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The Border-Adjustment Tax Is No Free Lunch

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House Republican leaders Speaker Paul Ryan, R-Wis., and Ways and Means Chairman Kevin Brady, R-Texas, are still pushing their year-old scheme of a "border adjustable tax" (BAT) to exempt exports from their proposed 20% corporate tax while disallowing firms any deduction for the cost of imported parts, materials or inventories.

Congressmen Ryan and Brady claim the BAT will "level the playing field" which, in the plain English of Boston University economist Larry Kotlikoff, means "reducing the U.S. trade deficit." The tax is also projected to raise $1 trillion over the next ten years. In other words, a "free lunch" that will pay for itself.

Unfortunately, if the tax truly is to raise $1 trillion dollars, it "cannot change the size of the trade deficit," as BAT supporter and Harvard economist Martin Feldstein puts it. The BAT is a tax on the trade deficit, and would raise nothing if that deficit ceased to exist.

Feldstein and other BAT advocates argue their plan won't affect trade because it will drive the dollar up 25% and thus make imports cheap and U.S. exports costly.

The reason for the dollar's assumed rise is that tax-free exports would rise, increasing the world's demand for dollars, while newly taxed imports would fall, reducing the world dollar supply. The reason the trade deficit can't change, in other words, is that imports and exports must first change quite a lot before the supposedly end up unchanged.

Why else would the dollar soar? Scholars may say that initial trade disruption is temporary, but they can't tell us whether "temporary" means months or years.

The promised 10-year revenue windfall rests on a shaky foundation, and contradicts politicians' promises of a level playing field. Yet foregoing that hypothetical treasure might mean "settling for a 25% corporate rate," which isn't ideal for Rep. Brady.

In reality, 25% under current law is about the same as 20% under the Ryan-Brady plan, which Goldman Sachs economists estimate has an effective rate of 24%. Why? Because the Ryan-Brady plan taxes costs as if they were income.

Companies could no longer deduct the cost of imports or interest, which makes a huge difference when imports or interest are an important cost of doing business. Former Treasury Secretary

Larry Summers noted the Ryan-Brady tax could "substantially exceed 100% of profits" for large retail chains with thin margins who count on imports for much of their inventory.

Even in the same industry, a BAT would hit different firms differently. Refiners could still deduct the cost of Dakota crude oil under the BAT, but not Canadian crude. Manufacturers of electric motors could deduct the cost of Arizona copper, but not Chilean copper.

BAT proponents claim it is like a foreign VAT (value-added tax), but also entirely different. A VAT clearly raises consumer prices, for example, but BAT fans insist their plan won't do that. A VAT applies equally to foreign and domestic goods, but a BAT only applies to imports.

BAT architect Alan Auerbach of U.C. Berkeley says retailers, refiners and automakers are wrong to worry; the 20% tax on corporate imports will be totally painless, because "a stronger dollar would make imports cheaper, offsetting the increase in taxes paid."

Economists can't predict exchange rates. But even if other currencies really did fall by 20%, there is no evidence import prices would fall nearly that much.

In a 2009 study for the U.S. International Trade Commission (ITC), Cathy Jabra surveyed the evidence and found that, aside from crude oil, very little of exchange rate changes were passed through to import prices. Only 18% of rate changes passed through in the case of consumer goods in general, only 12% for those from Japan and *zero* for imports from New Industrialized Economies such as China, Mexico and South Korea.

So even if all currencies did fall 20% against the dollar, prices of consumer goods might drop by only about 3.6%, rather than by the 20% required to make the BAT harmless. Prices of imports from the New Industrialized Economies might not fall at all.

Arguments for slapping a new border adjustment tax on corporate imports and exempting exports from the same are like running through a maze in Wonderland. The tax is said to level the playing field for trade and raise a ton of money, but that shimmering pot of gold on that horizon depends on trade being totally unaffected.

If these contradictory conjectures are half as mistaken as they appear to be, a BAT could wreak havoc on some of the largest employers in the country, including retailers and automakers. And if the U.S. economy goes down, tax revenue will too.

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