The key to evaluating the border adjustment is to keep in mind the big picture benefits of the overall Brady-Ryan tax reform: lower tax rates mean a stronger US economy with more jobs, higher incomes, more spending by families, and more investment by businesses. The Brady-Ryan plan also addresses the tax bias in favor of debt over equity financing, leading to not just a stronger economy but a more stable one as well. With the Brady-Ryan plan, the United States will have a much more competitive tax system, and become a more attractive destination for global investment and economic activity.

The border adjustment makes it possible to achieve the most progress in these dimensions. Without the border adjustment, tax reform would involve either smaller improvements in terms of lower tax rates, or larger budget deficits over the foreseeable future. The border adjustment allows for a more pro-growth tax reform.

The border adjustment in its own right has important positive effects on the U.S. economy because it removes the tax incentives for American firms to use accounting techniques to shift profits overseas, or to invert their corporate structures to relocate headquarters outside of the United States. In the Brady-Ryan plan, firms are taxed based on the place in which their sales are made, and thus are not induced by the tax system to move production abroad or to use transfer pricing to shift profits overseas.

The destination-based tax treatment provided by the border adjustment removes a current bias in the tax system that affects firms deciding whether to expand production in the United States or in other countries. The border adjustment makes it so that US firms face the same tax treatment as foreign firms selling into the United States, because all products sold in the United States, whether produced here or abroad, will be subject to the same tax. In contrast, the current U.S. tax system typically subjects American firms to higher tax rates than foreign firms, leaving U.S. businesses at a disadvantage. At the same time, the border adjustment ensures that U.S. firms selling products abroad are on a level playing field with firms in the countries to which they export. American firms that export will face the same foreign tax paid by their overseas competitors. Indeed, the advanced economies with which we trade already have border adjustments in their tax systems (typically with their value-added taxes, or VATs). The border adjustment thus ends the current U.S. tax treatment in which American firms pay a higher tax rate than their foreign competitors, making the U.S. tax system more competitive.

The impact of the border adjustment in removing the incentives in our tax system for inversions and profit-shifting is a better approach than trying to devise rules against these activities. Attempts to get at inversions and profit-shifting by layering rules upon rules—the route taken by the Obama
administration—are bound to fall short because firms will find ways around the restrictions, even while increasing costs for businesses and the government. Indeed, removing the tax biases for inversions and profit-shifting will mean fewer resources dissipated on tax avoidance activities such as accounting maneuvers. A tax measure that reduces the U.S. corporate tax rate without the other pro-growth features of the Brady-Ryan plan would also make the U.S. tax system more competitive and reduce incentives for profit-shifting and inversions, but by less than the complete reform including the border adjustment, which eliminates the perverse incentives altogether.

Tax reform leads to a stronger economy today as lower tax rates improve incentives for work, while lower corporate tax rates improve incentives for saving and investment. More investment in turn will lead to increased capital and thus improved productivity. Importantly, wages over time track with labor productivity. Increased investment and improved productivity over time would thus be expected to translate into higher wages for American workers.

The beneficial outcomes brought about by the Brady-Ryan plan help everyone, including firms such as retailers who criticize the border adjustment. The benefits for retailers come about in two ways. First, retailers themselves will face a lower corporate tax rate. Indeed, retailers would be among the industries most helped by the lower tax rate, because they often now actually pay the 35 percent corporate rate, while other sectors generally have lower effective tax rates. Somewhat ironically, this is documented by the group Americans for Affordable Products (AAP), which has shown that retailers face higher effective tax rates than firms that support the border adjustment. But this means that retailers would benefit the most from the lower rates in the Brady-Ryan – and would therefore benefit from the impact of the border adjustment that makes it possible to reduce tax rates by more than without the border adjustment. There is a sense in which this implication of the data collected by AAP sits awkwardly with the group’s own message.

The second and perhaps even more important benefit of the Brady-Ryan plan for retailers is that their customers will have higher incomes and thus more to spend in stores and online. What is good for customers ultimately is good for merchants. That is the big picture positive of tax reform.

This is not to deny that there will be costs along with the benefits—some of these costs are discussed below. Evaluating the Brady-Ryan tax proposal involves weighing the costs against the benefits. The big picture evaluation is that the plan comes out ahead in terms of net positives for the U.S. economy.

