

The Price of Policy: Taxes, Tariffs, and Capital Flows

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>> The first recorded tax was probably in Egypt around 3,000 B.C.E. Long before currency was invented. Loads of different taxes have been created since then, many of which failed from unintended consequences. In 1698, Russia enacted a "beard tax", trying to modernise society towards European style grooming, except that was in direct opposition to the Russian Orthodox Church. It lasted nearly 80 years before it was overturned. Around the same time, a tax on windows was levied in England. It was thought to be a progressive tax, as only the rich could afford large homes with many windows. Instead, the tax had a tragic impact, reducing ventilation and worsening epidemics. It was repealed more than 100 years after it was widely known to be a dismal failure. In Germany, bribes were tax deductible for companies until 1999, so long as neither the briber nor the bribee were involved in criminal proceedings. Nearly 10 years later, the multinational firm Siemens became the centre of a global corruption scandal, which cost the firm \$1.6 billion in fines and penalties. It had been running an annual bribery budget of around \$40 million.

Most tax policies don't have such dubious distinctions, but that doesn't take away from the difficulty, and the importance, of crafting good tax policy. It's essential for a healthy economy. Taxes and government spending impact the financial markets directly and indirectly. What's blocking greater efficiency in corporate tax policies? How do tariffs, which are effectively a kind of tax, add to the mix? And how does deficit spending affect the cost of capital and U.S. dollar strength?

To understand today's investment landscape, it's important to know how we got here. This is **The Outthinking Investor**, a podcast from PGIM that examines the past, the present-day opportunities, and the future possibilities across global capital markets. Three experts will discuss how taxes and government spending affect the financial markets. Douglas Holtz-Eakin is the president of the American Action Forum and former head of the Congressional Budget Office. Kimberly Clausing is the Eric M. Zolt Chair in Tax Law and Policy at the UCLA School of Law and formerly the lead economist in the U.S. Treasury Department's Office of Tax Policy. Jeffrey Young is head of investment strategy for PGIM's quant team.

For decades, the U.S. federal government has been collecting less tax revenue than what it spends. These large deficits have compounded over time in a debt trajectory that's becoming unsustainable. The increasing cost of servicing the federal debt is now a big component of budgeting, but voters are typically more interested in lower tax rates, so little has been done to reign in budget deficits and pay down the debt. According to Douglas Holtz-Eakin, the problem starts at the top.

I think it's fair to say that in the 21st Century, the American people have not been told that the deficits are a problem or that debt is a problem. I worked for George W. Bush. I was at the White House in 2001 and 2002 and his budget sent the message that the most important thing was winning the war against global terrorism and the Obama administration did the Affordable Care Act. They expanded entitlements. Their budget sent the message that it's all fine as long as the rich pay their fair share. In his first time in office, President Trump said nothing about deficits and debts. He never once even uttered the words in a State of the Union. Then the Biden administration came in with big plans for Build Back Better and huge new entitlements and lots of spending, so over that period, the average American, who doesn't pay attention to this stuff, hasn't had the most important public educator, the most important official in the land say to them, "Listen, the deficit is a problem. We need to do something about it and that's now going to change." And so they will hear that and start to support people who take care of the problems that people have identified. We've been downgraded three times now as a nation. S&P Global did it in 2011. They said, "Oh, you've got the T Party and these terrible politics. We're worried about your ability to manage your finances." Fitch said essentially the same thing. They said, "Look, the political ability to manage finances is at risk. We're going to downgrade you." Moody's downgraded the United States because it has too much debt and too much interest. It was

no longer about the process. It's now about the problem and I think that should be a wake-up call to people. I think the evidence is we're paying a price for it every day. The rating agencies are now putting us on notice that the risks are even bigger going forward.

Higher bond risks mean higher costs of capital. Fiscal policy impacts the economy and the financial markets directly and indirectly and in different ways over the near term and over the longer term. Jeffrey Young sees two key risks for rising debt.

