How Border Adjustments Do Matter, and How They Don't

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December 2, 2005

Alluring Idea

- Growth and Investment Tax proposed by Tax Reform Panel: rebate for exports, tax imports at 30% tax rate
- A border-adjusted tax; same treatment as VAT
- Common belief: border adjustment helps trade balance by subsidizing exports, taxing imports
- But this logic is wrong, because of exchange rate response

Exchange Rate Adjustment

- Export subsidy alone:
  - encourages foreign demand for US exports
  - this increased demand strengthens the dollar
  - a stronger dollar partially offsets the rise in exports and increases US import demand

→Export subsidy promotes trade (increased exports and imports) and causes dollar appreciation

Exchange Rate Adjustment

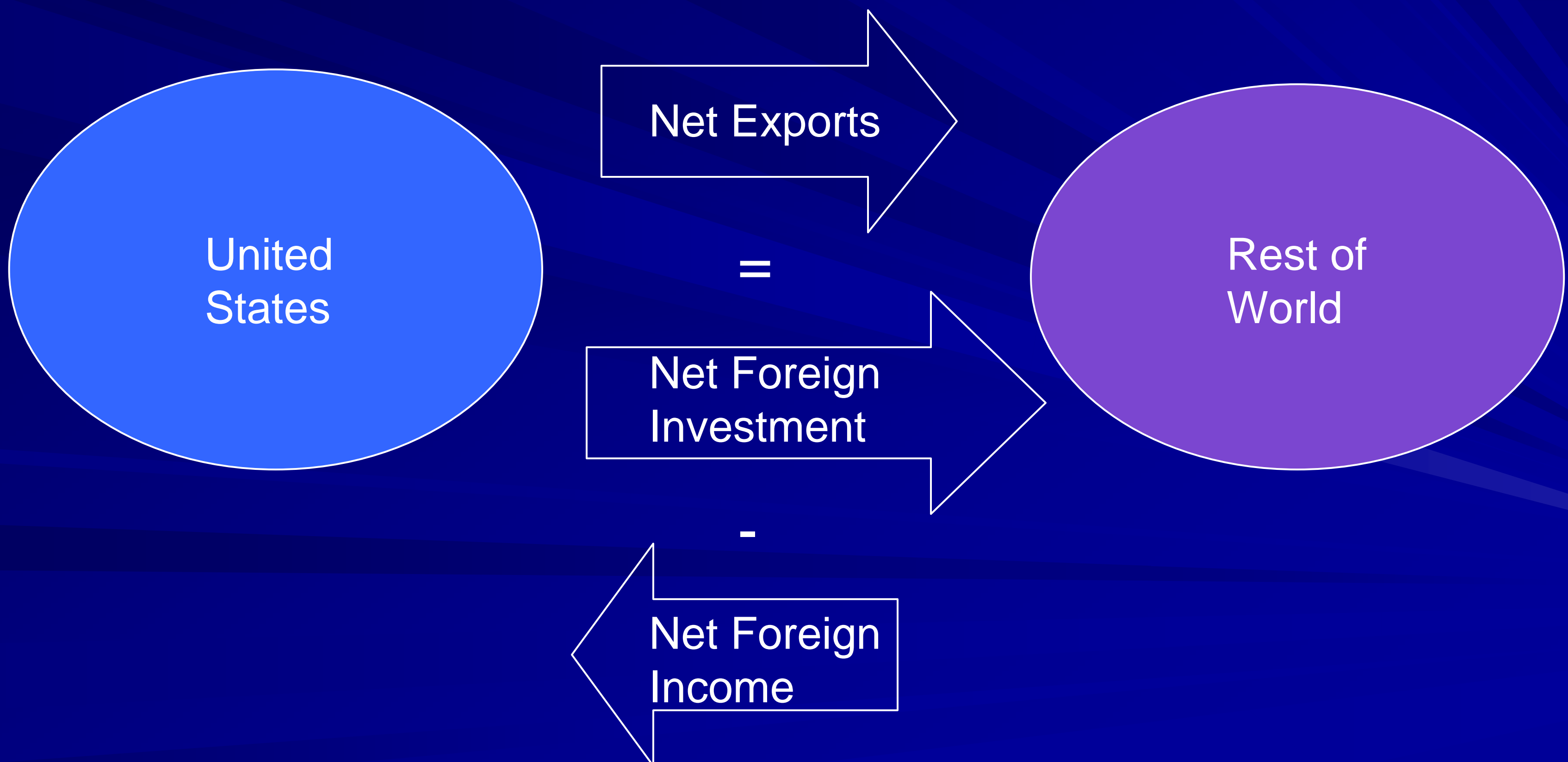
- Import tax alone:
  - discourages US demand for imports
  - this strengthens the dollar
  - a stronger dollar lessens the drop in import demand and reduces US exports

