RIETI Special Seminar

U.S. Tax Reform: Prospects and Roadblocks

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US Tax Reform: Prospects and Roadblocks

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Outline

- **US state of play**
- **Evaluation of alternatives that have been considered, including destination-based cash-flow tax (DBCFT)**
- **Outlook for reform**

State of Play

- **Republican-controlled government**
- **In US system, “President proposes and Congress disposes”**
  - But Congress isn’t simply reactive – initiates proposals of its own
  - Within Congress, tax legislation starts in the House of Representatives (Ways & Means Committee)

State of Play

- **Initial Congressional Agenda:**
  - Health care, then tax reform, both using budget reconciliation process
  - Allows passage by simple Senate majority (52-48)
- **Health care:**
  - Delays, failure to act
- **Tax Reform:**
  - House "Blueprint" plan

State of Play

- **House Blueprint (June 2016)**
  - Individual tax cuts (top rate of 33% vs. 39.6%)
  - Business tax shifts from current worldwide income tax at 35% (corp.) or 39.6% (non-corp.) to a Destination-Based Cash-Flow Tax (DBCFT) at 20% (corp.) or 25% (non-corp.)

State of Play

- **“New” Trump plan (≈ old Trump plan)**
  - One page document released in April
  - Top individual rate = 35% (from 39.6%)
  - Business tax rate = 15% (from 35%/39.6%)
  - Territorial tax system (instead of worldwide)
  - Eliminate estate tax
  - Eliminate many personal deductions

State of Play

- **"New" Trump plan (≈ old Trump plan)**
- **Previous estimate (Tax Policy Center):**
  - Revenue loss over 10 years = $6.2 trillion – 2.6% of GDP over the period, or about 14% of federal tax revenues
- **Plan did not include DBCFT**
  - DBCFT had border adjustment, key component and a large source of tax revenue (TPC: $1.2 trillion/10yrs.)

DBCFT – What is It?

Starting from current US tax system…

- **Income tax for corporate and non-corporate businesses**
- **Worldwide approach to international activities**
  - Tax US-source income of all businesses
  - Tax foreign-source income of US resident businesses, with a foreign tax credit

DBCFT – What is It?

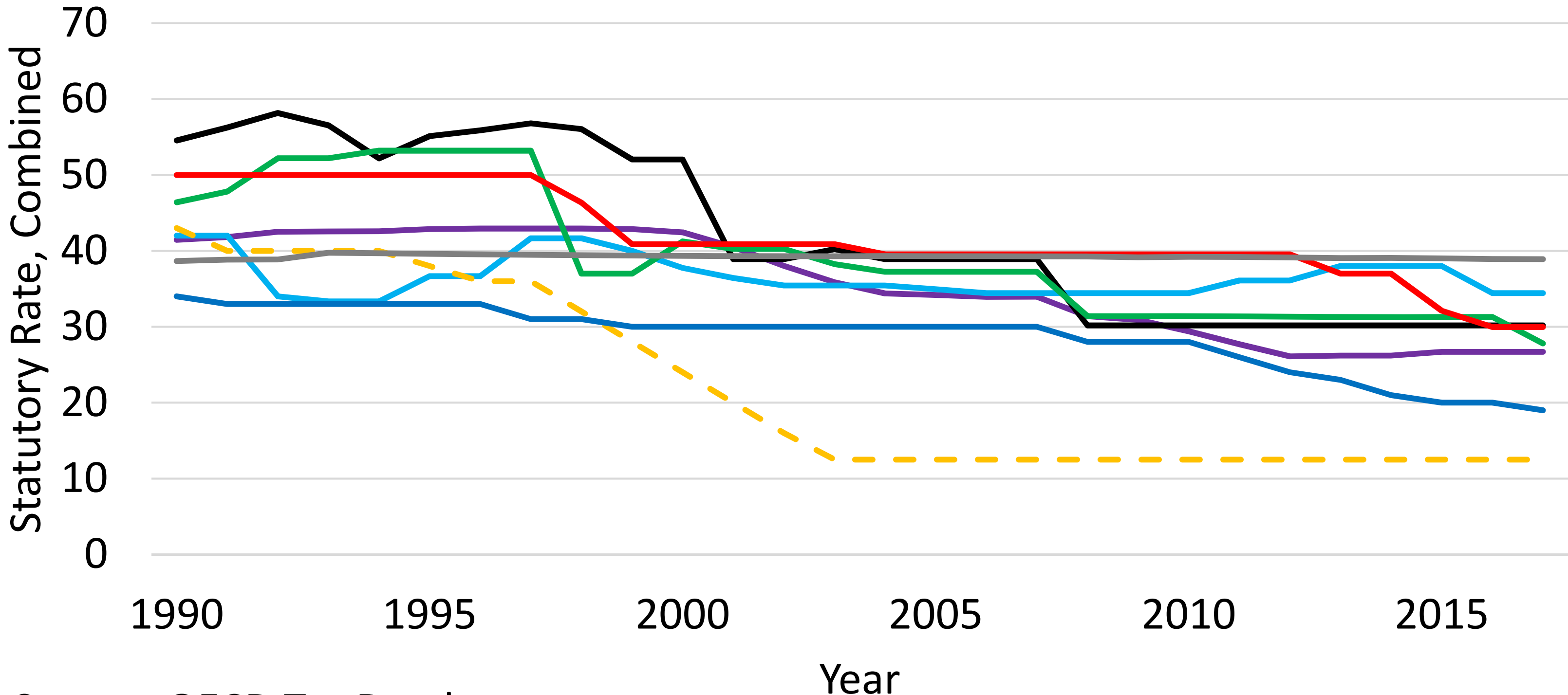
Adopt big domestic and international changes

