Trump’s Virtual Wall

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CAMBRIDGE – In many ways, the Republican Party’s plan to implement a “border adjustment tax” in the United States is the virtual complement of the physical wall President Donald Trump plans to erect on the US-Mexican border. Although the border adjustment tax has not seeped into public consciousness in nearly the same way as Trump’s physical wall has, it could end up affecting the average American a lot more – and not necessarily in a good way.

On the surface, the basic idea is to slap a tax of, say, 20% on imports, and to provide tax breaks worth a similar amount on exports. Most populists’ gut reaction is that this must be fantastic for US jobs, because it discourages imports and encourages exports. Unfortunately, as many have pointed out, there is a loose screw in this logic, which is that the United States has a floating exchange rate.

A stronger dollar – a likely result of imposing a border adjustment tax – makes it cheaper for Americans to buy imports (because a dollar buys more foreign currency); conversely, a stronger dollar makes US exports more expensive to foreigners. In fact, the baseline textbook result is that the exchange-rate effect would fully offset the tax, leaving the trade balance unchanged. If you think the Republicans’ proposal sounds like hocus pocus, you might be right, but let’s hold that thought.

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