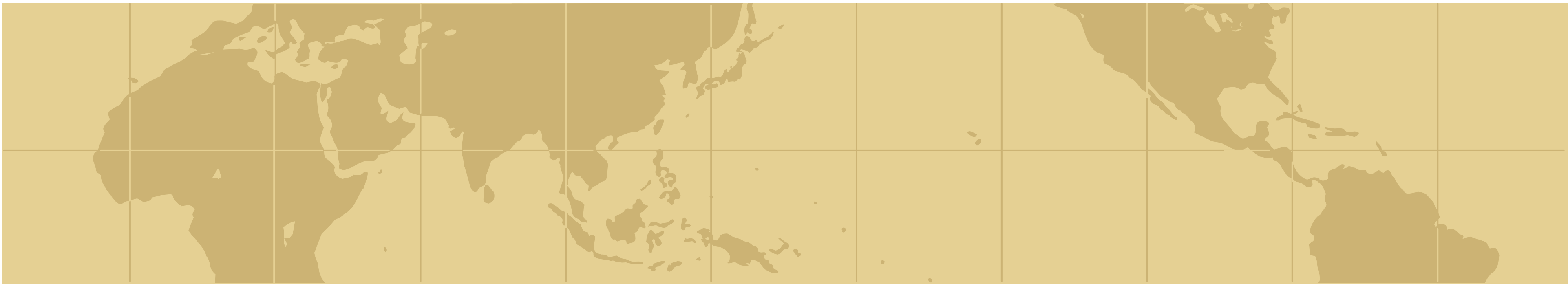

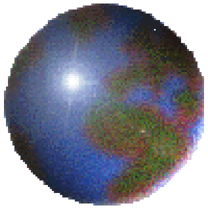

Tax Reform and Trade

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Outline

Debunking some ideas about tax reform and trade

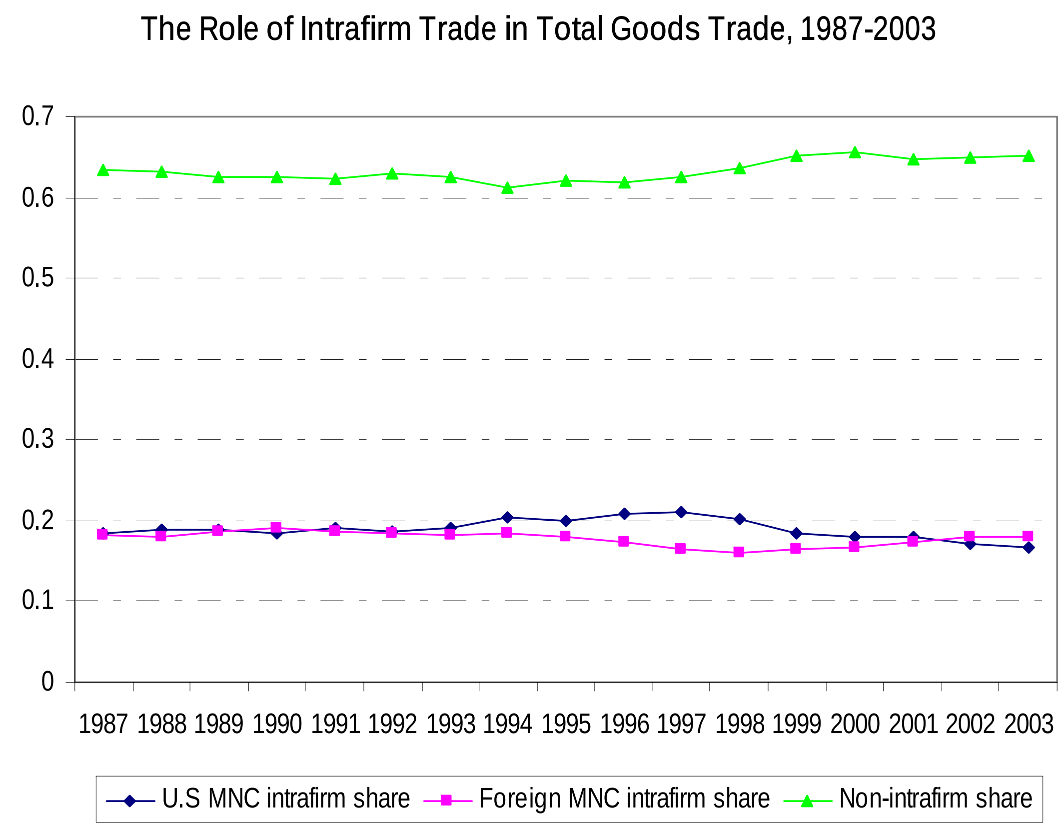
- Why is this important? Three pictures/facts…the connection between investment and trade
- The channels through which tax reform CAN influence trade patterns
- The channels through which tax reform CAN'T influence trade patterns

Some facts about recent trade patterns (1)

Widening trade deficits and concerns about sustainability

=> Can tax reform influence this pattern?

