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Why the Border Adjustment Tax Should Be Killed

The BAT is a bad idea. There are far better ways to shrink the federal budget deficit.

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March 18, 2017

“Anytime I hear border adjustment, I don’t love it,” Donald Trump told The Wall Street Journal shortly before his inauguration, noting that the proposed border adjustment tax was “too complicated.”

Trump isn’t always right when he makes off-the-cuff remarks such as that, but this time he was. The proposed border adjustment tax is so complicated that even its advocates can’t agree on how its disruptive effects on the U.S. economy will play out, and there’s nothing to love about that. The BAT is a bad idea, and it should be scrapped. And while taking it off the table will bring more red ink to the federal budget, there are better ways to stanch the bleeding than subjecting the economy to the trauma of a BAT.

Despite protestations to the contrary, the border adjustment levy is a tax hike embedded in the program of tax reductions that House Republicans put forward last June under the rubric of “A Better Way.” It’s there, presumably, to help offset the effect of the administration’s planned cuts, since the Republicans’ stated aim is to keep those cuts revenue neutral. *Barron’s* fully supports the goal of not adding to deficits that, before too long, will be running above $1 trillion a year, given repeated warnings from the nonpartisan Congressional Budget Office about the risk of a financial crisis, due to exploding debt.

The attraction of a BAT is that it could generate an estimated $100 billion a year in revenue. There may be reasons to challenge that estimate, but we’ll accept it for now. There are, however, better ways to slash the fiscal deficit by $100 billion a year than the Better Way plan, and most fall under the heading of spending cuts.

President Trump has spoken about "waste, fraud, and abuse" in "every agency" of the federal government. Indeed, he promised that "we will cut so much, your head will spin." He should therefore find plenty to love in our proposed reductions in spending. Just for starters, if all corporate welfare were cut from the budget, as much as $100 billion a year could be saved, about matching the total expected from the BAT.

The president also favors slashing the top rate on corporate income to 15% from 35%. *Barron's* has proposed a more modest cut, to 22% ("Cut the Top U.S. Corporate Tax Rate to 22%," Nov. 26, 2016). The Republican package calls for a reduction to 20%, which is close enough to our original proposal and which we believe should boost revenue rather than shrink it.

A list of potential cuts and revenue enhancements, totaling $200 billion, is in the table at the bottom of this page.

THE BETTER WAY PLAN, as noted, would reduce the top federal tax rate on corporate profits to 20% from 35%—which is all to the good. The proposed tax cut would not only be revenue neutral; it would probably be revenue enhancing.

In a study released this month by the London based Centre for Policy Studies, analyst Daniel Mahoney traces the effect on revenue from Britain's cuts in the corporate tax rate over a 34year period. According to his calculations, the take from the corporate tax has added three tenths of a percentage point annually to gross domestic product since rates were slashed.

Similarly, last year, in calling for a maximum U.S. rate of 22%, we traced the significant decline in the average top rate on corporate income for 19 countries in the Organization for Economic Cooperation and Development, which includes the U.S. and the United Kingdom. Over 33 years, their average tax take as a share of GDP rose sixteenths of a percentage point.

While that might not sound like much, every tenth of a percentage point of U.S. nominal GDP is worth $18.9 billion. So if revenue from the corporate tax rises by, say, three tenths of a percentage point, to 2.5%—a conservative guess—that increase would translate into a bonus of nearly $57 billion a year in revenue. That alone gets us more than halfway to the $100 billion value of a BAT.

The idea of a revenue enhancing cut in the corporate income tax was put forward in 1978, when economist Arthur Laffer was first cited as arguing that some rate decreases could generate enough added economic growth that the government wouldn't lose revenue over the long run—and might, in fact, even gain revenue. Laffer also noted that most tax hikes generate less revenue than a conventional "static" analysis indicates, and that most tax cuts lose less.

Laffer's "dynamic" analysis covered all of the behavioral changes likely to result from a cut. To begin with, if the tax collector claims a lower share of income, there is an incentive to produce more income. Second, a lower rate means there's less incentive to spend time and effort avoiding the tax.

