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Something to Think About

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COMMON CENTS

Let's assume I am a pretty major manufacturer (high-tech) based in California, and have designed a product which I believe will sell well in the overseas markets, particularly China. In fact, I think I can sell $5 billion worth of product outside the US to start, and grow my sales 5% per year for 10 years.

If those numbers seem like funny money, consider Pfizer, who recently ditched a plan to do a corporate inversion in Ireland, got 55.6% of its 2015 fiscal year revenue from foreign markets. Put another way, the company generated $27.147 billion in revenue offshore. For its part, Apple sold $139.851 billion worth of goods & services outside of the 'Americas' for its same reporting year, for 59.8%. Some $58.7 billion was in so-called Greater China alone.

The only problem is I will likely to have to construct a new facility to make this particular product, regardless of where I sell it So, knowing I intend to export most of finished product, should I build in the United States or elsewhere?

Well, you have to make some assumptions and run some math. However, if I anticipate making a 15% pretax margin on this product line, the US tax code makes the decision for me. I will construct the facility closer to my target market, and save money in the process. In fact, the numbers aren't even close. Trust me, it has very little to do with US worker productivity, which is some of the highest in the world.

Of course, there are any number of accounting costs and tax gimmicks associated with building a new manufacturing facility, no argument. However, in China, the corporate tax rate for high-technology companies is a stated 15%, according to a list Deloitte compiled. As many of you know, the standard IRS corporate tax rate is 35%. What a lot of people don't either realize, or perhaps appreciate, is most of the individual states also charge a corporate income tax. In Alabama, it appears to be 6.5%. In California, the state in our example, the stated corporate tax rate is 8.84%.

As a result, all over things being equal, if I produce this product in California and export it to a distributor in China, I realize the income in California. This means I will fork over upwards of 43.84% of my taxable profit to the various government authorities. Obviously, that is an apparent spread of 28.84%. On $5,000,000 worth of sales, with a 15% pretax margin, that works out to be a tax savings of, get this, $216.3 million in Year One alone….if I produce in China.

Even more jaw dropping is I can effectively pay for a $400 million manufacturing facility in China in two years just with the tax savings by producing, selling there, and not repatriating the money back to the United States, where it would be subject to the 43.84% tax. This is a no brainer.

Sure, CFOs and accounting departments can find any number of loopholes, tax credits, and loopholes in the US tax code. States and municipalities often offer sweetheart tax incentives to locate in a particular area. So, most firms don't have to really pay 43.84% in California. However, for-

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Whatever you tax, you get less of.

Alan Greenspan

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eign governing authorities aren't above doing the same tricks to attract business. Couple in the proximity to the desired local market, which mitigates distribution issues and shipping costs, and you can make a pretty coherent argument that: the US tax code penalizes domestic exporters, and makes it overwhelmingly attractive for US manufacturers to produce 'overseas' and export back into the United States. Obviously, this inflates our trade deficit (current account deficit), which means we have to attract money in the capital account to keep the dollar from falling apart.

If this seems like a stretch, consider the following….straight from the most recent Census Bureau report on the matter:

> The U.S. Census Bureau, U.S. Department of Commerce, announced today that in 2014 related-party trade accounted for 42.3 percent ($1,667.3 billion) of total goods trade ($3,937.4 billion). Related-party total goods trade is based on consumption imports and total exports. Related-party trade accounted for about 50.9 percent ($1,178.7 billion) of consumption imports ($2,314.0 billion) and about 30.1 percent ($488.5 billion) of total exports ($1,623.4 billion) (Figure 1). These percentages for 2014 data are consistent with historic related party trade figures. In 2014, U.S. related-party trade increased by 4.9 percent ($77.9 billion) while total trade increased by 3.1 percent ($118.0 billion) from 2013. Related-party trade includes trade by U.S. companies with their subsidiaries abroad as well as trade by U.S. subsidiaries of foreign companies with their parent companies.

That is basically nerd speak for: over half our imports in 2014 came from US multinationals exporting back into the United States from foreign countries. This despite the fact a recent report from Deloitte, again, ranks the US second in terms of manufacturing competitiveness among the top 40 industrialized economies for 2016. China holds the top spot with a score of 100, while the US follows closely at 99.5. The remaining top 5 are, in order: Germany (93.9); Japan (80.4), and South Korea (76.7). Strangely enough, we ran a trade deficit with 3-5 of $171.17 billion in 2015. Shoot, with ran a $58.364 billion trade deficit with #17 Mexico in 2015; however, approximately two-thirds of our imports from that country were/are of the old, so-called 'related party' variety. Why? Page 13 (section 4.5) of the PwC-Immex Maquiladora Guide: Doing Business in Mexico study gives a pretty good reason: "Currently, this means an estimated combined (income tax and flat tax) effective tax rate of 17.5% for the Maquiladora operation."

