## The Daily Dish

# Intro Econ and Tax Reform

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On Wednesday Speaker Paul Ryan's office announced there will be no energy reform bill this year. According to the Speaker's office lawmakers have simply run out of time. Members of Congress have been working on an energy reform bill since the 2014 elections with the hopes of a bill finalized by the end of this year that would expand energy production and streamline federal regulations.

This week Dallas Federal Reserve President Robert Kaplan said that he backs an interest rate hike but believes the Federal Reserve needs to keep an eye on President-elect Trump's policies. Kaplan went on to say that it is extremely likely that the Federal Reserve will decide to raise interest rates next month. The Federal Reserve decided to forgo a rate hike during their September and November meetings despite pressure from some economists and some on their own board to raise rates. The last rate hike was in December 2015.

***Eakinomics: Intro Econ and Tax Reform***

Koch Industries took a swipe at one provision in the House Republican's A Better Way tax reform blueprint, arguing that it would raise consumer prices and "could be devastating" for the economy.  The Kochs are wrong.

The provision at issue is "border adjustment," which relieves exports of tax and imposes tax on imports. In doing so, it ensures that exports compete on a level tax playing field; wherever they are sold they are subject to the taxes in that country just like the competitor products. Similarly, goods produced in the U.S. and those imported pay the same tax. Border adjustment is intended to make sure that tax policy does not tilt the competitive playing field – may the best products win!

Border adjustment is *not* trade policy, is *not* a barrier to imports, will *not* raise consumer prices and will *not* be "devastating." To see this, note that relieving U.S. exports of the tax is economically equivalent to a "subsidy" that immediately makes those goods more competitive in global markets and increases the demand for dollars to buy them. This is the shift from D to D' in the demand-supply diagram below (shout out to my co-author Alan Auerbach).  Similarly, the U.S. tax on imports is equivalent to a "tariff" that will reduce demand for imports and lessen the supply of dollars to purchase them (the shift from S to S').

Together, these provisions cause the dollar to appreciate until the incipient increase in export demand and decrease in import demand are eliminated. The dollar appreciation makes imports cheaper pre-tax, so that inclusive of the tax the overall cost is unchanged. For a 20 percent tax, what used to be an import cost of $1 will change into $0.80 of purchase costs and $0.20 in tax liability for the same total cost of $1. The reverse would be true for exports.

Because the move to a border-adjusted tax system changes the *composition* of the cost structure, but not overall costs and prices, the system does not distort trade. It is not trade policy.  Because it does not change the all-in cost of imports, it will not raise production costs or consumer prices.

It is basic economics that any mainstream, market-oriented observer should accept immediately.

The mechanics of border adjustment are laid out at length here, as well as its virtues as a way to protect the integrity of the tax base and remove incentives to locate production offshore and sell back into the United States.

None of this should be construed as a comment on the impact of the Blueprint as a whole, or the desirability of its enactment. But it *is* important that any debate over those issues should be grounded in economic reality about the components.