Article | 14 February 2025

Reciprocal tariffs are on, but VAT is the bigger elephant in the room

Three weeks into office, President Trump advanced his 'America First' trade agenda by investigating reciprocal tariffs and scrutinising the VAT system, viewing it as a tariff. While countries could lower tariffs to US levels to avoid new tariffs, abolishing the VAT system is unlikely

Trump signed the reciprocal tariffs executive order in the Oval Office on Thursday, 13 February

The next stage in trade escalation: reciprocal tariffs and targeting VAT

While new tariff announcements were eagerly awaited, Trump instead directed key government officials to investigate the complex task of applying reciprocal tariffs, where a country matches the tariffs imposed by another country. The responsible ministers have until 1 April to submit their reports, and within 180 days, a report must be delivered on the fiscal impacts of potential trade policy changes.

Given the time required for these investigations and implementations, the process is likely to start with trading partners with the highest trade deficits and higher tariffs than the US: China, the EU (with Germany and Ireland leading), Vietnam, Japan, South Korea, Taiwan, and India.

In theory, to avoid tariffs, these countries could lower or abolish their tariffs or manufacture their goods in the US. Yet, there is a difficulty in lowering tariffs for one country only, as this would trigger the Most Favoured Nation (MFN) principle, which requires a country to extend the same favourable trade terms to all its trading partners that it grants to any one of them, i.e., granting the lowest tariff to any other nation with MFN status. Likewise implementing reciprocal tariffs would also conflict with the MFN clause, because it involves treating different countries differently based on their specific trade policies, undermining one of the key pillars of the World Trade Organisation (WTO).

But there is an even more significant caveat in this announcement: the investigation into the value-added tax (VAT) system, a tax on final consumption, which the US administration views as similar to a tariff. Countries could, in principle, lower their tariffs to US levels. However, abolishing the VAT system is extremely unlikely. In the EU, VAT revenues account for 7.5% of GDP and 18.6% of total tax revenues (as of 2022). The EU-27 average standard VAT rate was 21.5% in 2023, with Luxembourg at 16% and Hungary at 27%. Globally, 175 countries have a VAT system, with the US being one of the few exceptions, using a sales tax system by state varying from 0% to 11.5%, instead. Since VAT is typically applied as a destination-based tax, meaning it is charged based on where the goods or services are consumed rather than where they are produced, it aligns with WTO principles.

Avoiding tariffs, therefore, seems to be an impossible task, especially since the memo is not limited to tariffs, nor VAT, but extends the investigation into non-tariff barriers such as digital trade barriers, exchange rates, and other unfair market access limitations.

Who will get a deal and who will not? India and Japan lined up for a deal, while the EU and China might not get as lucky

Nevertheless, the window for deals is still open. And so far, Trump's tariffs have been used to bring countries to the table for Trump's domestic agenda. Remember that no new tariffs have entered into force except for additional 10% tariffs on Chinese goods. Steel and aluminium tariffs will only enter into force on 12 March, while tariffs on Mexican and Canadian goods have been delayed until 4 March and might never see the light of day given the interconnectedness between those three economies.

Since President Trump sees himself as a dealmaker, we still expect the US administration to use targeted tariffs to gain concessions, at least for the time being. India, Japan, and Australia have already positioned themselves for potential trade deals.

During a summit between the US and Japan in the first week of February, Japanese Prime Minister Ishiba announced plans to raise investment in the US by some $200 billion and to buy more LNG from the US. India's Prime Minister Modi already slashed tariffs on an array of goods, such as heavyweight motorcycles from 50% to 30% and smaller bikes from 50% to 40%, and scrapped tariffs on satellite ground installations altogether. Also, the Indian government promised to take back undocumented Indian immigrants and pledged to buy more US oil.

US tariff plans highly likely to spark legal and retaliatory backlash

But others might not get as lucky. We see Europe and China in the spotlight here, which have long been a thorn in Trump's side. While the European Union still prefers negotiations, it has positioned itself strongly by announcing plans to fight back against unfair trade practices. In fact, the US also applies higher tariffs to certain product categories, such as clothing (12% in the EU and up to 32% in the US) and light vehicle trucks (10% in the EU and 25% in the US). While a White House official said Trump would gladly lower tariffs if other nations lowered theirs, it highlights the complexity and the challenges in achieving mutually beneficial agreements.

And, if history is anything to go by, EU policymakers will not be the only ones opting for retaliation in the event of failed negotiations. Similarly, China has taken a firm stance, implementing retaliatory measures to protect its interests against the 10% tariff hike from the US, although its combination of measures shows China is taking care not to flip the proverbial table but also to show it has cards to hit back at real US economic interests if talks sour.

From “The Art of the Deal” to “America First”- unilateral tariffs might still be on after April

The 1 April and 30 April deadlines will now be watched even more closely. Even before his reciprocal tariff memo, President Trump had ordered a comprehensive investigation into America's trade policy, looking into unfair and unbalanced trade, the trade policy with China, and additional economic security measures as well as foreign subsidies on US federal procurement.

As mentioned earlier, no new tariffs have entered into force except for additional 10% tariffs on Chinese goods, leaving room for negotiation. But while initial deals might be made, the goal of increasing tariff revenues for domestic tax cuts could lead to unilateral tariffs. And the complexity of the customs project will make it easy for the US to take targeted country-by-country measures as of April. This means a bumpy ride ahead. President Trump has set the stage for further trade escalations, and with retaliation likely, things could get nasty pretty soon.

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