Management and Accounting Journal
ISSN: 2997-6707 |
Volume 11 Issue 3, July-September, 2023
Journal Homepage: https://ethanpub.online/Journals/index.php/E2
Official Journal of Ethan Publication

FINDING THE BALANCE: TARIFFS AND THEIR EFFECT ON FOREIGN DIRECT INVESTMENTS

Alexander R. Thompson
Department of Accounting, Finance and Marketing, University of New Haven, West Haven CT

Abstract:
In the global economic landscape, foreign direct investments (FDI) play a pivotal role in shaping market entries and financial advantages. These investments often hinge on factors such as favorable taxation, affordable labor, and production costs, which can attract global players (Beck and Chaves, 2011). Nevertheless, the interplay of foreign investments with governments extends to the realm of import duties, commonly referred to as tariffs. Tariffs represent a significant juncture where the interests of foreign investors and governments converge. They are a source of revenue for governments through taxation while simultaneously posing costs on companies. Striking a balance with tariff rates is crucial, creating an optimal "sweet spot" that effectively contributes to government revenues and economic planning without discouraging foreign entities from expanding their businesses across borders (Doupnik and Perera, 2015). However, tariffs can be a double-edged sword. Excessively high tariff rates can hinder economic growth, while too low rates can attract foreign businesses, stimulating economic expansion. Achieving equilibrium is paramount for governments, as they aim to protect domestic industries without compromising accessibility to affordable goods and overall economic development (Chatzky, 2019). The history and contemporary scenarios underscore these dynamics, emphasizing the far-reaching implications of tariffs on foreign direct investments and the broader economy.

Keywords: foreign direct investments, tariffs, economic growth, government revenue, global economy.

Introduction

Foreign direct investments (FDI)is a crucial mechanism for entry into new markets, unveiling potential tax benefits, and cheaper labor and production costs (Beck and Chaves, 2011). Accompanying this is the net increase in global income which is returned to the host government either through direct or indirect taxation. (Mohs, Wnek and Galloway, 2018). One major tax that sits at the intersection of foreign direct investment decisions and its related global players are import duties, otherwise known as tariffs. As with all taxes, tariffs are a source of revenue for governments and a cost for companies. In theory, this creates a middle “sweet spot” for tariff rates that is high enough to fill government coffers and meet their economic plan while not detracting foreign companies from investing money in bringing their business into the foreign country (Doupnik and Perera, 2015). From a different perspective, if tariffs are too high, economic expansion can become impaired whereas its absence can attract foreign businesses and support economic growth. The effect is the need for a delicate balance, the “sweet spot”, where governments can protect homegrown industries but not a cost of inaccessibility to cheaper goods and stunted economic growth. (Chatzky, 2019). History and contemporary events do well to demonstrate these extremes and serve as reminders that tariffs have a wide grasp, capable of benefiting governments, companies, and individuals to wonderful highs but also shut them out. These wide effects make the impact of tariffs on foreign direct investments and economies too important to ignore.

The Impact of Tariffs on Governments, Companies, and Consumers

The impact of tariffs is not the sole deciding factor behind foreign direct investments, but it is a significant determinant. As a result, policy and business decision makers must routinely compare the tax effect of various locations. As with many taxes (i.e. Consumption taxes, income taxes, etc.), tariffs are subject to fluctuation and change potentially resulting in significant downstream effects on the company's employees, business operations, and bottom-line profits.

Tariffs can have a significant impact on all parties involved, including the local government, multinational enterprises (MNE), and consumers. In theory, tariffs can provide a modest means of revenue for local governments. However, in an ever-expanding global and competitive environment, increased tariffs may not necessarily correlate to an increase in revenue stream. Instead, it may only deter foreign companies who bring in new jobs and opportunities for the local economy (Wiseman et al, 2018). From an MNE perspective, tariffs hurt exporters by making their products more expensive, which directly impacts the company's return on investment (ROI) and profits. Exporters could choose to cut their prices to maintain their sales records, but it would, inevitably, still shrink their profits (Chatzky, 2019). The final component to consider is the consumer.

