PROPOSED BORDER TAX ADJUSTMENT-
IMPLICATIONS TO THE U.S. AUTO INDUSTRY

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A Border Adjustment Tax (BAT) has been proposed as part of a "blueprint" by GOP House Speaker Paul Ryan and Rep. Kevin Brady intended to offer Americans simplification of the existing tax code, increase competitiveness, and subsequently lower taxes (Wolf, 2017). BAT would be one component of a larger comprehensive tax reform program and would potentially reduce the corporate tax rate from 35% to 15%. BAT applies when "…payments for goods and services cross international border "(Auerbach and Holtz-Eakin, 2016). A proposed 15-20% BAT would result in higher cost for all imports, which means, on average, about $2,000 more per imported vehicle. Foreign parts would also add to price increases in U.S. made autos. Overall, an impact could be a reduction in the U.S. workforce due to overall rising production costs, insufficient plant capacity and higher parts prices from OEM suppliers.

Introduction

How to effectively combat growing U.S. debt, which is more than $19 Trillion, has generated tremendous debate among Republicans in the GOP-controlled house who are considering major revisions to the tax code (Peters and Rappeport, 2017). President Trump has repeatedly pledged to reduce national debt by lowering the corporate tax rate from 35% to 15%, claiming that imports are typically under-taxed while domestic production is unfairly taxed. Unfortunately, such a move would shift the shortfall in revenue from businesses to individuals. However, it can be argued that this shift has in fact already been felt by three possible groups: 1) shareholders through reduced dividends, 2) decline in wages for workers, and 3) consumers experiencing higher pricing for goods and services.

A Border Adjustment Tax (BAT) was proposed as part of a "blueprint" by House Speaker Paul Ryan and Rep. Kevin Brady, intended to offer Americans simplification of existing tax code, increase competitiveness, and subsequently lower taxes (Wolf, 2017).

A BAT is different than a traditional border tax. A border tax, "when properly interpreted, is a tax imposed when goods cross an international border and as such must be inimical to international trade and therefore to the achievement of the economic benefits of international specialization and division labor. A border tax adjustment, on the other hand, is an adjustment of the taxes imposed on a producer when the goods he produces cross an international border." (Horn and Mavroidis, 2011)

In other words, BAT is a value-added tax applied to all imported goods. With BAT in place, companies would no longer be able to deduct business expenses associated with importing goods as they are under the current tax code.

Recent changes in the political climate have affected BAT and its integration in the tax reform plan, thereby sending mixed messages of its true impact. Given the long-standing nature of globalization in the auto industry dating back since early 20th century, U.S. car makers would face multiple challenges with the inclusion of BAT in a major tax-code revision. They would have to address how to deal with complexities of global supply chains, and manage trade treaties which are certain to affect economic growth, cost structures, job creation and productivity.

This paper reviews corporate taxation issues and proposed BAT in current literature to determine how BAT would impact the US auto industry. A detailed overview of BAT is provided as well as a discussion of the potential impact of BAT on the U.S. auto industry.

Corporate Income Tax Implications

BAT is part of a larger comprehensive tax-code reform program proposed by GOP House Speaker Ryan. It is intended to reduce the corporate tax rate from 35% to 15%. BAT applies when "…payments for goods and services cross international border (Auerbach and Holtz-Eakin, 2016)". According to Pomerleau and Potosky (2016), the U.S. is third in the world behind Puerto Rico and United Arab Emirates with a blended corporate tax rate of 38.9% (based on a federal tax rate 35% + average tax rate among all states). It is not surprising that the United Arab Emirates has the highest corporate tax rate at 55% because base revenues are derived principally from oil production. And unlike other countries such as the United States, Saudi Arabia is governed by a monarchy which determines its corporate tax rate. The rate is lower in other countries, especially developing ones like Chad at 35%. Tax rates for other noted countries are listed in Figure 1.

Figure 1. Top Ten Highest Marginal Corporate Tax Rates in the World

Rank	Country	Rate	Region
1	United Arab Emirates	55.0%	Asia
2	Puerto Rico	39.0%	North America
3	United States	38.9%	North America
4	Argentina	35.0%	South America
5	Chad	35.0%	Africa
6	Congo, Democratic Republic of the	35.0%	Africa
7	Equatorial Guinea	35.0%	Africa
8	Guinea	35.0%	Africa
9	Malta	35.0%	Europe
10	Virgin Islands, U.S.	35.0%	North America

Source: (Pomerleau and Potosky, 2016)

The U.S. tax code with its layered sets of rules and complexities have forced many businesses to seek tax shelters abroad or adopt off-shoring strategies to reduce operating costs. Auto industry giants like General Motors and Ford took advantage of these cost saving strategies by shifting some of their operations in Michigan and relocated them to Mexico because labor costs were very attractive.