- **Cash flow tax:**
  1. Replace depreciation with immediate expensing
  2. Eliminate net interest deductions (for NFCs)
- **Destination based:**
  3. Ignore foreign activities, as under a territorial tax
  4. But also effectively ignore cross-border activities, by having border adjustments offset business export revenues and import expense deductions

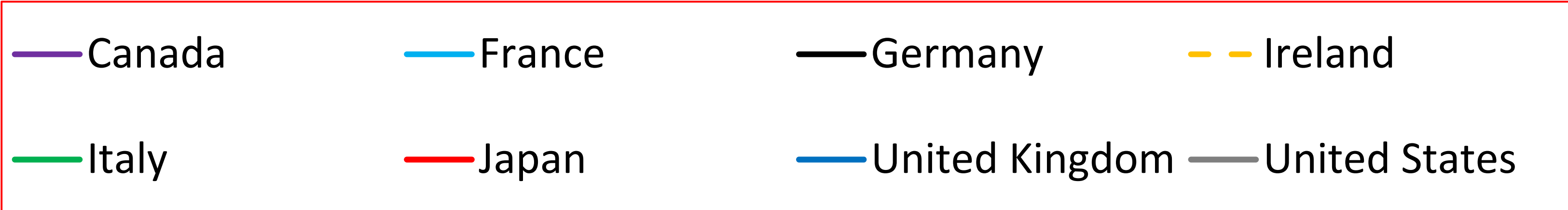
Relation to Other Policies

- **Equivalent to a "subtraction-method" VAT plus a wage deduction (or an equal-rate payroll tax credit)**
  - Border adjustment as under a VAT
- **For the US, more compelling given the past political difficulty of adopting a VAT**

Motivation



Source: OECD Tax Database



Top Five US Companies

1966:

1. AT&T
2. IBM
3. GENERAL MOTORS
4. EXXON MOBIL
5. EASTMAN-KODAK

2016:

1. APPLE
2. ALPHABET
3. MICROSOFT
4. EXXON MOBIL
5. AMAZON

A Changing Economic Setting

In last half century,

- Share of IP in nonresidential assets doubled (BEA, Fed FOF)
- Share of before-tax corporate profits of US resident companies coming from overseas operations quadrupled (BEA)

Implications

Increased pressure on systems that tax corporate income in traditional ways, based on where companies have residence

- With greater multinational activity, easier to engage in "inversion"
  - Incentive for US firms to do so since other countries (even with high tax rates) don't tax foreign source income

Corporate Inversions Per Year

New Treasury Regulations (2014 and 2016)
American Jobs Creation Act (2004)
Number of Individual Inversions
9
8
7
6
5
4
3
2
1
0
1980 1982 1984 1986 1988 1990 1992 1994 1996 1998 2000 2002 2004 2006 2008 2010 2012 2014 2016

Source: Neely and Sherrer, "A Look at Corporate Inversions, Inside and Out," FRB St. Louis, 2017

Implications

Increased pressure on systems that tax corporate income in traditional ways, based on where companies have residence

- Also, incentive for US firms to keep profits offshore ("lock-out" effect)
  - US companies now have $2.6 trillion (or more) offshore

Implications

Increased pressure on systems that tax corporate income in traditional ways, based on where companies produce

- Location of production easier to change because of multinational activity and lower costs of transportation (e.g., chips vs. steel)
  - Incentive for firms (US and foreign) to do so because US tax rate is higher

Implications

Increased pressure on systems that tax corporate income in traditional ways, based on where companies report profits

- Profit-shifting easier (via related-party transactions) when have foreign operations and are locating and valuing IP

Estimated Profit Shifting, 2012

Canada: –$13.7

Ireland: –$29.5
United Kingdom: –$14.7

United States: +$280.1

Luxembourg: –$23.6
Netherlands: –$73.0
Switzerland: –$12.7

Qatar
–$10.0

Bermuda: –$32.4

Singapore: –$19.0

U.K.I. Caribbean: –$22.0

Source: Guvenen et al., "Offshore Profit Shifting and Domestic Productivity Measurement," NBER, 2017

