HOW US RETAILERS CAN MASTER THE ART OF TARIFF MANAGEMENT

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Ever since the trade wars began between the US and its major trading partners in early 2018, US retailers have been left hanging. Successive rounds of tariffs on products imported from China and other sources, start-and-stop negotiations, and tentative partial "deals" followed by renewed tensions have made it difficult for retailers to manage supply chains and project their costs.

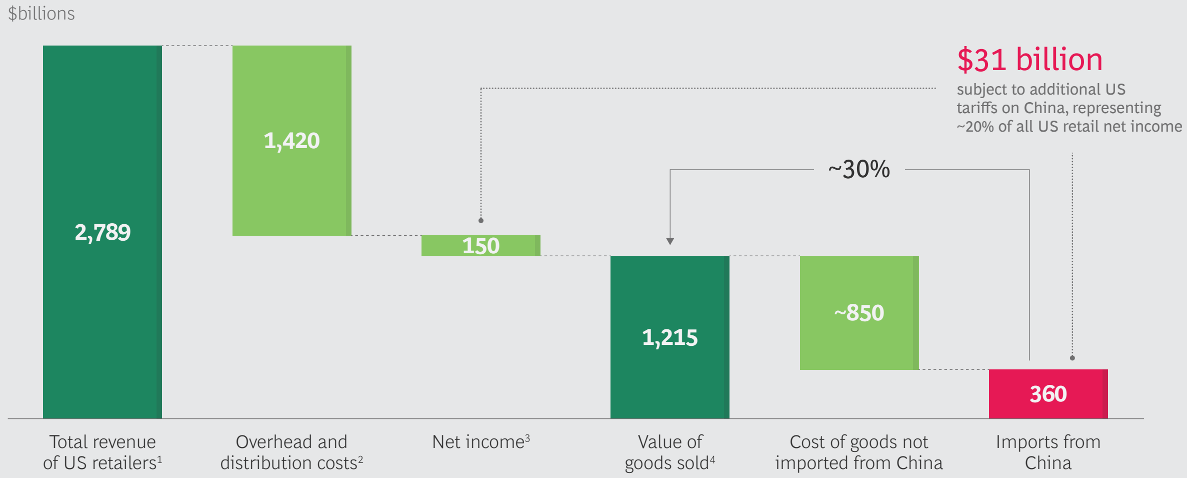
The economic and trade agreement signed by the US and China in mid-January of this year provided some clarity. The US agreed to call off some threatened tariff increases on such key Chinese imports as cellphones, toys, and tools. But it left in place tariffs imposed in 2018 and 2019 on $370 billion worth of Chinese goods that, by our analysis, translate into as much as $31 billion in added tariff costs. That is roughly equivalent to 20% of the $150 billion in net income generated by the entire US retail sector in 2018. (See Exhibit 1.)

What's more, the uncertainty for retailers is by no means over. Additional 15% tariffs on Chinese goods that originally were to go into effect on December 15, 2019, have merely been "suspended until further notice," according to the Office of the US Trade Representative. That means they could be reimplemented at any time—if the US were to decide that China wasn't living up to its promise to increase imports of US agricultural goods, for instance. If those additional tariffs were to go into effect, the negative impact on US retailers would rise to $63 billion—equivalent to 40% of retailers' 2018 net income.

Many retailers are now at a strategic crossroads. They can hold tight and gamble that trade negotiations will eventually produce some deal that will prompt the US to roll back the tariff hikes already in place—or at least commit to no further hikes. Or they can take concerted action now to mitigate the damage.

The latter approach is far more prudent. In our experience, retailers that have mobilized to mitigate tariff risk in their supply chains over the past nine to twelve months

Exhibit 1 | Tariff Hikes on Chinese Imports Will Cost US Retailers $31 billion



Sources: US Bureau of Economic Affairs; Capital IQ; BCG analysis.
1 Based on 2018 personal consumption data, excluding food and groceries.
2 Difference between retail profits and reported cost of goods sold.
3 Assumes an average net income margin of 5.4% for the 20 largest US retailers in the four quarters ending in the second quarter of 2019.
4 Proxy for "'trade value" of goods" (i.e., declared cost upon importation into US); calculated using an industry average reported cost of goods sold ratio of 67%, of which ~65% is the true trade value of goods (i.e., less costs incurred once goods arrive in the US).

have been able to reduce the potential impact of increased US tariffs on Chinese products by 35% to 50%, or even more. One major retail chain has halved the potential multibillion-dollar financial hit from tariff hikes by renegotiating with suppliers, finding alternative sources of goods, modifying its product lines, and implementing very selective price increases.

