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Tax Reform and Trade Policy

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President Trump has returned trade policies and related taxes to the spotlight. Last Thursday, the Trump administration floated the idea of a 20% border tax adjustment or a tariff on Mexican imports to have Mexico pay for the wall. This article looks further at the issue of border tax adjustments, tariffs and trade policies.

According to basic economic theory, a standard tariff is a tax applied to imported products and is therefore generally expected to increase their cost. Accordingly, much of the burden of a tariff would fall on US consumers. By comparison, a border tax adjustment is a recalibration of a domestic tax, such as a sales tax or a value-added tax, designed to put traded and domestically produced goods on the same tax footing In other words, a border tax adjustment isn't a border adjustment if it isn't adjusting for a specific approach of domestic taxation, like a value-added tax. Nor is a border tax adjustment applied to a single country. In fact, if it isn't adjusting for domestic tax rules, it looks a lot like a tariff, and, like a tariff, it would run counter to US trade commitments and would therefore likely generate trade retaliation.

A Quick Intro to Tax Policy

Fundamentally, all nations face a fundamental question about what to tax to raise government revenue: consumption or production. If we tax production, we would tax everything we produce, or income from what we produce, regardless of whether we sell it domestically or abroad. If we tax consumption, we tax everything that we consume, whether it is produced here or abroad. Sales taxes and value-added taxes are generally consumption taxes.[1] Sales taxes are assessed on the sale price of a good, whereas value-added taxes only tax the difference between the sales price less the cost of material inputs to that good. So if I'm feeding cattle, a sales tax would be on my sales price of the cattle, while a value-added tax would be on the sale price of the cattle, less the cost of the calves and the purchased cost of the feed.

[1] Just to be complicated, one can have a production-type value added tax. One of the big differences between a production value added tax and a consumption value added tax is whether one allows for complete expensing of that asset when it is purchased and then taxes the future income from that asset as part of the 'value-added' (consumption), or whether one allows for deductions for depreciation each year that asset generates income (production).

Many people have an aversion to a consumption tax, because we think it will inherently hurt those who consume a higher fraction of their income, typically the poor rather than the wealthy. Note that either a production or consumption tax can be designed to be progressive, and have higher rates for wealthier individuals or corporations, or be regressive, where poorer people pay a larger fraction of their income or consumption to the tax. A typical argument in favor of a consumption tax is that any tax can create disincentives and we might be more worried about creating a disincentive to produce than a disincentive to consume. Note that many other countries such as the EU, Japan and Mexico use a consumption tax.

How is a tax on consumption different than a tax on production? The first difference is that in a production (or income) tax, savings are taxed before those dollars go into the bank. On the other hand, a consumption tax applies to those dollars when they are spent. The second difference is how non-resident people or firms are treated. A production tax will tax all US production regardless of where it is consumed, while a consumption tax applies to consumption by all US residents, be they firms or people. The third difference is how imports and exports are taxed, which we will return to later.

In the US, we're more familiar with production or income taxes, where we tax what we produce or the income we get from that production. Just from its name, one might think that the current US corporate income tax applies to corporate income, which would make it a production tax. But it is really an inconsistent mix of the two approaches. For example, to tax income from an asset, one should tax the gross revenue minus actual costs such as the economic depreciation of that asset. On the other hand, a consumption tax would theoretically allow for immediate expensing of that asset, knowing that the future consumption from the income of that asset would be taxed. However, the current corporate income tax allows expensing for some assets and accelerated depreciation for others – somewhere between economic depreciation and immediate expensing – both of which mean that the annualized income is understated relative to a pure income tax. Many other issues surround the current corporate tax system in the US, and any revisions could create windfall gains and losses during the transition (a background here; and more detailed discussion of consumption taxes here).

