The Economics of Border Adjustments

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Border adjustment debate

- Debate has focused on alleged trade deficit reduction and burden on importers
- But those effects would be negated by relative price changes
- Less attention to relevant issues
  - Above-normal-return investments
  - Initial cross-border asset holdings
  - Design issues

Simple model

- No above-normal-return investments
- No initial cross-border asset holdings
- Markets function perfectly

Trade balance

- In present discounted value, individuals will not sell more than they buy and cannot buy more than they sell
- Same condition holds for countries
- Trade must be balanced in present discounted value, although deficits or surpluses may persist for decades
- Current account need not be balanced

Immediate permanent uniform border adjustment (IPUBA)

- Uniform import tax, uniform export subsidy
- Tax rate same as subsidy rate
- Brady-Ryan: Import tax equal to 25 percent of before-tax price, export subsidy equal to 25 percent of after-subsidy price
- Consider effects of IPUBA, holding rest of tax system fixed

IPUBA changes relative prices

- Prices (including wages) paid and received by Americans rise 25 percent, relative to prices paid and received by foreigners, when expressed in any common currency
- Tax on left-handers’ net purchases from right-handers would have similar impact on their relative prices

Prices and exchange rates

- Possible monetary policies
  - U.S. price level rises 25 percent
  - Foreign price levels fall 20 percent
  - Dollar appreciates 25 percent
  - Mixture of the above
- Identical real effects in simple model – modest differences in general model
- Dollar appreciation likely – assumed below

Neutrality of IPUBA

- No shifts between U.S. and foreign goods
- No change in trade, investment, or output
- No changes in real incomes
- Neutrality holds, regardless of domestic tax system
- In simple model, no reason to support or oppose IPUBA

No change in investment returns

- Foreigners buying U.S. assets
  - IPUBA increases real cost of buying asset
  - Also increases its real payoff
  - No net effect (with normal returns)
- Americans buying foreign assets
  - IPUBA lowers real cost of buying asset
  - Also lowers its real payoff
  - No net effect (with normal returns)

No net revenue effect

- Due to trade balance, IPUBA has zero revenue effect in present discounted value
- Revenue gain during trade deficits (over $1 trillion in next decade), revenue loss during trade surpluses
- Government effectively borrows from foreigners buying U.S. assets, lends to Americans buying foreign assets

No change in trade “competitiveness”

- IPUBA doesn’t permanently increase export and reduce imports
- That’s for the best – permanently increasing exports and reducing imports would lower Americans’ living standards
- Import tax and export subsidy cancel out each other’s trade effects (regardless of how import tax compares to tax on domestic products)

Generalizing the simple model

- Above-normal returns (ANR)
  - Returns higher than those available on marginal investments
  - Rents, inframarginal returns, pure profits
  - *Not* risk premium
- Initial cross-border asset holdings

Americans investing abroad

- Border adjustment shrinks both real investment cost and payoff
- For ANR (where payoffs exceed costs), net loss to investor and net revenue for government
- For initial holdings (where costs already incurred), loss to investor and revenue for government

Foreigners investing in U.S.

- Border adjustment increases both real investment cost and payoff
- With ANR (where payoffs exceed costs), net gain to investor and net revenue loss for government
- For initial holdings (where costs already incurred), gain to investor and revenue loss for government

Effects of border adjustment

- Border adjustment imposes tax on:
  - ANR earned by Americans on foreign assets
  - Americans' initial holdings of foreign assets
- Border adjustment provides subsidy to:
  - ANR earned by foreigners on U.S. assets
  - Foreigners' initial holdings of U.S. assets

Border adjusting a business cash flow tax

- Tax base of non-border-adjusted BCFT:
  - ANR earned in U.S. by anyone
  - Everyone's initial holdings of U.S. assets
- Tax base of border-adjusted BCFT:
  - ANR earned by Americans anywhere
  - Americans' initial holdings of any assets

Desirable effects on ANR

- Border adjustment eliminates disincentive to make mobile ANR investments in U.S.
- Eliminates incentive to use transfer pricing to book ANR abroad
- Minor drawback – foregoes tax on foreigners who earn ANR from *immobile* investments in U.S.

Undesirable effects on initial assets

- Windfall tax cut for foreigners holding U.S. assets when border adjustment introduced
- Initial asset holdings are similar to *immobile* ANR investments
- Costly, and misdirected, foreign aid

Windfall tax cut for foreign investors (if no transition policy)

- Replacing corporate income tax with non-border-adjusted cash flow tax harms foreigners – deferred tax liabilities forgiven, but larger capital levy
- Replacing corporate income tax with border-adjusted cash flow tax helps foreigners – deferred tax liabilities forgiven, no capital levy

Possible transition policy

- Don’t provide business-level transition relief – instead, impose business-level windfall recapture tax
- Provide household-level transition relief for Americans, who will pay the tax
- Foreign investors may still receive windfall tax cut, but smaller one

Exchange rate response with perfect markets

- Full immediate response for IPUBA
- Response before implementation if border adjustment is not immediate
  - Consumption and investment rise (increasing the trade deficit) before implementation
  - No incentive for asset swaps
- Partial response if perceived not to be permanent (WTO?)

Exchange rate and price responses with market frictions

- Many currencies pegged, but they can and should be re-set
- A few countries are dollarized and can’t reset, but they’re very small
- Dollar-denominated contracts
- Market confusion possible – economists not good at predicting market timing
- Border adjustment could be phased in

Addressing potential pitfalls

- Provide cash refunds, not carryforwards, to exporters
  - Mergers and other self-help costly, of limited effectiveness
  - If import tax rate exceeds true export subsidy rate, excess is a tariff
- Reject calls for exceptions, elections, etc.
- Address WTO concerns

VAT-relabeling option

- Eliminate cash flow tax’s wage deduction, provide tax relief for wages elsewhere
- Satisfy WTO, facilitate export refunds
- Fed would probably raise U.S. price level
  - Dollar need not appreciate
  - Shift transition burden from equity to debt (which foreigners are more likely to hold)
- But could spur growth of government

Conclusion

- Commonly discussed effects on trade deficits and importers are illusory
- Important effects actually involve above-normal returns and initial cross-border asset holdings
- I opposed border adjustment in 2012 – now undecided
- If adopted, transition policy and potential pitfalls must be addressed