For many products lines, however, this degree of engagement with the intricacies of supply chains will require resources, organizational capabilities, and a level of market intelligence and cross-functional collaboration that was generally not regarded as necessary in a world of free trade and reliably low tariffs. In the uncertain, high-tariff environment that is likely to be the new normal for the foreseeable future, the art of tariff management could spell the difference between red ink and sustained success—and be a key source of competitive advantage.

Why the Tariffs Will Continue to Sting

Since China's entry into the World Trade Organization in 2001, many American retailers have developed sourcing strategies that depend heavily on Chinese factories. Of the $1.2 trillion in US retailers' total cost of goods in 2018, products imported from China accounted for 30%. Moreover, around 20% of those goods were in retail sectors that we classify as "highly dependent" on China, meaning that China supplies more than 60% of products sold in the US. In key sectors such as consumer electronics, the supply base of components and materials is also highly concentrated in China.

The US–China economic and trade agreement made public in January 2020 is certainly ambitious. Over the next two years, China has agreed to purchase $200 billion more US goods and services than it did in 2017, before the current trade war began, and there are specific purchase targets for financial services and manufactured, agricultural, and energy products. China has also committed to take detailed actions to lower its trade barriers against financial services and agricultural goods, to safeguard US intellectual property rights, and to address US concerns over the valuation of its currency. In addition, China has agreed not to force US companies to transfer technology. New bilateral consultations and dispute resolution mechanisms are designed to make these provisions enforceable.

But for retailers, what matters is getting relief from the US tariff hikes. And in fact, despite the fanfare, the January 2020 agreement did not remove any US tariff from Chinese goods. (See the sidebar, "An Overview of the US Tariffs on China.") Tariffs assessed in July through September 2018 on $250 billion worth of Chinese goods remain in effect at 25%, except in cases where the Department of Commerce has granted a one-year exclusion. Additional duties announced in September 2019 on so-called List 4A goods—including many consumer items—were merely reduced from 15% to 7.5%.

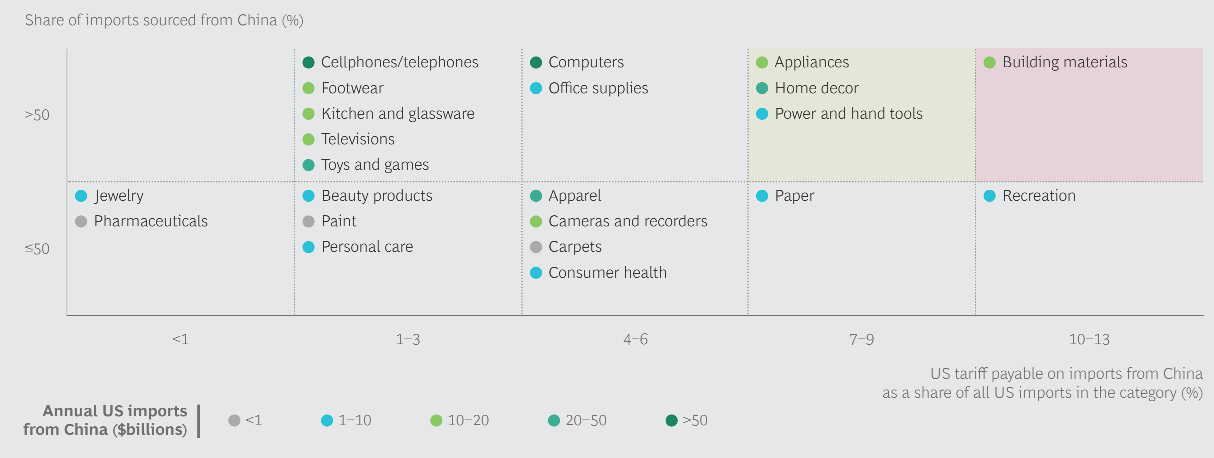
It remains unclear if and when these tariffs will be rolled back, since many issues in the bilateral relationship remain unresolved. These issues include US concerns over cybersecurity and China's industrial policy plans and subsidy programs. It is also unclear whether China can fulfill its new commitments, including the ambitious targets for purchasing more US financial services and manufactured, agricultural, and energy products.