What would a consumption tax look like? Imagine a flat 20% consumption tax. In its simplest form, it would just be a sales tax - when you purchase an item, you pay a 20% tax on that item. But that's not how many value-added or other consumption-based taxes work.[2] A personal consumption tax may instead tax individuals on their income less their savings. The assumption here is that the difference between income and savings is consumption. Note that in this system, people or firms can be charged different rates depending on their total consumption. Assuming that that total consumption is highly related to long-run income and wealth, we might want lower rates for lower-consuming (poorer) households and higher rates for higher-consuming (richer) households.[3]

Returning to Trade and Border Adjustment Taxes

Back to the third difference between consumption and production tax: how they treat imports and exports. If we want to tax corporations based on consumption instead of production, then we need a border tax adjustment to ensure imports and domestic production are treated equally. Imagine you have an automotive assembly plant that uses both domestically-produced and Mexican-produced parts and the US has a 20% value-added tax. The domestic auto parts have already been taxed when they were sold by the domestic parts plant. The Mexican auto parts have not yet been taxed, at least not by the US. Thus, if the policy stopped here, the domestic auto assembly plant would always have the incentive to buy the untaxed Mexican parts -- which they presumably could get more cheaply than the taxed domestic auto parts. Thus, to put both domestic and imported goods on the same footing, the US needs to tax the imports at the same 20% rate as the domestic parts were already taxed. This tax is part of the border-tax adjustment; it is not an extra tariff on imports but a necessary step just to treat imports the same as domestically-produced goods.

Now imagine that same auto assembly plant is selling vans both domestically and in Mexico, where it competes with Mexican automotive plants. If the US firm is paying a 20% tax on all of its production less

[2] One issue is that a flat sales tax would not allow for a progressive rate structure and thus be a larger burden for people who consume a higher fraction of their income. If I wanted to have a progressive rate structure on a sales tax, it would mean that my grocery store would need to know whether to tax me at the low, middle or high rate just based on what was in my basket that specific trip.

[3] Alan Aurbach, a key proponent of the cash-flow based corporate tax, argues that a destination-based value added tax would neutralize the incentive to move firm headquarters

savings (that is, less new investments via expensing), then it is paying taxes on those cars destined for the Mexican market. There, it competes with firms that have a different tax structure. To put those exports on the same footing as its competitors, the U.S. firm will be rebated the 20% tax that was already paid on those vehicles that are now being exported. Then the foreign country can tax them as they enter the country at the same rate as they tax their own domestically-produced vehicles. This is why the border tax adjustment is called an 'adjustment' – it's tweaking the tax rate on exports to be zero and changing the rate on imports to be the same as those goods produced domestically. It implicitly assumes that Mexico will respond in the same way – taxing imports from the US so that they are also taxed at the same rate as goods produced in Mexico.

Many articles have referred to a border tax adjustment as a subsidy to exports and a tax on imports. In fact the current White House has complained about Mexico's border adjustment to its VAT as being trade distorting. But if done appropriately (admittedly, a big 'if'), the adjustment is merely equalizing the tax rate on imports to that of domestic goods. Second, if the adjustment added the comparable tax on imports and gave it back on exports as described above, it would raise the value of the US dollar, making our exports more expensive. Note that the peso already tumbled relative to the dollar in response to the Trump administration's suggestion of imposing a border tax. (That exchange rates affect exports is something those of us in agriculture will know about from the drop in agricultural exports in 2015 driven largely by a rise in the value of the US dollar). Thus, if exchange rates adjust quickly enough, the consumption-based tax system and its border-adjustment should be trade-neutral. This trade-neutrality is why it would likely comply with the WTO. Note from above that many other countries have this kind of tax system – with border adjustments -- already in place.

But…

(1) This whole "adjustment" thing is contingent on us having a consumption-based corporate tax system; It doesn't make sense to have a border-tax adjustment in isolation of the domestic tax reforms – i.e. when there's nothing to adjust.

(2) The above theoretical border tax adjustment isn't (quite) what's being proposed in the House. The House proposal would change the domestic corporate income tax to a cash-flow tax that would allow corporations not only to expense their investments as mentioned above, but also to deduct their wage bill. The idea is that we're already paying taxes on wages in through payroll taxes and worker's income taxes, and it doesn't make sense to tax wages once more. On the other hand, it sounds like the border tax adjustment that's being proposed would tax imports on their total value. Because it's therefore not exactly a value added tax with a standard value-added tax border adjustment – a system which is accepted under the WTO -- the proposed border adjustment might be challenged under the WTO. (See discussion in Bloomberg and the NY Times).

(3) You don't impose the above kind of border-tax adjustment only on one country. The point of the 'adjustment' is to generate a level playing field for our domestic production relative to all imports. Such an adjustment shouldn't just apply to imports from Mexico. If it is just applied to a single country and is not adjusting our domestic corporate tax structure, then it would be trade distorting. And I believe it would be eminently problematic under our existing trade commitments, including the WTO and under NAFTA.

Further reading: Border Tax Two-Step

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