US runs a trade deficit, a border–adjusted tax would raise revenue for the US Treasury because the tax on imports would exceed the revenue forgone by not taxing exports. The Tax Policy Center estimates that the border-adjusted tax proposed by House Republicans in June 2016 would raise an additional $1.2 trillion over 10 years. However, eventually the United States will run a trade surplus when foreigners buy US goods with the dollars they have accumulated. When that happens, the border–adjusted tax would lose revenue. In the long run, because the present value of net imports must be zero, the net present value of the border-adjusted tax revenue would be zero also. That would likely not materialize, however, within the budget window.

Finally, depending on how much the exemption of exports lowers foreign prices of US goods, firms might expand their operations to produce more goods for export. Although that might increase growth of the American economy in the short run, it would also put additional upward pressure on the value of the dollar because foreigners would need more dollars to buy the additional goods. Therefore, any stimulus would only be in the short run. Most economists who support a border–adjusted tax reject the notion that it would boost US exports and export-related jobs in the long run.

FINAL THOUGHTS

A complicating factor of a border–adjusted tax is that it would affect some other countries' abilities to service their existing debt burden. Many countries, especially developing ones, have large existing debts denominated in US dollars because lenders would not accept the currency risk associated with the borrowers' own currencies. If the US dollar appreciates, it would cost those countries more (in their own currencies) to repay those debts. Those added costs could cause economic slowdowns in those countries, which could adversely affect the rest of the world, including the United States. A similar effect applies to asset holdings. The rise in the value of the dollar also would impose a capital loss on Americans holding foreign assets while providing a windfall gain to foreigners with investments in the United States.

The border-adjusted tax is among the most novel features of the DBCFT and has garnered much attention. Theoretically, markets would respond to a border-adjusted tax through exchange rate movements that increase the value of the dollar enough to offset the real trade effects that otherwise might occur. So the DBCFT by itself would be expected to have no significant effects on the US trade deficit. However, critics have raised several concerns regarding the applicability of the theoretical model. Some of their concerns can be addressed in the drafting of specifications for the DBCFT legislation, and market reactions will determine the validity of their other concerns.