Tax Reform in Theory and Practice

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Tax Reform – Theory

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- Empirical evidence should be used to the extent possible
- Economic substance should govern decisions
- **Economists are informed and help educate policy makers**

Tax Reform – Practice

- **An illustration, based on recent US experience considering the destination-based cash-flow tax (DBCFT)**
- **Introduced by Republicans (majority) in US House of Representatives in June, 2016**

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 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 the following policy combination:

1. Corporate/business income tax repeal
2. Introduction of a "subtraction-method" VAT, with standard border adjustment
3. Introduction of payroll tax credit at the same rate as the VAT

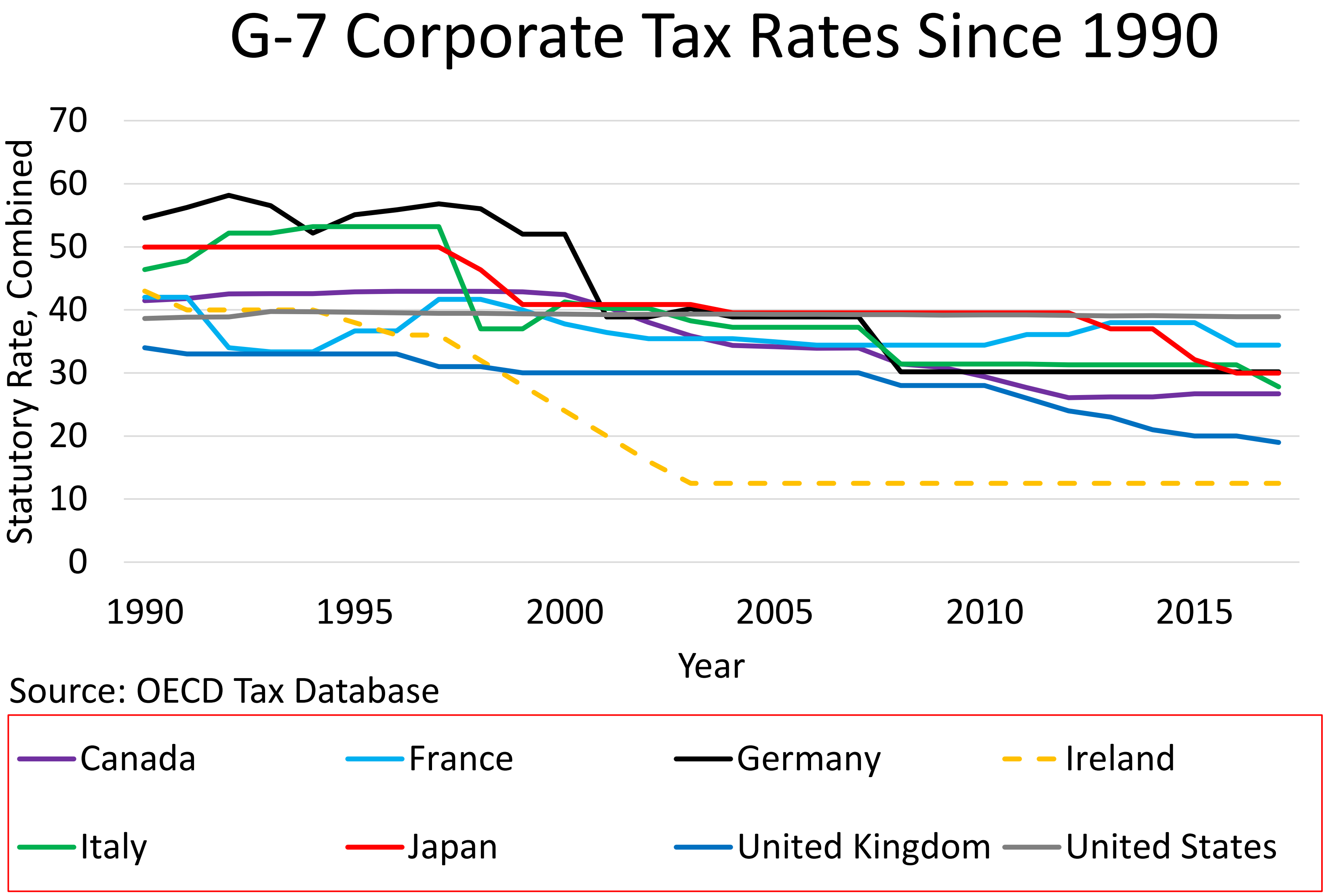
Why Not a VAT?

- **The US does not have a VAT**

Why Not a VAT?

