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Implications of a US Border Adjustment Tax, Especially on Developing Countries

By Martin Khor

Executive Director, The South Centre

The US border adjustment tax blueprint

A new and deadly form of protectionism is being considered by the leadership of the United States that could have devastating effect on the exports and investments of developing countries like Malaysia as well as destabilise the world economy.

The plan, known as a border adjustment tax, would have the effect of taxing imports of goods and services that enter the United States, while also providing a subsidy for US exports which would be exempted from the tax.

The aim is to drastically reduce imports while promoting exports and thus reduce the huge trade deficit in the US.

On the other hand, if adopted, it would depress the competitiveness or viability of goods and services of countries presently exporting to the US. The prices of these exports will have to rise due to the tax effect, depressing their demand and in the worst case make them unsalable.

And companies from the US or other countries that have invested in developing countries because of cheaper costs and then export to the US may find their business affected because their products will cost more.

Some will think of relocating back to the US, and investors will be discouraged from opening new factories in the developing countries. In fact this is one of the main aims of the plan – to get companies to relocate to the US and provide jobs for Americans. It is an intrinsic part of the America First strategy of US President Donald Trump, with his subsidiary policies of "Buy American" and "Hire Americans."

The border adjustment tax is expected to be a key part of a tax reform bill the Republican Party is preparing. Leading advocates are Paul Ryan, speaker of the House of Representatives, and Kevin Brady, Chairman of the House Ways and Means Committee, who released a tax reform concept paper, "A Better Way"[1], in mid-2016.

President Trump originally criticised the plan for being "too complicated" but is now considering it seriously. According to a press report, in an address to congressional Republicans, Trump said: "We're working on a tax reform bill that will reduce our trade deficits, increase American exports and will generate revenue from Mexico that will pay for the (border) wall if we decide to go that route."[2]

The proposal of a border adjustment tax[3] has however generated a tremendous controversy in the US, with opposition coming from some Congress members (including Republicans), many economists and American companies whose business is import-intensive.

It however has the strong support of many Republican leaders and Congress members and some version of the tax reform blueprint is expected to be tabled in Congress soon.

During his campaign and after his election, Trump made the imposition of a high tariff on imports from countries having a trade surplus with the US, mentioning a 45% duty for goods from China and 35% for Mexican goods.

This might technically be more simple to understand and implement, but is so blatently protectionist that it would be sure to trigger swift retaliation. When challenged at the World Trade Organization for going against its rules, the US would almost certainly lose and then would have to remove the tariffs or face retaliation by countries successfully challenging it.

The tax adjustment plan may have a similar effect in discouraging imports and moreover would promote exports, but it is more complex and thus difficult to understand. The advocates hope that because of the complexity and confusion, the measure may not attract such a strong response from US trading partners. Moreover they believe that the measure is permitted by WTO rules and are presumably willing to put it to the test.

The tax works like this. As part of the reform, the corporate tax rate would be reduced from the present 35% to 20%. The border adjustment aspect of the plan has two main components. Firstly, as part of the overhaul of the corporate tax system, the expenses of a company on imported goods and services can no longer be deducted from a company's taxable income. Wages and domestically produced inputs purchased by the company can be deducted.

The effect is that a 20% tax would be applied to the companies' imports.

This would hit many US-based companies, especially those that rely more heavily on imports, such as retail shops and traders that deal with imported goods like toys and electronics, and the oil and automobile sectors.

In an information document on border adjustment[4], the Wall Street Journal gives the example of a firm with a revenue of $10,000 and with $5,000 imports, $2 000 wage costs and $3,000 profit. Under the present system, where the $5,000 imports plus the $2,000 wages can be deducted, and with a 35% tax rate, the company's taxable total would be $3,000, tax would be $1,050 and after-tax profit would be $1,950.

Under the new plan, the $5,000 imports cannot be deducted and would form part of the new taxable total of $8,000. With a 20% tax rate, the tax would be $1,600 and the after-tax profit $1,400.

Given this scenario, if the company wants to retain his profit margin, it would have to raise its price and revenue significantly, but this in turn would reduce the volume of demand for the imported goods.

For firms that are even more import-dependent, or with lower profit margin, the situation may be even more dire, as some may not be financially viable anymore.

