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Trump's Confrontational Trade Policy

President Trump ran an election campaign that ridiculed existing US trade policy. He labeled NAFTA a "disaster", claimed that China was "raping" the US, and referred to the Trans-Pacific Partnership (TPP) as a "job killer". Once in office, he immediately issued a memo withdrawing the United States from the TPP and called for a renegotiation of NAFTA. Trump has repeatedly threatened a "border tax" that will affect firms that move production outside the United States. His confrontational approach to international trade will at best be intermediated by the World Trade Organization and at worst lead to retaliation and an unraveling of existing trade agreements.

The metric that Trump favors to judge international success is the trade balance, where a deficit indicates losing and a surplus indicates winning. He would like to see the United States have balanced trade or run a trade surplus. It will be important to him that the trade deficit shrinks during his presidency.

As election politics recede, can we expect Trump to tone down the rhetoric? After all, as many pundits have noted, candidate Bill Clinton criticized NAFTA only to pass it as president, and candidate Barack Obama also criticized trade agreements, only to negotiate the largest US agreement in history.

One of Trump's first actions as president was to exit the trade deal negotiated by his predecessor, so early indications and administration appointments suggest that Trump's protectionism is here to stay. Trump will emulate the stance of President Reagan, leading to a stark increase in petty protectionism, such as anti-dumping, countervailing duties and safeguards. He is also likely to take more trade cases to the WTO, being less concerned about whether the cases are winnable than previous administrations. He has nominated Robert Lighthizer, an experienced trade lawyer (mainly for the US steel industry) and former trade official under Reagan, as the United States Trade Representative, the country's top trade negotiator. Lighthizer has long believed that the US approach to China has been too weak and supports a more "imaginative" approach toward China. Peter Navarro, head of the new National Trade Council, is best known for directing a documentary entitled "Death by China". Wilber Ross, Trump's new head of the Commerce Department, made his fortune in distressed steel and manufacturing companies, aided by US protection.

Also pulling Trump towards greater protectionism, as in the Reagan years, will be a rising dollar. The broad real dollar has appreciated by three per cent since the election and by 20% over the last three years. The ongoing appreciation will worsen the trade deficit, as imports become cheaper and exports become more expensive. The appreciation is likely to continue, especially if Trump is successful with his plans for corporate tax reform and infrastructure spending. As Reagan did with voluntary export restraints on autos from Japan and other industry agreements, Trump is likely to try to fight the deficit with ever-increasing protectionism. From someone who prides himself on "the deal", more industry agreements, such as a global steel pact, are to be expected.

Trump has focused on China and Mexico, calling for a border tax of 35 or 45% on imports. The tax responds to the trade deficit with these countries and also to what he perceives as an asymmetry in value added taxes (VAT).

Despite being well understood by economists to have no effects on competitiveness, the border adjustment that is associated with the VAT has been a major point of contention for

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Trump and his trade advisors. For example, Trump described the VAT issue as the main problem with NAFTA in the September debate: “Let me give you the example of Mexico. They have a VAT tax. We’re on a different system. When we sell into Mexico, there’s a tax... 16 per cent, approximately. When they sell into us, there’s no tax. It’s a defective agreement.”

Trump may choose to amend this asymmetry through a blanket import tax or through the border adjustment tax that House Republicans propose. A broad-based punitive tax on China or Mexico would certainly violate WTO commitments and lead to retaliation. China has already identified a list of US-made products worth targeting. The House’s border adjustment plan would more likely be adjudicated in the WTO.

The Brady-Ryan tax plan converts corporate tax into a destination-based cash flow tax that exempts exports while charging imports the full 20%. This basically amounts to a tariff and subsidy of 20%. The attraction of the cash flow tax with border adjustment is that it would eliminate the incentive for companies to shift profits abroad in order to avoid paying US income tax. In addition, the plan would produce significant revenue for the near future, with the incidence falling partly on foreigners. The US annual trade deficit is running at $500bn. All else equal, a 20% border adjustment would yield $100bn of revenue a year, or $1 trillion over ten years.

What remains to be seen is whether the House border adjustment plan satisfies Trump’s desire for a border tax. Economists note that because it is a tariff *and* a subsidy, it will simply be offset by the exchange rate and will have no real effect on trade and competitiveness. Trump has called it “complicated”, suggesting he prefers other means, but House Republicans are fixated on border adjustment, as the revenue it would yield paves the way for greater tax cuts. There seems to be enough overlap in their visions that border adjustment may very well be the one policy that satisfies both Congress’s tax plan and Trump’s objective of leveling the playing field and instituting a border tax.

It is worth noting, however, that the cash flow tax proposed in the House also does not adhere to international rules. The WTO only allows border adjustment on indirect taxes, like a sales tax or a VAT. And by labeling it a border tax, Trump makes it even more likely that other countries will protest. Using previous cases as a guide, arbitration would take many years; meanwhile, the tax would generate both revenue and, potentially, distortions.

Not all of Trump’s moves will be protectionist, but even trade agreements will be different – gone are the days of big multi-country pacts. New trade agreements with other advanced countries, such as the UK, the EU or Japan are feasible, but new trade agreements with developing countries are unlikely. The Trump administration believes that bilateral deals yield more benefits because the United States has more leverage. NAFTA could well be renegotiated as two bilateral agreements, with stricter rules of origin or VAT-free access to foreign markets for some goods.

Given how difficult trade agreements are to get through Congress, this approach overlooks the returns to scale in the negotiation of broader agreements. It also dismisses the ability of the US to gain from trade-offs between other pact members. Most importantly, it disregards the advantage of getting a large bloc of countries to follow one set of rules.

Overall, Trump is bringing a highly confrontational approach to trade policy, whether through his approach on contingency protection, border taxes or trade agreements. While this tactic will stall ongoing liberalization efforts – as the US will no longer be the leader in opening global markets – the gravest danger is that it leads to an unraveling of global cooperation.