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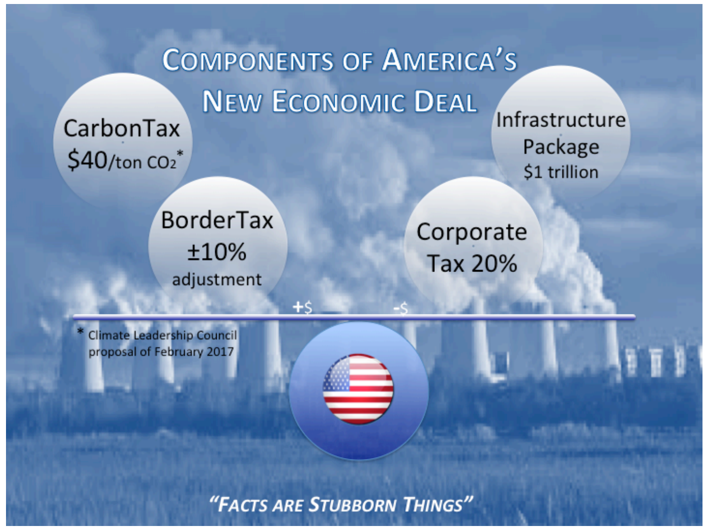

"FACTS ARE STUBBORN THINGS"
AMERICA'S NEW ECONOMIC DEAL

Ronald Reagan quoted John Adams who famously said "*facts are stubborn things*". Stubborn indeed are the media recounting facts on Russia, legal challenges on immigration, facts from intelligence agencies, backtracking on health care, and hiccups on foreign affairs. The White House now appears on the receiving end of Reagan's approach "*when you can't make them see the light, make them feel the heat*". Having polarized during an extended campaign, the President now must feel the heat to deliver results by building alliances for a new economic deal in America.

Paradoxically, such a messy start may bode well for a more collaborative approach on economic policies. Last week, a most promising proposal of the Climate Leadership Council was presented to the White House by an impressive group of former Reagan officials, including James Baker and George Shultz, and received bipartisan support, including from Marty Feldstein, Greg Mankiw and Larry Summers. The team was received by Gary Cohn, White House official and former Goldman executive, who has an impressive record of getting things done. The council aims to repeal environmental regulations and replace them with a carbon tax, which is revenue neutral and part of a big tax reform package, and which includes a collaborative approach to introduce a border adjustment tax that is being favored by the Republican leadership. The policymakers do recall the bold Reagan message that "*morality in the long run aligns with strategy*", referring both to taxes and the environment.

How would an ambitious bipartisan new economic deal be structured? The President is facing problematic approval ratings and needs to deliver jobs to his supporters in form of a proclaimed $1 trillion infrastructure program. That program may have bipartisan support IF the financing can be found, counting on corporations to repatriate foreign assets in conjunction with a big tax reform package. Although a carbon tax may not be appealing at first sight, it has three distinct advantages for policymakers: first, it would repeal and replace a web of suboptimal regulations; second, at the proposed level of $40 per ton, it would raise significant tax revenues which are essential to finance a neutral tax reform package; and third, it would facilitate to establish a border adjustment tax to deter carbon imports. The last point is critical, because it would combine bipartisan support with an international effort by the G20 to advance the climate agenda, even it that requires a somewhat more protectionist border adjustment tax, which otherwise might face protracted legal WTO challenges.

The potential new economic deal would hence need to contain four components:
<1> a broad **carbon tax** starting at $40/ton combined with a repeal of misaligned environmental regulations and a promise of tax-revenue-neutrality
<2> a comprehensive tax reform with **corporate taxes** cut to 20% and incentives to repatriate major corporate assets and eliminate tax deductions
<3> a **border adjustment tax** in the ±10% range, designed as equivalent to VAT rebates for exports, also equalizing import prices for carbon products
<4> a massive **infrastructure** and industrial policy initiative ($1 trillion 10-year tag) partly funded by repatriated assets and additional tax revenues (border, carbon).

What has been the experience with carbon taxes? "State and Trends of Carbon Pricing" (World Bank, 2016) reveals that carbon taxes are currently implemented by 40 national and 20 sub-national jurisdictions and that 1,200 large corporations currently use an internal price of carbon. Finland was one of the earliest countries to introduce a carbon tax in 1990, which is currently at $65 per ton. British Columbia offers an impressive sub-national example of having used a carbon tax since 2008, currently at $23 per ton, which has been revenue neutral, reduced emissions by 10% without negative impact on prices, jobs, and growth, so that recently the province of Alberta, with its heavy energy focus, implemented its own carbon tax and the Canadian federal government intends to follow soon.