- The US does not have a VAT
- **The US does not want 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:

Top Five US Companies

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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

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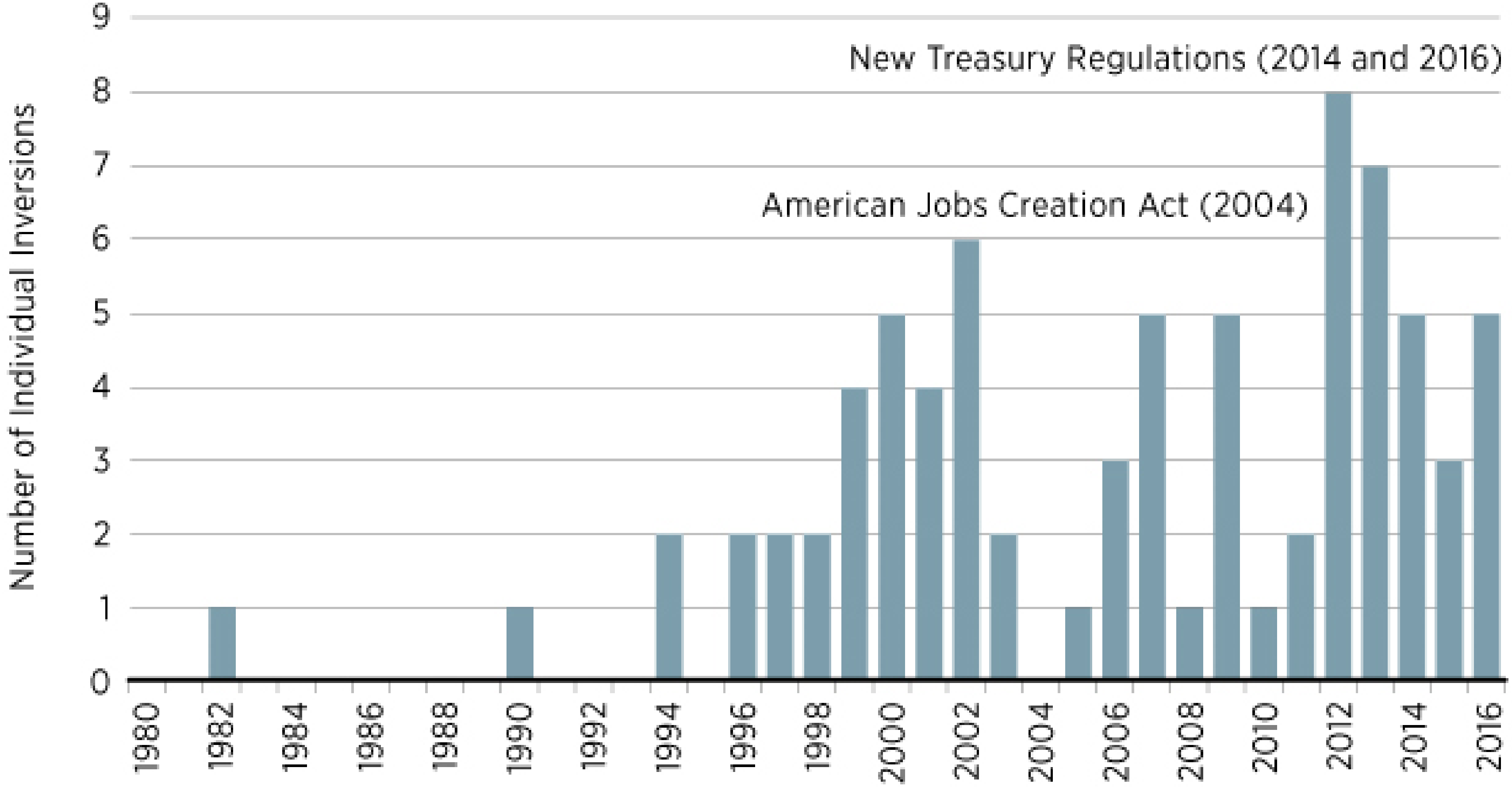
Increased pressure on systems that tax corporate income in traditional ways, based on where companies <u>have residence</u>