The increase of tariffs ultimately drives up the cost of imports and while, in theory, it can reduce foreign competitive pressure and allow local business to thrive, it gives these businesses the opportunity to raise prices for goods and services to incredible heights. Additionally, it limits the available variety of goods and services to be consumed. The overall effect may be great for local businesses, but it severely reduces the average Joe's purchasing power, making daily living extremely expensive.

International Approaches to Tariffs

Nearly every country imposes some tariffs and there is no international standard, in turn, this has made certain countries more appealing with respect to foreign direct investment opportunities. At one extreme are the countries that impose no tariffs, such as Hong Kong, which are known as a "free ports" (Chatzky, 2019). At the other extreme end are countries that impose high tariff rates such as countries in Africa, the Caribbean and South Asia (Desilver, 2018). In 2016, the lowest weighted-average applied tariff was 0% and the highest was 18.6% (World Bank).

Recent history has shown that the global trend has been favorable towards lower tariffs. This reduction of tariffs is also known as "trade liberalization" and its popularity is justified, by lowering tariffs it removes a cost associated with international trade, opening doors for domestic companies to access foreign labor, resources, and deliver goods and services into new markets. The overall effect of the amalgamation of these factors is a boost in domestic and foreign economy (Ahn, D, Duval, H, and Njie, 2016). In a study of 28 Organization for Economic Co-operation and Development (OECD) member countries, results have shown that tariff barriers have decreased from an index scale of 0.8 in 1998 to 0.2 in 2013 (OECD Product Market Regulation Database), indicating that the global economy does indeed favor an economic environment of trade liberalization. These OECD countries include major economies such as the United States and the European Unionwho had an average tariff applied across all products at 1.7% and 1.8% in 2017, respectively (Figure 1).

Despite the clear benefits of a world of lowered or no tariffs, many countries have been slow to adopt the model. As previously mentioned, implementing high incentives is a mechanism to protect local businesses and reduce reliance on imported goods. However, it can also backfire. An example is the Bahamas. Aside from making the country less attractive to foreign companies, high tariffs has alsomade the country extremely reliant on their own locally grown businesses, primarily tourism (Encyclopedia Britannica). The result of this is that the country's economy has become so reliant on one means of supporting itself that if anything were to happen that directly impacted its tourism industry, there would be a direct and unavoidably large impact on the country's economy as a whole (Robles, 2019). Considering the direct and indirect challenges posed by countries who impose high tariffs, it is then logical that countries who have low or no tariffs are the most appealing for FDIs.

Hong Kong is a classic example and because of its non-existent tariffs and unique culture, it has become not only a gateway between the east and west, but also a major player in the global supply chain. Countries that elect to impose high tariffs are ultimately creating a trade barrier, suffocating the flow and accessibility to resources and goods for home and host economies. The obvious economic benefits provided by lowered tariffs has not gone ignored by the major global economies. In 2018, six out of the seven of the Group of Seven (G7) nations reported mean tariff rates on all products of less than 2% (World Bank). While Japan stood out as the exception at 2.45%, this value still represented a decrease of 0.06% and 0.1% from 2017 and 2016, respectively (World Bank).

Tariffs and Transfer Pricing

Transfer pricing refers to the agreed upon cost for the transaction for goods and services between related parties and is a process that is directly impacted by tariffs mechanisms (Doupnikand Perera, 2015). These transfers can be from a subsidiary to parent (upstream) or parent to subsidiary (downstream) and occur across borders. Regardless of the direction, intercompany transactions representa significant portion of international trade and therefore, its relationship with tariffs cannot be ignored. This section will explore the mechanisms and the how country-specific tariff structures directly impacts transfer pricing decisions.