Some facts about recent trade patterns (2)

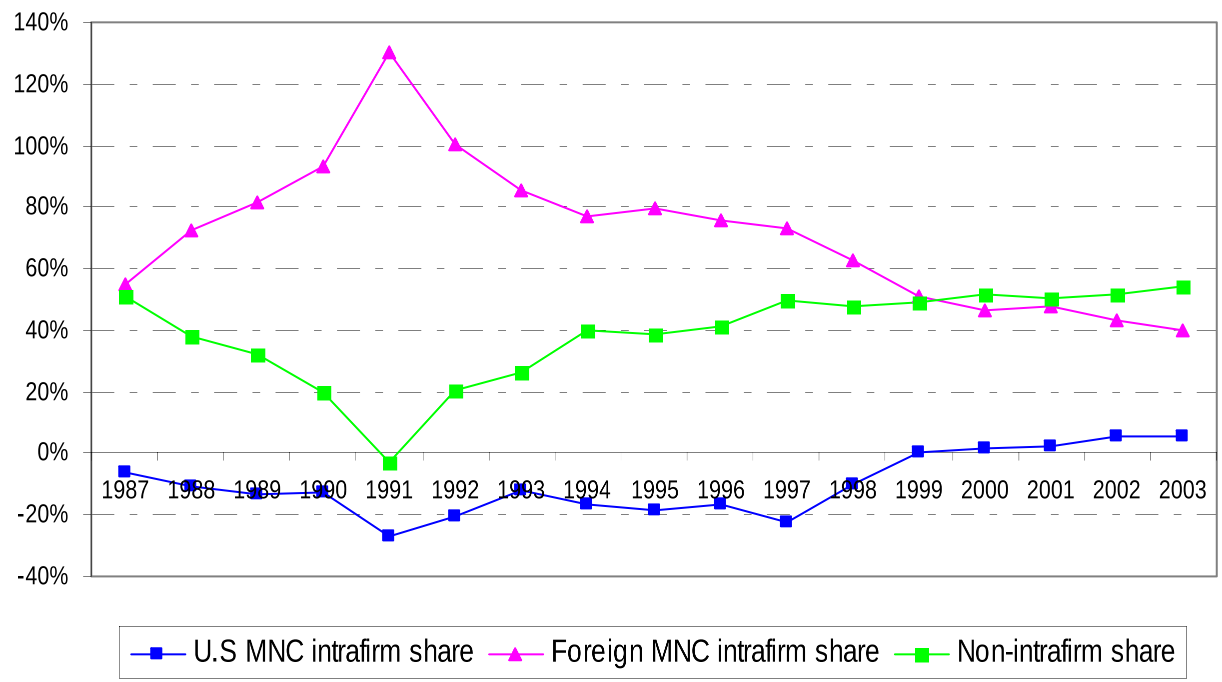


Intrafirm trade is steadily 35% of total trade

=> Intrafirm production/investment decisions are critical to trade patterns

Some facts about recent trade patterns (3)

The Share of Goods Trade Deficit by Ownership Type, 1987-2003



Breaking the trade deficit down by ownership reveals considerable heterogeneity

=> Investment responses and transfer pricing responses by MNCs may be critical to measured trade deficits

How tax reform *CAN* influence trade (1)

Revisiting some basic national income accounting…

$$Y = C + G + I + NX$$

Income = Consumption+ Government Expenditures + Investment + (Exports – Imports)

Rearranging terms: $Y - C - G - I = NX$

Taxes?: $(Y - C - \text{Taxes}) + (\text{Taxes} - G) - I = NX$

So what?: Private Saving + Public Saving – I = NX

Or: <u>Savings – Investment = Net Exports</u>

Capital Account = Current Account

What does this tell us? *Trade deficits are a reflection of imbalances between savings and investment*

How tax reform *CAN* influence trade (2)

<u>Savings – Investment = Net Exports < 0</u>

Trade deficits are a reflection of imbalances between savings (too low?) and investment (too high?)

Tax reform really can only impact trade patterns through effects on savings and investment

eg. Reduced taxes on savings

Things that *don't* influence savings and investment *can't* influence trade deficits …

How tax reform *CAN'T* influence trade (1)

A common belief is that the "border adjustments" associated with destination-based VATs serve to impact trade

What are border adjustments?

Tax consumption within jurisdiction

=> so tax imports but exports get rebates for VAT paid

=>"border adjustability"

The virtues of a sales tax without taxation on intermediate goods – including capital goods

=> Common perception: If exports are rebated, but nothing else is, then it's a subsidy for exporters …

How tax reform *CAN'T* influence trade (2)

Why is this common intuition wrong? Border adjustments should be neutral for trade:

1) Things that don't influence savings and investment can't influence trade deficits …

2) How? Prices move instead of quantities - Exchange rate adjustments neutralize effects of the export rebate and tax on imports

3) Imagine a roundtrip trade without a rebate…

Export a widget and then reimport it…

Without a rebate, a roundtrip trade would be taxed…

With a rebate, the roundtrip trade has no tax consequences as rebate is collected at import…

Conclusions

Intrafirm trade is critical to trade patterns – so tax reform effects on FDI can be important for tax reforms effects on trade

Tax reform will influence trade patterns through its effects on the structural imbalance between savings and investment

Border adjustability should not be a factor in dictating trade outcomes – indeed, border adjustability is the reason that VATs are trade-neutral

…but are they in practice?…could it go the other way?