One way to see this is to consider the counterfactual situation in which the United States had instituted the Brady-Ryan plan with its lower rates and border adjustment long ago. Is there any chance that we would change to our current tax system? Not by a long shot. We would not want to go to a tax system with higher rates that reduce saving and investment, or tax-induced biases that provide incentives for corporations to invert or shift earnings overseas. We would not want to move to a tax system that puts U.S. firms at a disadvantage relative to their foreign competitors. This conclusion is strengthened by the observation that most other advanced economies already have border-adjusted taxes that are economically equivalent or nearly-so to the setup in the Brady-Ryan proposal. None of those other countries seek to move toward the U.S. tax system. The U.S. tax system is a hindrance to our prosperity.

This observation highlights that the main costs of moving to the border-adjusted tax in the Brady-Ryan proposal are involved with the transition from the current system to the new one. This is a familiar situation in that tax reform creates winners and losers, even if the net is positive, as is the case here.
Criticisms of the border adjustment have focused on the impact of the 20 percent tax on imports, often while ignoring or discounting the associated response by which the dollar will strengthen with the border adjustment. In principle, there should be a 25 percent dollar appreciation that offsets the 20 percent tax on imports. No one can know for sure how much of this textbook response will be seen in practice and how quickly, but we should expect most of the 25 percent dollar appreciation to take place and to take place quickly, because currency markets adjust rapidly to economic developments. To be sure, this will still be an adjustment, but the impact of the border adjustment in raising import prices is vastly exaggerated by critics of the border adjustment. It is important to remember that the 20 percent tax applies only to the value of the imported item as purchased from the foreign supplier, and not to the price at which an item is sold to American consumers. Retailers add substantial value to the U.S. economy—they do not merely buy things from China and push them out to American families. Instead, retailers provide valuable services that are appropriately compensated with the retail markup that is the difference between the wholesale price paid to suppliers and the higher price at retail. The value embedded in this markup is not subject to the 20 percent tax. That means even if the dollar adjustment is not complete, the impact in raising prices of consumer products is greatly muted.

A related concern over the border adjustment is that the approach in the Brady-Ryan plan might run afoul of WTO proceedings and expose American businesses to retaliation in the form of other countries raising barriers to U.S. products. In considering this concern, the first thing to have in mind is that the arrangement in the Brady-Ryan plan is essentially economically equivalent to the value-added tax (VAT) systems of our major trading partners, plus a wage subsidy (which is allowed by the WTO). The possible WTO problems of the Brady-Ryan plan are thus matters of form over substance. It would say more about the WTO and other countries if a pro-growth U.S. tax policy that mirrors those of Europe in economic substance is not acceptable—such a finding would raise serious doubts about the validity of the WTO system, more than about the Brady-Ryan tax plan. Again, our major trading partners already have the border adjustment. It would be improper for them to retaliate against the U.S. moving to such a system.

A further concern related to currency movements is that the stronger dollar brought about by the border adjustment means that foreigners’ holdings of US assets would be worth more in terms of those foreigners’ currencies, and Americans’ holdings of foreign assets would be worth less in terms of dollars. In other words, the concern is that the dollar appreciation associated with the border adjustment would bring about a wealth transfer from Americans to foreigners. The irony of this concern is that it comes about because of the dollar appreciation, in contrast to the concern over import prices, which requires a disbelief in the response of the dollar. Set that irony aside, however. Such a change in wealth is what happens when the US economy becomes more vibrant for any reason, because after all, a stronger US economy means a stronger dollar. Any action taken by the Congress and President that improves the US economy would lead to a stronger dollar and have a similar implication for the value of cross-border asset holdings. But this does not mean that we should not hold back from taking steps to improve the US economy.

A different concern over the border adjustment is that the resulting tax system is much more efficient in the sense of raising revenue with a smaller distortion to the economy than the present US tax code. Instead of seeing this as a positive of tax reform, the argument goes that a more efficient tax code will facilitate additional government spending. I understand the political economy argument involved here. At the same time, I am confident that convincing arguments can be made on why a more limited
government is better than the expansive one feared under this concern. The way to ensure low taxes is to keep government spending in check. I prefer to win the argument for the appropriate size and role of government than to intentionally hobble the United States with an inefficient system of collecting revenue.

A stronger economy with rising incomes and better job creation means more money for families to spend in stores and online. These desirable outcomes are what the Brady-Ryan tax plan will bring about. And importantly, this stronger economy is good for retailers and other critics of the border adjustment. The key is to focus on the big picture benefits of tax reform for the overall economy—and thus for the customers of retailers and all other parts of the U.S. economy.