The greatest impact will be on product categories in which China accounts for the largest percentage of imports and in which US tariffs on imports from China are high. Among the most highly affected categories will be building materials, 57% of which are imported from China; home décor products (53%); and recreational products such as bicycles and canoes (45%). (See Exhibit 2.) China also accounts for 40% to 60% of imported apparel, cameras, footwear, televisions, and personal care and consumer health products, but here the impact of US tariffs will be somewhat less owing to lower average tariff rates.

If the US were to reinstate the tariff increases that were originally to be implemented on December 15 of last year, however, a far larger swath of consumer products would be hit with sharp cost increases. These include computers and power tools (around 50% of each is imported from China), mobile handsets and kitchen products and glassware (around 60% each), and toys and games (80%).

By our analysis, the retailers most exposed to the impact of tariffs on these product categories would be mass-merchandise stores, dollar and discount stores, and retailers specializing in goods targeted with the highest tariffs. Retailers specializing in products that are primarily manufactured outside of China could be affected indirectly, owing to tariffs on key materials used in the products they sell. In fact, unless they can quickly find ways to reduce that tariff burden, some retailers could see a significant share of their profits wiped out.

Exhibit 2 | Home Décor and Building Materials Will Be Among the Hardest-Hit Retail Categories



Sources: Global Trade Atlas; BCG analysis.

AN OVERVIEW OF THE US TARIFFS ON CHINA

Since July 2018, the US has introduced multiple waves of tariffs on imports originating in China. The affected product categories are detailed in a series of "lists" numbered 1 through 4B. Taken together, they cover nearly the full value of US imports from China. Most of these tariffs are currently in force, while others could still be implemented this year. Importantly, the tariffs are applied as a "surtax" *on top of* any tariff that the US already imposes on Chinese goods under WTO rules.

The Trump administration's authority for imposing these tariffs is Section 301 of the Trade Act of 1974. The process began with a Section 301 investigation launched by the Office of the US Trade Representative (USTR) in August 2017 regarding "China's acts, policies, and practices related to technology transfer, IP, and innovation." Section 301 is normally used to address unfair trade practices in specific industries, such as digital services (on which France recently imposed a tax) and softwood lumber. In this case, however, the investigation swept up a vast array of Chinese industrial policies related to technology. The USTR concluded its investigation in March 2018 with various findings that contend that China's policies and practices are "unreasonable" and "burden US commerce." A series of US tariffs on imports from China followed, in parallel with efforts by the US and China to resolve their differences through start-and-stop negotiations.

At present, the status of the US Section 301 tariffs on China can be summarized as follows:

- **List 1 and List 2 Tariffs.** Imposed in July and August 2018, these tariffs together affect $50 billion in US imports from China and focus primarily on nonretail categories. In the wake of the January 2020 economic and trade agreement between the US and China, a tariff of 25% remains in effect on all List 1 and List 2 products.

- **List 3 Tariffs.** Imposed in September 2018, these tariffs affect a massive $200 billion in US imports from China, including many key retail categories. Initially set at 10%, the rate was raised to 25% in May 2019. Following the January 2020 agreement, the 25% tariff remains in effect on all List 3 products.

- **List 4a Tariffs.** Imposed in September 2019, these tariffs affect a further $120 billion in US imports from China and are heavily weighted toward retail products, particularly apparel and footwear. The tariffs were initially set at 15% on all List 4a products, but the US agreed to change that rate to 7.5% as of the end of February 2020.

- **List 4b Tariffs.** Originally scheduled to go into effect on December 15, 2019, these tariffs would affect a further $160 billion in US imports from China, in particular, consumer electronics such as cell phones and laptops. The rate was set at 15%, but in the wake of the January agreement, the US announced that it was suspending List 4B tariffs "until further notice," in line with progress made in bilateral trade talks. However, they could still be imposed at a future date.

Four Ways Retailers Can Mitigate the Damage

There are a number of actions retailers can take to limit the additional costs of higher tariffs. There are even opportunities for using the changed rules to gain a competitive advantage. Specifically, four key levers can help retailers minimize the impact of potential tariffs: they can negotiate with suppliers, realign pricing and product assortments, develop dynamic supply chains, and implement smart trade policy compliance. (See Exhibit 3.)

