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***'The Trump Phenomena – Will the "insurgent in the White House" disrupt Australia's Economy and our region?'***

The reference in the title of today's address to "*an insurgent in the White House*" comes from an *Economist* Magazine article earlier this year.

It goes on to say "*As Donald Trump rages against the world he inherited as President, America's allies are worried—and rightly so*"

Should we be worried? And if so, how worried? And if not why not?

We see a lot of coverage here about the activities of the new President and his administration.

Some of it is wide-eyed, some of it disbelieving and some of it reverential.

But we need to keep to the front of our minds:

- what we can control;
- what impacts directly on us; and
- what and how we can respond to the opportunities to make Australia a better place to do business and generate the growth and employment that are the foundations of broader social progress.

Some quick observations:

Donald Trump was elected because on the back of China and the GFC, enough Americans, particularly in the industrial north, felt their economic model was broken.

Those Americans are impatient and unforgiving. Remember overall he gained no more votes than Mitt Romney in 2012. It was <u>where</u> he got his votes that is crucial.

His focus is purely on rebuilding a manufacturing base and here the Make it in America mantra is paramount.

This fact alone should add urgency to those considering the energy security and affordability questions that are hanging like the sword of Damocles over key parts of our own manufacturing sector.

The new president now has a little over 18 months until the next mid-term elections to make a serious change or the caravan may well shift allegiances.

The President knows it and the business community knows it.
That explains why he ditched health care reform so quickly and moved to tax reform – an area where if he achieves success will have profound implications for Australia.

Second, he is not running the United States like a business.

He appears to be running it like a Trump business. That's a fundamental difference.

Third, his concerns over trade appear to have two targets. China and Mexico. (*Note Mexican Ambassador Armando Alvarez-Reina* (pron rainer)

China because he and others in the American business community do not believe they are operating on a level playing field driven by:

- a lack of market access;
- the need for joint venture partnering;
- concerns over intellectual property rights;
- concern over rule of law; and
- the view that American companies are not competing against Chinese companies but against the state.

Mexico, because it appears he believes that Mexico's 47 free trade agreements with other countries means Mexico is being used by others to gain back door access into the American economy.

Our concern must be that we get caught up as collateral damage in any potential trade dispute that emerges in the period ahead.

The fundamental question for any business observer is to ask whether President Trump is a disrupter or a transformer or eventually neither.

- A disrupter throws the current system up in the air.
- A transformer makes fundamental changes.

His legacy will be as one or the other or if it all turns to custard, as a complete failure.

I don't think that Donald Trump is someone who countenances failure.

So what will be the impacts on Australia?

It is worth reminding ourselves that the US is our most important <u>economic</u> partner.

We hear a lot about China being our largest <u>trading</u> partner.

That is true but US companies account for the largest share of foreign investment in Australia – more than ten times as much as China's direct investments here. And the US is the leading destination for Australian investment abroad.

There is a lot at stake.

I'm going to quickly now touch on the areas of:

- business tax;
- infrastructure;
- defence spending;

- at some issues related to an increase in the US budget deficit; and
- also at considerations surrounding an increase in US protectionism.

***Tax***

The President has committed to reduce the US federal corporate tax rate.

He has also indicated a strong interest in the idea that a destination-based cash flow tax could replace the current business income tax.

*Tax rate*

First, on the lowering of the US company tax rate, on one level if it were to occur it would be part of a well-established trend across the OECD.

Mr Trump at one point proposed a reduction in the US federal company rate from its present level of 35% to 15%.

This would see the US go from the highest rate in the OECD to one of the lowest.

A reduction of this size would be more than part of the OECD-wide trend. It would be more like turning the US into a tax haven.

Whether to 15 per cent or a lesser change, there would be two impacts on Australia.

- First, if a lower US tax rate increased total investment in the US by more than the amount diverted from other countries, it would underwrite a higher productivity, higher growth path both for the US and the global economy than would otherwise occur. In itself that would be beneficial for trading nations like Australia.

- But investment *would* also be diverted to the US from other countries.

- Following last week's developments in our Senate, there would be less of an impact for companies with turnover of under $50 million, but in general it would make Australia less competitive in after-tax terms than the US.

- Multinational companies that invest in both Australia and the US would be more inclined to locate their next investments in the US rather than in Australia. This includes US, Australian and multinationals from other countries.

We are not talking small beer. The US accounts for 28 per cent of all our foreign direct investment – that's about $860 billion dollars. And Australian direct investment in the US is not small either.

In 2013 Australia had 116 direct affiliates of Australian companies operating in the US employing nearly 100,000 people. Interestingly, manufacturers make up 43 per cent of the Australian companies operating in the US.[1]

The overall outcome for Australia would depend very much on the extent of US rate reductions.

[1] Trumping Trade: Understanding the Australia-United States Economic Relationship – Perth USAsia Centre

It would also depend on any responses in other countries.
We could expect that pressure would build around the world for tax cuts in response.

There would be further pressure for an Australian response and we have seen over the past year the difficulties we, as a nation, have in dealing with this.

*Destination-based tax flow cash*

Perhaps an even bigger shake up would come from an introduction in the US of a destination-based cash flow tax.

This idea has been debated in the US for many years and has a strong academic pedigree.

The infamous Henry Review also injected the idea into Australia's now barely-alive national tax conversation.

At first glance the cash flow tax is beguilingly simple.
The tax base for a purely domestic business would be its sales revenue less its expenses – including its capital expenses.

That's it!

No depreciation schedules.

No distinction between capital and recurrent expenditure.

No distinction between income from the sale of capital assets and other sales revenue.

Just cash in less cash out. Not unlike a GST really.

And like a GST, there would be border adjustments.

Export revenue would be exempt but imports would be included in the tax base.

