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Should U.S. Imports Be Taxed to Subsidize Exports?

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The tax debate in Congress has shifted away from simply cutting taxes to restructuring the tax system. There is no shortage of reform proposals, but current initiatives in tax and trade policy are no longer pointing in the right direction.

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International Trade: What Goes Around Comes Around. In two recent *Wall Street Journal* articles, Harvard University's Martin Feldstein endorsed a House Republican plan to impose a new, 20 percent tax on U.S. imports coupled with a 20 percent subsidy to exports, called a border-adjusted tax (BAT). He calculates a net annual revenue gain of $120 billion, enough to fund a cut in the corporate tax rate from 35 percent to 20 percent. This revenue, he claims, would be "paid for by foreign businesses that sell to Americans."

He could hardly be more wrong. It is an illusion to think that any nation's tax policies have the power to divert income from foreigners to domestic residents. If such sleight of hand were thought possible, governments would be constantly adopting policies to outwit each other, thereby condemning the world to unending economic warfare.

There are four categories of error in Professor Feldstein's reasoning.

Holding Constant What Is Variable. Perfect constancy is an extreme rarity in the world economy. International trade, therefore, is like a mathematical problem with more equations than variables and, strictly speaking, intractable. Some parts of the global economic system are more constant than others, but one has to be very careful when determining what is constant and what is changing.

According to Feldstein, "Imports constitute about 15 percent of American gross domestic product (GDP), so the 20 percent tax would raise revenue equal to 3 percent of GDP." It is tempting to admire the simplicity of this "static" calculation, but it completely ignores the axiom that when you tax something you get less of it.

Not only would a tax cause Americans to substitute cheaper domestic goods for foreign goods, but it would also therefore reduce their total spending. There would be a chain reaction of consequences for prices in foreign and American markets, as well as feedback loops between U.S. spending, income, output and employment. Thus the revenue raised from this tax would be less than 3 percent of a reduced GDP.

With a rate as high as 20 percent, the revenue might be *substantially less* than 3 percent of a *substantially reduced* GDP.

Neglect of "Tax Shifting." While policymakers may think they can choose who bears the burden of a tax, it is markets that decide. Both sides of the market share the burden, and the equilibrium result is that it makes no difference on which side of the market a tax initially falls.

