THE INTERNATIONAL ECONOMY
THE MAGAZINE OF INTERNATIONAL ECONOMIC POLICY
220 I Street, N.E., Suite 200
Washington, D.C. 20002
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A Case for a Border-Adjusted Tax

Not as bad as you think.

BY HANS-WERNER SINN

The new U.S. President shocked German car manufacturers with his statement that a 35 percent tariff will be levied on U.S. imports. On closer inspection, however, the proposal is less outlandish than it may at first appear. For the 35 percent is presumably not meant to be understood as an import tariff, as many people think, but as part of a new form of taxation reminiscent of the value-added tax system. The United States has already largely exhausted the options for tariffs that can be levied within the General Agreement on Tariffs and Trade. It can hardly raise the current average import tariff of around 2.5 percent any further. And leaving GATT and the World Trade Organization would be a risky undertaking even for a daring business leader like Donald Trump.

What Trump's announcement may mean is more of a border adjustment mechanism within a new tax on the real cash flow of enterprises. Such a tax has a long history dating back to 1970s and earlier periods. It was put forward in 2016 as a substitute for the corporate income tax by Paul Ryan, the Republican Speaker of the House of Representatives, presumably after consulting Trump.

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The real cash flow of a company is defined as its domestic sales revenues minus expenditure for domestic intermediaries, wages, and investments. Compared to the United States' current taxation system, the taxation of cash flows primarily means that an immediate write-off of investment expenditure is introduced, while debt interest is no longer tax-deductible. Moreover, there is a border adjustment in that profits from exports remain tax-free, while profits from the further sale of imported goods to consumers are subject to tax and imports are not tax deductible. Domestic tax will therefore also be levied on foreign value added, while the domestic value added present in export goods remains tax-free.

This border adjustment is urgently necessary if the ultimate goal is to mimic a tax on domestic consumption by combining a wage income tax with a cash flow tax. This is the explicit aim of those who support a cash flow tax. Critics claim that this border adjustment represents discrimination against imports as opposed to domestic production. This, however, isn't really the case, as the cash flow tax inherently means that domestic tax is only levied once on domestic and foreign added value. It is true that the full tax rate—probably even less than the 29 percent mentioned by Trump—will be levied on a German car sold by a U.S. distributer to consumers. But this tax rate equally applies to a U.S. car purchased by American consumers. Nor is it the case that German cars will be taxed twice in the United States: once on their importation and a second time when sold by distributors. There will be no violation of the GATT rules, as these rules explicitly allow for border tax adjustments.

German machine tool makers do not need to worry.

Moreover, domestic and foreign goods sold to investors will generally not be liable for tax due to their immediate write-off. From this point of view, German machine tool makers do not need to worry. On the contrary, the likely revaluation of the dollar resulting from the taxation of imported consumption goods may even boost their bottom line.

Of course, in terms of sales to consumers, the fact that German manufacturers have already paid a revenue tax on their value creation in Germany may be seen as discriminatory. That, however, is a German problem, not an American one. There is nothing stopping the Germans from doing exactly the same thing and adopting the U.S. cash flow tax concept, which would be an advisable move anyway.

To better understand Trump's tax reform, it is worth taking a look at European value-added tax. This is also a consumption tax, which enables an immediate write-off of investments and has the same tax border adjustment as the United States is thinking of introducing, regardless of the possible taxation of imports abroad. If Europe were not to introduce a cash flow tax too, as it should, it could increase its value-added tax rates and lower its income taxes. This, in turn, would reduce the double burden on European exports to America. Adopting this idea, together with the appreciation of the dollar that will probably result from the U.S. reform, would mean that European exporters would largely no longer be at any disadvantage. ◆

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