U.S. companies are required to pay taxes on world-wide income, while non-U.S. companies in other developed countries are not subjected to the same taxable income policies (Sommer, 2017). Some U.S. companies have explored "adopting a new home to seek favorable tax holidays" or "merger" opportunities to strategically lower their tax liability, eliminate redundant and overlapping operations (Tsang and Leung, 2009) and improve overall cashflow. This approach promises to produce significant cost savings for future investments in new product development and other R&D initiatives. It is not uncommon for shareholders and other stakeholders in the target company to positively benefit from a merger by increased earnings per share (EPS) appreciation (Gurrib, 2015). For example, Volkswagen and

Porsche completed a merger in 2009. Porsche joins Audi, SEAT, Bugatti, Bentley and Skoda who are all subsidiaries of Volkswagen pushing the car maker to the number one producer of automobiles in the world by 2018. (Topham, 2012). More importantly, the merger helped Porsche restructure its business operation to reduce its operating costs and its tax liability.

An extensive search of secondary sources found no substantive data on the effectiveness of BAT in the automotive industry, because the automotive sector has not had to deal with BAT in the past. Tax reform policies have suspended inclusion of BAT in its present form. As noted by GOP House Speaker Paul Ryan, "…border adjustment tax not 'dead,' but not going to pass as is. . . ." (Soergel, 2017).

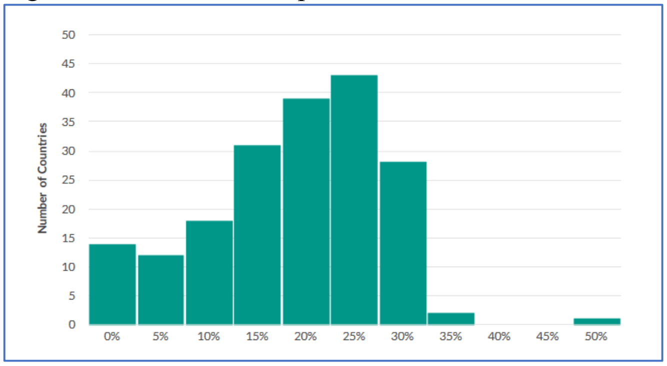
However, there are some data from the pharmaceutical industry, which is another major industry, like the automotive industry, would be affected by the inclusion of BAT in a major tax-code revision by Congress. For example, Pfizer, the world's second largest drug company, had planned a $160B merger with Allergen, which is now an Ireland-based drug company after going through with a separate merger on its own. The Pfizer-Allergen merger would have produced the largest drug company in the world. The merger was halted because of new treasury rules in April 2016 (Humer and Banerjee, 2016). The failed merger was a victory for President Barack Obama's administration which had been urging Congress for eight years to introduce bills to prevent U.S. companies from expatriating. Further, the Pfizer-Allergen merger would have provided $2B in annual savings over a span of three years for Pfizer. Its effective corporate tax rate would have been reduced to 17-18% as compared to 25% (Mole, 2015). This was not Pfizer's only attempt at lowering its effective corporate tax rate. It was also unsuccessful in its bid to merge with AstraZeneca in 2014, which would have allowed its headquarters to relocate to Britain.

Pfizer's head office in New York has a combined 2016 tax of 42.1% (35% federal corporate rate + 7.1% New York state rate). When asked about the proposed merger with Allergen, Pfizer CEO, Ian Reid had indicated that shareholders were interested in maximizing their return on investment and employees shared a desire for a "successful company in the future (Sommer, 2015)." Pfizer's claim that its effective tax rate is 25% can be misleading. This would imply that its use of allowable deductions (i.e. interest expense, tax credits etc..) would reach the 25% threshold. Upon closer examination of Pfizer's accounts, $74B was held abroad, which means that it could not be taxed unless it crosses the border back onto American soil. While these practices involving tax deferment are not illegal, the average American taxpayer would not benefit from them.

