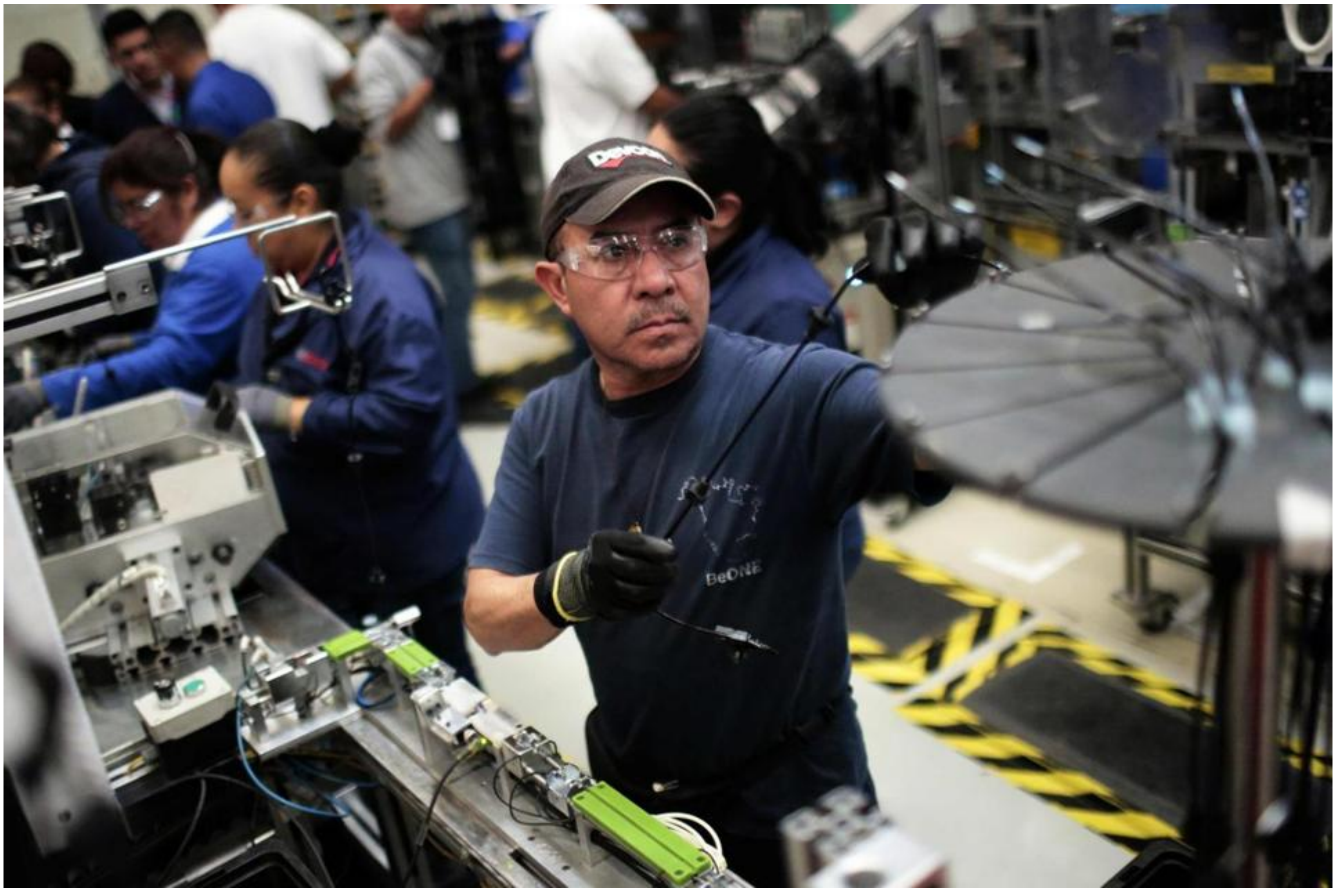
OPINION | KENNETH ROGOFF

Trump’s damaging border tax



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A worker assembles auto parts in the production line at the Bosch factory in San Luis Potosi, Mexico, in January. President Trump has threatened to impose an import tariff on companies that ship jobs to Mexico.

By Kenneth Rogoff | MARCH 20, 2017

IN MANY WAYS, the Republican Party’s plan to implement a “border adjustment tax” in the United States is the virtual complement of the physical wall President Donald Trump plans to erect on the US-Mexican border. But it could end up affecting the average American a lot more — and not necessarily in a good way.

