January 30, 2017

Trump and protectionism: Separating the rhetoric from reality

Introduction

This report examines President Trump's ability to fully implement his protectionist agenda. More specifically, it looks at what he can do unilaterally, what parts of his agenda require congressional approval, and what his limitations are from a political perspective. It also covers the impact that all this could have on Canada.

During the presidential election campaign, Donald Trump championed the cause of protectionism. He threatened, among other things, to pull out of NAFTA, place tariffs on imports from Mexico and China, and penalize U.S. companies that transferred operations abroad.

U.S. politicians criticizing free trade is nothing new. Many of them criticize it when running for office, but then change their tune in support of free trade once in power. For example, Obama did not follow through on his pledge to renegotiate NAFTA in order to insert labour rights and environmental protection measures to its mix of provisions after winning his first mandate in 2008.

This time around, however, hopes of seeing Trump moderate his anti-free-trade stance have for the moment been dashed by his inaugural speech. What's more, his views on trade are also widely in sync with public opinion. In fact, opposition to free trade is now one of the few issues uniting an otherwise deeply divided U.S. electorate.

Can President Trump shred NAFTA unilaterally?

Trump's threats have sparked a debate over whether the President actually has the authority to withdraw from trade deals such as NAFTA without congressional approval. According to Gary Hufbauer of the Peterson Institute for International Economics, a leading scholar on the matter, while Congress must approve all new trade agreements, the President can withdraw from them unilaterally with only six months' notice.[1]

Regardless of whether he is right or wrong, we believe it is unlikely that President Trump will actually withdraw from NAFTA. This is because doing so would elicit an uproar in Congress, risk disrupting the activities of companies with supply chains spread across the hemisphere, and trigger a wave of lawsuits. All of this would consume Trump's Presidency and prevent the administration from advancing other parts of its agenda.

Even more importantly, President Trump does not have to resort to the nuclear option of ripping up trade agreements in order to advance his protectionist agenda. He has the legal authority to impose tariffs or quotas on virtually any sector of the economy without the approval of Congress. This is because, over the past century, Congress has relinquished much of its power to regulate trade to the executive branch.

It has done so through such laws as the Trading with the Enemy Act of 1917, the Reciprocal Trade Agreements Act of 1934, the Trade Expansion Act of 1962, the Trade Act of 1974, and the International Emergency Economic Powers Act of 1977. The only way for Congress to block this authority is to pass new legislation to repeal the powers it previously granted, but this would require a two-thirds majority in both the House and the Senate in order to override a presidential veto.

Does President Trump have the legal authority to target specific companies that outsource operations abroad?

Trump has also threatened to hit U.S. companies with heavy tariffs if they send jobs abroad. While the President has broad authority to unilaterally impose tariffs on most business sectors, it is much less clear whether he has the legal authority to target specific companies.

[1] "Assessing Trade Agendas in the US Presidential Campaign," Peterson Institute for International Economics, September 19, 2016.

Many trade experts feel that targeting a particular company would contravene constitutional guarantees of equal protection. [2] Consequently, any such action would be extremely vulnerable to being challenged in the U.S. courts and/or before the World Trade Organization.

However, these cases could take years to wind their way through the courts. **The uncertainty this would create, together with fears of ending up in the President's crosshairs, explains why certain companies have found it more expedient politically to cancel plans to relocate factories abroad rather than resist in the courts.**

As for Canada, it is much less at risk of being targeted by President Trump in this manner than are Mexico or China. Bluntly put, relatively few companies are tempted to move operations from the United States to Canada on the account of its relatively higher operating costs.

Congressional Republicans propose a border adjustment tax?

While President Trump vows to penalize companies that send work abroad, Congressional Republicans are proposing something much broader: a radical overhaul of the corporate tax system aimed at improving the international competitiveness of U.S. corporations. In addition to tax cuts, the plan includes two other key measures:

- Eliminating the deduction for debt interest, which critics claim encourages over-indebtedness. A deduction would be granted instead for capital investments.
- Taxing products/services based on where they are consumed rather than where they are produced. In practical terms, this would mean imports to the United States would be taxed, but U.S. exports would not. This is referred to as a border adjustment tax.

