Trump's Border-Adjusted Tax

How Europe would react.

BY CLEMENS FUEST

U.S. President Donald Trump has repeatedly warned that he is no longer willing to tolerate trade deficits with countries such as China or Germany. To bring down those deficits, he wants to punish foreign companies which distribute their products in the United States, but do not produce there. He wants them to pay an import tax of 35 percent. He has not yet explained how he plans to implement this tax.

There are, however, strong indications that he may adopt a reform plan put forward by Speaker of the House Paul Ryan (R-WI). Instead of customs duties, the plan outlines far-reaching reforms in the taxation of corporate profits. Interestingly, the tax plan is an academic idea. It is based on a proposal developed by the Oxford-based economics professor Michael Devereux called destination-based cash flow tax (DBCF tax). If implemented unilaterally, the effect of the reform is similar to the effect of introducing a tariff. This would have adverse consequences for both U.S. trade partners and the United States itself. The reform could even trigger a trade war. In contrast, if the new tax is implemented internationally, the plan would revolutionize the global tax system. The new system would have a number of advantages compared to the existing system. However, it would also have significant redistributive effects.

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THE INTERNATIONAL ECONOMY
THE MAGAZINE OF INTERNATIONAL ECONOMIC POLICY
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Washington, D.C. 20002
Phone: 202-861-0791
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How does the new tax system work? The reform would bring about a number of changes, including immediate write-off of investment goods, rather than depreciation over a longer time period. The core of the reform, however, is a border tax adjustment that has only existed in value-added tax to date, but not in taxes on income or corporate profit. Let's look at the example of exporting a vehicle from Germany to the United States. The exporting company incurs production costs of €30,000 in Germany, gives the vehicle an export value of €40,000, incurs €5,000 in distribution costs in the United States, and demands a sales price of €50,000. To date the company has been taxed on profits of €10,000 in Germany. In the United States, it makes a profit of €5,000, which corresponds to the sales price minus the costs of the imported car and its distribution. According to the new U.S. tax system, the costs of the imported car would not be tax-deductible any more, so the taxable profit on the car in the United States would amount to €45,000, leading to a huge increase in the tax burden.

A key question is: how might foreign countries like Germany react to this new system? They could react in three ways. First, they could do nothing and stick to their corporate tax systems. Second, they could retaliate by introducing tariffs on imports from the United States, that is, start a trade war. Third, they could follow the United States and introduce the DBCF tax as well. If they do nothing, the new U.S. tax system implies that their exports to the United States face an additional burden that amounts to an import tariff equalling the U.S. tax rate. Speaker Ryan has proposed a rate of 20 percent; Trump wants 15 percent rather than 35 percent. How would a U.S. import tariff of 20 percent affect trade and production in the United States, Germany, and elsewhere? Clearly, this depends on the volume of exports to and from the United States. For Germany, the United States is the most important export market. Roughly 2.2 percent of all jobs are related to U.S. exports. In 2015, German exports of goods and services to the United States were US$157 billion. U.S. exports to Germany were half that size. To what extent the U.S. trade deficit would fall as a result of this reform will depend, among other things, on the exchange rate effect. If the reform leads to a revaluation of the U.S. dollar, it may well be that the trade deficit does not fall by much. But it is unlikely that the exchange rate adjustment would fully offset the reform.

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The economic effects of U.S. protectionism would be significant. In a recent study, Felbermayr and Steininger (2017) have analyzed a scenario where the United States introduces a tariff on imports of 20 percent and, in addition, non-tariff barriers equivalent to a 15 percent tariff. As a result, German exports to the United States would decline by roughly 30 percent. Since German companies are highly integrated into international value chains, a large part of the decline in activity would be passed on to other countries. Therefore the impact on value added in Germany would be limited—German GDP would decline by 0.3 percent. Other countries would be much more affected, in particular Mexico, where GDP would decline by close to 4 percent. However, there would also be a negative impact on the United States itself. While companies competing with importers would benefit, there would be three groups of losers. The first group is U.S. consumers. They would face higher prices on both imported and domestically produced goods. The second group includes companies relying on imports. Within this group, retailers such as Walmart would probably lose most. They import a large share of the products they sell. They would probably be able to pass on some but not all of the import tariffs to their customers, so that their profit margins would decline. The third group includes U.S. exporters. Even in the absence of countermeasures by other countries, changes in terms of trade and income losses in other countries would reduce demand for U.S. export goods. Felbermayr and Steininger (2017) calculate that U.S. exports would decline by 60 percent. In the case of a trade war, where other countries

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would respond by introducing new tariffs and non-tariff barriers as well, the losses would be even larger.

The situation would be different if other countries reacted by reforming their corporate tax system in the same way—by also introducing the DBCF tax. Their exports would then be fully exempt of taxation. The production costs of exports would nevertheless be domestically tax-deductible. Let us return to the example of a car exported from Germany to the United States. The U.S. tax on the car would be as described above. The difference is that the exporting company would now be able to offset the production costs of €30,000 in Germany and deduct it, for example, from profits made on vehicles sold nationally.

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A comparison of the existing and the proposed new DBCF tax systems introduced in both countries reveals that total taxable corporate profits in Germany and the United States amount to €15,000 in both cases. The difference is that the right to tax those profits shifts massively towards the United States. In the United States, €45,000 are taxable instead of €5,000, while in Germany a tax-deductible loss of €30,000 is created instead of a profit of €10,000. In this example, Germany is at a disadvantage. But no disadvantage would arise if Germany were to import the same volume of goods. If, for example, Apple were to sell iPhones in Germany that were also worth €50,000, for instance, €45,000 in profit would also be taxable in Germany, sales costs being equal. The problem is that Germany exports far more goods than it imports—not just in its trade with the United States. The German foreign trade surplus was around €280 billion in 2015, so with a profit tax rate of 30 percent, a switch to the Trump tax system would result in losses of around €84 billion for Germany, while deficit countries, including the United States, would gain tax revenues. As in the case of the unilateral introduction of the new tax, some of its effects could be mitigated by exchange rate changes, but it is unlikely that the impact would be fully neutralized.

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From a global perspective, the new system would have a number of properties that make it attractive for policymakers. First, if introduced internationally, it would lose its protectionist effect. The additional tax burden on imported goods would be compensated by the exemption of exports. Second, the existing corporate income tax is under pressure because capital is internationally mobile and countries compete for investment and jobs. They try to attract investment by cutting corporate taxes. The view is widespread that this will lead to an erosion of the corporate income tax in the long term. The destination-based corporate income tax eliminates this type of tax competition because taxation effectively happens in the country where goods are sold to final consumers, not where they are produced. Third, the new system makes tax avoidance by multinational companies more difficult. Apple, for example, currently generates a significant share of its profits in tax havens, at least before repatriation, because the rights to Apple technology are located offshore. In the DBCF tax system, what counts in taxation is where products are sold—whether a multinational has a letter-box company on the Cayman Islands which administers patent rights or not is irrelevant. That could increase the attractiveness of the "Trump tax." The redistributive effects from countries with trade surpluses to those with export deficits, however, make it unlikely that the international reform will find enough support to revolutionize the global tax system. For similar reasons—the redistributive effects within the United States—it is far from clear whether Trump will be successful in introducing it in the United States alone. ◆

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