Commentary
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January 2017

UNDERSTANDING THE LANDMINES IN THE TAX REFORM INITIATIVE

Bringing a Bat to a Badminton Game

The Republican proposal to lower the corporate income tax will permit U.S. companies to compete on a level playing field with many of their foreign competitors. It is a worthy effort. We have had years of low economic growth and inadequate business investment. Many of these economic problems are clearly related to a dysfunctional tax system on the business sector. However, even if we use dynamic scoring, the tax cut will require revenues from another source to compensate for the lost revenues.

Speaker Ryan and the Republican caucus have proposed a so-called Border Adjustment Tax (BAT) to make up for the lost revenues from the cut in corporate taxes. An important feature of this proposal is that the BAT will raise over $1 trillion over ten years according to the Tax Foundation. The corporate tax cut is in fact held hostage to the trillion-dollar revenue requirement. Any single member of Congress opposing the BAT must come up with an alternative tax to raise a trillion dollars over ten years.

Precisely then how would the BAT work? It is not a value added tax (VAT) or tariff, but in fact very much like a bat, a clumsy club. The thinking is that the BAT will compensate for the main differences in the incidence of taxes on companies between the US and many of our trading partners. Our trading partners collect much of their taxes through a VAT, and operate with lower corporate tax rates. Among most of our trading partners, the VAT is only applied to domestic consumption, but is removed on goods and services, which are exported. Because U.S. goods and services have embedded in them a high corporate tax rate, the BAT is viewed as an effective policy to adjust for these differences.

The BAT seems to be a favorite of academic economists running simulation models and theoretical assumptions that show any increase in domestic prices from the BAT are quickly reduced through changes in dollar exchange rates. Here the operative word (and working assumption) is that the dollar exchange rate SHOULD adjust enough to prevent domestic prices from rising. Anyway, that's the assumption. Given the limited experience with this tax, if the BAT becomes law, we are about to experience the most extensive experiment with the US economy and consumers will be the laboratory animals.

Of special concern is that we are proceeding with this tax policy without any analysis of impacts on U.S. industries, specific companies, or regions of the country. Oil for example is priced in dollars. What would be the impact on refiners, particularly along the East Coast, where almost all feedstock (crude oil) is imported? The BAT will create artificial winners and losers not based on merit, but by accident of location. It is likely to bring about a civil war, and not just among different segments of the petroleum industry.

We should also keep in mind that countries such as China, Japan, Canada, India, South Korea and the those on the European continent will unlikely let their currencies experience a substantial decline relative to the dollar without some response. In addition, we have no idea whether this dollar exchange adjustment will occur rapidly or slowly, and even the nature of the adjustment process. No one has an answer on how the Federal Reserve will view these currency shifts with regard to both economic growth and measured inflation.

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The BAT proposal leaves a lot of questions on the table. Uncertainties and questions over this proposal will likely stall this legislation, if not in the House of Representatives, then certainly in the Senate. Optimism for proposed tax reform legislation may have already played a small role in the rising value of the dollar, but how the markets will react when and if the BAT legislation stalls or becomes law remains to be seen. **BAT**ten down the hatches, we are in for a long and drawn out fight.

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The Foundation researches and publishes reports on all aspects of the petroleum industry which are made available free of charge to all interested organizations and individuals. It also provides analysis for quotation and background information to the media.

Furthermore, it has been called on to testify before Congress on many occasions, and it briefs government officials and legislators, and provides written background materials on request. Additionally, EPRINC has been a source of expertise for numerous GAO energy-related studies and has provided its expertise to virtually every National Petroleum Council study of petroleum issues.

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