Take the example of a company with $10,000 revenue, $7,000 imports, $2,000 wages and $1,000 profit. With the new plan, the taxable total is $8,000 and the tax is $1,600, so after tax it has a loss of $600 instead of a profit of $1,000.

The company, to stay alive, would have to raise its prices very significantly, but that might make its imported product much less competitive. In the worst case, it would close, and the imports would cease.

The economist Larry Summers, a former Treasury Secretary under President Bill Clinton, who is strongly against the border adjustment plan, gives a similar example of a retailer who imports goods for 60 cents, incurs 30 cents in labour and interest costs and then earns a 5 cent margin. With 20% tax, and no ability to deduct import or interest costs, the taxes will substantially exceed 100% of profits even if there is some offset from a stronger dollar.[5]

On the other hand, the new plan allows a firm to deduct revenue from its exports from its taxable income. This would allow the firm to increase its after-tax profit.

The Wall Street Journal article gives the example of a firm which presently has export sales of $10,000, cost of inputs $5,000, wages $2,000 and profit $3,000. With the 35% corporate tax rate, the tax is $1,050 and after-tax profit is $1,950.

Under the new plan, the export sales of $10,000 is exempt from tax, so the company has zero tax. Its profit after tax is thus $3,000. The company can cut its export prices, demand for its product increases and the company can expand its sales and export revenues.

Some implications for developing countries

At the macro level, with imports reduced and exports increased, the US can cut its trade deficit, which is a major aim of the plan.

On the other hand, the US is a major export market for many developing countries, so the tax plan if implemented will have serious adverse effects on them.

The countries range from China and Mexico, which sell hundreds of billions of dollars of manufactured products to the US; to Brazil and Argentina which are major agricultural exporters; to Malaysia, Indonesia and Vietnam which sell commodities like palm oil and timber and also manufactured goods such as electronic products and components and textiles; Arab countries that export oil; and African countries that export oil, minerals and other commodities; and countries like India which provide services such as call services and accountancy services to US companies.

Malaysia is one of the more exposed countries. The US is Malaysia's third largest export market, in 2016 accounting for RM80 billion or 10% of the total RM786 bil exports. The most important exports to the US are by far electronic products, then optical and medical instruments, rubber and rubber products, palm oil and palm oil products.

An equivalent of 20% tax on these products may render some firms that use or sell them less profitable; and if the prices are forced upwards they may lose competitiveness with substitute products or locally-made similar products.

American industrial companies are also investors in many developing countries, including China, Mexico, Brazil, Malaysia, Indonesia and other ASEAN countries.

The tax plan if implemented would reduce the incentives for some of these companies to be located abroad as the low-cost advantage of the foreign countries would be offset by the inability of the parent company to claim tax deductions for the goods imported from their subsidiary companies abroad.

Perhaps the most vulnerable country is Mexico, where many factories were established to take advantage of tariff-free entry to the US market under the North American Free Trade Agreement. President Trump has warned American as well as German and Japanese auto companies that if they make new investments in Mexico, their products would face high taxes or tariffs on entry, thus encouraging them to keep or set up factories in the US.

According to a report in The Star (6 Feb. 2017), speculation on industries relocating to the US is sparking concerns in Malaysia. Major US factories in Malaysia producing electronics would be "under watch". Also, electronic and electrical as well as garment companies in Malaysia, which are mainly sub-contractors for multinational companies, may be affected should they decide to bring back manufacturing jobs to the US.

After the implications of the border adjustment plan are understood, it is bound to generate concern and outrage from the United States' trading partners, in both South and North, if implemented. They can be expected to consider immediate retaliatory measures. A former undersecretary for international business negotiations of Mexico (2000-2006), Luis de la Calle, said in a media interview: "If the US wants to move to this new border tax approach, Mexico and Canada would have to do the same….We have to prepare for that scenario."[6]

In any case, it can be expected that countries will take up complaints against the US at the WTO. The border adjustment taxes are meant to be an alternative to the US raising its tariffs, which would be clearly against the rules of the WTO.

Is the border tax plan compatible with the WTO's rules?