NEGOTIATE WITH SUPPLIERS

Don't take all higher costs as a given. Many Chinese manufacturers can afford to absorb at least part of the higher US tariffs because other factors have been making them more cost competitive. The value of the renminbi has dropped by around 10% against the US dollar since January 2018. Prices for key materials such as steel, aluminum, and plastic have declined by anywhere from 5% to 40% since the onset of the US trade war. In addition, the Chinese government lowered the value-added taxes for exporters from 16% to 13% in 2019.

As a result of these developments, we have noted that some Chinese manufacturers, when asked, are willing to adjust their prices to account for a portion of the tariffs. US buyers should actively leverage the recent reductions in suppliers' costs to negotiate post-tariff prices that are fair to both parties. Any proposed price increases that US distributors attribute to tariffs should exclude the importer's shipping costs and overhead, for example.

To maximize value in negotiations, retailers will need to clearly understand their leverage and positioning with Chinese suppliers. They should assess how reliant a supplier is on the retailer's business, for example, and whether it could easily find other customers outside the US. On the other hand, the retailer should also understand how unique the supplier's products and capabilities are in order to determine how critical the supplier is to the retailer's portfolio. A deeper appreciation of these relationship dynamics can help determine when negotiations should take a more transactional tone or a more partnership tone.

REALIGN PRICING AND PRODUCT ASSORTMENT

Once prices with suppliers have been set, retailers should have a clear picture of their US tariff burden. They then need to figure out how to manage the added costs without destroying profit margins or damaging their brand and market position with onerous price hikes. Realigning prices and product assortment are two levers for minimizing the financial impact.

Decisions over whether and how to pass along the cost of tariff hikes to customers

EXHIBIT 3 | Four Ways to Ease the Impact of a Tariff

Negotiate with suppliers Many Chinese manufacturers can afford to absorb at least part of the US tariff hikes	• Currency devaluation • Falling prices for materials • Lower Chinese VAT taxes
Realign pricing and product assortment Some cost increases can be passed on to customers	• Higher price on tariffed good • Higher prices across entire category • Removal of product from assortment
Redesign supply chains Shift production to nations other than China	• Shift manufacturing out of China • Find suppliers capable of shifting production outside of China
Use smart trade policy compliance Retailers in some cases can legally avert some tariff hikes	• First Sale Rule • Tariff exclusions • Reclassification of imported products

Source: BCG analysis.

should depend on the specific dynamics for each affected product category. These include the price elasticity of demand (the degree to which price changes influence consumption), the retailer's prices versus those of competitors in the current tariff environment, whether the product is a "key value item" that drives overall price perception, and the importance of the category to the retailer's brand.

There are several ways to pass on costs. In some cases, retailers can simply raise the price of a Chinese-made product to reflect the tariff increase. They can also cushion the impact by "pooling" the price increase—that is, they can spread it across an entire category—such as by slightly raising the prices of all bicycles, say, even those not made in China. Another option is to spread out the impact by slightly raising prices on all of the retailer's products.

The best approach, we believe, is to adopt pricing strategies according to the specific product category. Although Walmart has publicly stated in a call with financial analysts that it prefers to mitigate the tariff impact through negotiations with suppliers, it will raise prices on a category-by-category basis. Walmart has revised its internal IT systems to allow vendors that are the importers of record to submit tariff-related price changes, which, in turn, allows Walmart to make repricing decisions more quickly. The retailer has suggested that its inclination is to minimize the impact on individual SKUs and instead to pool any price increases—something that its wide product assortment facilitates.

In many cases, retailers will need to reconsider their assortment structures at a category level in light of the changes in product costs—particularly, for many categories, changes in their opening-price-point items. Under the new tariff regime, imported Chinese rugs, say, that used to be at the bottom of a retailer's product line because they were 20% cheaper than those from another country may now be only marginally less expensive than some premium rugs. Retailers will need to consider whether these products still have a role in the assortment, given demand elasticity and the share of total sales that they account for.