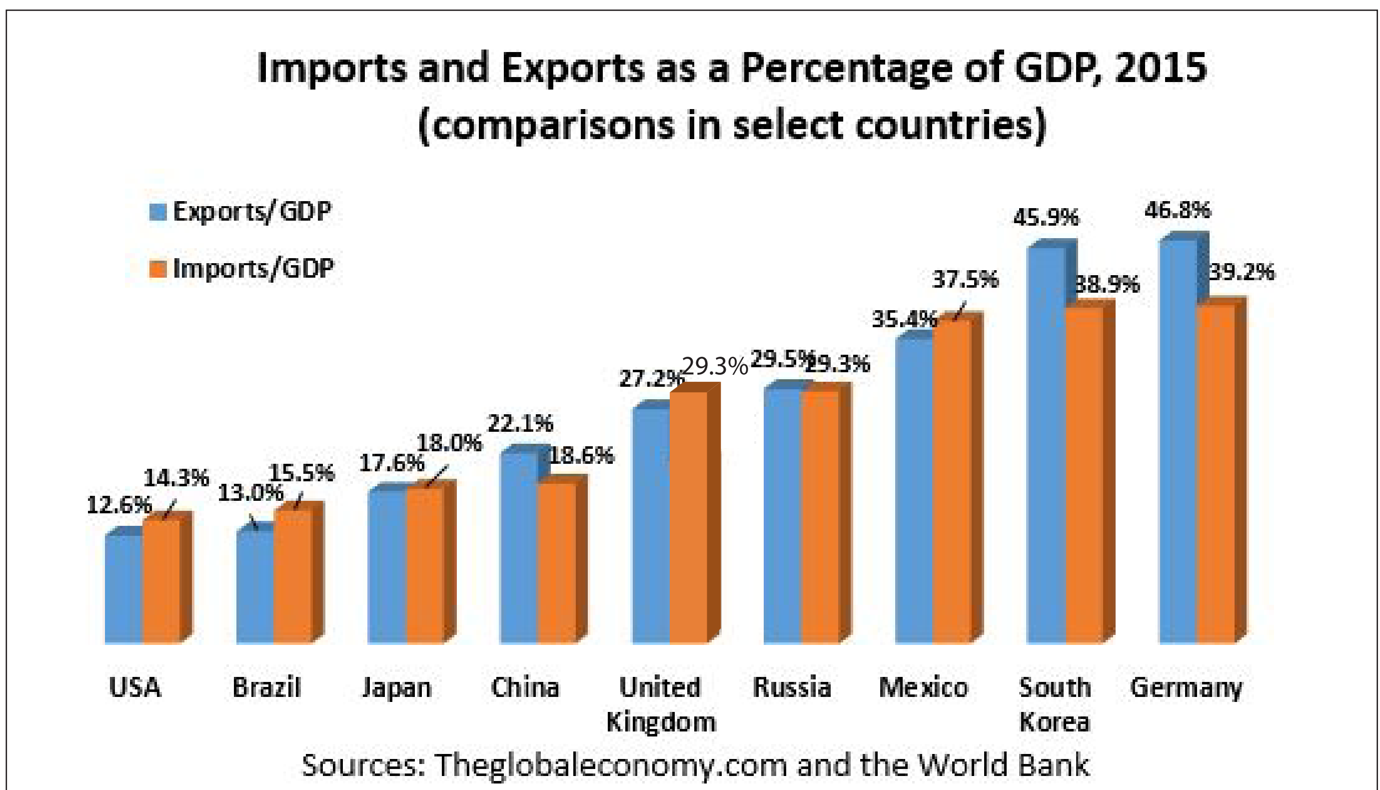
This "tax shifting" is vital in understanding cross-border taxation. Milton Friedman got to the heart of it when he emphasized what is surely the most important axiom of international trade: "Exports are the price we pay to get imports." Indeed, Friedman rejected the popular idea that "exports are good, imports bad."

Tax policy in international trade and tax policy in the domestic economy work in the same way. Imports and exports are tied together by market forces in the same sense that national output is tied to national income, spending and employment. You cannot tax one without effectively taxing the other. Nor can you subsidize one without subsidizing the other. The figure demonstrates how tightly exports and imports are related from one country to another, even after adjusting for the size of each economy.

The burden of a tax on a country's imports is shared by consumers, producers, importers and exporters in roughly the same way as the burden of an equivalent tax on exports. Much as a government may aspire to force foreign exporters to foot the bill, leaving importers unscathed, this cannot be done in internationally competitive markets. In a similar way, U.S. government subsidies to favored domestic groups tend to spill over and be shared by foreigners.

Reliance on Currency Adjustment. Feldstein's arguments are not unique, but he simplifies them to such a degree as to reveal the pitfalls with exceptional clarity. He allows that "retailers and importers understandably fear that the [20% import] tax would raise the cost of their products and inputs." But he reassures them that "the border-adjustment would also cause the international value of the dollar to rise, reducing the cost of imports by enough to offset the tax."

Feldstein reminds his readers that "the size of a country's trade deficit equals the difference between national investment and national saving." And that "since the border-adjustment tax would not alter either investment or saving, there must be no change in the trade deficit. What would happen instead," in



Feldstein's world, "is a 25 percent increase in the dollar relative to other currencies, enough to offset the tax on imports and the subsidy on exports."

There is no precedent for such a large currency adjustment. In no year since records began in 1973 has the Federal Reserve's index of the foreign-exchange value of the dollar risen by as much as 12 percent, let alone 25 percent.

Furthermore, U.S. investment and saving are not constants. Indeed, the difference between them — the trade imbalance — is plainly unstable. These are all economic variables like any other — susceptible to changes in economic policies, tax structures and other factors.

The contrary view affirms that saving and investment are variable. Trade imbalances are determined by capital flows, which in turn are governed by countless incentives and disincentives, *including international taxes*. Everything in the world economic system would therefore be affected by a U.S. BAT.