When you combine a large deficit with measures that make foreign investors on the margin a little bit less willing to finance those deficits, that's where you can have an issue in the market. It can raise the risk premium in long-term U.S. government debt. In other words, do you really want to hold a 30-year treasury at the same yield that you held it before liberation day? Or would you want a little bit of extra yield in order to compensate for those risks? That's one potential impact. The second would be the impact on the dollar overall. Possibly, these tariffs are a signal that the dollar's long-term value would decline. So I think that we have to look at a lot of these in tandem together and the ones that I think are probably the most important would be higher risk premium on long-term U.S. government debt and a bit weaker dollar.

Should the interconnected nature of the modern global economy influence the way investors compare opportunities in the financial markets across different countries and regions? Growth and inflation are still the fundamental drivers at the macroeconomic level and capital flows are driven by the combination of monetary, fiscal, and structural policies.

So right now, I would say that these favour the U.S. over most other countries, and that's a bit of a change from where we have been for most of 2025. The rest of the world had a pretty good run, especially in stocks. The Euro area in particular outperformed the U.S. by a mile and I think a lot of that had kind of two roots. The first was the uncertainty about the tariffs and a lot of complaining about what Trump is doing that did favour a lot of countries, but the other is a bit shorter run and I think it's pretty much run its course. I think that a lot of investors simply don't trust the Euro area's institutional framework. They feel that it's very unwieldy, that the Euro area is a low growth area and people get super, super pessimistic and that means they get very underweight Euro area assets. In those circumstances, it doesn't take that much good news in order to force everybody to the other side of the boat and into Euro area assets. I think that that's a lot of what happened in the first half of 2025, but it has largely run its course. Once you're back kind of in the middle, then the bar toward further improvement in the relative performance in say equities is much higher. You really have to outrun the U.S. and everybody else in that growth and inflation equation and that I have some doubts about.

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Growth is often cited as the key differentiator. A country can offset its debt-to-GDP ratio if it's growing fast enough. But that argument also assumes fiscal and monetary policy working in tandem, which is how the system was built to work. Sometimes, however, politics get in the way.

It was certainly in the late 1990s. In that era, we had a real assignment of roles. Monetary policy was going to deal with business cycles and short-term fluctuations. Fiscal policy would be set to do two things: support long-term growth by not running large deficits, and providing adequate social safety nets. We had the young income tax credit. We had things that were cemented into place. That was broadly supported and very successful and a return to that kind of policy making would be a good idea. From the perspective of both debt and tax policy, if you look at the 20th Century, so 1960 to 2000, we saw GDP per capita, roughly speaking, income per person, measure the standard of living. It grew an average annual rate of 2.3%, which means the standard of living doubles every 29 years. That's one working career. In the 21st Century, GDP per capita has risen at an average annual rate of 1.3%, which means the standard of living is doubling every 56 years and there is a palpable sense of reduced opportunity for today's young.

We also need to have tax policies that support more rapid economic growth and I thought the 2017 Tax Act was a good step in that direction, a real tax reform for the first time 1986. I thought the most recent tax bill was mediocre at best. It took business as usual and extended it. It added permanent expensing of some investments and I think that's the best thing in there and then it had a whole bunch of political handouts, which are anti-tax reform. We need to get back to the real path of tax reform.

At the same time, income inequality is on the rise and tax policies are often seen as a solution, especially corporate tax policies. But it's difficult to develop efficient and effective corporate tax policies in part because of the ability to move capital to tax-favored places. Kimberly Clausing explains.

So this problem is sometimes referred to as the corporate tax base erosion and profit shifting problem and the acronym they used at the OECD was BEPS for base erosion and profit shifting. Once the policymakers developed some will to kind of tackle the problem, after a period of time, they were able to come to this international tax agreement that happened in 2021 and what that agreement did was say, OK, we're going to recognise as a group of countries, and it was a group of countries that was about 95% of world GDP, that multinational income should be taxed at some minimum rate and the rate they picked was 15%, but the thought was just raise that bottom and the race to the bottom zero to 15 to reduce that big pressure on the corporate tax system for the tax base to erode due to this mobility and one of the key questions going forward is whether that argument can hold up. That agreement now will affect the multinational income of the vast majority of companies operating throughout the world. There have been some hiccups recently because the United States government has actually objected to the implementation of aspects of this agreement, so it is trying to negotiate a side-by-side treatment where U.S. firms would be subject to different treatment than the rest of the world. It remains to be seen how that's going to turn out. In principle, the G7, which is six countries beyond the U.S., have agreed to this side by side treatment, but we might expect that to lessen the enthusiasm for other countries working with this agreement.