Whether BAT would disable these tax "loopholes" and discourage mergers or companies relocating in search of a new "tax friendly" home is part of the ongoing discussion in the U.S. GOP controlled House. Under a broader tax-code reform blueprint combined with strategically crafted legislation by Congress, the intended outcome of both a simplified and fair taxation system would allow U.S. companies to remain competitive with their overseas counterparts. Any changes to existing federal and state taxes laws must also benefit the average tax-paying American, because tax loopholes afforded to multinational companies with millions or even billions of dollars in revenue may not apply to him or her.

As discussed, U.S. companies currently pay some of the highest tax rates in the world; BAT has the potential to make these companies more competitive; however, significant changes to the tax code must occur before this can happen. For example, a distribution of worldwide corporate tax rates in 2016 representing 188 countries is shown in Figure 2. Approximately 60% of these countries have a corporate tax rate of 20% or less, whereas an estimated 38% have rates between 25%-35%. The American corporate tax rate is included in the 2% range of those with a rate of 35% or higher.

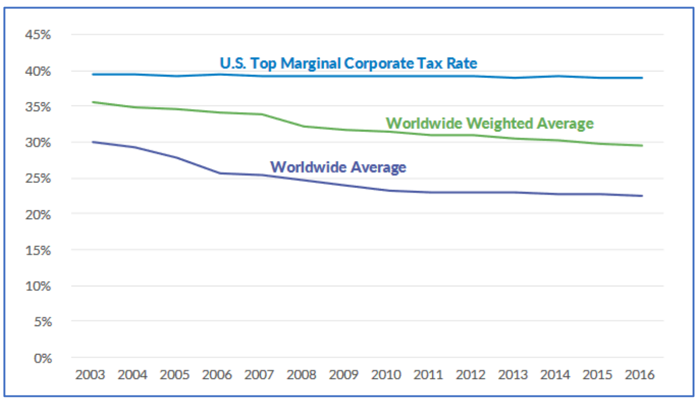
Figure 2. Worldwide Corporate Tax Rates, 2016



Source: (Pomerleau and Potosky, 2016)

Many countries worldwide including both developed and developing have shown improvement in their economies over time. Marginal corporate tax rates have shown a steady decline over the past 13 years, whereas the U.S. corporate tax rate remained steady as shown in Figure 3. Worldwide corporate tax rates declined from 30% to 23% over this time, while the U.S. corporate rate moved 1% from 39% to 38%.

Figure 3. Top Marginal Corporate Tax Rates



Source: (Pomerleau and Potosky, 2016)

The potential outcome is that the U.S. would lose its world dominance and competitive markets if it does not make changes to its corporate tax rate. Emerging markets with improved economies such as Brazil would become a key player in global markets. China is poised to surpass the U.S. followed by India, Japan and Russia by 2020 (Euromonitor International, 2017).

Border Tax Adjustment

Part of the discussion in the USA House of Representatives about BAT is that its impact on the auto industry, would be a reduction of the U.S. corporate tax from 35% to 20%. BAT should not be confused with a tariff. A tariff is "a schedule of duties imposed by a government on imported or in some countries exported goods (Merriam-Webster, 2017)". Increasing tariffs has an immediate impact on consumer goods and services, which often results in higher prices and ultimately a reduction in trade. BAT is an adjustment of the taxes imposed on a producer when the goods he produces cross an international border." (Horn and Mavroidis, 2011)

By lowering the U.S. corporate tax rate, it is clear that falling revenue must be collected elsewhere by another mechanism. BAT is being considered in the House of Representatives as one possible mechanism, integrated within a much broader reform tax program. BAT's role is to help increase revenue by taxing the full cost of imports. Under BAT, interest deductions from imports would be eliminated. Moreover, U.S. companies would be enticed to spend and re-invest in American goods and services with a repatriation holiday on foreign profits. Otherwise, multinational companies like Pfizer would continue to be content with leaving $74B worth of profits from investments in their off-shore accounts to avoid taxation. The same could be logically true for the automotive industry.

The general objective of the BAT proposal would be to encourage companies to make their goods in the United States. It's meant to remove incentives for companies to move jobs away (i.e. off-shoring) solely for tax reasons. Under BAT, only the profit from automobiles made in the U.S., for example, would be taxed at 20% as opposed to the current U.S tax rate of 35%. To further help the U.S. auto industry, all U.S. exports would receive a tax holiday making goods more attractive to foreign markets. Consumers fear that BAT would result in higher prices for goods made in America and even higher prices imposed on imports.

