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OPINION | COMMENTARY

The Illusory Flaws of 'Border Adjustment'

Foreign exporters would pay for the Republicans' proposed trillion-dollar corporate tax cut.

By **MARTIN FELDSTEIN**
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The border-adjustment feature of the House Republican tax plan is the key to cutting the corporate tax rate—and stimulating economic growth—without a major increase in the budget deficit. The tax would produce more than $100 billion in annual revenue, paid for by foreign businesses that sell to Americans. Yet the idea of border adjustment has been under siege lately, mostly by critics who seem to misunderstand its effects.

The House plan calls for cutting the corporate tax rate to 20% from 35%. It would also impose a 20% tax on all imports while giving a 20% subsidy to all exports. What would this mean in practice? Imports constitute about 15% of American gross domestic product, so the 20% tax would raise revenue equal to 3% of GDP. On the other side of the ledger, exports are about 12% of American GDP, meaning the subsidy would cost the Treasury only 2.4% of GDP. The net effect of the two would therefore be tax revenue equal to 0.6% of GDP—about $120 billion a year and more than $1 trillion over the next decade.

Retailers and importers understandably fear that the tax would raise the cost of their products and inputs, ultimately increasing prices for consumers. But 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.

Here’s why the dollar would rise: Without a change in the currency’s value, the border adjustment would cause imports to fall and exports to rise, reducing the overall U.S. trade deficit. But it is a fundamental fact of economics that the size of a country’s trade deficit equals the difference between national investment and national saving. 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 is a 25% increase in the dollar relative to other currencies, enough to offset the tax on imports and the subsidy on exports.

Consider a product that costs $100 to import today. A 20% border tax alone would raise its selling price in the U.S. to $125. (At this price, the importer would pay the tax of 20% of that $125 and have $100 left to pay for the cost of the import.) But a 25% rise in the dollar would reduce the import cost to $80—that is, $100 divided by 1.25. The border tax would then raise the domestic selling price to the original $100, so the importer could pay 20% of that and have $80 left to cover the cost of the import.

The 25% increase in the value of the dollar would have the same neutralizing effect on exports. An American company with an export that costs $100 to produce could sell it for $80 because of the 20% subsidy. But the dollar would be 25% stronger, meaning a buyer purchasing the product in euros or yen would pay 1.25 times what he used to—or $100.

ILLUSTRATION: PHIL FOSTER

The combination of the border-adjustment tax and the rise in the dollar leaves prices in the U.S. unchanged. It also leaves the prices that foreign consumers pay for American goods unchanged. So who, then, bears the cost of the tax? Foreign exporters to the U.S.

Assume the exchange rate is initially one dollar equals one euro. So a French firm that sells a product to the U.S. for 100 euros receives $100. After the dollar rises by 25%, the French firm would receive only $80 for the sale. The French firm can therefore buy 20% less in American goods and services for its export. That holds true world-wide: Every country that exports to the U.S. will receive 20% less in American goods and services for their exports.

Why then do American importers and retailers object to the border-adjustment tax? One reason may be that they do not understand how the rise of the dollar would keep the selling prices of imported goods unchanged. Alternatively, they may not trust the economic analysis, worrying that the dollar would rise only partially or slowly, leaving them worse off. To them, border adjustment looks like an unnecessary risk with no potential upside. But there is a real benefit: The border-adjustment tax would produce enough revenue to make cutting the corporate tax politically feasible.

Oil producers also object to the current plan. Since oil is priced everywhere in dollars, there is no exchange-rate effect to offset the higher cost of oil: A 25% rise in the dollar would increase the price of oil produced in the Middle East and sold to European buyers by 25%. To prevent that, the basic price of oil would have to be reduced—including the price of oil produced and sold in the U.S. The resulting loss to American oil producers, however, would be a gain for Americans consumers and businesses that use oil.

Some economists raise a different objection to the border-adjustment tax: that the rising dollar would reduce the real value of foreign investments owned by Americans. But my analysis suggests this effect would be very small. A 25% rise in the dollar would cause a one-time reduction in the value of Americans' net foreign assets equal to about 3% of their household net worth. For comparison, during the past year alone household net worth rose by twice that amount, or 6.1%.

The bottom line is that the border-adjustment tax would not hurt American consumers or businesses. But it would raise $1 trillion over the next decade from foreign exporters. That revenue is enough to finance almost all of the proposed reduction in the corporate tax. It would be a serious mistake to pass up the opportunity to stimulate investment and growth by adopting this novel plan.

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