The proponents claim the tax plan will be designed in a way that is compatible with the WTO rules. Congressman Kevin Brady has said he is convinced the plan is WTO-consistent, citing "three key tests that the WTO uses in making these determinations" and stating that "looking at the three key tests I'm very confident that we meet all three." Although Brady did not elaborate on these tests, an aide explained that the WTO will examine "whether a provision constitutes a subsidy, whether it is otherwise a prohibited export subsidy and whether it is consistent with the WTO national treatment principle."[7]

However, many trade experts are of the opinion that the border adjustment plan violates against the principles and rules of the WTO, although they also caution that until the actual text of the anticipated law is seen and its actual effects are known, it is not possible to give a final opinion. Their general view is as follows:

Firstly, the inability to deduct import expenses from a company's tax (while allowing deductions for locally sourced products and services and wages) discriminates against imports vis-à-vis domestic products, and violates the national treatment principle of the WTO and the rules of the GATT which specify that imports must be treated no less favourably than similar locally produced goods.

Secondly, the exemption of export sales revenues from corporate tax would be most likely assessed as an export subsidy that is prohibited under the WTO agreement on subsidies and countervailing measures (SCM). It gives an unfair advantage to US-based companies to export more cheaply, thus under-cutting the products of other countries, because export revenue would be tax-exempt whereas revenue from domestic sales is not exempt under the new plan.

The renowned international trade expert, Bhagirath Lal Das, who has written many books on the WTO and the WTO agreements, made the following comments:[8]

A proper examination of the impending US action can be done only after the US issues the order.

"As I see, there are two separate issues to be considered: (i) differential treatment of domestic material input and the like imported material input used in domestic production; and (ii) differential tax treatment of income based on whether the product is domestically consumed or exported.

Let us take the first issue. It appears that the proposal is to deduct the cost of domestic input (product) from a company's income while computing the tax, whereas there is no such deduction if a like imported input (product) is used in the production. If this be the case, such a provision will clearly violate the principle of national treatment contained in Article III of the GATT 1994. Article III.4 reads: "The products of the territory of any contracting party imported into the territory of any other contracting party shall be accorded treatment no less favourable than accorded to like products of national origin in respect of all laws, regulations and requirements affecting their….use."

If the "use" of the domestic product results in tax reduction whereas the "use" of the like imported product does not get similar treatment, clearly the imported product will get "less favourable" treatment. And that will violate the principle of national treatment contained in Article III. Even without going into the fine print of the provisions of subsidy, such a provision can be successfully challenged in the WTO on this ground.

Now the second issue. As I understand it, the proposal is to differentiate between the earning from domestic sale and that from export in the matter of taxation in respect of a product. Here it would appear that the exemption of the tax is conditional on export. Thus some government tax revenue is forgone conditional on export. This practice will clearly qualify for being categorised as export subsidy which is prohibited under Article 3 of the WTO's Subsidy Agreement. "

Das cites a case of an American company, the Domestic International Sales Corporation (DISC)[9]. A portion of its profit which was engaged in export was tax free. The EEC, the predecessor of the EC, raised a dispute in the GATT in 1973. The matter was delayed for a long time until in 1999 a panel at the WTO ruled that the US practice was in fact an export subsidy and was prohibited.

"This case may not be exactly the same as the currently anticipated proposal, but it does point to the fallibility of providing government benefit contingent on export," says Das.

Das was formerly Chairman of the General Council of GATT, Indian Ambassador to GATT, and subsequently

Director of Trade in the UN Conference on Trade and Development, and has written many books on the WTO and its agreements.

Another eminent expert on the WTO, Chakravarthi Raghavan, Chief Editor Emeritus of the South-North Development Monitor, who followed and analysed the negotiations of the Uruguay Round and of the WTO on a daily basis ever since, is also of the opinion that the border adjustment aspect of the tax plan would be against WTO rules. His comments[10] on the matter:

"Whether the US law is considered "legal" depends on the language of the law and its actual effects. In "drafting" language, the US Congress will run against two problems: firstly, the US Constitution that prohibits bills of attainder and secondly the WTO rules, especially its provisions in the General Agreement on Trade and Tariffs (GATT) and the Agreements on Subsidies and Countervailing Measures (SCM).

There is little doubt that the "pith and substance" of the proposal or ideas being floated in the US by the Republican leaders in Congress and by the Trump administration will be in violation of Articles II and III of GATT and Article 3.1 of the SCM."

Limits to the use of the WTO dispute settlement system

However, there are several problems in expecting that the WTO rules can discipline the US if it decides to go ahead with implementing its border tax plan.

