Trump’s Tax Plan and the Dollar

By Emmanuel Farhi, Gita Gopinath and Oleg Itskhoki *Wed, Jan 4, 2017*

'Trump’s proposed tax plan—particularly the border-adjustment tax—would most likely not have a positive impact on the US trade balance,' write these Ivy League economists. 'Worse, it could be very costly in terms of US net foreign assets.'

Now that Donald Trump has been elected President of the United States and Republicans control both houses of Congress, corporate tax reform is coming to America. The package currently being discussed includes two important features:

- A cut in the tax rate to 20%, or even 15%, from the current 35%
- A “border-adjustment” tax, which is typical of a value-added-tax (VAT) regime, but unusual for corporate taxes

A border-adjustment tax would treat domestically purchased inputs and imported inputs differently, and encourage exports. Corporations would no longer be able to deduct the costs of imported inputs from their taxable income; but, at the same time, their export-sales revenue would not be taxed.

The proposal has generated an intense debate about whether it will improve the US trade balance. Having published our own work on “fiscal devaluations,” we believe that a border-adjustment tax would have minimal prospects for success, and that it could significantly undermine America’s net foreign-asset position.

The idea of using fiscal-policy instruments to improve trade competitiveness dates back to John Maynard Keynes. In his 1931 Macmillan Report to the British Parliament, Keynes proposed that an import tariff be paired with an export subsidy, which would mimic the effects of exchange-rate devaluation, while maintaining the gold-pound parity. In our own work, we have demonstrated that, in addition to this policy combination, countries that maintain a fixed exchange rate or are in a currency union can achieve the same effect by raising their VAT and cutting payroll taxes by equivalent amounts. This tax-swap policy has received a lot of attention in the eurozone, with Germany implementing it in 2006, and France in 2012.

The incoming Trump administration’s proposal to cut corporate-tax rates and impose a border-adjustment tax is similar to the VAT-payroll tax swap, because both strategies raise the cost of imports and subsidize exports. But we do not expect such a strategy to improve US competitiveness for the simple reason that the US authorities maintain a flexible exchange rate.

If Trump's proposed tax reforms are implemented in full, the dollar will appreciate along with demand for US goods: a 20% tax cut will push the value of the dollar up by 20%. And this, in turn, will offset any competitiveness gains. The only way that this would not happen is if the US Federal Reserve prevented the dollar from appreciating by lowering interest rates. But this would fuel domestic inflation, so there is no reason to believe that the Fed would take such a step.

Thus, while a border-adjustment tax can benefit countries that have a fixed exchange rate or are in a currency union, it basically has nothing to offer countries with floating exchange rates, because the resulting currency appreciation offsets the fiscal devaluation.

But the effect of a US border-adjustment tax would not be neutral. An appreciating dollar would erode America's net foreign-asset position, because an overwhelming 85% of its foreign liabilities are denominated in dollars, while around 70% of its foreign assets are denominated in a foreign currency. With US foreign assets amounting to 140% of its GDP, and its foreign liabilities amounting to 180% of GDP, a dollar appreciation of 20% would result in a capital loss equal to about 13% of GDP.

The fiscal consequences of Trump's proposals would be mixed. On one hand, the border-adjustment tax could push up tax revenues, because the US imports more than it exports. With the US trade deficit at 4% of GDP, a 20% border-adjustment tax would create additional tax revenues equal to about 0.8% of GDP. On the other hand, the lower corporate-income-tax rate would decrease revenues and essentially cancel out any gains from the tax on imports.

To be sure, a border-adjustment tax would have other benefits that we have not discussed. It might generate additional tax revenues, by discouraging international companies from engaging in "transfer pricing" between their subsidiaries, or from shifting profits to low-tax countries. And, of course, lower tax rates could provide an economic stimulus and decrease the budget deficit.

But in terms of international competitiveness, the bottom line is that Trump's proposed tax plan—particularly the border-adjustment tax—would most likely not have a positive impact on the US trade balance. Worse, it could be very costly in terms of US net foreign assets.

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