> *"Capital will flow toward any country that keeps taxes low, regulations simple and markets free."*

The one given (and even this is only a short-run given) is the limited total quantity of capital the world can summon at any given time. While that quantity may be roughly constant, the flow of capital is fluid. As capital flows back and forth among countries and industries around the world, it pushes trade surpluses and deficits up or down in its wake. It will flow toward any country that keeps taxes low, regulations simple and markets free.

The Myth that Exchange Rates Automatically Compensate for Taxes. Feldstein not only holds as given what is variable, he also asserts the variability of what can reasonably be taken as given. He insists that currency exchange rates will *automatically* change to prevent trade imbalances from changing. Other economists are more careful. For example, Alan Auerbach of Berkeley and Douglas Holtz-Eakin of the American Action Forum state that: "Border adjustments do not distort trade, as exchange rates should [*sic*] react immediately to offset the initial impact of these adjustments." The "should" here betrays the weakness of the argument. If exchange rates somehow fail to do what they "should," what then?

Unlike relative prices, which international competition forces to adjust automatically to outside influences, currency values are policy variables within the domain of governments and central banks. Exchange rates are flexible, but central banks defend them all the time. In the end, the value of any currency in terms of other currencies is governed by decisions made by the monetary authorities of that country and its trading partners. Currencies could be adjusted for a variety of policy-related reasons or expectations, but taxes are not prominent among them.

Ironically, if the dollar were to do all the adjusting, tax changes would be pointless! A policy change can have "real" effects only by changing relative prices. If currency movements offset changes in relative prices perfectly, then all real effects of the policy would disappear! Feldstein, Auerbach and Holtz-Eakin rely on this to claim that "border adjustments do not distort trade." They are right for the wrong reason: Taxation has real effects. But tax revenue drawn from either imports or imports reduces both.

Capital Mobility: The True Casualty of Border Adjustment. Some hope, forlornly, that the BAT will transfer wealth, economic activity and jobs from foreigners to Americans. According to Auerbach and Holz-Eakin, "border adjustments eliminate the incentives to shift profitable production activities abroad to take advantage of lower foreign tax rates."

Thus, the BAT aims to block U.S. business from shifting its capital base and operations to take advantage of lower tax rates overseas. If effective, it would undercut natural pressures on governments around the world, including Washington, to keep domestic tax rates down. Although American business is much criticized when it farms out its operations overseas, it is merely contributing one of the checks and balances that restrain over-taxation in Washington and elsewhere. Blocking companies from deploying their capital around the world is an underhanded way

to keep capital from exiting the U.S. economy in the short term; in the longer term, it will keep new capital out.

The BAT is a nontariff barrier in disguise. Capital always migrates away from high-tax toward low-tax regimes. Freely migrating capital encourages lower tax rates and thereby smaller government; a BAT facilitates higher tax rates and bigger government. No surprise Europe adopted it long ago!

The Self-financing Character of Tax Cuts. Supply-side economists point out that you don't necessarily have to raise one tax in order to offset the expected revenue loss from cutting another. It is now well accepted that "static" tax calculations produce overly pessimistic estimates. But even "dynamic scoring" is insufficient to tell the full story.

"While policymakers may think they can choose who bears the burden of a tax, it is markets that decide."

Administrative cost is another net revenue issue rarely taken into account. The BAT would introduce a new business tax while retaining the old corporate income tax at a reduced rate. That means two mini-bureaucracies instead of one. The business cost of complying with a complex and burdensome tax system is enormous, and generally ignored by the government's revenue calculations.

For these and other reasons, the chances that tax-rate cuts on capital could be self-financing from the viewpoint of the economy as a whole are greatly under-appreciated.

Conclusion. It is a good idea to cut and simplify the corporate income tax — an even better idea to get rid of it, if possible. To hunt for devices to tax foreigners is a bad idea. The over-arching objective of U.S. policy should be to give international capital an honest motive to flow into the United States rather than out, and to encourage foreign governments to act on the same wisdom.

A border-adjusted tax is a policy that ignores basic economic axioms. An attempt to tax foreigners and subsidize Americans would lead to backlash and retaliation overseas. But competitive international markets would completely undermine it in any case. In an open world economy, total exports and total imports are inextricably tied together by general equilibrium. Like two sides of a coin, one cannot be adulterated without the other.

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