The worrying macro-economics of US border taxes

by GAVYN DAVIES*

Investors are beginning to focus on the likelihood that the Republican reforms to the US corporate tax regime may well include so-called “border taxes” that will operate like a combination of import taxes and export subsidies. This research note explains the possible reform, which is likely to be counter to WTO regulations, and could lead to trade retaliation by other countries. Simulations suggest that this part of the US tax reforms may result in a stronger dollar, but may have adverse effects on US inflation, GDP growth and (possibly) equity prices. Any such change to the US tax regime would probably be phased over several years, but could still have market consequences in 2017, as the legislative process gets underway in Congress.

The financial markets have begun to wake up to the fact that the Republican reforms to US corporate taxation will probably include important new “border adjustments” to the definitions of company revenues and costs. The basic idea is that US should shift to a “territorial” system, with corporations being taxed only on revenues and costs incurred within the US itself, and not on their worldwide aggregates, which is the principle behind the present system.¹

A border tax was not explicitly part of the Trump platform before the Presidential Election. It was, however, included in the tax plan published last year by Paul Ryan in the House of Representatives, and Mr Trump has recently tweeted that companies that do not “make in USA” can expect to “pay big border tax”²⁻³ That might be compatible with the Ryan plan, though it also might not be.

Although most other countries already operate “territorial” systems, the Republican plan includes other features that would make the new tax regime operate like a tariff on imports into the US, combined with a subsidy on many exports from the US, a combination that would have profound international economic consequences.

This is not just an obscure change to the details of America’s corporate tax code. It would be seen by trading partners as a protectionist measure that could disrupt world trade.⁴

The direct effects of a border tax adjustment to the US corporate tax regime would be likely to raise American inflation, cut imports, boost exports and raise tax revenue, possibly by over $1.2 trillion over a decade.⁵ However, it would also raise the dollar’s exchange rate, which could offset or cancel out some of these other effects.

The impact on real GDP and employment would depend on how these effects panned out, and how the Federal Reserve reacted to the increase in infla-

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¹See this extreme clear analysis of the topic from Reuven S. Avi-Yonah and Kimberly A. Clausing at the Michigan Law School and Reed College respectively.


⁵“US corporate tax reform: break for the border”, Financial Times, 04 January 2017
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It cannot be assumed that the effects would be beneficial. Recent estimates by Michael Gapen and Rob Martin at Barclays Capital suggest that the first year effects would be to raise US inflation by about 0.5-1 per cent, and to reduce real GDP by 1.0-1.5 per cent.

Given these economic effects, it is very doubtful whether this form of border tax, taken in isolation, would be good for the overall equity market, though other planned reforms to the corporate tax regime (including lower marginal tax rates, and full deduction of capital spending in the first year) certainly would be.

How would the new border tax work?

Although complicated, the basic principle is that goods purchased outside the US (i.e. imports) would no longer count as “costs” to an American corporation, so they would not reduce taxable profits. Meanwhile, exports sales would no longer count as “revenue”, so taxable profits would be reduced dollar-for-dollar by a firm’s export receipts, provided that exporting firms also have some domestic revenues.

In effect, imports would be taxed by an amount equal to the import bill multiplied by the corporate tax rate of around 20 per cent, while exports would be subsidised by the same amount.

Why would the US want to do this? First, in practice the new tax would be likely to raise a lot of revenue which could be used to pay for other reforms to the corporate tax system. Imports into the US exceed exports, so there would be a net gain reflecting the trade deficit.

Second, it seems clear that the border tax would protect domestic US producers and penalise importers. This is exactly what the Trump administration wants to achieve in order to “bring jobs back home”. The effect would be rather similar to a 20 per cent tariff on all imports, along with a 20 per cent subsidy on exports, provided that exporting firms have not already wiped out all of their taxable income.

It is very doubtful whether the border tax would be compatible with WTO regulations, which forbid using the direct tax system to discriminate in favour of US producers compared to foreigners. Republican supporters have countered this argument by saying that a border tax would simply be the American equivalent of VAT, which almost all other countries “levy” on US exports when they are sold in foreign markets. Therefore, they argue, the border tax would “level the playing field”.

These arguments are dubious. Most economists (e.g. [Krugman, 2016]) argue that VAT does not discriminate between domestic and foreign producers, either in home markets or in foreign markets and it certainly does not breach WTO rules. An American border tax would be seen by the WTO and most of America’s trading partners as adding a new discriminatory tax into the world system, not removing an old unfairness.

Some proponents of a border tax, like [Feldstein, 2017], argue that the discriminatory nature of a border tax would be offset by an immediate rise in the dollar exchange rate which would exactly offset the impact of the tax on import and export prices. In theory, this could be true, but in practice any upward adjustment in the dollar would be likely to take a long time.

William Lee at Citigroup suggests that a 20 per cent border tax rate would lead to a 15 per cent rise in the dollar’s effective index, but that this would

6Furthermore, some of the export subsidies would not, in practice, result in lost revenue to the US treasury. Firms could in theory offset more than the whole of their domestic tax burden by the export-subsidy, so they would be able to carry forward tax losses into future years. But since these tax losses may never be utilised, the taxes raised on imports would substantially exceed the export subsidies, even if the trade balance were zero.

7The difference between the Ryan proposal for the border tax, and the VAT operated by most other countries, is that US wage costs are deductible from corporate tax under the Ryan plan, but are not deducted from VAT paid in other countries. This means that the Ryan border tax discriminates in favour of US producers, whereas VAT in foreign economies does not. See pages 7-8 in the paper quoted in footnote 1.
take at least three years to happen, or longer if the Federal Reserve tries to prevent it from taking place.

So, would a border tax be a good idea from the US perspective? This question runs into familiar arguments about whether conventional import tariffs are a good thing. If there is no retaliation by other countries, then an “optimal” US border tax might, like an optimal tariff, improve welfare in a large economy like the US.

But if there is widespread retaliation by foreign countries imposing tariffs on US exports, then any gains to the US would be eroded over time. In that event, all countries would probably be worse off, because the welfare gains from world trade would be reduced. Furthermore, there could be huge disruptions to established supply chains that could damage production as the adjustment to the new taxes and tariffs take effect.

The Trump administration might decide that foreign countries would not dare to retaliate against the world’s largest economy. They might also decide that they could ignore attempts by the WTO to declare the border tax illegal. In that case, the border tax could become a reality, despite bitter political lobbying by US importers that would be damaged by the new regime.

The border tax may well get heavily watered down during its passage through Congress, and would certainly be phased in over a long period. But the potentially large long term effects of this reform on equity sectors, the dollar, and foreign economies are not yet factored into financial asset prices. This could be one of the big stories of President Trump’s first year in office.

References


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9 A large economy like the US might have enough market power to force foreign producers to cut their prices when selling into the US after the border tax is imposed. In that event, foreign producers would bear part of the burden of the border tax instead of US consumers.
Disclaimer

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