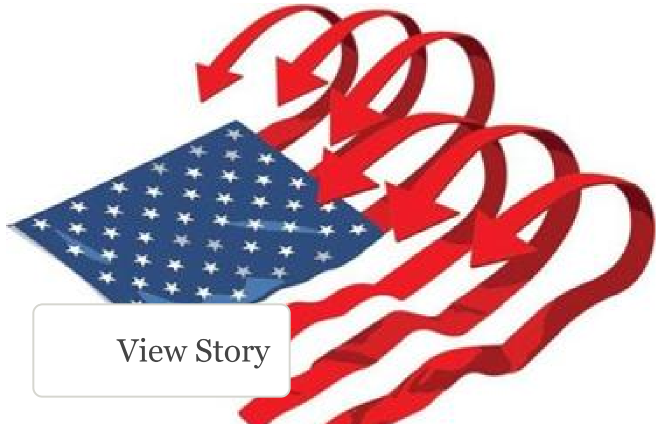
The basic idea is to slap a tax of, say, 20 percent on imports, and to provide tax breaks worth a similar amount on exports. All of this must be fantastic for US jobs, because it discourages imports and encourages exports, right? Unfortunately, as many have pointed out, there is a loose screw in this logic: America's floating exchange rate.

A likely result of a border adjustment tax is a stronger dollar, making imports cheaper for Americans and US exports more expensive for foreigners. In fact, the baseline textbook result is that the exchange-rate effect would fully offset the tax, leaving the trade balance unchanged.

Several highly regarded academic economists favor the scheme, but for entirely different reasons. They take it as an article of faith that the exchange rate will in fact rise to neutralize the trade effects of a border adjustment tax. But they like it anyway.

First, the United States imports a lot more than it exports, so it runs a large trade deficit, with the broadest measure (the "current account") at around 2.5 percent of GDP. While that is a vast improvement over the 6 percent of GDP deficits the United States was running a decade ago, the nation still imports considerably more than it exports, meaning the government stands to collect far more revenues from its 20 percent import tax than it would have to give in tax breaks to exporters. Indeed, the tax-subsidy schedule could, on paper at least, bring in roughly $90 billion a year.

Comment



View Story

The balance sheet on 'America First'

There is one truth in Trump's ideas but several dangerous myths.

And the magic doesn't stop there. Roughly half of all trade is intra-firm — transactions between foreign and US divisions of the same company. And because US corporate taxes are among the world's highest, firms go to great lengths to assign as much value as they can to foreign subsidiaries, and as little as possible to US companies.

One way to do this is by putting an artificially high bookkeeping price on intra-firm imports, and an artificially low bookkeeping price on exports. Under- and over-invoicing is a time-honored way to get around taxes and controls. When a transaction is all "in-house," it essentially just involves accounting sleight of hand to book profits in low-tax jurisdictions.

As the University of California at Berkeley's Alan Auerbachpointed out, the border adjustment tax is a way to push back on under- and over-invoicing in a high-tax jurisdiction such as the United States. So, even if it does not directly make US goods more competitive, it is an efficient way to raise revenues, potentially making room for other tax cuts.

So what could possibly be wrong with such a technocratically sound idea? First, it relies on some heroic assumptions — for example, that people cannot easily game retaliating. Second, it ignores a host of difficult transition problems.

For starters, the overwhelming majority of US imports are priced in dollars, not foreign currency. So, even if foreign currencies become cheaper, it might not help importers locked into dollar contracts. Their costs would just be 20 percent higher because of the import tax. And, despite the tax subsidy, some exporters would lose, because, as a recent New York Federal Reserve note points out, they rely on imported intermediate goods in producing their products.

Another problem is that a stronger dollar would mean a massive wealth loss for Americans, because the value of many foreign assets would fall, as my colleagues Emmanuel Farhi, Gita Gopinath, and Oleg Itskhok have discussed. The biggest problem of all, though, is the blithe assumption that the dollar exchange rate would neatly move to offset the tax/subsidy scheme.

In fact, 40 years of research have taught us that it is unrealistic to assume that a border tax will quickly lead to a sharp offsetting movement of the dollar, because exchange rates can move wildly away from their fundamentals for many years at a time. The process could take many years, and the short-term effects on US unemployment easily could be negative.

True, high border taxes could boost US employment. The scheme would require a huge increase in customs agents, and it would most likely lead to significant expansion in the underground economy as people seek to evade the taxes. But are those really the types of jobs proponents of a border tax have in mind?

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