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For Free Traders, Trump's Corporate Tax Cut Is the Better Way

Instead of making the tax 'border adjustable,' simply lower rates to 15%, as the president-elect proposes.

By Donald L. Luskin

Donald Trump is fighting with House Speaker Paul Ryan again. And—who knew?—this time Mr. Trump is the one acting like a free trader, while Mr. Ryan is playing protectionist.

Their spat is about how to reform the corporate tax code. During his campaign, Mr. Trump offered a simple and elegant plan: Slash the top rate for all businesses to 15%. That would offer significant relief from today's top corporate rate of 35%, which is the highest in the developed world and makes American businesses globally uncompetitive.

But this summer House Republicans, led by Mr. Ryan, began advocating an agenda that they grandly call "A Better Way." It proposes cutting the top corporate rate to 20%, but also making the tax "border adjustable." On goods and services that they export, corporations would pay no tax at all. But anything they import from overseas would not be deductible as a business expense.

On its face, the tax exemption for exports might seem to make sense: Businesses could cut prices for foreign buyers, making American goods and services more attractive overseas. But Mr. Trump's proposal to cut the tax rate to 15% would already do that. Further, how does it help the U.S. overall to have American goods sold for lower prices in Paris, France, than in Paris, Texas?

Which brings us to imports. Border adjustability means that companies would no longer be allowed to count inputs from overseas as deductible business expenses. At the 20% tax rate proposed by "A Better Way," that has the same effect as a 25% tariff, pure and simple. The costs would be passed on to Americans in some form: either to consumers through higher prices or to stockholders through lower profits.

Consider American oil refiners, who import about 7.6 million barrels of foreign crude every day, worth about $150 billion a year at current prices. Under the "Better Way" plan the industry would not be able to count that as a business expense—a deduction worth $30 billion against taxable income, assuming a 20% tax rate. By my firm's calculations, a typical refiner would end up paying more in taxes at the 20% rate than it does today at the 35% rate.

Businesses may have limited ability to respond to the protectionist incentives embedded in this border adjustment plan. Refiners, for example, would demand more petroleum produced in the U.S. But replacing all of their imports would mean almost doubling domestic oil production. That's a worthy goal, but it's many years away in even the best of circumstances.

The same is true for other industries. Countless American firms use goods and services that the U.S. simply does not produce, cannot produce enough of, or does not produce efficiently. The border adjustment would punish them nevertheless.

Supporters of the idea have an answer for all this: the rising dollar. They claim that higher demand around the world for American exports, along with a smaller market in the U.S. for imports, would cause the dollar to appreciate against other currencies, perhaps by up to 25%.

A stronger dollar, the argument goes, would offset the implicit tariff on imports, protecting American consumers. But from the perspective of foreign buyers, it would also offset the lower prices of tax-free U.S. exports. That's the looniest aspect of this argument: If a strong dollar will offset all the effects of border adjustment, then why implement the policy in the first place?

No one can say with any certainty what the dollar will do on the volatile foreign-exchange markets. Even if the supporters of border adjustment are right, they are ignoring that such a massive move in the world's reserve currency could send unpredictable shocks through global supply chains and debt markets.

And even if the dollar does strengthen, it's hard to see how that would help American industries like the oil refiners, whose imports are already priced in dollars. The currency can strengthen or weaken, but the border adjustment will remain effectively a tariff on imported crude.

Mr. Trump is pushing back against the House plan. The president-elect called border adjustment "too complicated" in a Friday interview with this newspaper. "I don't love it," Mr. Trump said. "Because usually it means we're going to get adjusted into a bad deal."

At any moment, Mr. Trump might be one tweet away from endorsing outright tariffs. But he told this newspaper that he would defer acting on his campaign promise to immediately declare China a "currency manipulator," saying "I would talk to them first." That's good news for those who remember the Smoot-Hawley Tariff Act and the Great Depression that it caused. For the moment at least, Mr. Trump is standing up for free trade—whether he intends to or not.

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