In addition, economists believe that higher priced imports would create lower demand combined with increased demand for U.S. goods leading to sharper increases in the U.S. dollar's value (Hodge, 2017). Therefore, consumers would be able to leverage the dollar's stronger purchasing power against higher priced imports in the short-run leaving importers unharmed.

Of course, no tax-code change could occur without scrutiny. Businesses and consumers who think of BAT as simply another form of a Value Added Tax (VAT) would have to understand the differences. By definition, "a value-added tax (VAT) is a type of consumption tax that is placed on a product whenever value is added at a stage of production and at final sale. VAT is most often used in the European Union. The amount of VAT that the user pays is the cost of the product, less any of the costs of materials used in the product that have already been taxed" (Investopedia.com, 2017). The United States does not have VAT or a harmonized tax like some countries. Canada, for example, use a "goods and services tax" across its provinces to raise revenues.

There are over 140 countries with BAT. The United Kingdom raised its BAT three times (1979, 1991 and 2010) and in each of those instances, its currency increased in value (Pomerleau, 2015). Many countries sell more to the U.S. than it produces locally. BAT would discourage exporters to the U.S.

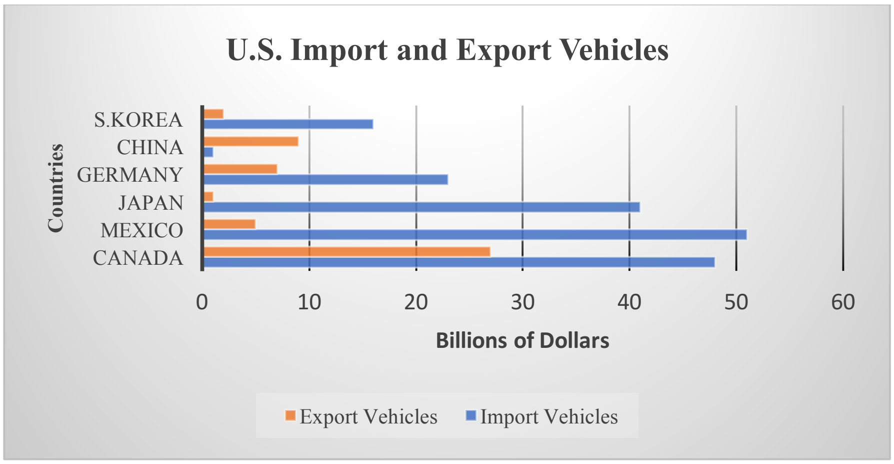
For example, China runs massive trade deficits with the U.S. In 2016 alone, the trade deficit was $347B (Yu, 2017). U.S. imports from China had steadily risen from March 2016 to December 2016 with an average of $38.9B, while exports to China remained stable throughout 2016 averaging about $9.8B (U.S. Census, 2016). During the 2016 Federal election cycle, China was accused of currency manipulation or devaluating its currency to make its goods more affordable. BAT would moderate the trade deficit with countries like China by lowering the costs of exports to and raising the costs of imports from those countries.

Any adoption of a BAT in broader U.S. tax-code reform would have to be approved by the World Trade Organization (WTO) in which the U.S. participates. The WTO has guidelines in place to prevent predatory practices by countries who place higher taxes on exports relative to in-house goods. This can lead to retaliation by other countries escalating possible trade wars. The concern is protectionism for one's goods. WTO does make it clear that an application for BAT must follow established procedures to protect the sanctity of fair trade. Any country is free to petition WTO and present its case for the inclusion of BAT. If a country does not request or receive WTO approval for its BAT policy, it is subject to penalties and is not protected against retaliation by other countries.

Impact of BAT on U.S. Auto Industry

To better understand how BAT in a revised tax code would impact U.S. consumers, it's necessary to examine and analyze trade flows. These would have a significant bearing, because U.S. companies import and export both parts and vehicles world-wide. For example, Figure 4 highlights globalized partnerships where countries like Canada and Mexico export much of what each produces to the U.S. However, the U.S. exports more of its production to Canada, China and Germany. Japan, Germany and S. Korea round off the list of countries who are major suppliers of autos to the U.S. industry.