That is, sales revenue from exports would be exempt and business expenditure on imports would not be deductible.

Interest expenses would not be deductible and profits earned abroad would not be taxed in the US.

Now I'm not a tax expert - and I give you notice that I have no intention of responding to technical tax questions - but clearly this approach to business tax is a major departure from existing practice.

Whatever else, it would disrupt the global taxation of business income.

It is a contingency that Australia should do much more preparation for: including by readying for the difficult public policy debate that would be involved.

***Infrastructure and Defence Spending***

An increase in US infrastructure spending could have several favourable impacts in Australia.

In generally stimulating the US economy, a major catch-up on US infrastructure could generate some of the additional activity and earnings that seem to have been factored into global equity prices.

So that's the jobs and growth piece.

Moreover, Australia as a global supplier of some of the basic ingredients of infrastructure construction would have a particular set of benefits.

Even if we did not sell iron ore and metallurgical coal directly into the US, we would stand to benefit from the higher prices resulting from the additional US demand.

And there would be other opportunities for Australians to benefit – including in the finance sector.

An uplift in US defence spending, could also feed into the global growth story and, as with infrastructure, there may well be potential for additional benefits for Australia including from US defence R & D.

We have a strong defence industry in Australia – much of which feeds into the supply chains of foreign-owned primes.

Some of our local companies have similar defence-related operations in other countries including in the US.

As part the increase in our own defence spending, there is considerable scope for us to generate greater leverage from these relationships both in the domestic market and abroad.

While in some areas, such as the Joint Strike Fighters, unit costs may well fall, more generally a boost to US defence spending could lift price pressure in this sector and raise the costs of our own defence acquisition programs.

***A Higher US Deficit?***

In combination, these three areas of US policy – business tax cuts and more spending on infrastructure and defence - pose major questions for US public finances.

As clear from its recent health insurance episode, in the US - like here – there is considerable resistance to winding back major areas of public spending. And it is difficult to see President Trump calling on US citizens to pay more taxes.

So there is a clear risk that the US budget deficit could worsen considerably. How would that play out for the global economy?

Could we shift from the "great recession" in which the fear of deflation was so prominent, to a return to a global inflationary environment fueled at least in part by a new wave of US deficit spending?

To some extent this depends on the extent of spare capacity in the US economy.

While the US is already approaching full employment, there is still some way to go before they reabsorb the discouraged workers and the under-employment that we also have in our own economy.

If expansionary policies lift the capacity of the US economy in a self-sustaining way there may be less reason to be concerned about higher US deficits.

On the other hand, we could well see the US Reserve pushed to lift US interest rates more rapidly than otherwise thus slowing down the rest of its economy.

This would include the slowing that would occur through the agency of a higher US dollar - by constraining its export sectors and encouraging more imports.

At the very least these countervailing macro policy considerations should dampen some of the enthusiasm for the jobs and growth outlook priced into equity markets.

**Protectionism**

The final policy area that I want to mention is protectionism.

Mr Trump's protectionist messages were not insignificant factors in his election win.

It is difficult to see how a resurgence of US protectionism would benefit other countries and particularly Australia.

We are just beginning to see global trade pick up after a long slump.

This could be killed in its infancy if barriers against trade are pushed up in the US – particularly if they incite similar increases around the world.

This clearly has the potential to be disruptive to the global economy and for Australia whose exports of goods and services to the US are around $21 billion a year.

Australia is unlikely to be a direct target of US measures – at least initially.

We are very generous with the access we give to our domestic market – and certainly more generous than even our closest trading partners – New Zealand aside of course.

But we would be affected by a general rise in barriers to trade and, because China is our own largest trading partner, US measures targeting China could well play out unfavourably for us.

Another dimension of this is that although not a direct target, protectionism begets protectionism.

Every lobby group wants to get into the act and it is easy to see the internal political dynamic in the US snowballing in ways that cut off trading opportunities for Australian exporters. Many in the US think they would stand to gain more than they would lose.

Certainly, they have a very large domestic market. So, unlike Australia they are much less reliant on exports to generate economies of scale.

That said, the blockage in the US of the TPP seems like it will be a strong candidate for the greatest own goal in the history of trade relations.

As an open economy, the US would have needed to concede next to zero in negotiations and its export sector would have benefitted enormously from the countries that would have reduced barriers from 10, 20, 40 percent.

And one final point before winding up, one dimension of the disruption that could arise if the US headed more vigorously down the protectionist path is that there could be some compensation from a diversion of trade.

As noted by many others, it would be ironic if countries like Australia were pushed – economically and therefore eventually politically – closer to China because of US insularity.

But the potential for trade diversion could also see us building stronger ties with a range of other countries – Mexico comes to mind as do a range of South American countries.

**Ladies and gentlemen,**

The US is a massive investor in and partner with Australia.

It is our leading source of and destination for investment.

It is our second largest two-way trading partner.

The US is perhaps much more economically important to us than we are to them – we are their 15th largest export destination and 29th largest import source.[2]

But keep in mind the US's investments in Australia are more than double its investments in China. And Australian companies have more than eight times more investment in the US than in China.

Australia more than ever needs an economically strong and open US to allow us to grow.

But we also need to adapt to the challenges that change there produces.

We must be open to new ideas such as around the Trump tax agenda to both compete and complement the US.

After last week's gyrations over small business tax cuts here, Australia's challenge is not just to lag behind or to try to keep up, but rather to stay ahead of the game to remain relevant and competitive.

Australia risks being drowned in Trump's promised Tsunami of tax relief and reform.

To wait for the US to act before acting ourselves makes no sense and does not represent good policy.

It would be national folly.

[2] Trumping Trade: Understanding the Australia-United States Economic Relationship – Perth USAsia Centre