THE WALL STREET JOURNAL.

The Border-Adjustment Sleight of Hand

The double levy on U.S. companies' overseas profits is the actual 'Made in America tax.

Veronique de Rugy and Daniel J. Mitchell

April 16, 2017

With Republicans in control of Capitol Hill and the White House, this should be an opportune time for major tax cuts to boost American growth and competitiveness. But much of the reform energy is being dissipated in a counterproductive fight over the "border adjustment" tax proposed by House Republicans.

The plan calls for dropping the top corporate tax rate to 20% from 35%, while exempting exports and taxing imports. House Republicans have latched onto the border-adjustment tax for a very practical and understandable reason. It supposedly would generate more than $1 trillion of tax revenue over 10 years. That money could finance other parts of their agenda to generate growth, such as replacing today's onerous depreciation rules with immediate expensing.

Although their intentions are reasonable, this strategy is questionable. Start with the political blunder: Republican tax plans normally receive overwhelming support from the business community. But the border-adjustment tax has created deep divisions. Proponents claim border adjustability is not protectionist because it would automatically push up the value of the dollar, neutralizing the effect on trade. Importers don't have much faith in this theory and oppose the GOP plan.

Their concerns are legitimate. No country has ever imposed a border-adjusted corporate-income tax, so this is uncharted territory. But many countries have value-added taxes, or VATs, that are border-adjustable, and their experience might serve as a reasonable proxy. A review of the empirical literature shows that currencies adjust when a VAT is applied, but they do so neither entirely nor quickly. Factors such as poor design or improper administration can get in the way.

If the currency adjustment were perfect, there should be no effect on trade volume. But research has shown that VATs are associated with both lower exports and imports. A 2005 academic study examined 136 nations and concluded: "Countries using VATs have one-third fewer exports than do countries not using VATs, and 10 percent greater VAT revenue is associated with two percent fewer exports."

Proponents of the border-adjustment tax also are using a dodgy sales pitch, saying that their plan will get rid of a "Made in America Tax." The claim is that VATs give foreign companies an advantage. Say a German company exports a product to the U.S. It doesn't pay the American corporate income tax, and it receives a rebate on its German VAT payments. But an American company exporting to Germany has to pay both—it's subject to the U.S. corporate income tax and then pays the German VAT on the product when it is sold.

Sounds horribly unfair, right? Don't be fooled. Like magicians, those making this argument are distracting the unwary, hoping that nobody will notice the trick.

Here's the real story: What matters from a competitive perspective is whether the playing field is level—and it is. When the German company sells to customers in the U.S., it is subject to the German corporate income tax. The competing American firm selling domestically pays the U.S. corporate income tax. Neither is hit with a VAT. In other words, a level playing field.

What if an American company sells to a customer in Germany? The U.S. government imposes the corporate income tax and the German government imposes a VAT. But guess what? The German competitor selling domestically is hit by the German corporate income tax and the German VAT. That's another level playing field. This explains why economists, on the right and left, repeatedly have debunked the idea that countries use VATs to boost their exports.

Companies can be disadvantaged, though, if their country's tax regime is onerous. One big plus for Americans is that Washington does not impose a VAT, which would enable government to grow. This is a major reason that the U.S. economy is more vibrant than Europe's. In Germany, the VAT raises so much tax revenue that the government consumes 44% of gross domestic product—compared with 38% in America.

On the other hand, America's top corporate income tax of 35% is the highest in the developed world. If state corporate income taxes are added, the figure hits nearly 40%, according to the Congressional Budget Office. That compares very unfavorably with other nations. Europe's average top corporate rate is less than 19%, and the global average is less than 23%, according to the Tax Foundation. The damage is compounded because the U.S. has a "world-wide" tax system, putting an extra levy on income that American companies earn overseas. That's the real "Made in America Tax," and it's our own fault.

The solution is to reduce the corporate rate and adopt a territorial tax system, taxing only profits earned at home, as almost all other Western countries do. The good news is that the House plan does both these things. The bad news is that the proposal is weighed down by the border-adjustment tax. Republicans should drop this controversial provision and focus on the policies that will boost growth.

To get the maximum bang for the buck, the final package should include restraints on spending—which doesn't even mean an absolute budget cut. If Congress simply limits the growth of outlays to about 2% a year, that would create enough fiscal space to balance the budget over 10 years and adopt a $3 trillion tax cut. If Republicans want a win-win, dropping the border-adjustment tax is the way to get one.

Ms. de Rugy is a senior fellow at George Mason University's Mercatus Center. Mr. Mitchell is a senior fellow at the Cato Institute.