Proponents of this overhaul say it would eliminate the incentive for companies to hoard money overseas. At present, companies are not taxed on their foreign income until it is transferred back to the United States.

While this plan represents a tremendous boon to exporters, importers risk taking a big hit. Major importers in the retail and energy sectors have already announced plans to lobby against the proposal. They are not convinced by the claims of certain analysts that the import tax would be largely offset by a corresponding rise in the dollar due to a potential drop in imports. There are also fears that the purchasing power of the middle class would be negatively impacted as higher import prices reduce disposable income.

Further, there is a real risk that other countries will consider this new tax system a form of protectionism and retaliate with countervailing duties and/or file complaints with the WTO. The United States tried something similar once before. In 1971, it introduced a tax break for exporters that, despite several modifications, the WTO ruled illegal in 2002. On that occasion, the United States complied with the ruling and changed the law. However, if a similar bill is approved this time, it is safe to say that the Trump administration will probably be much less amenable to the concerns of the WTO.[3]

President Trump has flip-flopped several times on the border adjustment tax (most recently, he came out in favour). However, even with his support, the Republicans' narrow majority in the Senate and stiff opposition from major importers means that its approval is far from a sure thing. **One scenario could be that a border adjustment tax mechanism could pass, but only with exemptions for certain sectors.** To cite one example, the influence of the energy lobby plus the fact the U.S. would like to reduce its reliance on OPEC makes it very likely that Canadian oil imports would be exempted from any potential import tax.

Canada sends 75% of its exports to the United States and could suffer badly if a border adjustment tax is levied. **Such a turn of events could then force Canada to rejig its own tax code in order not to leave its companies at a competitive disadvantage.**

[2] "Trump's Punitive Power over Companies Appears Hedged," The Wall Street Journal, December 12, 2016.
[3] "Export-Friendly U.S. Tax Revamp Risks Cool Reception at WTO," The Wall Street Journal, December 21, 2016.

Trump's protectionist-leaning advisors

Not surprisingly, Trump has chosen trade advisors that share his wariness of unfettered free trade.

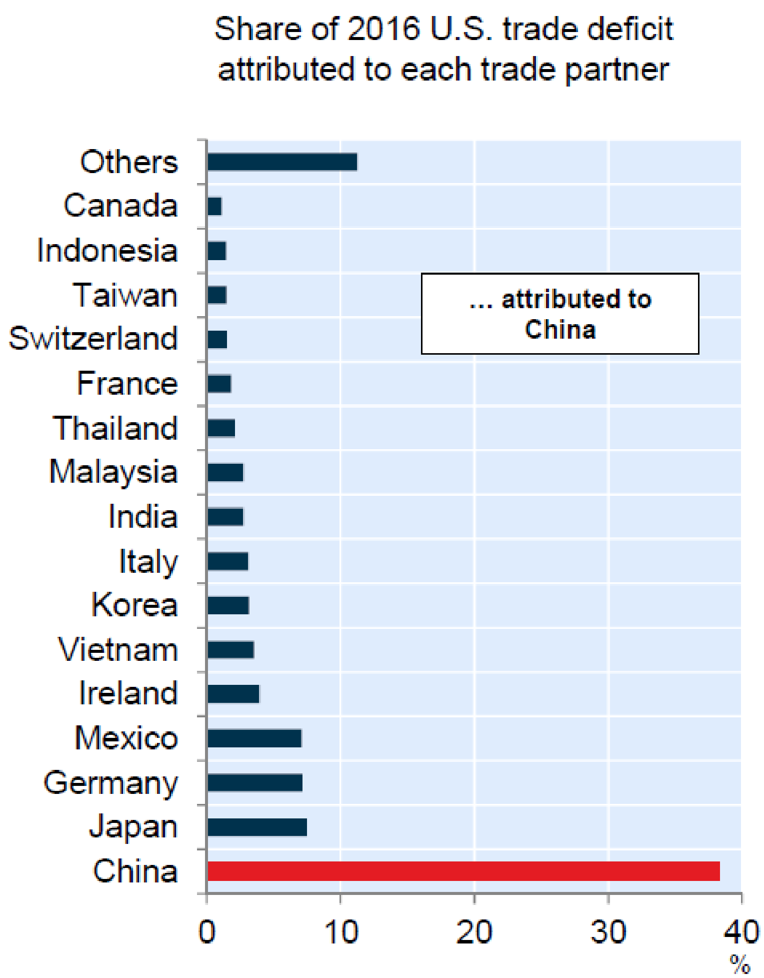
U.S. Trade Representative: Robert Lighthizer. This trade lawyer has argued for decades that the United States should impose tariffs on international companies that do not play by the rules.

