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The planned US border tax would most likely violate WTO rules

By Martin Khor

As the US Congress and President consider whether to introduce a border adjustment tax, a major question is whether such a measure will violate the rules of the World Trade Organization. Experts have good reason to believe the tax in several ways go counter to the WTO. But there are also shortcomings in the WTO system that could limit its usefulness in stopping the US if it is determined enough. A shorter version of this article was published by the IPS. This is the second of a two part series on the US border tax plan.

As American lawmakers and the Trump administration prepare the ground for introducing a border adjustment tax, many controversial issues have emerged, including whether they go against the rules of the World Trade Organization.

The border tax is part of the overhaul of the US corporate tax system proposed by Republican Congress leaders and appears to have the support of President Donald Trump.

If adopted, the tax measure is sure to attract the opposition of the United States' trading partners, as their exports to the US will have the equivalent of a 20% tax imposed on them, whereas the exports from the US will be exempted from a 20% corporate tax.

The tax on US imports, without the same being applied to US-made products, discriminates against foreign products, and US exports being exempted from taxes is tantamount to being an export subsidy.

How will this be taken at the WTO, the guardian of the multilateral trading system?

US Congressman Kevin Brady, chairman of the House Ways and Means Committee, and the plan's main advocate, is convinced the plan is WTO-consistent, but has yet to explain why.

On the other hand, many trade and legal experts think the plan violates the principles and rules of the WTO, although they caution that a final opinion is possible only when the language of the law is known.

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 General Agreement on Tariffs and Trade (GATT) which specify that imports must be treated no less favourably than similar locally produced goods.

Secondly, the exemption of export revenues from the taxable income would be most likely assessed as a prohibited export subsidy under the WTO's subsidies agreement.

The renowned international trade expert, Bhagirath Lal Das, says that there are two separate issues to be considered: firstly, the differential treatment of a domestic product used as input and a like imported product used as similar input in domestic production; and secondly, the differential tax treatment of income based on whether the product is domestically consumed or exported.

On the first issue, Das says: "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."]

Adds Das: "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."

On the second issue, Das commented: "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 WTO's Subsidy Agreement."

Das cites a case of an American company, the Domestic International Sales Corporation (DISC). A portion of its profit which was engaged in export was tax free. The EEC, the predecessor of 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.

According to another eminent expert on the WTO, Chakravarthi Raghavan, whether the US law is considered "legal" depends on the language of the law and its actual effects.

"There is little doubt that the "pith and substance" of the Republican border tax proposal or ideas will be in violation of Articles II and III of GATT and Article 3.1 of the Subsidies Agreement."

Raghavan, Chief Editor Emeritus of the South-North Development Monitor, followed and analysed the negotiations of the Uruguay Round and of the WTO on a daily basis ever since.

Countries 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, and for the winning Party to get the go-ahead to take retaliatory action. 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 two to four 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, Raghavan said: “Apart from the difficulties of taking up cases in the WTO, including costs, the lengthy process and no retrospective damages when any WTO member, raises a dispute, the onus of proving the violation is on them.

“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.”

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. The Republican Congress leaders and Trump 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.

They claim the border tax would correct this disadvantage that the WTO should similarly recognise the border tax as legitimate.

However, several well-known economists and lawyers are of the opinion that there are important differences between the VAT and the border tax.

There are two parts of their arguments. Firstly, the VAT 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.

In a 1990 paper, Martin Feldstein and Paul Krugman found that the VAT does not improve the trade competitiveness of countries using it. They said: “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, reiterated that “a VAT does not give a nation any kind of competitive advantage, period.” But a destination-based cash flow tax like the border adjustment tax has a subsidy element that “would lead to expanded domestic production.”

In another paper, Reuven Avi-Yonah and Kimberly Clausing from 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 said: “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.

“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.”

Economists also agree that the border tax will raise the value of the US dollar but there is a debate as to how long this will take and by how much it will rise.

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 former US Treasury Secretary Lawrence 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.”

From the above, it is clear that a border tax measure by the US would have terribly adverse, if not horrendous, effects on the economies of its trading partners, the world trade system and even the stability of global finance.

Using the WTO's dispute system to discipline the US would be a useful way of countering such an action, but this will have limited effect if the US administration is determined to pursue its new protectionist device, and will also involve a lengthy process, and thus damage will be done for several years.

Some countries, like Mexico, are already considering more immediate counter-actions, matching a unilateral US measure with a similar unilateral counter-measure. Making these intentions known may get the US administration and the Congressional Republicans to think twice.

Prevention is better than cure, especially if the cure involves a trade war of giant proportions. How to succeed in prevention is the really big question.

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