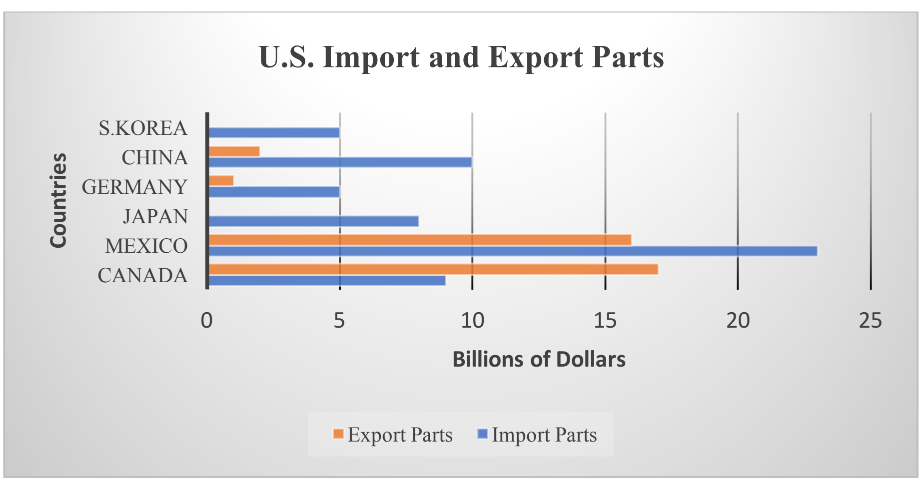
Figure 4. U.S. Vehicle Trade Flows, 2016



Source: (Mosquet et al., 2017). Note: Passenger and light duty trucks are combined.

By contrast, in terms of automotive parts, Mexico and China are the largest exporters to the U.S. followed closely by Canada as shown in Figure 5. These countries are largely suppliers of OEM parts, which are used in new auto production and sourced by retailers and dealers. BAT would add to the price of imported parts, likely resulting in higher production costs and ultimately lead to higher repair bills at mechanics' shops.

Figure 5. U.S. Parts Trade Flows, 2016



Source: (Mosquet et al., 2017)

If a 20% BAT is added to imports, there would be an estimated $1,800-$2,000 increase in the price of a vehicle for U.S. consumers. Vehicles with a higher percent content of foreign components would also adversely affect BAT. U.S. consumers would more likely choose vehicles (i.e. models) less impacted by BAT. It is also possible that manufacturers would exclude pricy options, like safety-related features such lane change warning systems and parking-assist technology to lower cost of the production (Mosquet et al., 2017).

A list of vehicles shown in Figure 6 details the impact of BAT. Tesla would be unaffected as its build content is derived wholly within U.S. German imports such as BMW, Mercedes and Volkswagen would have price increases from $3,725 to $6,779. Asian producers such as Honda, Nissan, Toyota, Hyundai/ Kia, Subaru, Mazda, and Mitsubishi would have price increases from $1,312 for a Honda and $6, 779 for a Volkswagen.

Figure 6. BAT Added to Price of New Vehicle, 2017

Average vehicle price increase needed to offset a border-adjustment tax

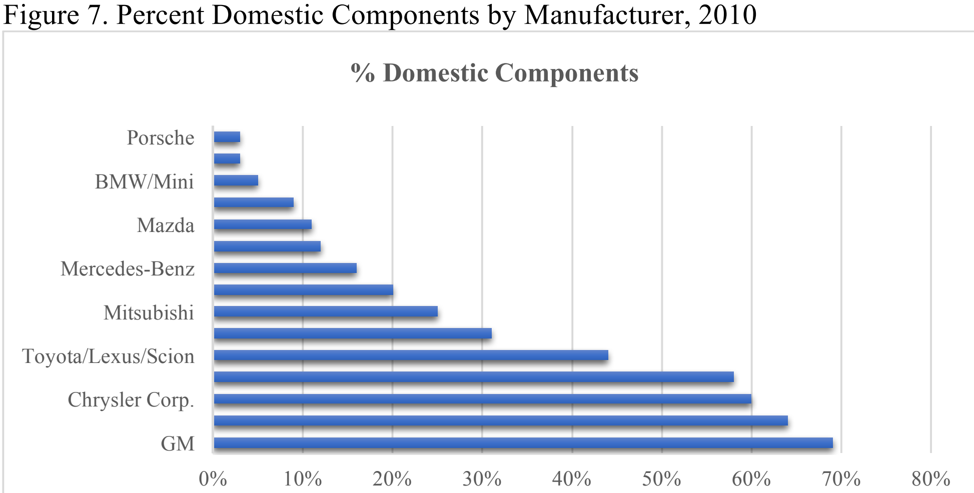
Tesla	$0	**Subaru**	$3,656
Ford	$282	**BMW**	$3,725
General Motors	$995	**Mercedes**	$4,211
Honda	$1,312	**Mazda**	$5,156
Fiat Chrysler	$1,672	**Mitsubishi**	$5,938
Nissan	$2,298	**Volkswagen**	$6,779
Toyota	$2,651	**Geely (Volvo)**	$7,643
Hyundai/Kia	$2,704	**Tata (Jaguar Land Rover)**	$17,204