Hmm….manufacture in San Diego and pay 43.84% of my profit to the government (IRS and California) or go 20-25 miles south, produce in Tijuana, and pay 17.5% of my profit in tax? Hey, by all the accounts, the Mexican manufacturing complex isn't as competitive as the US, but that is a 26.34% spread. At a 15% pretax margin on $5 billion in sales, that works out to be potentially as much as, what, $197.55 million. Is that amount worth a 20 mile detour and some additional paperwork? Could be. I suppose it depends on exactly what it is I am making, huh?

Here are the links to the various studies: http://www2.deloitte.com/us/en/pages/manufacturing/articles/global-manufacturing-competitiveness-index.html. AND https://www.census.gov/foreign-trade/Press-Release/2014pr/aip/related_party/rp14-text.pdf. AND https://www.pwc.com/mx/es/industrias/archivo/doing-business-maquiladora.pdf.

Disclosure

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I admit global trade is far more nuanced that this. I will also admit there are far more variables at play than a few studies and a fancy spreadsheet. However, the primary goal of any company is to generate a profit and/or return for its shareholders. It isn't to pay taxes or even provide employment opportunities for the local labor force. As such, as hateful as this may sound to many, it is management's responsibility to the shareholders to maximize profit for the corporation, even if that may mean producing in a foreign country and exporting back into the United States.

If you want one more statistic, consider this: According to the OECD, in 1981, the United States had an 'OECD Corporate Income Tax Rate' of 49.7%. The simple average for OECD countries in that year was 47.5%. The US had a trade deficit of roughly $16.2 billion in nominal terms, mostly, if not completely, explained by our deficit in crude oil and petroleum related products. In 2013, the US had an effective corporate income tax of 39.1% (IRS and local), and the simple average for OECD countries that year was 25.5%. Think about that shift in tax competitiveness and then take in the US ran a $653.514 billion trade deficit in non-petroleum related goods in 2015. Remember, the math suggests slightly over half that deficit is trade back into the US from foreign subsidiaries and/or related parties of US multinational firms.

Obviously, the strong dollar didn't help matters much, but the simple fact remains. US manufacturers, particularly exporters, are already at a severe disadvantage in the global economy. Keeping corporate income tax rates well above the OECD average doesn't help them in the slightest, and only makes offshore manufacturing that much more attractive.

Now, this isn't to say the state of manufacturing and manufacturing employment would suddenly pivot IF the United States were to suddenly, and dramatically, cut its corporate income tax rate. However, it would certainly remove a major impediment facing our exporters and other multinationals, particularly with so many supposed 'free trade' agreements in place around the globe. In other words, it would help to level the playing field, and let the US worker fight it out a little more 'mano a mano' with the remainder of the world.

Essentially, you can think of US manufacturing as this: Overall competitiveness of manufacturing sector? Check. Availability of capital? Check. Flexibility of local labor laws? Check. Access to advanced technology? Check. Access to lower cost energy? Check. Access to global sea lanes and military ability to protect economic interests? Check. Wage competitiveness relative to other OECD countries? Check (seriously….overall wage growth since 2010 has been significantly less than OECD average, actually second lowest of all OECD countries over last 5 years). Tax and trade policies promoting corporate interests and/or exporting? Negative. In fact, tax policy seems to be one of the few competitive disadvantages the US has relative to the rest of the 'developed world,' if not the only one.

So, why allow it? Are we really so ideological as to put our economy at a disadvantage? It is like sending contemporary American soldiers into ground combat wielding WWI era M1917 Enfield rifles just because the US enjoys air and artillery supremacy. It doesn't make sense to me.

In the end, I went through this exercise for a simple reason: we now know, with finality, who the candidates will be in November (or should). Of the two, Trump has a far more favorable corporate tax strategy which should benefit US exporters and other multinationals. Secretary Clinton's corporate tax policy is still something of a work in progress. From what I have seen of her proposals, it isn't necessarily good or bad….it just isn't at this time. Knowing what I think I know of her, I suspect the corporate tax policy she proposes during the campaign will be significantly different than what she will allow the Congress to get past her desk if she becomes President. In other words, I anticipate the corporate tax rate will likely go down, at least somewhat, in the US should the GOP maintains control of both houses of Congress. I also suspect a Clinton White House will close a lot of loopholes in the tax code in return for signing off on even a somewhat lower corporate tax rate….she will have to go back to the party faithful with something.

Hey, if I can pull up this data in a couple of hours on one Friday morning, certainly the candidates' economic teams in Washington can pull the same stuff up. There is a big difference between 'corporate welfare' and not putting your private sector behind the proverbial 8-ball.