The Daily Dish

# Border Adjustment and Oil Markets

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On Friday the Obama Administration issued a new set of rules aimed at strengthening the Obamacare marketplaces. The administration argues the new rules address many of the concerns about the marketplaces that insurers have raised, including changes to the risk adjustment program which is intended to protect insurers from financial losses brought about by high-cost enrollees. While Congress works to repeal and replace Obamacare the Obamacare marketplaces are expected to stick around for the next couple of years.

Last week the Federal Reserve finalized a new rule that will require large banks to increase their capital and debt reserves. Under the rule banks will need to satisfy a "total loss-absorbing capacity" which is expected to protect U.S. taxpayers from having to bailout large banks should they fail. The Federal Reserve is giving banks until January 1, 2019 to satisfy the requirements for the new rule.

***Eakinomics: Border Adjustment and Oil Markets***

The border adjustment provision of the House Task Force "A Better Way" http://abetterway.speaker.gov/?page=tax-reform remains poorly understood and the subject of misleading and alarmist commentary. One recent such piece is by the Brattle Group, which asserts that under the border adjustment of the 20 percent tax in the House plan "the retail price of gasoline would increase by 13 percent, or approximately $0.30 per gallon" and "Retail prices of diesel fuel would rise by $0.27 per gallon or approximately 11 percent." They go on to asset that "The proposed border adjustment tax would create a windfall for domestic oil producers. A company in the Permian Basin of Texas producing light crude oil would receive the world price of oil less any transportation costs free and clear of any taxes if the crude oil were sold to a buyer in China or any other foreign country."

Let's think about these claims.

Recall that border adjustment of a tax means that exports are relieved of the tax, while the tax is imposed on imports. In this way, all goods and services sold in the U.S. pay the same tax regardless of where they are produced. Similarly, U.S. produced goods compete on an even basis on the playing field created by taxes in the country to which they are exported.

The simple version of the situation envisioned in the oil analysis is one in which world oil — which is priced in dollars — is $50 per barrel. Ignoring issues created by various grades of crude and transportation costs, U.S. producers receive $50, world producers receive $50 and all purchasers pay $50. Imposing the 20 percent border tax initially raises the price to $60 for U.S. consumers, although sellers may not be able make the whole increase stick. Thus, the analysis presumes that consumer prices will rise sharply, and the amount received by producers will fall somewhat. Because of the latter, producers selling in the U.S. will net less than $50. But the paper asserts that because there is no tax on exports, that there will be an advantage in selling outside the U.S.

Unfortunately, none of this adds up. The moment the border adjustment is made the dollar will begin to appreciate relative to other currencies, and will do so enough to offset the imposition of the 20 percent tax (this is laid out in detail here). This has tremendous implications for the global oil market. If the dollar appreciates, it moves from, say, $1 per euro, to $0.80 per euro. The flip side is that it now takes roughly 1.2 euros to purchase a dollar. That means that oil (recall, priced in dollars) in any euro-based country immediately jumps from 50 euros to 60 euros.

Now 60 euros is a fine price and if world producers could have sold for that initially, they certainly would have. But they couldn't. At that price global demand drops off and a glut forms in world oil market. That leads inevitably to downward pressure on the price dollars. Indeed, the slide continues until oil commands $42 in world markets. This, in turn, means that the price plus border adjustment totals $50 — exactly the same as before — and there is no upward pressure gasoline prices, diesel prices, or petroleum-based products in general. Notice as well that there is no new incentive to export to China or elsewhere as all producers are netting $42.

In short, the paper is badly wrong and mostly because it doesn't analyze the global implications of a global market.

As I have emphasized elsewhere, border adjustment is a tax policy that is trade neutral — including trade in oil. Its virtue, however, is that it makes a firms's tax liability depend only upon its domestic transactions. This eliminates any incentive to use international transactions ("transfer pricing") to shift profits out of the United States, only to be returned tax-free under the House territorial system. I can understand why some interest groups might like to blow a gaping hole in the tax system. But that's tax robbery, not tax reform.