Countries aggrieved by the border adjustment tax plan can challenge the US at the WTO and if they succeed the US has to change its law or face retaliatory action. The winning party can block US exports to it equivalent in value to the loss of its exports to the US.

However, there are many shortcomings with the WTO dispute system. Few countries have the courage or financial resources to take up cases against the US.

If some countries do take up cases, it takes as long as three to four years for a case in the WTO to wind its way through panel hearings and to a final verdict at the Appellate Body. During that period, the US can continue with its laws and practices.

If the US loses, it need not pay any compensation to the successful Party for having suffered losses. Moreover, in the past, when it loses cases at the WTO, the US has typically not complied with the orders made on it. Even if it does comply, it needs to do so only in respect of the Parties that brought the action against it; it need not do so for other Parties. If it does not comply, the complainant countries are allowed to take retaliatory action by blocking US goods and services from entering their markets up to an amount equivalent to the losses they have suffered. This retaliatory action can only be taken by those countries that successfully took up the cases.

Thus, the US may decide to implement the border adjustment taxes and wait several years before a final judgment is made at the WTO, and for retaliatory action to be allowed by the WTO. It can meanwhile reap the benefits of its border tax measures.

Another possibility is that Trump may make good his threat to leave the WTO, if important cases go against it. That would cause a major crisis for the WTO and for international trade.

With regard to the WTO process, Das has these comments:

"The main problem with the current proposal lies in the motive behind it. Some members of the present US administration stated at some stage that they would consider policies and measures even at the very edge of the WTO. Thus what we should be anticipating are policies and measures with questionable WTO compatibility and perhaps clearly violating the WTO rules. The main problem in that situation is that the other countries will have to launch a series of disputes in the WTO which will be very burdensome for the developing countries. Besides, the dispute process can take up to about twenty-seven months in getting final relief and that too without any retrospective relief. Then a chain of such disputes in the WTO against the US may have a political cost for the developing countries and that will weigh heavily while they decide to initiate the disputes.

These appear to be the problems which need the thinking and attention of developing countries. Perhaps, instead of going to the dispute process or along with going to the dispute process, some countries may consider taking some retaliatory action of their own in the area of goods, services, IPRs and even other areas. But that needs determination. "

Raghavan has also commented on the complexities of the WTO dispute system, as follows:

"Apart from the difficulties of taking up cases in the WTO, including costs, the lengthy process (minimum of 2 years for panel and Appellate Body rulings), and no retrospective damages when any WTO member, developing or developed, raises a dispute, the onus of proving the violation is on them.

And if the US administration does not implement a ruling against it, the retaliatory right will accrue only to the complainant, not to others similarly placed. For example, Brazil won its cotton subsidy dispute with the US, and agreed to some compensation from the US, and that was the end of the matter. The other cotton producers, including the African countries that had highlighted the cotton subsidy problem, were not complainants and did not get any relief.

To the best of my knowledge, in none of the rulings against US, requiring changes in law or regulations, has the US implemented them, and even major trading partners have been chary of taking retaliation action.

Countries that are affected, could act to unilaterally deny the US some rights; but they cannot justify that this is retaliation, until there is a ruling in their favour. However, they can take some actions, without saying it is in retaliation, and force the US to raise a dispute."

Is the border adjustment tax similar to a value added tax?

American advocates of the border adjustment tax plan have claimed that it is similar to a value added tax (VAT) which is considered by the WTO to be a legitimate measure; and thus that the border adjustment tax would also be compatible with the WTO.

Almost all major developed countries have instituted the VAT system, with the notable exception of the US, which has a sales tax. Both the Republican Congress leaders and Trump and members of his administration have argued that this places the US at a disadvantage in its trade relations because the VAT system imposes a tax on imports, whilst allowing companies to obtain a refund for taxes paid on their exports. The border adjustment tax advocates have argued that their proposed border tax would be correcting the disadvantage that the US has unfairly been suffering vis-à-vis countries that use the VAT, and that the WTO should similarly recognise the border tax as legitimate, or else change its rules to so recognise it, or else the US might reconsider its relationship with the WTO.

However, some eminent WTO specialists and several eminent economists are of the opinion that there are important differences between the VAT system and the proposed border tax system.