→Import tax hinders trade (reduced exports and imports) and causes dollar appreciation

- Together: trade neutral + appreciation

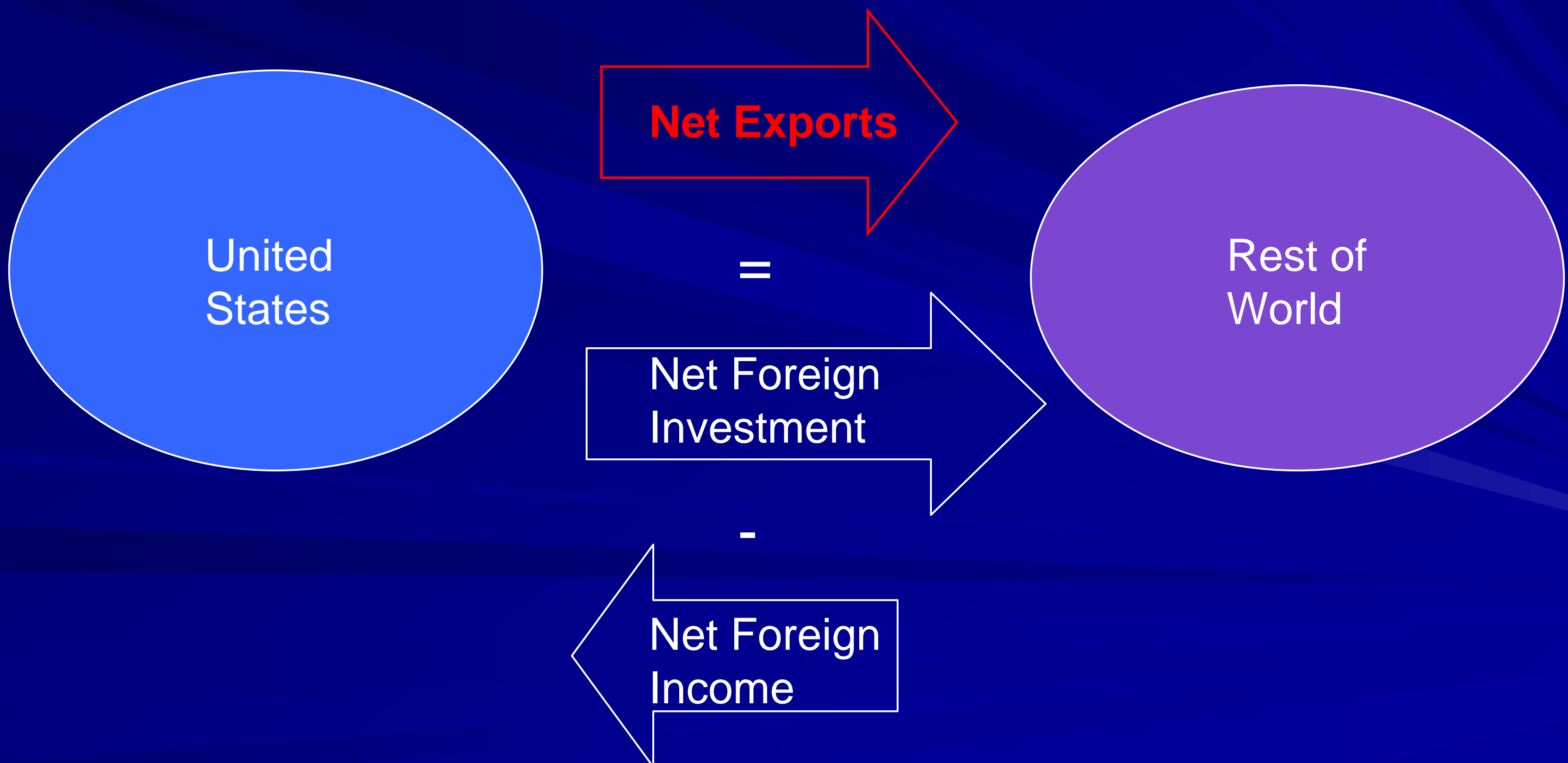
Alternative Logic

- Trade flows and non-trade flows MUST be equal in the aggregate.