There's also concern that corporate taxes should concern that corporate taxes should be kept low to maintain the incentive for corporate investment, but the relationship between taxes and corporate investment is much more nuanced.

It's not a tax on investment. It's a tax on profits of firms and if you're not profitable, you don't pay the corporate tax. The reason that's an important distinction is that we don't necessarily want to discourage investment plans and equipment and the like. In fact, our tax code on that is subsidising that because we allow expensing, but we also allow debt deductibility and those two together mean the tax code is actually subsidising plans and equipment. So what are we taxing when we tax corporate **profits**? We're taxing profit above what you need to justify buying the machine or building the building, and that tax can actually be relatively efficient. It's a way of the government sort of sharing in these extra profits above the normal rate of return on investment and I think there's a strong argument that we could support a higher corporate tax if we were willing to also handle this international tax mobility issue. But it's a progressive source of revenue and it's a source of revenue that's shrinking in the United States because we keep giving big tax cuts to corporations, so I think that's a place we can turn to in the future when we need more tax revenue.

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Tariffs impact the economy like a kind of tax. They also add uncertainty, which is played out in the stock and bond markets this year. But we've also seen significant flows into U.S. foreign direct investment holdings and equities.

I think it's an interesting development and it does tell us that we have to be careful about believing everything that we read, because certainly the media has been overwhelmingly negative about the tariffs, most economists have been as well, but on the other hand, we have seen robust capital inflows into U.S. private assets, foreign direct investment and equities, and if we look at the investment plans that have been announced as part of these bilateral deals with

many countries or transactions or announcements that happened even before the tariffs were announced, you're seeing a lot of investment coming into the U.S. and again I think that does tell us that the underlying fundamentals of the U.S. economy are pretty robust and they can survive an awful lot of what I would call suboptimal monetary and fiscal policy. There are a lot of reasons for that, but one I would point to would be indeed the adoption of technology throughout the entire business sector.

Data may be the differentiator today in how companies adapt to shifting monetary and fiscal policy. Large companies have invested heavily in how they collect and analyse data to support their core business.

Every company these days has data scientists. They have people who can analyse their own data, that purchase data from vendors. There's an incredible ecosystem here and what that does is allows them to finetune their businesses much more carefully than in the past. Let's apply that to tariffs. If you look at what products prices have gone up and which ones haven't, companies can use this information to determine where should we pass it through to the consumer. Well, those are going to be products where the consumer is not so price sensitive. Maybe they are products that are bought more by higher-income consumers that can bear the hit a little bit better, but we want to preserve lower prices on products that are bought more by lower-or-middle-income consumers and where they don't have as much ability to substitute away. And the ability to make that judgement on a product-by-product and area-by-area basis is magnified exponentially by the amount of data that companies have now. I think in the old days, if this had happened, there would have been a blanket across the board increase and it would've been very difficult for companies to finetune and that would've had a more sledgehammer effect on the economy than what we've seen so far. One small example of how the use of technology has made the U.S. economy just much more efficient. Efficiency is sort of like a magnet that draws capital into an economy. Any economy that's very efficient is going to have internationally mobile capital allocate to it.

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Another magnet for capital is innovation. Tax rates are often blamed for hampering innovation, but that's not always the case. Kimberly Clausing points out three factors that have greater influence on innovation starting with research.

That includes not just our universities, but basic government funding for things like the National Institute of Health and the National Science Foundation. It includes attracting bodies of researchers from abroad who come to our country to study. That's been a huge source of innovation. A second issue is I think institutional strength is really important. I think you need to be able to rely on property rights and a central bank that's got inflation under control and rule of law and making sure that those basics are taken count of. It's sometimes easy to take for granted in the United States, but I think as we've seen a little bit of institutional decay this year in terms of respect for rule of law and corruption standards and the like, I think that that risks killing the goose that lays the golden egg if we let that go too far.

