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Trumponomics and the Border Adjustment Tax

Will Cash Come Into the U.S. Economy?

By Anish Ramachandran, CFA

The first 100 days of the Trump Presidency have been full of headlines; some warranted, some surprising, some even suggesting "fake news". As money managers, separating fact from noise in order to focus on what could affect your portfolio is an important part of our process. Headlines may drive initial actions or reactions in the market, but we feel it is vital to look behind the headline to the potential results in order to position client portfolios effectively for such scenarios.

Now that "repeal and replace" is on the back-burner for healthcare, the focus will likely turn to trade policy and tax reform. Trade policy was a hot issue during the campaign, and President Trump brought attention to it by using Mexico as an example. A border tax may not be headline that you feel will affect you, but think again. This subject is likely to gain momentum and could have lasting implications for the economy and markets.

President Trump stated that when the U.S. sells into Mexico, U.S. goods are taxed at 16% but when they sell to the U.S., there is no tax. To tackle this issue, the U.S. House of Representatives ("House") has proposed addressing both the reduction of the trade deficit and corporate tax reform by proposing a tax on corporate cash flow with border adjustments or border adjustment tax ("BAT"). The proposal makes the business tax border adjustable by exempting gross export sales and imposing a tax on imports, through the denial of import cost deduction. The border adjustment portion of the proposal is controversial and has its costs and benefits depending on whether the company is a large importer or an exporter. The purpose of this article is to look at some of the basic mechanics and the pros and cons of BAT, so we can better understand this proposal. As well as how this tax may play into market movements.

How does the BAT work?

Before I get into the details, it is important to clarify the statement made by President Trump regarding taxes on U.S. imports in Mexico. The statement that President Trump made is correct, but the context in which it was laid out is not. President Trump made that statement to highlight the perceived unfair tax or tariffs on U.S. goods, thus making them more expensive, and therefore less competitive than local goods in Mexico. He was referring to the Value Added Tax ("VAT") that is employed in Mexico as well as 160 countries in the world. A VAT is just a domestic tax on goods and services. It works like a retail sales tax, except instead of a consumer paying it all at once at the end like we do, producers pay it incrementally, every time they "add value" to a commodity. The VAT is also border adjustable in that an exporter does not have to levy VAT on his or her supply because it is assumed that the supply will be subject to VAT in the country of destination. The destination principle puts imports and locally consumed goods on an equal footing and achieves neutrality in cross-border trade. So, VAT is not a tariff or an unfair tax that is imposed on U.S. goods in Mexico

The House proposal, however, might have unintended consequences. The best way to show this would be through an example. Let's start with a case where there is no border adjustment. Consider a company with only domestic sales but one that relies on imports for some of its inputs. Assume the company has $1000 in sales and input costs of $ 600 (half domestic and half imported). Its pretax income is $400. At a 20% tax rate, the tax it pays is $80 and gets to keep $320.

	WITHOUT BORDER ADJUSTMENT	WITH BORDER ADJUSTMENT
Sales	$ 1,000	$ 1,000
Deductible Costs (Domestic and Import)	$ 600	$ 300 (Domestic)
Non Deductible Costs	-	$ 300 (Import)
Taxable Base	$ 400	$ 700
Taxes: Tax Rate @ 20%	$ 80	$ 140
After-tax Income	$ 320	$ 260

Source: Ken Stern & Associates

If we take border adjustments into account, where imports cannot be deducted as costs, then the taxable income becomes $700, and at a 20% tax rate, the tax is $140 leaving after tax income of $260. On the other hand, if you are an exporter, the revenues that a company receives from exports are tax exempt, which results in a lower tax base compared to a situation where there are no border adjustments. One of the major goals of this proposal is to make imports less attractive and promote the use of domestic inputs to go along with the "Made in America" slogan. However, the example above assumes that other variables, especially the exchange rate, stay constant. The story becomes more complicated if we start playing with currency movements, but before we get into that, let's take a look at what the proponents and the opponents of this scheme say.

Benefits of Border Adjustment Taxes

The prospect of BAT excites both proponents and opponents. Proponents offer these arguments:

1. With BAT, the incentive to produce abroad is greatly reduced as import costs cannot be deducted. As a result, more production will move on-shore and employ more Americans.
2. With BAT, the tax code is simplified because it is easier to identify where a product is sold compared to where it's made especially when parts come from numerous countries.
3. U.S. would reduce the trade deficit as exports are favored over imports.