Source: Baum & Associates

Source: Bunkley (2017)

Manufacturers often assemble their cars using parts and components from varied sources. Some of these sources are domestic, while others are located overseas. Imported parts under BAT would add to the car's Manufacturer Suggested Retail Price (MSRP), while domestic parts would have less of an impact. As shown in Figure 7, General Motors uses about 69% domestic components in its cars assembled in the U.S., while Ford uses 64% and Chrysler 60%. Honda and Toyota use 58% and 44%, respectively (Mays, 2009).

Figure 7. Percent Domestic Components by Manufacturer, 2010



Source: (Mays, 2009)

Interestingly enough, Honda's percent domestic component is comparable to those of GM, Ford and Chrysler. It has plants in Indiana (civic), Ohio (Acura, Accord, CR-V), and Alabama (Civic, Odysee, Ridgeline, Pilot) where it produces many of its popular models for the U.S. market. Despite the percent of domestic components in the assembly process. At these plants, it is estimated that BAT would increase light vehicle prices of these manufacturers by 5.6% and raise overall cost about $34.6B higher for consumers (Center for Automotive Research, 2017).

Relocation of foreign plant operations from neighboring countries would not be economical at this point. Reshoring would add several billions more to the U.S. auto industry and further drive cost higher for consumers because of current limited production capacity. Estimated capacity utilization at Mexico, U.S. and Canadian facilities are 114%, 113% and 102% respectively (CAR, 2017). Given these current capacity limitations for U.S. automakers, more domestic plant facilities would need to be built to increase production of automobiles and parts. A revised tax code with a favorable BAT could potentially encourage capital investments (i.e. foreign direct investment) in new U.S. plant construction. Such investments would offer new jobs to workers in the U.S. auto industry.

U.S. auto companies with lower labor cost locations such as Mexico have been the subject of scrutiny by President Trump. The President indicated that U.S. auto companies who shifted their operations to Mexico would face a 35% tariff on their exported goods to the U.S. He targeted GM who makes some of their vehicles in Mexico. For example, GM imported 4,500 Chevy Cruz, while American purchased 190,000 all built at their Lordstown, Ohio plant (Pettypiece et al., 2017). If such a move were to take place Mexico might seek retaliation on U.S. produced goods.

Ford Motor Company decided against building a $1.6B plant for its small car production in 2017 because of the threatened higher tariffs. Instead it will shift those costs into expanding its factory in Flat Rock, Michigan (Naughton, 2017). Ford executives have strategically decided to keep plans on relocating manufacture of some of its small cars like the Focus into an existing plant in Hermosillo, Mexico. This is a result of the drop in demand for these cars as demand increased for its more profitable SUV and light trucks. The move to Mexico with its less restrictive labor laws would allow Ford to keep its Focus production cost manageable.

According to BCG (the Boston Consulting Group), the effects from a BAT component in a U.S. tax-code revision would impact many sectors within the U.S. auto industry. It estimates a loss of 20,000-45,000 jobs at suppliers with 3% reduction in vehicle component content. There are approximately 870,000 workers in the U.S. producing vehicle components. U.S. workers could see a 20,000-45,000 reduction in workforce. In fact, an estimated 2.9% of the U.S. workforce is employed in the vehicle parts manufacturing. Workforce in the U.S. auto industry increased from 734,000 in 2012 to 871,000 in 2015 representing an 18.7% increase over this period (Mosquet et al., 2017).

Conclusion

The corporate tax rate in the U.S. cannot remain at 35% for an industrialized country because it discourages productivity and growth in the economy. Off-shoring in the 1990s was key for stimulating an economic recovery. A recent proposal by the House to include a BAT within a broader tax program reform was intended to keep companies from fleeing the U.S. so that they could find a better tax shelter abroad. A proposed 15-20% BAT would be imposed resulting in higher cost for all imports, which means adding on average about $2,000 per a new imported vehicle which would lead to a reduction of the workforce. The answer to whether BAT is an appropriate solution to combat revenue shortfall in the U.S. economy is not simple. There are many independent factors which would affect how markets would react to a 15% corporate tax rate.

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