

# 100 days of change

February 1, 2017

## Trade policy chess

### In brief

- While the first days of the new administration have featured many important statements and decisions, policy changes on trade and corporate taxes could be the most consequential for markets.
- In analyzing policies in this area, it is crucial to understand the differences and similarities among a tariff, a value-added tax (VAT) and a cash-flow tax with border adjustments (BAT).
- One possible outcome could be a relatively low-rate BAT as a replacement to the U.S. corporate income tax. Such a compromise could boost U.S. inflation, interest rates, the dollar and after-tax corporate earnings but would be a negative for foreign investments and could trigger damaging retaliation from trade partners.

### Prelude to a trade war?

President Trump's first days in office have been busy on many fronts. However, for investors, his statements on trade policy maybe the most consequential. So what actions are being discussed, what is likely to be enacted and what does all of this mean for the economy and investing?

To understand why trade policy is such a hot issue, just note that last year the U.S. ran a current account trade deficit of roughly USD500 billion or 2.7% of our GDP. This was a key issue in the presidential election as it was alleged by both the left and the right that this trade deficit was just a manifestation of "unfair" trade deals, such as NAFTA, which have allegedly decimated U.S. manufacturing. As an example of this argument, in the first presidential debate, when discussing NAFTA, Mr. Trump said: "When we sell into Mexico, there's a tax... - an automatic 16% approximately - when they sell to us, there's no tax. It's a defective agreement." The 16% he mentioned was presumably Mexico's 16% value-added tax or VAT - a subject to which we will return.



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## Why tariffs are terrible

In prescribing policy remedies for our trade deficit, the president has argued in favor of tariffs on China in retaliation for alleged currency manipulation. In addition, the new administration has speculated on whether a tariff on Mexico could “pay” for a wall on the U.S. border with Mexico. The president has separately proposed leaving the current corporate tax structure in place but dramatically cutting the tax rate and allowing for an even lower rate on repatriated foreign profits.

As an alternative, House Speaker Paul Ryan has proposed achieving the goals of both tariffs and corporate tax reform by replacing the current corporate tax system with a tax on corporate cash-flow with border adjustments, which, for simplicity, we can call a border-adjustment tax or BAT.

In order to consider which policy might be adopted and what it might mean for investors, it is crucial to understand the difference between a tariff, a VAT and a BAT.

So let’s start with a tariff.

A tariff is simply a tax on imports that could raise substantial revenue for the government. Indeed, the president’s press secretary has suggested that a 20% tariff on Mexican goods and services would be one way to force Mexico to “pay” for the cost of building the wall. It should be noted that, in 2015, the U.S. imported USD316 billion in goods and services from Mexico and exported USD267 billion to Mexico, thus running a trade deficit with Mexico of USD49 billion. A 20% tariff on goods and services imported from Mexico would, in theory, raise roughly USD62 billion, far more than the total cost of the wall, assuming that the volume of U.S. imports from Mexico was roughly unchanged. Even if the volume of imports from Mexico fell, the revenue raised would be substantial.

However, economists generally regard tariffs as a terrible idea. The first result of such a policy is that

U.S. consumers would have to pay more for Mexican imports, making them worse off. They would presumably also buy fewer of these imports, leading to layoffs among Mexican workers. The second result of such a policy is that Mexico would very likely retaliate with tariffs of its own, hurting Mexican consumers and U.S. workers. The volume of trade would be lower, consumers and workers would be worse off on both sides of the border and Mexican and U.S. government revenue would be higher. In short, a tariff for a tariff makes the whole world poor.

But what about the president’s charge that current U.S.-Mexico trade relations are grossly unfair because Mexico taxes our exports at the border and we don’t tax theirs?

To adjudicate this, it’s crucial to understand that this is not a Mexican tariff on U.S. goods and services. There have been virtually no Mexican tariffs on imports from the U.S. or vice versa since 1994 when NAFTA was implemented. Rather, this is the impact of Mexico’s VAT.

Most global consumers are very familiar with value-added taxes since roughly 160 countries have them, although the U.S. does not. Essentially, it’s like a national sales tax with one key difference. In the U.S., sales tax is only charged once, when the consumer buys it from the retailer. With a VAT, every importer, manufacturer, wholesaler and retailer has to charge VAT on the value they added to the process.

## The essence of a BAT: How to hide a tariff in a corporate tax?

It’s worth going through an example to see how this works.

Suppose I buy a mop at the store and there is a 10% sales tax on mops. The manufacturer makes the mop in the U.S. using \$20 worth of imported components, sells it to a distributor for \$30, who sells it on to a retailer for \$40, who sells it to me for \$66, including \$6 in sales tax.

Now suppose the government imposes a 10% value-added tax, or VAT, instead.