DEVELOP DYNAMIC SUPPLY CHAINS

Over the longer term, retailers can cut their exposure to Chinese tariffs by sourcing from other countries. Vertically integrated retailers that control their own production can consider redesigning their supply chains. Others can persuade suppliers to shift production to other nations or choose suppliers with a diversified manufacturing footprint to provide flexibility. One major footwear manufacturer that relied primarily on China a few years ago now produces only around 10% of its footwear there; most of the work has shifted to Vietnam.

Even if the US and China strike a trade deal that makes the new tariffs disappear, US retailers that depend heavily on Chinese-made goods should still seek to diversify their sourcing. Despite recent trends that have lowered some costs in China, the longer-term trend is the erosion of China's once overwhelming manufacturing cost advantage. Average direct manufacturing costs in China are now only 5% lower than in the US and just 3% lower in the Yangtze River Delta, according to BCG's Global Manufacturing Cost-Competitiveness Index. In 2004, direct costs in the Yangtze River Delta were 13% lower. The index assesses changes in labor costs adjusted for productivity and for energy and currency exchange rates. Direct manufacturing costs in Indonesia, Mexico, and Thailand are substantially lower than those in China.

Some economies are in a good position to absorb manufacturing in categories now dominated by China. Mexico is already a major exporter of goods such as computers, home appliances, and home furnishings, for example, and likely has the production capacity to increase shipments to the US. South Korea, Taiwan, Thailand, and Malaysia are also important US suppliers of electronic products, while Japan is a significant source of building materials and kitchen and glassware.

In some categories, however, China is virtually irreplaceable. (See Exhibit 4.) China accounts for 84% of all US imports of toys and games, for example, while production scale in alternative locations is minuscule. China also enjoys an overwhelming advantage in many sectors in terms of the depth of its supply base of parts and materials, its manufacturing expertise, and its logistics networks. There is also the question of how much of China's production other economies can actually absorb. Vietnam has been a big winner in the US–China trade war, with exports to the US surging by 35% during the first nine months of 2019, compared with the same period in 2018. But Vietnam is struggling to cope: there are growing backlogs of shipments at key ports, and industrial real estate prices shot up over that period.

IMPLEMENT SMART TRADE POLICY COMPLIANCE

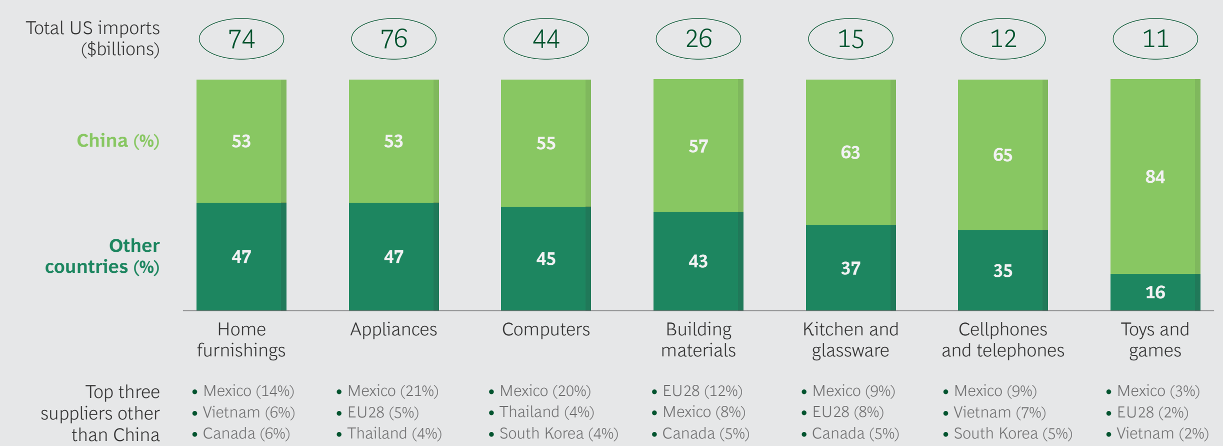
Among the legal measures that retailers can take to reduce or avert their tariff burden are taking advantage of the First Sale Rule, applying for product exclusions, and getting a product reclassified.

Under US law, the First Sale Rule provides that when goods are sold and resold several times before they are imported into the US, the importer can use the price paid in the "first or earlier sale"—rather than the price it ultimately paid—as the basis for the customs value of the goods. Taking advantage of this rule can lower the duties paid on goods imported from China. Say a trading company based in Hong Kong purchases reading lamps directly from a Chinese factory and then resells them to a US lighting store. That store would become the importer of record. But instead of the duty being assessed on the basis of the price that the store paid the trading company, which could include the latter's margin, the duty would be assessed on the lower price that the trading company paid to the Chinese factory.