Traditional Approaches

1. **Lower corporate tax rate**
   - Lessens each of the problems mentioned, all of which relate to the difference between the US tax rate and foreign tax rates
   - Would generate large revenue loss

Traditional Approaches

2. Strengthen worldwide taxation (Obama)

- For US companies,
  - Reduces profit shifting and offshoring, by imposing higher taxes on such activities
  - Reduces lock-out effect, by taxing earnings even if they aren't repatriated
- But makes inversion problem worse, by increasing the tax penalty on being a US corporation

Traditional Approaches

3. Move toward territorial taxation (Camp)

- Lessens inversion problem, because US and foreign companies treated more equally by the US
- But increases profit-shifting and offshoring by US companies, by reducing US tax on such activities

Traditional Approaches

4. **Adopt "anti-abuse" rules against profit-shifting (OECD/G20 "BEPS" project)**
   – Align reported profits more closely with location of factors
   – Could lead to less shifting of profits, but more shifting of factors

DBCFT as an Alternative

- Eliminates ability to shift profits out of US, since affects only foreign tax liability
- Eliminates incentive to shift production out of US, since zero tax on US-source profits
- Eliminates incentive for corporate inversions, since no distinction in the treatment of US and foreign companies
- Eliminates lock-out effect, since no tax on profit repatriations

Potential Economic Effects

Tax Revenues

- **DBCFT appears to be roughly revenue neutral, even with large cut in tax rates**
  - A big part is attributable to border adjustment, because of large US trade deficit
  - But, is this a "real" revenue gain?
- **Critique:**
  - trade balance averages 0 over long term
  - With negative initial International Investment Position, need future trade surpluses

Tax Revenues

But – a lot of the trade deficit may be due to income shifting, with offsetting income surplus reported in current account

- Such trade deficits can be permanent, since no increase in international liabilities
- Getting rid of such income shifting provides a permanent revenue gain

Exchange Rates

- **In theory, fiscal devaluation should be largely offset by real exchange rate appreciation**
  - Evidence for VAT changes generally supports this (e.g., Freund and Gagnon, 2017)
- **Domestic vs. FX adjustment**
  - Major difference between VAT and DBCFT – wage deduction, so no initial upward wage pressure under DBCFT; FX adjustment would suffice
  - Evidence for fiscal devaluations limited but consistent with this (DeMooij-Keen, 2013)

Exchange Rates

Several other factors might or might not matter in the short run

- Dollar invoicing
- Portfolio rebalancing
- Inbound real investment flows
- Currency pegs
- Concerns about WTO action

https://www.aei.org/publication/border-adjustment-and-the-dollar/

Exchange Rates

If dollar appreciates substantially or fully

- An issue for countries using the dollar (small, few) and US territories
- Also a transfer from foreign private and sovereign borrowers to lenders, unless positions have FX hedges

Investment

- **Cost of capital for investments for existing US operations could go up or down; depends on**
  - Investment mix (structures/equipment/intangible)
  - Debt-equity ratio
- **But after-tax profitability of overall operations increases due to shift from source-based to destination-based taxation**
  - Strong evidence of international location response (Devereux-Griffith, 1998)

But DBCFT has been controversial

Domestic Winners & Losers

- **In theory, fiscal devaluation should be largely offset by real exchange rate appreciation**
  - But import-intensive industries have been skeptical
- **Also, elimination of interest deduction would more than offset benefits for some industries**

Foreign Impacts

- **A big US step in the tax competition game, as companies would be encouraged to**
  - Shift borrowing to other countries from the US
  - Shift profits from other countries to the US
  - Shift production from other countries to the US
- **EU, in particular, has reacted negatively**
  - In support of an alternative approach attempting coordination, via the OECD's BEPS project
  - A likely WTO challenge, increasing uncertainty

Outlook for Reform

- **July 27**: Joint Statement on Tax Reform from Ryan/McConnell/Mnuchin/Cohn/Hatch/Brady
  - Lower tax rates for small and large business
  - Investment expensing
  - No border adjustment
  - Silent on interest deduction
  - "Bring back jobs and profits trapped overseas"
  - "Level playing field between American and foreign companies and workers"
  - "Protecting American jobs and the U.S. tax base"

Outlook for Reform

What does this mean?

- Without border adjustment, need much lower tax rate to accomplish stated objectives
- No border adjustment or reduction of interest deductions; expensing and much lower tax rate would imply huge loss of tax revenue
  - Giving up on budgetary responsibility would necessitate 10-year sunset (as in 2001)
- **Does "protecting jobs" mean tariffs?**

Outlook for Reform

Possible outcomes

1. A large, 10-year tax cut (and tariffs?)
2. Bipartisan action (what would it look like?)
3. Nothing this year
4. But 2018 is a Congressional election year