NATIONAL REVIEW

The Border-Adjustment Tax, Tariffs, and More WTO Questions

Veronique de Rugy

July 12, 2017

The *Wall Street Journal* has an article about the meetings taking place on tax reform and the problems that participants are trying to solve. According to the article, "the resulting bill is most likely going to be deficit-neutral, [says a] senior White House official." If this is correct, it means that Speaker Paul Ryan and House Ways and Means chairman Kevin Brady have finally moved away from their misguided plan to make tax reform revenue neutral by having tax cuts offset by tax increases.

The article also acknowledges the fact that a bill that includes a border-adjustment tax (BAT) wouldn't get through the Senate. That's great to hear. The problem with the border-adjustment tax goes far beyond its only goal of creating a new source of revenue to pay for tax reform. Its destination-based design is incredibly problematic because it undermines tax competition. That may not seem like a big deal when the tax rate is 20 percent, but it becomes a big problem when the rate is 30 or 35 percent. And why not assume this is a real possibility with this tax design — especially considering the spending explosion in our future that no one in Congress seems willing to address? As some have noted while talking about the BAT, "you should tax the hell out of it." Translation: "If taxpayers can't escape, tax the hell out of them" or "destination-based taxes are a great source of revenue because taxpayers are trapped."

And yet, I continue to worry. That's because in Washington no bad idea ever fully dies. Unless lawmakers commit to fiscal responsibility — which really means committing to reforming Medicare, Medicaid, and Social Security — the increasing budget gaps pretty much guarantee that there will be a clamoring for more tax revenue and for new forms of taxation that are now big no-nos. I am thinking about the value-added tax (VAT) and the carbon tax in particular.

So since we aren't sure the border-adjustment tax is *really* dead, I would like to point to another potential implementation problem with the BAT. Remember that the idea behind the tax is that it would impose a 20 percent tax on imports and exempt exports. The way it would implement the tax is by denying a tax deduction for a U.S. company's imported cost of goods sold. By prohibiting the importer from deducting the purchase price of its imports from its total tax base (domestic sales), you're indirectly subjecting those import purchases to the tax.

Now, as this article noted "the question still remains on whether or how the BAT will be assessed on [business to consumer] import transactions." In other words, the question is whether or not the tax would apply to an importer in the U.S. consuming foreign goods — that's an importer consuming the foreign good rather than reselling it. So let's think about that.

First, let's assume that imported goods consumed by individuals in the U.S. aren't subjected to the 20 percent tax. This is the most likely scenario. It would mean that, under this system, the BAT could encourage the direct sales of imported finished goods. It may not seem like a big deal now, and yet I can see companies like Alibaba being all over the distortions introduced by the new regime. How long will it take for these companies to come up with the international equivalent of Amazon Prime shipping? While it is much less efficient for foreign companies to send their stuff to millions of U.S. consumers, there may be a point where imported finished goods sold from foreign Amazon-like companies could end up being cheaper than U.S.-sold goods — especially those made with imported goods. Either way, the final result is a less efficient system induced by tax distortions.

In addition, as Cato Institute's trade-policy analyst Scott Lincicome wrote to me when I asked him about this: "One of the biggest questions I have about the [destination-based cash-flow tax] is whether it will contain a 'loophole' for direct sales, or whether Congress will try to close it somehow. I'm struggling, however, to think of a way they can do the latter without running into major WTO problems."

Second, if imported finished goods sold directly to consumers are subjected to the BAT, the question becomes, How will it be implemented? This is less likely but worth considering. In that case, the U.S. would impose an import tax, a.k.a. a tariff. And we are back with the WTO challenge mentioned above by Lincicome since it would then be a direct tax on a good. Again, I don't know how Brady and Ryan get around this except by exempting finished goods sold directly to consumers. If that's the case, that's a huge loophole and we are back to a situation where U.S. businesses that import goods for resale in the U.S. would fare poorly under the border-adjustment tax as it would put them at a further cost disadvantage.

Finally, there is the question of what happens if the final consumer is a corporation importing finished goods or services? My understanding is that if a U.S. company imports office equipment, it can deduct the cost of those imports under the current system but would no longer be able to do that under the BAT. That's an increase in the cost of doing business for sure, unless Congress exempts it and that becomes a big loophole.

Considering all these questions, the best way forward is to drop the border-adjustment tax once and for all, regroup, and move on with a truly conservative tax-reform agenda. We have wasted enough time on this already.