Successfully using the First Sale Rule requires careful documentation. The importer must show that the first or earlier sale was a sale for export, and it must provide details of ex-factory prices and costs incurred further down the supply chain. Some retailers have successfully used outside audit firms to manage this process or to wall off sensitive data between departments to ensure that the information will not be used as leverage in future negotiations with the vendor.

When tariffs are low, the savings generated by the First Sale Rule can be negligible compared with the added costs of preparing the necessary documentation. A study by the US International Trade Commission, based on shipments from September 2008 to August 2009, found that only 8.5% of all

EXHIBIT 4 | In Many Product Categories, Few Countries Other Than China Can Supply the US at Scale



Sources: Global Trade Atlas; BCG analysis.
Note: Figures based on trade data for the 12 months ending June 2019.

importing entities in the US took advantage of the rule. However, the additional duties now imposed on Chinese goods change that calculus: reducing the base cost of products under a 25% tariff could generate substantial savings for many retailers.

Retailers can also request "product exclusions"—the removal of tariffs for particular products if they meet certain criteria. According to US government guidelines, importers can obtain exclusions if they can prove that a particular product is only available from China, for example, or that the duties will cause "severe economic harm" to themselves or to US interests.[1]

Yet another potential way to reduce the tariff increase is to explore whether an imported good can be reclassified under the Harmonized Tariff Schedule coding system used in international trade. This could involve a minor modification of the existing product, leading to a substantially lower tariff under a different tariff code. Products may also obtain a special tariff classification if they were assembled in China using parts that originated in the US.

How to Develop a Holistic Approach to Tariff Mitigation

Acknowledging that tariffs are an issue that requires action is a first step toward mitigation. We have seen retailers take a variety of responses. The strongest all have the following four steps in common:

- **Make it somebody's problem.** Assign a clear owner of the initiative to lead the charge. This can be a single individual or a cross-functional group that includes purchasing, supply chain, and finance personnel, for example. But it is critical to have a focal point of responsibility for developing the response plan. When responsibility is instead spread across the organization, people may feel that they are insufficiently informed or lacking in the decision rights needed to adequately address the issue.

- **Determine your exposure.** Identify the potential exposure of each product in the assortment. Determine any issues with assortment structure and mix based on tariff exposure. Identify product categories and suppliers with the greatest potential exposure to tariff impact.

- **Develop a category-level plan.** For categories and suppliers with the greatest exposure to tariff increases, develop a detailed mitigation plan. An effective plan would likely use a combination of the levers discussed above. Determine where supplier negotiations are needed, where there is potential to diversify sourcing by country, and where pricing and product shifts may be required.

- **Stay nimble.** We are in a fluid environment in which predictions of tariff rates seem to change weekly. Ensure that the mitigation team is accountable, is staying on top of the shifting environment, and is updating category-level plans as the trade situation evolves.

A major chain that is heavily reliant on Chinese-made goods provides a real-life example of these four steps in action. The retailer began by assessing the impact on each product it stocked. It then mobilized a cross-functional SWAT team that was able to quickly make decisions and systematically renegotiate with suppliers to get them to share the tariff cost burden, persuade others to shift production outside of China, and optimize prices and assortment across each product line. Through this concerted effort, the retailer reduced its financial exposure to the tariff hikes by half.

Retailers can no longer operate under the assumption that they will continue to live in a static low-tariff, free-trade world. Taking a holistic approach to tariff mitigation will require different ways of sourcing and working with suppliers. But if navigated correctly, this dynamic situation can create opportunities to improve a retailer's cost position and strengthen its competitive advantage.

NOTE:

1. The deadline for requesting exclusions for List 1, 2, and 3 products has long passed, while requests for List 4A product exclusions were only eligible thru January 31, 2020. Retailers should bear in mind that an exclusion benefits all importers of the product. The US Trade Representative has already published a series of exclusion lists, with each exclusion valid for one year.

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Acknowledgments

The authors thank their BCG colleagues Iacob Koch-Weser, Ahsan Irfan, Raminder Gill, and Andrew Chua for contributions to this article.