Corporations don't pay taxes; only people do. And there is a tendency to forget that if a corporation nets more profits as a result of a lower tax, those funds will soon take the form of salaries, dividends, and capital gains, and will be taxed in those forms.

The second factor, less tax avoidance, applies with special force to a rollback of corporate taxes. As we noted last year, bringing down the top rate to 22% from 35% would dramatically reduce corporate flight to low tax jurisdictions in the rest of the world.

Following the publication of our article, the CBO released a study confirming that U.S corporate tax rates are among the highest in the world. Among the Group of 20 countries—including Japan, China, Russia, Germany, France, Canada, and the U.K.—the U.S. is No. 1, 3, and 4, respectively, in “top statutory corporate tax rate,” “average corporate tax rate,” and “effective corporate tax rate.” The Better Way plan would narrow this gap significantly and make the U.S. more competitive.

But when it comes to the Better Way plan for cutting tax rates on personal income, *Barron’s* believes that there would be a loss of revenue even after taking into account behavioral changes. The revenue reduction from the proposed personal income tax cuts has been estimated, on a static basis, at an average of $98 billion a year. We can assume that dynamic losses would run 10% less, or $88 billion, mainly because lower taxes are likely to encourage people to work.

Still, $88 billion a year is a huge loss of revenue. *Barron’s* proposes that the Better Way plan consider splitting the difference and going halfway on the tax cut, thus saving $44 billion.

The revenue enhancing corporate tax cut would include a special kicker in the form of the border adjustment tax. The BAT would deny corporations the ability to deduct the cost of imports from their taxable income, while all income earned from exports would be exempt from the 20% levy.

This means that companies selling imported goods in the domestic market would be taxed on the sale’s full proceeds—not just on the profit earned—which could more than offset the gains from the corporate tax reduction. At the same time, as noted, there would be no tax on the sale of exports.

The BAT would bring uncertainty and disruption to the U.S. economy, making it hard to predict whether it really would raise $100 billion annually in revenue. The basic idea is that, because the U.S. imports more than it exports, the export exemption would be more than offset by hitting imports hard. Regardless of how it shakes out, the value of the transactions affected by the BAT is huge.

The U.S. trade deficit—the difference between exports and imports—ran at just 3.4% of real GDP in 2016, much lower than the 5.5% peak of 2005. But the actual gross flows of exports and imports are much larger than the difference between the two flows. Exports last year were valued at $2.2 trillion, or 12.8% of real GDP, and imports at $2.7 trillion, or 16.2% (see chart). Given those magnitudes, the tax plan is likely to require massive readjustments throughout the economy.

That’s why major importers, like WalMart Stores, are objecting—and why exporters are clearly pleased. As you might expect, then, the BAT is pitting exporters against importers, creating needless discord at a time when the country is surely suffering from more discord than it can handle.

The position paper for the Better Way asserts that by “exempting exports and taxing imports,” the BAT does “not” consist of the “addition of a new tax.” But of course, the BAT’s designers know that imports normally exceed exports by about $500 billion a year. Apply a back of the envelope 20% to that $500 billion, and you get the hoped for $100 billion in revenue. So the maneuver of “exempting exports and taxing imports” certainly looks and sounds like a new tax.

The Better Way statement also argues that there is an imbalance in the tax treatment of imports and exports that the BAT must remedy. “In the absence of border adjustments,” it states, “exports from the United States implicitly bear the cost of the U.S. income tax, while imports do not bear any federal income tax cost. This amounts to a self-imposed unilateral penalty on American exports and a self-imposed unilateral subsidy for U.S. imports.”

But all other countries impose this “implicit cost” on exports through their own corporate income tax. And since the Better Way would slash America’s top rate to 20%, this implicit cost would finally become competitive with that of other nations.

Some supporters of the BAT like it precisely because it would help exports and penalize imports. The mercantilist view of economics implicit in that aim was discredited in Adam Smith’s 1776 treatise, *The Wealth of Nations.* And apart from the massive dislocations that will occur if imports shrink, this calls into question whether the projected $100 billion a year in revenue is realistic. As Alan Greenspan once wisely said, “Whatever you tax, you get less of.”