An objective of transfer pricing is to minimize cost. This can be achieved but requires the consideration of two key factors: the agreed upon transfer price and its tax implications, including tariffs.It is critical to note that these two factors do not operate in isolation, tariffs are dependent on the transfer price just as the transfer price is determined based on country-specific tariffs. To complicate matters, there is no single method to determine a transfer price and various factors taken must into consideration, such as variance in tax rates, minimization of tariffs-related consequences, and the interest of local partners.

Additionally, under the Internal Revenue Code section 482, the Internal Revenue Service (IRS) has the authority to audit international transfer prices and adjust their tax liability if they deem the transfer price to be too generous, in other words, a price that is too low (Doupnik and Perera, 2018).This concern has given rise to the establishment of guidelines for determining an arm's-length price or the price that is charged from one related party to another as if the parties were not related. However, the IRS'main concern is to ensure that the proper amount of income is being recorded and taxed appropriately considering the jurisdiction of the transaction of an American company within the United States and abroad. Similarly, to the IRS, the OCED has established international guidelines regarding the use of arm's-length pricing when determining the transfer price (Neighbour, 2002). The cumulative effect on the emphasis of using an arm's-length price has stabilized the range of potential prices that are considered appropriate for the exchange of goods, but it has not stabilized its relationship with tariffs.

As previously noted, tariffs are a tax on imported goods which are typically charged as a percentage of the transaction price that a buyer pays a foreign seller. For example, if a tariff for Good X is set at 5% in Country A and the potential transfer price for Good X is between $1,000 - $1,500 (derived from historical costs, industry standards, and other factors), the tariff that the Country A buyer pays to Country B seller would be between $50$75. The theoretical concept becomes clearer, if a country sets attractive tariffs on a certain good, it can create opportunities for domestic companies to acquire that good from foreign providers at overall lower prices and vice versa.The potential downstream effects are, but not limited to including, higher quality products, increased productivity, and enhanced innovation. Additionally, "attractive tariffs" does not need to mean tariffs have to be set at zero percent (even if some economists would disagree), but it does mean that tariff structures need to be set at a rate that does not deter international trade cooperation that benefits both domestic and foreign parties. However, seeing transfer pricing relative to tariffs through an optimistic lens also reminds us to consider its opposite. If a country sets unattractive tariffs, often rates that are too high, it creates a trade barrier for domestic companies to purchase goods from foreign suppliers and vice versa. Similarly, to above, there are always downstream effects that must be considered.

High tariffs can deter foreign companies from accessing goods from that high tariff country, limiting variation in available goods, high quality products, and untapped markets. Other downstream implicationsthat one may not immediately consider includes country-to-country relationships, which may be hardened due to tariffs, this concept will be explored later, or a domestic talent pool that lacks diversity of culture and skills as some foreign workers may no longer be needed in the domestic country as it is too expensive to bring in the goods that they are specialized for. Despite the various downstream impacts, the high-level concept is clear: Higher tariffs rarely benefits both parties. In an environment of high tariffs, the foreign company are less likely to suffer the consequences compared to the domestic country implementing the elevated tariffs. This is because they still have access to other markets which may have more favorable tariff rates, allowing them to pivot and still find resources and opportunities to thrive. However, if a country has high tariff rates, it is only self-harming as they are electingto close themselves off to foreign talent and resources.

The United States: Born from Tea and Tariffs

The role of tariffs and taxes in recorded history has not only shaped economies but also formed societies and created new nations, the most famousbeing the United States. It could be said that tariffs helped to make America great. While the original colonists may not have realized it at the time, tariffs not only provided the pathway for the original thirteen colonies to become an independent nation, but the lack-off kept the country together following its independence. On December 16, 1773 in Boston, the Sons of Liberty protested the infamous Stamp and Townshend Act, which was a direct tax by the English on the colonists and imposed a staggeringly high tariff on various goods, including glass, ink, but most importantly, tea (HISTORY, 2009). Teahad become a highly valuablecommodity and one that the English had an almost global monopolistic control over (Platt, 2018).