There are two parts of their arguments. Firstly, the VAT system imposes taxes on both imports and locally produced goods and services and therefore does not discriminate against imports; whereas the border tax system imposes a tax on imports whilst excluding domestic inputs and wages from tax, which therefore discriminates against imports. Secondly, the VAT system does not subsidise exports, whereas the border tax system does.

The expert on WTO agreements, BL Das has commented: "The proposed system is not what is commonly understood as VAT. The VAT is about imposing tax on a product based on the value added at each stage. Thus the base on which the tax is calculated is the price of the product minus the cost towards the material inputs. Thus VAT is a way of calculation of tax; it does not concern itself with the sourcing of the input materials. By contrast, the current border tax proposal involves the sourcing of the inputs (especially whether they are imported or locally sourced) and that is not included in the concept of VAT."

Among economists, Paul Krugman, a Nobel laureate, has been prominent in views on this issue. Like many other economists, he does not think that the VAT promotes exports. In a 1990 paper he co-authored with Martin Feldstein[11], the two economists examined whether the VAT improved the trade competitiveness of countries using it, and concluded it did not. They found that "a VAT is not, contrary to popular belief, anything like a tariff-cum-export subsidy…The point that VATs do not inherently affect international trade flows has been well recognised in the international tax literature…A VAT is not a protectionist measure."

Krugman in a recent blog[12], reiterates that "a VAT does not give a nation any kind of competitive advantage, period." But a destination-based cash flow tax (DBCFT) border adjustment (like the Republican plan) is not quite the same as a VAT. According to Krugman, with a VAT, a firm pays tax on the value of its sales, minus the cost of intermediate inputs---the goods it buys from other companies. With a DBCFT, firms similarly get to deduct the cost of intermediate inputs. But they also get to deduct the cost of factors of production, mostly labour but also land. The DBCFT can thus be thought of as a VAT combined with a subsidy for employment of domestic factors of production. "The VAT part has no competitive effect, but the subsidy part would lead to expanded domestic production if wages and exchange rates don't change."

Reuvan Avi-Yonah and Kimberly Clausing[13] (who are based in the Michigan Law School and Reed College respectively) analyse the difference between the VAT and the proposed border adjustment tax and why the former is WTO-consistent whereas the latter would violate WTO rules. They argue that the proposed tax Blueprint "does allow a deduction for wages, while a subtraction method VAT would disallow them. This feature makes the Ryan tax not WTO compatible." A VAT or a sales tax is allowed because "there is no distortion introduced by the tax; goods receive like tax treatment in the domestic market irrespective of where they are produced. Both the tax component in exports and the price of imports are measurable, and the border adjustment does not exceed the tax that is levied because (in the case of import) the full tax is levied at the border, and (in the case of exports) the refunded amount in an invoice-credit VAT is only the amount that was levied at previous stages, as shown on the invoice. By so limiting border adjustments, the WTO reduces opportunities for countries to subsidize exports or overtax imports….The Ryan Blueprint's treatment of purchases (including capital and inventory) and labor highlights the difference between a tax on value added and Ryan's tax on an income base."

Avi-Yonah and Clausing also examine in detail whether the Blueprint's various components are compatible with WTO rules. They conclude: "One pressing problem is that the Ryan blueprint is incompatible with WTO rules. And this incompatibility is no mere technicality. U.S. trading partners are likely to be hurt in several ways. The effects of the wage deduction render the corporate cashflow tax different from a VAT, and these differences have the net effect of increasing the incentive to operate in the United States, as both proponents and economists recognize. In addition, such a tax system would exacerbate the profit shifting problems of our trading partners, since the United States will appear like a tax haven from their perspective. If multinational firms shift profits to the United States on paper, this will reduce foreign revenues without affecting U.S. revenues."

Effect on the exchange rate and trade

There is also an interesting discussion on the effect of the proposed border tax adjustment measure on the US exchange rate and on the trade balance.

The Republican Blueprint itself does not mention the effect its measures will have on the exchange rate.

Some economists think that the measure will not have an effect on the trade balance because the initial reduction in imports and increase in exports will quickly or almost instantaneously raise the dollar's exchange rate to an extent that will then increase imports (as imports become cheaper) and reduce exports (as exports become more expensive in foreign markets). The dollar is expected to rise by about the same rate as the tax imposed, or about 20 per cent. Theoretically, this is because the border tax reduces US demand for foreign goods and thus reduces the supply of dollars to foreigners; while the tax will increase the demand for US exports and thus also increase the demand for dollars. These two effects will cause the dollar to appreciate.

