The trade war is morphing into a capital war

Description

By Miranda Xafa*

In a recent article ("The Global Role of the Dollar After the Tramp Tariffs") I discussed the possibility of a "Mar-a-Lago" accord, proposed by President Trump's adviser Stephen Miran with the aim of depreciating the dollar to help American industry regain competitiveness. The rationale is that the perpetual capital inflows to the US from its trading partners, reflecting the global demand for foreign exchange reserves, make the dollar chronically overvalued and cause a current account deficit.

Under the threat of tariffs and/or the loss of America's defense umbrella, the accord would provide for a massive sell-off of dollar-denominated reserves held by central banks, leading to a significant depreciation of the dollar. To prevent the sell-off from causing US bond yields to rise, central banks would be required to simultaneously swap their remaining US Treasuries for long-term obligations, e.g. 50-year US Treasuries, in order to reduce the corresponding yields due to increased demand.

The possibility of such an agreement has been of great concern to investors in recent months, as they believed that the turmoil that began as a trade war could morph into a more dangerous war of capital. Concerns were eased when Trump suspended the "reciprocal" tariffs announced in early April for 90 days, until July 9, reassuring investors that negotiations with partners would forestall their imposition. This is how Trump gained the acronym TACO ("Trump Always Chickens Out") to describe how the president, under pressure from the markets, always backs down.

But a new development is rekindling concerns about a capital war. The Trump administration's draft budget ("One Big Beautiful Bill"), passed by the House in late May and now being debated in the Senate, includes a provision that could trigger a new sell-off in US capital markets. Section 899 of the bill allows the U.S. Treasury Department to impose an additional staggered tax of 5-20 percentage points on investment income on US assets from countries that implement "unfair" tax policies. The tax on dividends can thus reach 50% (30%+20%). Income subject to additional tax under Section 899 includes interest (U.S. Treasury bonds are exempt for obvious reasons), dividends, rents, royalties, business profits, and certain capital gains. Taxable investors include foreign companies and their subsidiaries, foreign partnerships, foreign private foundations and individuals, and foreign governments.

The intent of Section 899 is to retaliate against countries that impose excessive taxes on U.S. corporations. It mainly concerns the global minimum tax of 15% provided for by the OECD Global Tax Agreement of 2021, as well as the Digital Services Tax (DST), which disproportionately burdens U.S. multinational corporations. The OECD Agreement aims to reduce the incentives for companies to avoid taxation by shifting their profits to low-tax countries. One of the first presidential decrees signed by Trump upon taking office suspended the validity of the global minimum tax of 15% that the Biden administration had agreed to, but Congress had not ratified.

The first pillar of the OECD agreement redistributes the taxing rights on large multinational companies, particularly digital platforms operating globally, to countries where they have significant sales, even if they do not have a physical presence there. The second pillar imposes a minimum global tax of 15%. But the parties were unable to meet the June 30, 2024 deadline for Pillar 1 due to disagreements over how to reallocate taxing rights and concerns about revenue loss, especially from the US, who believe the framework would disproportionately target American tech giants. The complexity of the implementation and disagreements over the DST further delayed the deal. Without a global agreement, countries have begun to unilaterally impose a DST, which can lead to double taxation and trade disputes.

Section 899, if passed, would primarily target EU countries, most of which have already imposed or are considering imposing a DST on U.S. platforms such as Google. Eight countries have already imposed DST (France, Italy, Spain, Portugal, et al.) and six others, including Germany, have announced their intention to do so. Greece is an exception so far. Section 899 gives the U.S. Treasury Department the power to designate Digital Services Taxes as “unfair,” to place countries that impose it on a list of “foreign countries that discriminate” by disproportionately burdening U.S. companies, and to impose increased taxes on their investment income in America. The Senate version, released June 16, seeks to delay implementation of the “revenge tax” to 2027, instead of 2026 in the House version, and reduce the incremental tax to a maximum of 15% from 20%.

Presumably the Trump administration views Section 899 as a negotiating tool to achieve a more favorable tax treatment of American multinationals. But even if the U.S. Treasury Department does not exercise this power, its very existence will be a disincentive for foreign investment in America by perpetuating the uncertainty about future taxes. Trump’s erratic tariff policy already has made investors more cautious about U.S. assets, as evidenced by the risk premium embedded in U.S. bond yields and the depreciation of the dollar against G10 currencies since March.

Obviously, investors will react very negatively to any intervention aimed at capital movements. There is already a great deal of mobilization by companies and market participants to prevent the Senate from approving this provision in any form. At least the Senate’s version puts it on hold for a year, providing time for a consensus to be reached on the taxation of multinational corporations. Clearly the automatic imposition of incremental taxes on companies and investors whose home countries implement “unfair” tax policies will harm America itself in the first instance. It will drive capital elsewhere and antagonize allies. The resulting drop in corporate investment and retreat from US assets would negatively impact economic growth, employment, and ultimately the revenues received by the U.S. government. Investors can only hope that Section 899 will eventually turn out to be another example of TACO (“Trump Always Chickens Out”).

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