The protest became known as the Boston Tea Party. Subsequently, the British blockaded the Boston Harbor in 1774, but this proved to be futile as the colonies had by this point become leading exporters of agricultural goods and were more than self-sustainable. The imposition of high tariffs and the British response to the Boston Tea Party would eventually result in the American Revolutionary War and, famously, the Declaration of Independence.The effect and stains of these tariffs was so deeply rooted in the American cause for independence that when the Founding Fathers wrote the Constitution, they explicitly outlined inArticle 1, Section 10, Clause 2, that no State shall impose interstate duties on imports (and exports) (The Constitution).If the role of tariffs in the formation and independence of the United States teaches anything, it is that trade wars can lead to unintended consequences, including harming those who initiated them and benefiting those who they were intended to harm.

Political Considerations

The relationship between tariff structures and economic cooperation between governments are highly intertwined. It is almost ironic that in a world that is becoming ever more integrated that some countries have maintained leadership in the production of certain goods and services that other countries continuously demand. The United States and Canada are a classic explain and have an extremely comprehensive trading relationship, one that is tightly woven together by their reliance on one another for various goods. Between the two, Canada is the largest foreign supplier of oil, natural gas, and electricity to the United States, with Canada providing almost 40% of the United States' crude oil imports (The Embassy of the United States of America). In terms of investments, Canada's foreign direct investment into the United States was $311 billion in 2014, making Canada the fourth largest source of FDI in the United States (The Embassy of the United States of America). The US and Canadian economies are incredibly interconnected and reliant on one another that in 1988 the Canada-Untied States Free Trade Agreement was signed, which eliminated barriers to trade between the two countries, this was updated by the North American Free Trade Agreement, which included Mexico, and more recently, the United StatesMexico-Canada Agreement in 2019 (Lobosco et al, 2019).

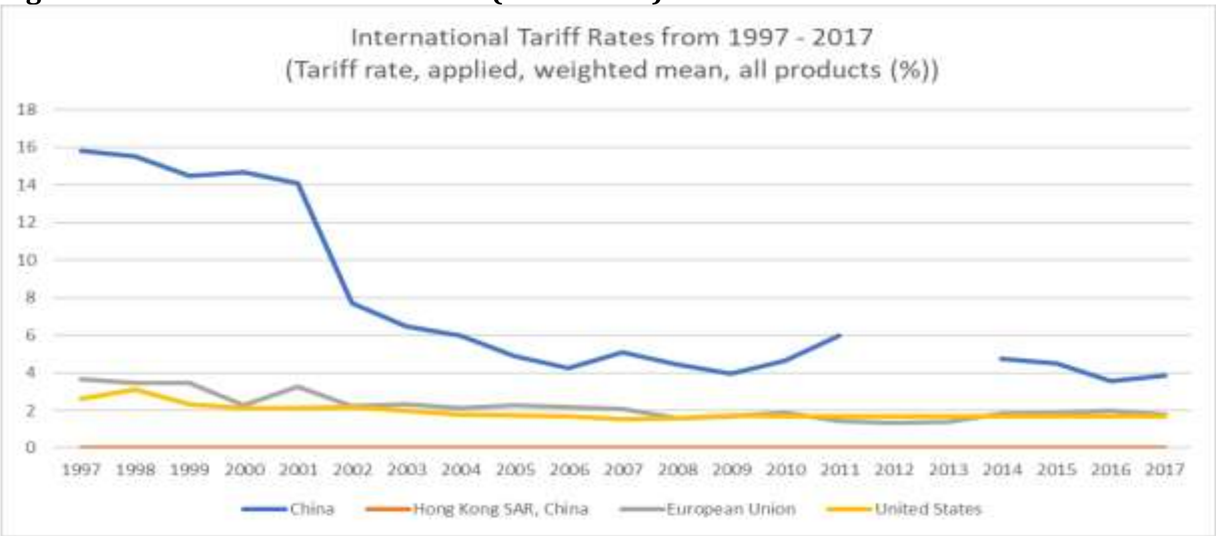
Beyond the economic mechanisms of tariffs, there is a sense of comradery and understanding in an economic relationship like that of Canada and the United States. Therefore, if one country were to do something drasticwith regards to their trade arrangement, it could potentially damage the existing and future relationship between the two nations. To illustrate, if the United States attempted to impose high tariffs on a crucial good like oil, it could lead to a trade war. Canada would see it as unfair and the United States would ultimately only be harming itself as it has a deep reliance on Canadian oil. Additionally, as history as shown us, tariffs tend to hurt the initiators more than those they were intended to harm. In other words, to maintain domestic economic prosperity relative to their reliance on foreign governments and their exports, countries need to design tariff structures that benefits all sides. Therefore, it is logical that global economies would seek to move towards a world of trade liberalization or complete free trade.