However, while economists agree that there would be an increase in the dollar, many are of the view it will not be to the full extent as the tax rate, and that this will only partially and not fully offset the positive trade effect on the US. This could be due to a number of factors, including other effects of the border tax, such as changes to the domestic savings and consumption rates. Moreover it will also take several years for the effects to be passed on through the system and be fully felt. In the meanwhile, the US would enjoy the trade benefits of the border adjustment tax measure. The extent to which the dollar value will change can only be seen a period after the border tax measure is implemented.

An important unintended effect of exchange rate changes is that if the dollar appreciation is significant, this may have an adverse effect on countries that hold debt in US dollars, as they would have to pay out more in their domestic currency to service their loans. This would include many developing countries with substantial dollar-denominated debts of the public or private sectors, and some of them may tip into new debt and financial crises. According to Summers: "Proponents of the plan anticipate a rise in the dollar by an amount equal to the 15 to 20 per cent tax rate. This would do huge damage to dollar debtors all over the world and provoke financial crises in some emerging markets. Since US foreign assets are mostly held in foreign currencies, whereas debts are largely in dollars, American losses with even a partial appreciation would be in the trillions."[14]

Conclusion

The proposal to introduce "border adjustment" elements to the US tax system has expectedly generated a great amount of interest and controversy. Such a measure would open the US to the charge that it is adopting a serious form of trade protectionism. It would certainly trigger a challenge or a number of various challenges in the WTO on the ground that the tax measure is in violation of various principles and agreements of the WTO.

Even before the cases are heard or decided upon, it is likely that some countries that are seriously affected by the tax measures will take some unilateral retaliatory measures. Some of these measures may themselves be challenged, most likely by the US, as being in violation of the WTO rules. There are however, several types of measures that countries can take in retaliation that would not contravene the WTO rules, as pointed out by Bhagirath Lal Das[15].

The imposition of border adjustment tax measures as proposed by some Republican leaders in the US Congress would signal a sea change in the US approach to international trade and could lead to the undermining of the international trade order which the US led in creating after the Second World War, which is embodied in the GATT rules that are carried over to the WTO.

At the time of writing (February/March 2017), it is unclear whether the border adjustment tax measures will be retained in a tax reform bill that is scheduled to be presented to the US Congress. Nor is it clear whether the Trump administration will support such a measure if it is introduced. While many businesses in the US would gain, other powerful business interests would be negatively affected and they have begun to organise to have their objections heard. Therefore, the proponents of the measure may decide to eliminate the contents of the border adjustment tax altogether.

However, even if the proposed measure in its present form does not survive, other measures may be proposed to take its place. This is especially if President Donald Trump is determined to implement an "America First" trade policy.

In any case, change is in the air, in the US as well as in the international trade system. The developing countries would be seriously affected, especially those whose economies are more dependent on trade. They should prepare themselves to respond to this challenge.

Endnotes:

[1] "A better way: our vision for a confident America", 24 June 2016, issued by the Tax Reform Task Force of the Republican Party, which described it as a "blueprint."

[2] "Trump says border adjustment tax will create revenue from Mexico to build border wall," Inside US Trade, 27 Jan. 2017.

[3] The text of the border adjustment tax in the document "A better way" is as follows: "For the first time ever, the United States will be able to counter the border adjustments that our trading partners apply in their VATs. The cash-flow based approach that will replace our current income-based approach for taxing both corporate and non-corporate businesses will be applied on a destination basis. This means that products, services and intangibles that are exported outside the United States will not be subject to

U.S. tax regardless of where they are produced. It also means that products, services and intangibles that are imported into the United States will be subject to U.S. tax regardless of where they are produced. This will eliminate the incentives created by our current tax system to move or locate operations outside the United States. It also will allow U.S. products, services, and intangibles to compete on a more equal footing in both the U.S. market and the global market."

[4] Brian McGill and Rubin Rubin, "Border Adjustment: Explained", 7 Feb. 2017, Wall Street Journal website: http://www.wsj.com/graphics/border-tax/.

[5] Lawrence Summers, "US reform is essential but Trump's plan is deeply flawed," Financial Times, 9 Jan. 2017.