Head of Commerce Department: Wilbur Ross. The billionaire financier has long complained that America has been taken advantage of when it comes to trade.

Head of the new National Trade Council: Peter Navarro. He supports taking a much tougher line against China and is the author of such books as "Death by China' and "The Coming China Wars".

How Canada will be affected by a more protectionist United States

For starters, it is important to note that the United States does not run a large trade deficit with Canada the way it does with China, Mexico, Germany and Japan. In 2015, its trade deficit with Canada amounted to only $15 billion, compared with $58 billion with Mexico and a whopping $366 billion with China. **While this means that Canada should not be the primary target of United States, it will still suffer collateral damage.**



NBF Economics and Strategy (data via Datastream)

The Trump administration recently announced it will be sending a formal request to Canada and Mexico to renegotiate NAFTA. **The most contentious issues between Canada and the United States will likely concern agriculture and lumber. Local content rules and regulations applying to government procurement projects will also be up for negotiation.**

To begin with, the United States will probably pressure Canada to at least partly dismantle its heavily protected dairy markets. U.S. dairy imports to Canada are subject to high tariffs. Next, U.S. rules requiring foreign beef and pork to be sold with stickers listing country of origin will likely be maintained and strengthened despite the fact the WTO recently ruled this practice illegal. More than 70% of Canadian beef exports are destined for the United States.

In the case of softwood lumber, there is a real risk that duties/quotas will once again be placed on Canadian timber exports to the United States. U.S. forestry companies have long accused the provinces of subsidizing the Canadian industry by charging below-market stumpage fees for Crown land timber. About 70% of softwood lumber exports head south to the United States.[4]

The United States could also push for stricter country-of-origin rules, which govern how much foreign components a product can contain and still qualify for duty-free shipping within NAFTA. Under current rules, a vehicle can be sold in the United States, Canada or Mexico free of any tariffs as long as 62.5% of its components are sourced from within the bloc.[5] **This could be revised upwards, thus making it harder to use components imported from countries such as China.**

NAFTA also currently requires the U.S. government to treat Canadian and Mexican companies on equal footing with their American counterparts for many government procurement contracts. This is a provision that the United States might want to see amended in order to gain greater flexibility to favour domestic companies.

Finally, the U.S. could seek changes to the dispute arbitration panels in order to reduce the ability of Canadian or Mexican companies to challenge U.S. government decisions

The mostly likely outcome is that Canada will have to cede ground on many of the issues mentioned above. This would be formalized through new side agreements. Something similar occurred in 1992 when President Clinton negotiated side agreements with Mexico concerning the enforcement of labour and environmental laws before getting Congress to approve NAFTA.