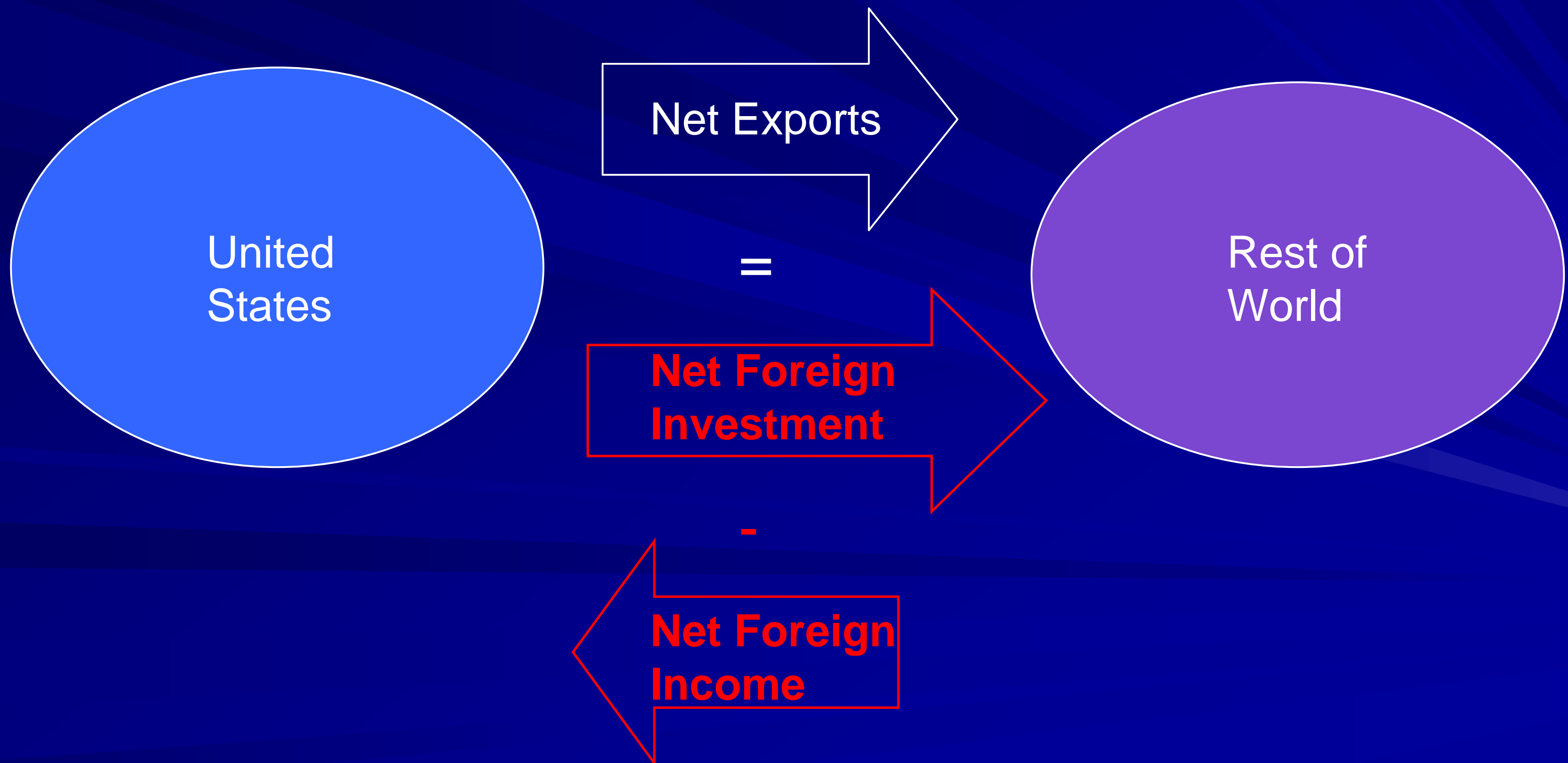
Alternative Logic

- Subsidizing net exports (border adjustment)…



Alternative Logic

- is equivalent to subsidizing foreign investment and taxing foreign income



Equivalence

- Thus, border adjustment amounts to a tax on foreign-source income with expensing of foreign investment…a cash-flow tax on foreign-source income
- As in domestic context, only a timing difference between cash-flow tax approach (border adjustment) and yield exemption approach (no adjustment)
- So, no difference in international investment incentives, either

Are Border Adjustments Irrelevant?

- No – there are two effects: asset valuation and revenue

Asset Valuation Effects

- Due to exchange rate adjustment
- End of year 2004 (BEA):
  - – US-owned foreign assets = $9.0 trillion
  - – Foreign-owned US assets = $11.5 trillion
- Border adjustment of a 30% domestic tax means foreign currencies must depreciate relative to the dollar by 30% $\Rightarrow$ a $2.7 trillion loss to US holders of foreign assets and an offsetting gain to foreign owners of US assets

Revenue Effects

- Because the US net international investment position is negative, we must run trade surpluses in the future to service this liability
- In present value, border adjustments lose money, equal to the net international liability times the border adjustment: ($11.5 trillion – 9.0 trillion) x 30% = $750 billion (Short-run revenue effects differ)

Summary

- Border adjustment affects assets values and revenues, but not incentives for trade or capital flows
- Impact of tax reform on trade balance and investment must come through other channels