Then again, whether we really will get fewer imports depends a lot on the exchange value of the dollar. Other supporters of the BAT predict that the dollar will respond by appreciating against other currencies, conforming to the dictates of textbook fundamentals. If the dollar appreciates enough, the advantage to exporters and disadvantage to importers will be nullified. Without getting into the technicalities of how all this would work, we concede that it is all quite possible.

But as currency analysts and traders can tell you, exchange rates are subject to all kinds of forces and can spend long periods flouting textbook fundamentals. So whether the dollar will really strengthen in response to the BAT is anyone’s guess. But even if it does, a much stronger greenback would bring other disruptions. American investors with holdings denominated in foreign currencies would take a huge hit. And America’s tourist industries, which are already hurting from what the Los Angeles Times has called a “Trump slump,” would be hurt even more, as the cost of traveling to the States jumps.

There are other questions. Would the World Trade Organization challenge the BAT? Might our trading partners respond in ways that would be unfavorable to us? The border adjustment tax is an experiment in Rube Goldberg economics that the U.S. can do without.

Since revenue neutrality is the goal of the Better Way package, what about making up for the $100 billion a year in revenue that the border adjustment tax is supposed to generate?

Whether this tax really will raise as much as $100 billion depends on how imports and exports respond, which is hard to predict. Also, the reduction in the corporate income tax would probably be revenue enhancing and could generate more than $50 billion in annual revenue.

We note that the full title of the House Republican plan is *"A Better Way: Our Vision for a Confident America*," which leaves room for a vision that includes cost cutting, along with tax cutting.

It's actually possible to reduce outlays by as much as $8.6 trillion over the next 10 years, as we pointed out in "*Barron's* Prescription for U.S. Economic Growth" (Dec. 24, 2016).

That discussion revealed much low hanging fruit. For example, the Medicare system is rife with "improper payments," which Medicare itself estimates at 11% of its spending in 2016. That's probably a low estimate, because those who get improperly paid tend to keep these payments hidden. *Barron's* calculated that if the improper payment rate could be halved, it would save more than $400 billion over 10 years.

That would contribute $40 billion a year to the $100 billion shortfall from forgoing the BAT. To that we add $65 billion, and perhaps as much as $100 billion, by eliminating corporate welfare.

The Better Way statement properly criticizes the tax code for being "littered with hundreds of preferences and subsidies that pick winners and losers" and "direct resources to politically favored interests." Spending on corporate welfare is another form of subsidy that picks winners and losers and directs funds to politically favored interests.

In a 2012 paper, "Corporate Welfare in the Federal Budget," the Cato Institute identified nearly $100 billion worth of yearly spending on corporate handouts, broadly defined, that could be ended. At *Barron's* request, Cato senior fellow Chris Edwards updated the scoring on just 10 of the institute's 40 categories of corporate welfare and came up with $66 billion in potential cuts.

High on Edwards' list: farm subsidy programs, which redistribute taxpayer money to relatively rich agribusinesses and landowners. That the farm industry receives subsidies makes about as much sense as channeling funds to the restaurant industry, which could well be riskier than farming, based on its high failure rate. This form of corporate welfare goes back to the Great Depression of the 1930s. But whatever argument might have been made for it then hardly applies today, with the yearly tab currently at $25 billion.

Also on the corporate welfare list: pork-barrel handouts administered by the Department of Housing and Urban Development, totaling $13 billion, which go under the heading of "community development," and which distribute funds to such recipients as museums, recreational facilities, and parking lots. Whatever one may think about the worthiness of these projects, they are better left to states and localities.

Another $10 billion could be saved by abolishing the Universal Service Fund, through which the Federal Communications Commission subsidizes telecommunications companies, among others. A creation of the Telecommunications Act of 1996, this attempt to pick winners and losers is more unnecessary than ever in this dynamic and competitive industry.

President Trump promises to "drain the swamp" of Washington's special interests. One route toward that admirable goal would be to cut corporate welfare. Trump should repeat his objections to a border adjustment tax that would favor the interests of some businesses over others. He can help make U.S. corporations great again by weaning them off subsidies and reducing their tax burdens.