What Is Border Adjustment Tax?

There is a growing likelihood that the U.S. will introduce, "Border Adjustment Tax". Under the proposal, U.S. businesses would subtract exports and add imports in calculating taxable profits. Clearly exports would benefit and imports would decline. As the U.S. trade balance improves, the value of the U.S. dollar would appreciate. Big industrial exporters like GE, Dow Chemical, Boeing and Caterpillar support the tax system while major importers such as Walmart, Target and Home Depot are against the proposal.

There are three key advantages of the "border adjustment tax" for the U.S. President Trump promised to raise economic growth significantly. Narrowing trade deficits could boost economic growth. Some estimate that a reduction of trade deficit by $500 billion would raise economic growth by 3 percentage points. The additional tax revenues from higher economic growth would pay for a part of tax cuts and infrastructure spending promised by President Trump.

The Trump proposal would also reduce the corporate tax rate to 20 percent from the current 34 percent cutting the tax revenue from corporations. The "border adjustment tax" would raise as much as $1.2 trillion in part offsetting the revenue loss. American importers could see their corporate tax bill go up by significantly, according to some estimates. If U.S. importers, say from China, were to raise prices to the consumers, the demand for the Chinese products would fall.

The proponents believe that the "border adjustment tax" is preferred to tariffs. While tariffs would work on imports only, the border tax would apply to both imports and exports. Also, the U.S. trading partners are less likely to retaliate against the border adjustment tax while higher tariffs would certainly invite tit-for-tat reaction.

The "border adjustment tax" is nothing new. 100 plus countries have been using it already. An American tourist in Europe could purchase luxury handbags with 27 percent value-added tax (VATs). Upon departure, the VAT is refunded at the airport. If the U.S. institute such a tax, other countries without the "border adjustment tax" might drift to a similar system.

How would foreign exporters to the U.S fare? Even if the tax goes into effect right away, its impact on the dollar and trade balance would be spread out over a number of years. Estimates of the U.S. border tax, as expected, show a large decline in the U.S. trade deficits. Canada and Mexico, which has close to $70 billion annual trade surpluses with the U.S. each would experience trade deficits as a result of the border tax. China's trade surplus with the U.S would fall by about $100 billion a year.

Some would argue that the new tax is just another tariff on imports. Exporters could challenge the U.S. at WTO, but it is unlikely that the threat would derail the proposal in the U.S. Congress. One benefit for our trading partners is the value of the dollar. The improving U.S. trade balance as a result of the tax would strengthen the dollar making Korean exports to the U.S. more competitive. But, U.S. exporters could lower their prices because the U.S. corporate tax rate would be lower.

The "border adjustment tax" is possible, but not a sure bet. Some legislators in Congress are worried that the tax is regressive imposing additional tax burden on the poor. After all, rich people don't need inexpensive imports; low- and middle-income households do.

The White House has yet to make its position clear except to say that it is one of several alternatives in "Making America Great Again". Since a tax reform is one of President Trump's major campaign promises, something will happen. The "border adjustment tax" could assist some of President Trump's economic goals including creating more jobs in the U.S. Some form of the "border tax" has a high probability of passage in the foreseeable future. For some of our trading partners, this tax could be more significant than additional tariffs on their exports and/or renegotiation of the existing Free Trade Agreement.