Conclusion

Management and Accounting Journal
ISSN: 2997-6707 |
Volume 11 Issue 3, July-September, 2023
Journal Homepage: https://ethanpub.online/Journals/index.php/E2
Official Journal of Ethan Publication

As history and current events have shown, tariffs have a directly negative impact on foreign direct investments and transfer pricing. Imposed on a country-specific basis, tariffs are import taxes that can open economies to foreign businesses or protect domestic ones by keeping out the competition. As history and our modern economy has shown, countries who have chosen to impose no or low tariff rates have prospered and benefitted greatly, these are economies such as the United States, Hong Kong, and the European Union, while others who have elected high tariffs, including the Bahamas and many African countries, have economies that are less developed and need to develop a trading system that makes them more attractive to foreign direct investments. As our research has shown, tariffs provide almost no benefit aside from contributing to government coffers. Therefore, the prosperity and growth of our future economy is dependent on the reduction or complete removal of tariff as barriers to global trade.

Figure 1: International Tariffs Rates (1997-2017)



Source: OECD

References

Beck, & Chaves, A, (2017) "The Impact of Various Taxes on Foreign Direct Investment. "Working Papers, 11-18, University of Delaware, Department of Economics.

Chatzky, Andrew. "The Truth About Tariffs." Council on Foreign Relations, Council on Foreign Relations, 16 May 2019, www.cfr.org/backgrounder/truth-about-tariffs.

DeSilver, Drew. "U.S. Tariffs Are among Lowest in World and in Nation's History." Pew Research Center, 22 Mar. 2018,Downloaded from: https://www.pewresearch.org/fact- tank/2018/03/22/u-stariffs-are-among-the-lowest-in-the-world-and-in-the-nations-history/.

Doupnik, T., & Perera, H,.(2015), International Accounting 4e, New York, McGraw-Hill.

Lobosco, K., Gallón, N., Malloy, A., & Vazquez, M. (2019, December 17). US and Mexico say trade deal is on track after hurried last-minute objections. Retrieved June 25, 2020, from https://www.cnn.com/2019/12/16/politics/usmca-mexico-labor-concerns/index.html

Neighbour, John. Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, OECD, 2001.

Mohs, J., Wnek, R., & Galloway, A., (2018), The Impact of Taxes on Foreign Direct Investment, International Journal of Accounting and Taxation, Volume 6(2).

Platt, Stephen R. Imperial Twilight: The Opium War and the End of China's Last Golden Age. Atlantic Books, 2019.

Ranish, R., Menz, P. & Mohs, J., (2015), Global Financial Model for the Value Chain, Journal of Finance and Accountancy, Volume 18.

Robles, Frances. "The Bahamas' Big Need Is Tourists, It Says." The New York Times, 17 Sept. 2019, Downloadedfrom:https://www.nytimes.com/2019/09/17/travel/dorian-bahamas-resorts.html.

The Embassy of the United States of America, Downloaded from https://photos.state.gov/libraries/canada-economic-relations-factsheet

Wiseman, Paul, et al. "Trump's tariffs: A closer look at what they are and how they will work." USA Today, 9 Jul. 2018, Downloaded from, https://usa.today.com/story/money/economy/2018/07/09/trump-tariffs-what-they-how- they-work/767230002/.