- 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



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 <u>have residence</u>

- 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 <u>produce</u>

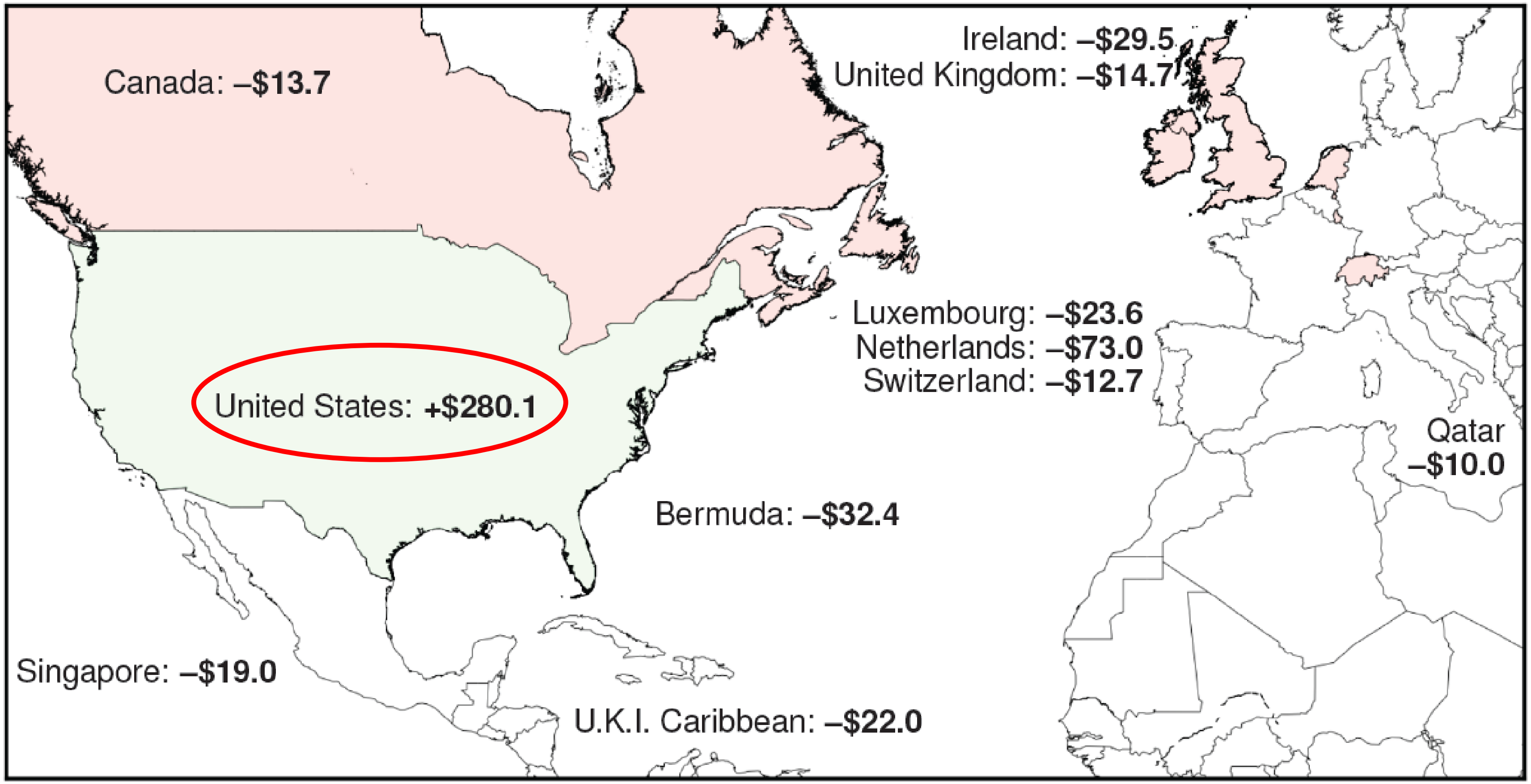
- Location of production easier to change because of multinational activity and lower costs of transportation (e.g., chips vs. steel)
  - Incentive for firms (US and foreign) to do so because US tax rate is higher

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



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

DBCFT as an Alternative

- Eliminates ability to shift profits out of US, since affects only (and increases) 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

Economic Effects

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- **To analyze key effects, consider the impact of the equivalent policy combination**
  - A tax on domestic consumption financed by non-wage income, in place of existing corporate/business income tax

Incidence

- A consumption tax that exempts measured labor income should be very progressive
- Additional benefits to labor, to the extent that US corporate tax currently borne by labor
- Windfalls to foreign owners of US assets, to the extent that US corporate tax currently borne by foreign asset owners

Efficiency

- **Elimination of US tax wedges on**
  - Choice between debt and equity
  - Intensive-margin investment decisions
  - Discrete income location decisions
  - Profit-shifting decisions
  - Income repatriation decisions
  - Corporate residence decisions

Economic Effects in Transition

- **In addition, many effects during adjustment, depending on**
  - Transition provisions
  - Speed of price, wage, and exchange-rate adjustment, etc.

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

Sources of Opposition

1. WTO

- **EU, in particular, has reacted negatively**
  - A likely WTO challenge
- **Does DBCFT interfere with trade?**
  - VAT – no; Payroll tax cut – no; Reduce or repeal corporate tax – no
- **But DBCFT…**
  - Is a direct tax, not an indirect tax
  - Border adjusts full VAT, > net tax collected
  - Doesn't give credit for foreign wages

2. 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:**
  – PV(trade balance) = 0 in long run
  – With initial IIP < 0, long-run PV(trade balance) > 0

2. Tax Revenues

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But – a lot of the US trade deficit may be due to income shifting, with offsetting income surplus reported in current account; in 2016:

- – US IIP = -$8.1 trillion;
- – US Net investment income = +$192 billion

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

3. Importers

- **In theory, fiscal devaluation should be largely offset by real exchange rate appreciation**
  – Evidence for VAT changes generally finds this happens within a few years (e.g., Freund and Gagnon, 2017)
  – Major difference between VAT and DBCFT – wage deduction, so no initial upward wage pressure under DBCFT; FX adjustment more likely
- **But importers skeptical – argue a permanent increase in their costs**

4. The Left

- **A consumption tax $\equiv$ a regressive tax**

5. The Right

- **A good tax ≡ a bad tax**

Outlook for Reform

- **July 27**: Joint Statement on Tax Reform from Ryan/McConnell/Mnuchin/Cohn/Hatch/Brady
  - Revenue losses:
    - Lower tax rates for small and large business
    - Investment expensing
  - No revenue gains:
    - 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?

- Big revenue losses
- Without a structural reform, does "protecting jobs" mean tariffs?