In Focus

February 7, 2017

ECONOMICS

Avery Shenfeld
(416) 594-7356
avery.shenfeld@cibc.ca

Benjamin Tal
(416) 956-3698
benjamin.tal@cibc.ca

Andrew Grantham
(416) 956-3219
andrew.grantham@cibc.ca

Royce Mendes
(416) 594-7354
royce.mendes@cibc.ca

Nick Exarhos
(416) 956-6527
nick.exarhos@cibc.ca

https://economics.cibccm.com/economicsweb/

The Border Adjustment: Gauging the Threat

by Avery Shenfeld and Benjamin Tal

With a new administration in Washington, Canadian business leaders have a right to be worried, but a reason to be cautiously optimistic. The optimism rests on signals that, on trade policy, the heavy guns in the US will be aimed at Mexico and China (and perhaps even Germany) rather than Canada, and that there are some influential voices in both business and government stateside who value the two-way relationship between our two economies.

But one proposal backed by Republican leaders in the House, which would replace existing US corporate taxes with a system that appears to penalize imports, has no obvious room for a special status for Canada. Herein we gauge the implications of such a step, and the likelihood that it will become law in its current form.

The Border Adjustment in a Nutshell

Speaker Paul Ryan has laid out a blueprint for fundamental tax reform, one that is backed by his GOP colleagues in the House but has less certain support in the Senate. The plan features lower personal tax rates that would pose a challenge for Canada in attracting high-skilled talent. But there's a more revolutionary change on the corporate side that would shift the basis of taxation from profits to cash flows, and cut the rate from 35% to 20% in the process. Its key features are as follows:

- Firms pay a 20% tax on their domestic revenues after deducting all purchases of domestic goods and services. Foreign operations serving markets abroad would not be taxed.
- Businesses immediately expense capital expenditures rather than having to depreciate them over time.
- Firms will not be able to claim an expense for purchases of imported goods or services, and those costs will therefore be included in their base for the 20% corporate tax. Export revenues, in contrast, will be excluded from the net revenues being taxed. Presumably, a 20% tax would also be applied to imports made directly by a final consumer.
- Interest costs will no longer get a deduction (with a potential grandfathering of those associated with debt already outstanding). It's not clear how financial services firms will be treated, given that interest paid on funds raised is a key part of their cost base.

Is the Tax Compatible with Trade Treaties?

In a word, no. That was the conclusion of the President's Advisory Panel that looked at potential reforms in 2005.

The World Trade Organization allows border adjustments for Value Added Taxes like Canada's GST (which is not imposed on exports), but this proposal is not a VAT because it allows a deduction for wages. There is no political momentum in the US, and plenty of opposition, to developing a federal VAT.

Advocates of this tax reform in the US have argued that rather than distort trade, exchange rates would immediately adjust to offset the price impacts on US imports and exports.

Of course, the textbook is not the messy world of real foreign exchange markets, where such adjustments can be countered by shifts in capital flows, sentiment, monetary policy and other factors. Foreign governments, including Canada's, are unlikely to be mollified by the argument that they needn't be concerned about trade impacts, because their currencies will plunge to offset the new tax.

Some argue that the tax on imports is "fair", since the same tax is imbedded in the price charged by a domestic supplier that has paid the tax on its net revenues. But the domestic supplier got a deduction for wages (an essential difference with the VAT system), which the import supplier didn't, and that supplier has already paid a corporate tax in his home country.

Why the Plan Might Not Happen

Speaker Ryan, meet Representative Smoot and Senator Hawley. The "border adjustment" is eerily reminiscent of the Smoot-Hawley Tariff enacted in 1930, which at its peak imposed an average 20% charge on imports.

The world didn't stand by when Smoot-Hawley came into effect. Indeed, Canada led the way for other countries when it soon imposed a tariff on US exporters, and others followed. The resulting stall in global trade was just one more factor in a deepening Great Depression, the reason why the names Smoot and Hawley went down in economic infamy.

There are also opponents on the home front. Companies in industries like retailing, with heavy import content, aren't buying the argument that the dollar would appreciate enough to hold down their costs of goods sold. Public opposition could be stirred up as large exporters with major capital expenditures ended up "paying" a negative tax, and getting a big cheque from Washington.