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A third environment I would point to is the international trade and investment environment. I think the United States has benefited a great deal from global trade and investment. It's made our companies more productive and successful and it's also provided a wealth of advantages to both our workers and our consumers. I think this trade war that's going on right now is going to wreck a lot of damage on the U.S. economy, not just for consumers because these are big cost increases to have all the taxes on imports go up, but also for workers. I think the majority of our imports are intermediate goods, so if you manage and you're trying to manufacture in the United States and you're paying a lot more for intermediate goods than firms are in other countries, that's going to hurt your ability to compete with those firms in those other countries. Even if they're not retaliating against your tariffs or restricting their demand for your products for other reasons, which they might be, you're still going to have these higher costs.

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An important question here is how long we can expect costs to remain elevated? That's especially difficult to forecast when the negotiation process is driven by presidential handshakes rather than following the traditional legislative process within Congress and assisted by the congressional budget office known as the CBO.

If the Congress had a tariff policy, it would have a rate, it would have a base, it would have an effective date of imposition, maybe a terminal date when it went out, all of the uncertainties that we've talked so much about would be gone. Right? We might have the same tariffs, but we would have much better economic policy, in my view, surrounding them. CBO would also advise the Congress on how much it would cost to implement those tariffs. Tariffs are hard to administer and they're expensive and the Department of Commerce is going to need a lot of money and Customs and Borders folks are going to need a lot of money and that would be included in an estimate and often you'll see CBO say, "Well, we're not going to get much in the first couple of years because of the startup costs." We'd know a lot more about that, so I think we'd have a not just better and more certain policy, we'd get an implementation that was quicker and more effective.

Developing trade and tax policies has always been difficult, as Douglas Holtz-Eakin first hand, especially during his time as head of the CBO.

So I'm in the White House in 2001 and there's a decision meeting about cutting the double taxation of dividends and Mr. Bush says, "It's a bad idea to double tax dividends. Why are we only cutting that double tax in half? Let's get rid of it entirely." So the idea was to eliminate the double taxation of dividend income and if we've got zero taxes on the return to capital, then I would argue we want to get rid of the deductibility of interest because I'm all in favour of zero tax return to capital, but the subsidy on top of them leads to a negative tax rate. And so I said, "Gee, we should get rid of the deductibility of interest." Which would've offended essentially every one of his political supporters, and I was told by Andrew Card, the Chief of Staff, "You will never utter those words again." And that was that. But that's the right thing to do. That was an absolute collision of what is good tax policy. You don't want to have negative effects of tax rates anywhere. That's just subsidies with the politics and the politics were we're not touching that, so they wanted the good news, but they didn't want any of the bag news. Not the first time I've seen that.

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How a country chooses to structure its tax policy is about more than regulatory details and financial technicalities. It's truly a reflection of the country's values and priorities.

There's an old quote that says something to the effect of "show me your budget and I'll show you your values". But there's also a quote that I like that the former IRS commissioner made where he said that the tax code really has every feature of life in it: goodness and charity and greed and so forth. I don't think the tax code alone is what reflects the values. I think we have to sort of take it together with how the revenue is used. For instance, you could imagine a tax reform that implemented a value added tax, which is a relatively regressive tax, but then use the money to fund health insurance for poor people. That combination might still make the poor better off in the United States than they would've been absent the small value added tax and the health insurance benefits, so you kind of really have to think of these as a package. But I think our current tax system is in many ways failing us. It's not raising enough revenue and it's not reflecting our values really well. It's kind of a shambolic stitched together of a thousand different impulses that is really overdue for reform.

The tax system has a long way to go to become efficient and productive. Even if voters aren't able to influence change, the market may have a say here. Investors should keep an eye on government debt, the U.S. dollar, and asset flows generally. Thanks to Douglas Holtz-Eakin, Kimberly Clausing, and Jeffrey Young for their insights on how taxes and government spending impact the financial markets. The Outthinking Investor is a podcast from PGIM.

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