Which political advantages would this new economic deal offer? Bipartisan collaboration would create an improved political climate when the President works with experienced policymakers, collaborates with his allies in Congress, and brings on board an important part of the opposition, many realistic Democrats and even Sanders' environmental Democrats. A broad political majority could take on vested interests that inevitably attack any tax reform efforts. Business would largely welcome a reduction of corporate taxes, even if it involves a revenue-neutral increase of carbon taxes while eliminating costly regulations. The Climate Leadership Council proposes to achieve tax neutrality by issuing annual dividends of $2,000 for each family to address regressive characteristics and to create long-term ownership incentives. WTO conflicts over border adjustment taxes may be alleviated by climate arguments, especially if tax rates are deemed equivalent to VAT rebates. There could be large political benefits, as compared to major liabilities that are currently piling up from attacks on intelligence agencies, the judiciary, and the media.

What would be the economic implications for the US? The four components of the new economic deal would impact prices, growth, trade, exchange rates, and asset prices. Chart 1 illustrates some stylized facts: The largest economic benefits would arise from infrastructure spending and corporate tax cuts, but funding would only be viable in combination with a carbon tax and border adjustment tax. The latter would probably imply an increase of inflation to a 3% handle while also leading to higher interest rates, a contraction of trade, and a stronger US dollar. The sectors that benefit most would be domestic energy (gas, storage, cleantech), the financial sector, the construction industry as well as innovative clusters (high-speed rail, IT infrastructure), although some delays are likely in the envisaged 10-year infrastructure program.

What would be the implications for emerging markets? The impact would be most pronounced on oil exporters and carbon polluters, which would face higher prices and lower demand in a more protectionist environment. Moreover, major exporters to the US would face new border adjustment taxes, which may erode their competitiveness. On the other hand, trade in services would likely be less affected and expand further, and valuations for the financial sector might revert upwards in a rising rates environment. Domestic consumer industries in emerging markets might benefit as well, given that global multinationals might be adversely affected by higher taxation and contracting trade. Manufacturing is not expected to migrate back to the US but rather face more margin pressure and further outsourcing to lower-cost jurisdictions. Clusters of niche industries could further expand across emerging markets, for example health tourism, pharmaceutical R&D, artificial intelligence hubs, and e-commerce. Indian service industries may benefit most whereas Russian energy and Chinese manufacturing industries may be most adversely affected.

Why is the EM rally going into the opposite direction? Mean reversion has been a major factor in emerging markets over the past year, breaking five-year trends, as illustrated in chart 2: energy and materials were by far the cheapest sectors in emerging markets, with five year annualized returns of -6%, which then had massive rallies over the past year with energy up 20%, materials up 30%, and metals & mining up 90%. In contrast, health and consumer sectors were most expensive and declined by 26% and 12% respectively. While mid-cap and dividend styles were in favor over five years, both declined by 8% over the past 12 months. Most surprisingly, the 50 largest ADR listings of emerging market mega-cap companies (ADRE) outperformed the EM index by 6% last year which is highly unusual, given that mega-caps typically underperform their indices, both in emerging and developed markets. If the new economic deal gets implemented, EM mega-cap resources are likely to suffer while mid-cap domestic consumer industries are likely to prosper.

Facts are stubborn things indeed and will outlast short-term political skirmishes. American voters do not want “alternative facts”, they want a White House that governs responsibly, builds coalitions, and delivers results. Fights with the media, the judiciary and intelligence agencies, with friends and foes in Congress and overseas are undermining credibility of the new administration. The heat is literally on the White House to face the facts and to deliver the promised jobs, which will require finding common ground rather than burning bridges. The best opportunity is reaching out for a new economic deal in America to rebuild the crumbling infrastructure, reform taxes comprehensively, and stop the heat by replacing misaligned regulations with a sensible carbon tax. Strong leadership must be able to face stubborn facts.

Chart 1: Impact of New Economic Deal

IMPACT POLICIES	PRICES	GROWTH	TRADE	DOLLAR	ASSETS
CARBON	↗	O	↘	↘	O
CORPORATE	O	↗	O	↗↗	↗
BORDER	↗↗	O	↘↘	↗	O
INFRASTRUCTURE	↗	↗↗	O	↗	↗

Chart 2: EM Recent Performance breaking Trends