[6] Emily Pickrell, "Mexico likely to retaliate against border adjustment tax," Bloomberg BNA, 26 Jan. 2017.

[7] "Brady defends border adjustability as WTO-compliant, but expects outcry from other countries", Inside US Trade, 25 Jan. 2017.

[8] See Annex 1 for the full comments by Das.

[9] Details of this case are cited in Annex 2.

[10] Personal communication with the author

[11] Martin Feldstein and Paul Krugman, "International trade effects of value-added taxation," in Assaf Razin and Joel Slemrod (eds.), Taxation in the Global Economy, University of Chicago Press, pp. 263-278.

[12] Paul Krugman, "Border Tax Two-Step (Wonkish)", 27 Jan 2017. https://mobile.nytimes.com/blogs/krugman/2017/01/27/border-tax-two-step-wonkish/?referer.

[13] Reuvan S. Avi-Yonah and Kimberly A. Clausing, "Problems with destination-based corporate taxes and the Ryan Blueprint", Law and Economics Research Papers, Michigan Law, University of Michigan, Feb. 2017

[14] Lawrence Summers, "US tax reform is essential, but Trump's plan is deeply flawed", Financial Times, 9 Jan. 2017.

[15] See Annex 2 of this paper.

Annex I:

WTO Compatibility of US Border Adjustment Tax and Possible Responses

Bhagirath Lal Das

A proper examination of the impending US action can be done only after the US issues the order. Right now there is a lot of confusion on what is coming. Besides, many terms in the US trade parlance have local connotation; hence some of them can be fully understood only through specific US examples. However we should be prepared with our views based on whatever provisional information is available at present.

As I see, there are two separate issues to be considered:

i. differential treatment of a domestic product used as input and a like imported product used as similar input in domestic production;

ii. differential tax treatment of income based on whether the product is domestically consumed or exported.

Let us take the first issue. Some reports indicate that the proposal is to deduct the cost of domestic input (product) from the income while computing the tax, whereas there is no such deduction if a like imported input (product) is used in the production. If this be the case, such a provision will clearly violate the principle of national treatment contained in Article III of the GATT 1994.

Article III.4 reads: "The products of the territory of any contracting party imported into the territory of any other contracting party shall be accorded treatment no less favourable than accorded to like products of national origin in respect of all laws, regulations and requirements affecting their….use."

If the "use" of the domestic product results in tax reduction whereas the "use" of the like imported product does not get similar treatment, clearly the imported product will get "less favourable" treatment. And that will violate the principle of national treatment contained in Article III. Even without going into the fine print of the provisions of subsidy, such a provision can be successfully challenged in the WTO on this ground.

Now the second issue. Some reports indicate that the proposal is to differentiate between the earning from domestic sale and that from export in the matter of taxation in respect of a product. Here it would appear that the exemption of the tax is conditional on export. Thus some revenue is forgone conditional on export. This practice will clearly qualify for being categorised as export subsidy which is prohibited under Article 3 of the Subsidy Agreement.

In fact the US has gone through a similar exercise once earlier. That is the famous DISC case, the case related to the Domestic International Sales Corporation (DISC). Here a portion of the profit of DISC which was engaged in export was tax free. EEC, the predecessor of EC, raised a dispute in the GATT in 1973. The US went on delaying this matter as was possible in the GATT those days, including giving a new shape and name to the organisation (Foreign Sales Corporations, FSCs). Finally, when the WTO came into being, a panel ruled in 1999 that the US practice was in fact an export subsidy and was prohibited. Thus the matter which was dragging on for about 26 years got finally settled. This case may not be exactly the same as the currently anticipated proposal, but it does point to the fallibility of providing government benefit contingent on export.

Some Options for Responses by Developing Countries

The main problem with the current proposal lies in the motive behind it. Some members of the present US administration stated at some stage that they would consider policies and measures even at the very edge of the WTO or by stretching the WTO to the extent possible. Thus what we should be anticipating are policies and measures with questionable WTO compatibility and perhaps clearly violating the WTO rules. The main problem in that situation is that the other countries will have to launch a series of disputes in the WTO which will be very burdensome for the developing countries. Besides, the dispute process can take up to about twenty-seven months in getting final relief and that too without any retrospective relief. Then a chain of such disputes in the WTO against the US may have a political cost for the developing countries and that will weigh heavily while they decide to initiate the disputes.