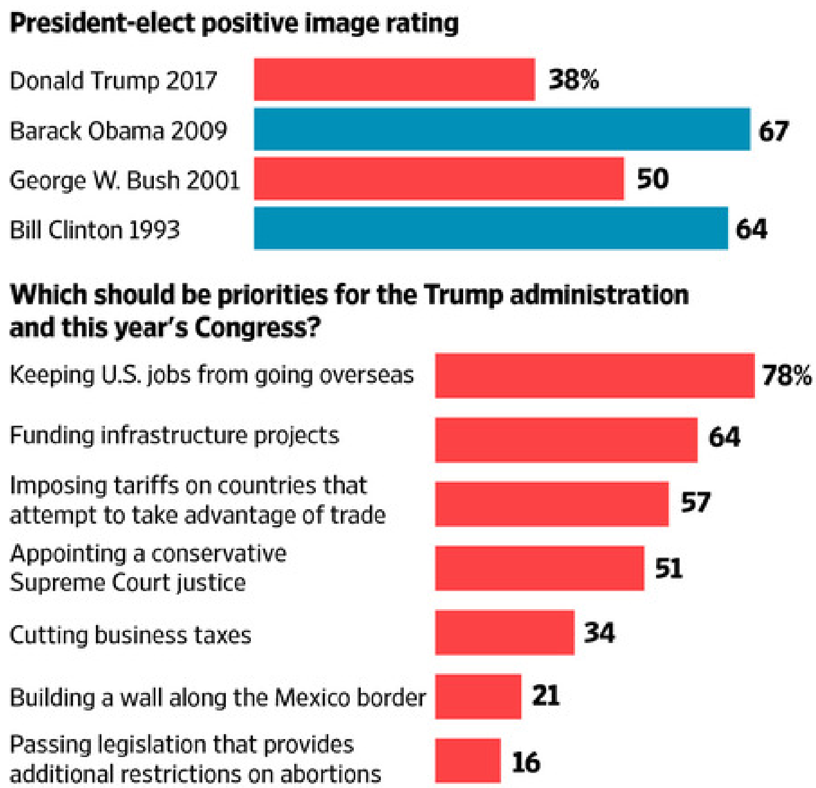
Will Trump's protectionist agenda be moderated somewhat by the free-trade wing of the Republican Party?

One factor that could force Trump to moderate his protectionist stance somewhat is that many of his fellow Republican leaders are pro-free traders. These include House Speaker Paul Ryan and Senate Leader Mitch McConnell. Furthermore, the business community is overwhelmingly in favour of free trade and it holds considerable sway within the Republican Party. **Congressional Republicans could lend support for some parts of Trump's agenda in return for a softer line on protectionism.**

[4] "Trump team flags Canadian livestock and lumber as targets in NAFTA reset," The Globe and Mail, November 16, 2016.
[5] U.S. Customs and Border Protection.

Trump positions capture the public mood

While Trump has begun his Presidency with historically low approval ratings, it is important to note that some of his ideas regarding keeping jobs in the United States and imposing tariffs on certain countries accused of unfair trade practices have widespread support. **Indeed, Trump has brought to the forefront the disconnect between the pro-free trade elites of the two main U.S. political parties and the working class, which views free trade in a much more negative light.**



Source: WSJ/NBC News polls. January 15, 2017

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Conclusion

- Opposition to free trade is one of the few things that unites an otherwise deeply divided U.S. electorate.
- Canada will not be the primary target of U.S. protectionism because, unlike other countries, it does not run a large trade surplus with the United States.
- While it is highly unlikely NAFTA will be revoked, Canada will nevertheless suffer collateral damage in ensuing trade negotiations.
- Canada's agriculture and lumber sectors will be targeted, and Canadian firms could see their access to U.S. government procurement contracts diminished.
- The U.S. could seek changes to the dispute arbitration panels in order to reduce the ability of Canadian or Mexican companies to challenge U.S. government decisions.
- If the United States implements a border adjustment tax, this could force Canada to rejig its own tax code in order not leave its companies at a competitive disadvantage. Certain import-reliant sectors in the U.S. could be exempted from this tax.
- President Trump has the authority to impose tariffs on a wide range of sectors without congressional approval - something he will not hesitate to use.
- Although it is doubtful that President Trump holds the legal authority to unilaterally target specific companies, fear of being in his crosshairs will prompt some companies to take action in order to appease the President.
- President Trump's threat to hit U.S. companies with heavy tariffs if they send jobs abroad is of lesser concern to Canada because relatively few U.S. companies are tempted to transfer operations north of the border where the cost of doing business is relatively higher.

In this environment, investors must do more than simply analyze a country’s - or a company’s – fundamentals. They must also look at any ongoing or potential future tensions with trading partners, since such conflicts can significantly impede access to key markets. Similarly, when assessing a company’s prospects, investors must focus on the country that the company considers its home base, and determine if that country’s relations with its main trading partners are strained in a way that might impact its bottom line.

Smaller countries are particularly at risk of a global surge in protectionism because they do not have access to large domestic markets to help cushion the blow of a potential loss of key exports markets.

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