The importer pays the government 10% VAT on his \$20 of imported components (i.e. \$2), which he adds to the price he charges the manufacturer. The manufacturer pays the government 10% VAT on his \$10 of value added (i.e. \$1) and adds this to the price he charges the distributor. The distributor pays the government 10% VAT on his \$10 of value added (i.e. \$1) and adds this to the price he charges the retailer. Finally the retailer pays the government 10% VAT on his \$20 of value added (i.e. \$2) and adds this to the price he charges me. I still end up paying \$66 and the government still gets \$6 - it's just that they get four different checks along the way.

Alternatively, suppose the government tries to get its \$6 with a cash-flow border-adjustment tax or BAT. If we assume in our example that U.S. manufacturers, distributors and retailers spend half their total value added on wages and interest, which they can deduct from the tax calculation, then a BAT rate of 15% will do the job. The importer pays 15% on \$20, or \$3, while the manufacturer, distributor and retailer pay 15% tax on half their value added, amounting to \$0.75, \$0.75 and \$1.50, respectively. The government still gets \$6 in tax, and I still pay \$66 for the mop.

But notice one important difference. Under a VAT, both domestic content and imported content face the same tax - 10%. Under the BAT, because domestic producers are able to deduct half their value added, the effective tax rate on imported content is 15% and the effective tax rate on domestic content is 7.5%.

**EXHIBIT 1: HOW TO TAX A MOP?**  
SALES TAX, VAT OR BAT

**10% SALES TAX**

Cost of import		Manufacturing value added		Distribution value added		Retail value added		Sales tax		Price
\$20	+	\$10	+	\$10	+	\$20	+	\$6	=	\$66

**10% VALUE-ADDED TAX (VAT)**

Cost of import		Manufacturing value added		Distribution value added		Retail value added		Sales tax		Price
\$20 + \$2 VAT	+	\$10 + \$1 VAT	+	\$10 + \$1 VAT	+	\$20 + \$2 VAT	+	\$0	=	\$66

**15% CORPORATE TAX WITH LABOR AND CAPITAL DEDUCTIONS AND BORDER ADJUSTMENTS (BAT)**

Cost of import		Manufacturing value added		Distribution value added		Retail value added		Sales tax		Price
\$20 + \$3 BAT	+	\$10 + \$0.75 BAT*	+	\$10 + \$0.75 BAT*	+	\$20 + \$1.5 BAT*	+	\$0	=	\$66

Source: Standard & Poor's, J.P. Morgan Asset Management; data are as of December 31, 2016. For illustrative purposes only. \*BAT is calculated as 15% of (value added minus labor and capital spending costs which we assume are 50% of value added). VAT rate is the same on domestic and imported content. BAT rate is lower on domestic content.

## Trade war end game

OK, back to the real world.

Mexico *does* charge a 16% VAT, and that is imposed on imports from the U.S. and everywhere else for that matter. However, this does *not* put U.S. goods and services at any disadvantage relative to Mexican goods and services because they also incur 16% VAT. Because of this, the Mexican VAT is not judged to be a trade barrier by the World Trade Organization (WTO). Mexico is not discriminating against imports.

However, a BAT would discriminate against imports and so would likely eventually be ruled as being in violation of WTO rules. In the meantime, our trading partners could reasonably decide that a tariff by any other name stinks as sour and impose retaliatory tariffs on us.

There is actually a solid argument for eliminating our corporate income tax altogether and replacing it with a VAT. The U.S. has relatively high income taxes (including the corporate income tax) and relatively low consumption taxes. Compared to almost all of our trading partners, our tax system favors consumption over production. One natural result of this is that, as a nation, we tend to over consume and under produce, resulting in a trade deficit. However, it hardly seems reasonable to demand that the rest of the world adopt our system or face tariffs. It seems more sensible to just change ours.

So what's likely to happen? The politics are tangled to say the least. However, the president would likely have a harder time getting Congress to approve of broad tariffs than a more opaque corporate tax reform that achieves the same result. For his part, the House Speaker will want to achieve a victory on his pet project. Congress will run into opposition from retailers, oil refiners and other industries that will argue that this amounts to a major tax increase on them, which they will have to pass on to consumers. Nor are they likely to be assuaged by the very dubious

claim that the dollar will immediately appreciate enough in response to such a tax as to negate its effects on import prices.

However, the way out of this dilemma for both Congress and the president is simply to abandon all pretense of revenue neutrality and cut the rate to a low enough level as to make the pain reasonable, particularly in return for an abolition of the corporate income tax.

## SUMMARY

In summary, while the political chess match will be complicated, a replacement of the corporate income tax with a low-rate cash-flow tax with border adjustments seems the most likely outcome. If this occurs, it could boost after-tax operating earnings and the budget deficit.

However, it would also add to inflation, potentially increasing interest rates. Finally, it would likely also increase the value of the dollar. In combination, these changes would favor U.S. stocks over bonds and U.S. stocks over international and particularly EM stocks.

Something to think about, in just the second full week of the Trump presidency.

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