The House GOP’s Good Tax Trade-Off

Exempting exports from corporate income taxes would strengthen the dollar and raise revenue.

By
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Taxes are one of life’s certainties, and this year so is business tax reform. The tax plan developed by the House Republicans is similar in many ways to President-elect Trump’s plan but has one additional favorable feature—a border tax adjustment that exempts exports and taxes imports. This would give the U.S. the benefit that other countries obtain from a value-added tax (VAT) but without imposing that extra levy on domestic transactions.

Retailers and others oppose the border tax adjustment because it appears to raise the cost of imported products. But their analysis ignores the increased international value of the dollar—and therefore the lower dollar price of imported foreign products—that would automatically result from the border tax. In the end, the prices paid by U.S. consumers would be essentially unchanged.

To understand how this would work, consider first what would happen if the value of the dollar doesn’t change. Without a border tax adjustment, a U.S. exporter could export a product with a $100 total production cost (including the return on capital) for a price of $100. A retail customer in a country with a 15% value-added tax would pay $115 for that product.

But the border tax adjustment would allow the company to deduct the $100 cost of production when it calculates the tax on corporate profits. That would save $20 under the 20% rate House Republicans propose. That $20 tax saving would reduce the price of the exported product to $80. The retail buyer in the country with the 15% VAT would therefore pay $80 plus 15%, or $92.

A U.S. importer that pays $100 to import a product can, if there is no border tax adjustment, sell that product to a U.S. retail customer for $100. But with the border tax adjustment, the $100 import cost is not deductible from the corporate tax base. The price to the U.S. retail buyer would have to be $125, of which $25 would go toward the 20% tax.

These calculations make it look as if the border tax adjustment causes the U.S. consumer to pay 25% more for imported products and the foreign consumer to pay 20% less than they otherwise would. But the price changes that I have described would never happen in practice because the dollar’s international value would automatically rise by enough to eliminate the increased cost of imports and the reduced price of exports.

Here’s why. If the exchange rate remained unchanged, the higher price of U.S. imports would reduce the U.S. demand for imports and the lower dollar price of U.S. exports would raise the

foreign demand for American exports. That combination would reduce the existing U.S. trade deficit.

But as every student of economics learns, a country's trade deficit depends only on the difference between total investment in the country and the saving done by its households, businesses and government. This textbook rule that "imports minus exports equals investment minus savings" is not a theory or a statistical regularity but a basic national income accounting identity that holds for every country in every year. That holds because a rise in a country's investment without an equal rise in saving means that it must import more or export less.

Since a border tax adjustment wouldn't change U.S. national saving or investment, it cannot change the size of the trade deficit. To preserve that original trade balance, the exchange rate of the dollar must adjust to bring the prices of U.S. imports and exports back to the values that would prevail without the border tax adjustment. With a 20% corporate tax rate, that means that the value of the dollar must rise by 25%.

With a 25% rise in the value of the dollar relative to foreign currencies, the $80 net price of U.S. exports would rise in the foreign currency to the equivalent of 1.25 times $80, or $100, and therefore back to the initial price. Similarly, the 25% rise in the value of the dollar would reduce the real import price to the U.S. retail customer back to $125/1.25, or $100, as it is without the border tax adjustment.

Although the combination of the border tax adjustment and the stronger dollar leaves exports and imports unchanged, it has the important advantage of raising substantial tax revenue. Because U.S. imports are about 15% of GDP and exports only about 12%, the border tax adjustment gains revenue equal to 20% of the 3% trade imbalance or 0.6% of GDP, currently about $120 billion a year. At that rate, the border tax adjustment would reduce the national debt by more than $1 trillion over 10 years.

The burden of the $120 billion annual revenue gain is not borne by U.S. consumers or U.S. firms, since they continue to pay and receive the same prices that they would without the border tax adjustment. The stronger dollar helps the U.S., and this benefit is captured in the higher tax revenue. The rise of the dollar relative to foreign currencies means that the real purchasing power of foreigners declines to the extent that they import products from the United States or sell products to the U.S.

American Treasury secretaries since Robert Rubin have said that a stronger dollar is good for America. The border tax adjustment strengthens the value of the dollar, raising revenue that helps to reduce the fiscal deficit. When Congress enacts a tax reform in 2017, it should include the House Republicans' border tax adjustment.

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