It is also important to realize that BAT proposal includes lowering the corporate tax rate. So, if the corporate tax rate goes down, BAT helps to pay for some the lost revenue from lower corporate tax rate. This is where the opponents of the plan come in and offer the following arguments.

1. U.S. is a net importer as evidenced by the trade deficit and that will hurt retailers that rely on imports for their products. BAT will lower their profits and will lead to layoffs at those firms, hurting domestic employment.
2. Other countries can change their tax policies and nullify the advantage that our exports will have.
3. If the dollar is negatively affected due to the BAT tax this could further alter the possible outcome and potential benefits. It's about the dollar!

The Dollar!!!

The dollar is a key component that ultimately determines the effectiveness of this proposal. What we hear in the media is that this plan will increase exports and reduce imports and therefore reduce the trade deficit. But, if we reduce imports, the supply of dollars goes down, and if there is an increase in exports then the demand for dollar goes up. Higher demand and lower supply will appreciate the dollar (by the amount of the tax rate) making imports relatively cheap and exports relatively more expensive, thus offsetting some if not all of the intended effects. So, for exports to be competitive, their price will have to drop. Economic theory will tell us that the currency adjustment will be immediate but realistically that seems uncertain given the various exchange rate regimes of the U.S. trading partners.

Once we take the effects of the dollar into account then a few more issues arise:

1. Firms that have financial investments abroad may realize a large decrease in the value of those investments. As a result, these firms may be incentivized to move their assets back to the U.S. which will hurt the economy of foreign countries. It is reasonable to expect a response from foreign countries in the form of tariffs or denial of treaty benefits. Needless to say, a trade war may lead to a global recession.
2. Another interesting case comes up when we look at a commodity like oil that is globally traded in dollars. In this scenario, the exchange rate adjustment will not offset the effect of the tax for importers. Importers will suffer as they will not be able to deduct the cost of imported oil, and will pay the full price of oil in dollars.
3. Finally, what happens if the exchange rate does not adjust fully to offset the effect of the tax? If that happens, the U.S. consumer could be in for higher prices. A simple example will illustrate this. Suppose we have a company that uses a battery in its product. This company now has an incentive to use domestically produced batteries over imported ones. The shift in incentives will lead to an increase in demand for domestic batteries and an increase in their price and a decrease in imported batteries. Domestic battery producers benefit from the price increase but they would prefer to export these batteries since export revenue is not taxed and exchange rate has not adjusted fully to make the producer indifferent to exporting or selling the battery domesti-

cally. However, if the domestic price increases by the amount of the tax, then the producer will be indifferent to exporting or selling the product domestically.

The Practical Investment Management Takeaway

Markets tend to move on the headlines, but markets also often overreact or respond incorrectly or shortsightedly. Brexit is a prime example; many talking heads suggested the markets could experience a downturn as a result of Britain voting to leave the European Union when the markets, in fact, rallied.

As we can see, the discussion on BAT raises several potential issues as well as potential opportunities. This proposal will be hotly debated, possibly causing market volatility. If it looks like BAT is going to be passed, what do you think the market will do? We think retail, technology and autos might actually experience downward pressure due to potential lower initial margins. Think big-box retailers that import a large percentage of their products, or parts for the auto industry. We think the market may fear that the tax will increase costs and lower margins for retailers that import their materials. Instead of getting too excited at the market's knee-jerk reactions, it may be prudent to wait and watch how the tax truly affects the space. Again, even if we feel one thing may happen, the market presents opportunities and the herd often goes its own way. If the market and these sectors drop sufficiently it may make sense to start building positions where value and growth looks to be solid. The first takeaway is to have cash or equivalent at the ready. The second is to look at companies that have limited upside that you may own in your portfolio to see if it makes sense to continuing to own that company today. The third takeaway is to be ready to jump into an emotional market to make a sound, opportunistic investment.

Our view is that nothing lasts forever. Companies will find clever ways to survive and thrive during various economic and political environments. When it comes to planning for the "core" of a portfolio we are believers in long-term trends; trends that are hard to argue. Trends such as the aging population and the growth of the middle class around the world will continue regardless of Congress' decision on the BAT. If short-term political and market events create an opportunity to take profits or an opportunity to build a position, take advantage of it! Nothing lasts forever!

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