There are also complexities still to be addressed, including the treatment of financial services. If the new tax rate is only 15%, small business owners could try to incorporate and pay themselves out of profits rather than wages which are taxed more heavily.

Finally, there are the deficit hawks, particularly those in the Senate. Add up all of the Republican House tax reform proposals being advocated on both the personal and corporate side and you have a roughly $3 trillion hole in the budget balance over the next decade. Trump's election proposals are even more costly. That said, the "border adjustment" provision, exempting exports but taxing imports, raises more than $1 trillion on its own given that the US runs a trade deficit. Dropping it would make the proposed 15% corporate rate difficult to achieve.

There are signs that the existing House proposal faces at least a lengthy battle in Washington. Trump called the border adjusted tax "too complicated". A few Senate Republicans are on record as opposing it, enough given the GOP's narrow two-seat majority to put it into question, with Senate Finance Chairman Hatch withholding judgement.

What if it DOES Happen?

Trump is Trump, so we can never be sure about where the final policy shifts will take us. So it's certainly not a small risk that the House proposal, including the border adjustment becomes law. How would that impact the US economy?

- Assuming there's no quick and full adjustment in exchange rates, US companies with a large reliance on domestic suppliers and a solid base of foreign customers will benefit. Those include industries such as electrical equipment, machinery, transportation equipment (by the Big 3) and chemicals.

- Of course companies with relatively high reliance on foreign suppliers and a large domestic client base will lose, including many retailers. To the extent that a retail sector doesn't face much competition from made-in-the-US goods, the cost would be at least partially passed on to consumers, leading to higher inflation.

- With the dollar not fully adjusting, the US trade deficit will probably narrow. Also given the inflationary aspect of the move, and the potential stimulus to capital spending in the US, the Fed's monetary policy might be more restrictive than otherwise.

- WTO trading partners will have the right to retaliate. The retaliation will not be only in terms of higher tariffs but also via changes in consumption patterns. For example, when the US imposed tariffs on Chinese-made tires, China retaliated by increasing imports of other products from countries (such as Brazil) at the expense of US exports. In the end, American exporters could be left worse off in an all-out trade war, despite initially benefiting from the tax-exempt status of export revenues.

Uh Oh Canada

How jarring would the proposed tax reform be for Canada? At the micro level, export-oriented sectors such as transportation equipment, chemical, machinery and computers will feel most of the pain. Our colleague in equity research, Ian De Verteuil, provided a good overview of these sectoral implications.

What about for the economy as a whole? The starting point is that roughly one-fifth of Canada's GDP is embodied in our exports to the US. So, to paraphrase Michael Jackson, it's bad, it's bad, you know it.

But how bad? While we are being asked to quantify that impact, and there are estimates from others floating around, the truth is that nobody can model such a change with any degree of credibility.

To do so would require a global model that allows for the interaction of far too many moving pieces across the entire world economy: the potential boost to US capital spending, the drag on growth in some of Canada's other trading partners that export to the US, a slowing in overseas commodities demand, the competitive challenge to Canadian exports to the US from the tax change, the falling value of the Canadian dollar and other currencies against the greenback, easier monetary policy from the Bank of Canada and other foreign central banks in response to the trade shock, and so on.

Fiscal policy in Canada might also have to respond. Keeping Canadian corporate tax rates above those stateside would not only incentivise companies to locate south of the border, but would also potentially undermine Canada's corporate tax base.

Under current US law, multinationals have an incentive to try to book as much profit as possible outside the US in their foreign operations, given higher marginal tax rates stateside. Much of that shows up in tax planning with respect to subsidiaries in very low tax jurisdictions. But under the proposed reform, a Canadian subsidiary would lean towards lowballing the price it charged a US parent for made-in-Canada goods or services (including royalties on intellectual property) to reduce taxes on Canadian corporate profits, since import costs are not a factor in determining the new US tax. Canadian tax authorities wouldn't be blind to this risk, but when it comes to intra-company transfer prices, enforcement can be a challenge.

With so many uncertainties on how such a sweeping reform might impact the US and its trade relationships, there's reason to hope that the Trump team will seek out a less revolutionary method of easing corporate tax burdens. But there's enough at stake for Canadian business and investors that the upcoming debate on tax reform will be at the top of our agenda in keeping clients up to speed on the latest developments.