These appear to be the problems which need the thinking and attention of developing countries. Perhaps, instead of going to the dispute process or along with going to the dispute process, some countries may consider taking some action of their own in the area of goods, services, IPRs and even other areas. But that needs determination. Here are some illustrative examples of the possible actions the developing countries could take.

In the area of goods, many of them have comparatively high "bound" tariffs, particularly in the agriculture sector. They could select some items and raise their MFN tariffs anywhere up to the bound tariffs. Such raising of tariffs in the agriculture sector is likely to be effective in the case of the US where agriculture is a sensitive issue. And raising of MFN tariffs up to the level of "bound" tariff will be fully in conformity with the WTO rules.

In the area of services, the developing countries could select such services on which they have not taken obligation under the GATS. Here they could prescribe some high restrictions for entry, for example, prescribing entry fees etc. Even where they have taken obligations under the GATS, they could select some sectors and some conditions and apply restrictions to the full in case they have not done so earlier. They could select services which may be sensitive for the US.

In the area of IPRs, they could apply the provisions of "compulsory license" liberally in order to encourage domestic producers and discourage foreign producers, particularly those from the US. Naturally this should be done in accordance with their domestic laws which they have formulated on the patent.

Annex II:

WTO compatibility of certain policies and measures

Bhagirath Lal Das

Below are some simple criteria as to whether certain policies and measures are compatible with the rules of the WTO, with respect to national treatment, domestic subsidy and export subsidy.

National Treatment

If a country gives some benefit to a domestic product and does not give such benefit to a like imported product, it violates the provision of national treatment contained in Article III of the GATT 1994.

[An exception is that a country may give subsidy to a domestic product without giving it to a like imported product. But subsidy has its own discipline as given later.]

Thus if a manufacturing firm gets a tax benefit for using a domestic intermediate product in the manufacture and such benefit is denied when the manufacturer uses a similar imported intermediate product, such measure/policy will violate the national treatment principle. For example, if the taxable income of the firm is reduced by deducting the cost of a domestic intermediate product and such deduction is not done when a similar imported intermediate product is used, the national treatment principle will be violated.

A country can impose import duty on an imported product up to the level of its commitment of bound duty.

A country cannot impose any other charge on the imported product if it does not impose such charge on a similar domestic product.

Domestic Subsidy

If a manufacturing firm or a specific manufacturing sector gets direct transfer of funds from the government or if the government forgoes some tax which would have been normally imposed on it, such measure/policy will be treated as domestic subsidy.

A domestic subsidy, by itself, does not violate WTO Subsidy rules. Violation occurs when another country is able to prove that:

the subsidy causes injury to its domestic production (by the import of such product from the subsidizing country), or

the subsidy prejudices this country's export interest in a third country (for example, by competition in the third country market).

If a country gives a subsidy to industry in general (i.e. not limiting it to a specific unit or to a specific industrial sector), such subsidy is not actionable and thus it does not violate WTO Subsidy rules. For example, a country may prescribe that it will exempt a part of income from tax in the case of all industrial firms with a maximum annual turnover of US$ 50,000 or those employing at least 10 physically handicapped persons . It will not violate WTO Subsidy rules.

Subsidy is also permissible for some specific reasons and purposes, e.g. those for research and development, for development of disadvantaged regions, for adaptation to environmental standards etc. Specific criteria and limits have been prescribed for such subsidy.

Export Subsidy

If a benefit is given by a country to a firm or for a product, making it conditional on export, such benefit is treated as export subsidy. Export subsidy is prohibited under WTO Subsidy rules.

Thus if a country exempts the export income of a firm from taxation, it violates the WTO Subsidy rules.

Refund of (or exemption from) taxes and other charges imposed in the production process of the export product (including such taxes and charges applicable to the prior stage production) is not export subsidy. Also, refund of import duty imposed on the intermediate products used in the manufacture of the export product is not export subsidy. (The basic idea is that internal taxes and charges are meant for the people who reside in this country and not for the residents of other countries.)

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SOUTH CENTRE

Chemin du Champ-d'Anier 17
PO Box 228, 1211 Geneva 19
Switzerland

Telephone: (4122) 791 8050
Fax: (4122) 798 8531
E-mail: south@southcentre.int
http://www.southcentre.int