International Spillovers from Proposed US Tax Reforms

Conference on “What Shall We Do With Company Tax?”

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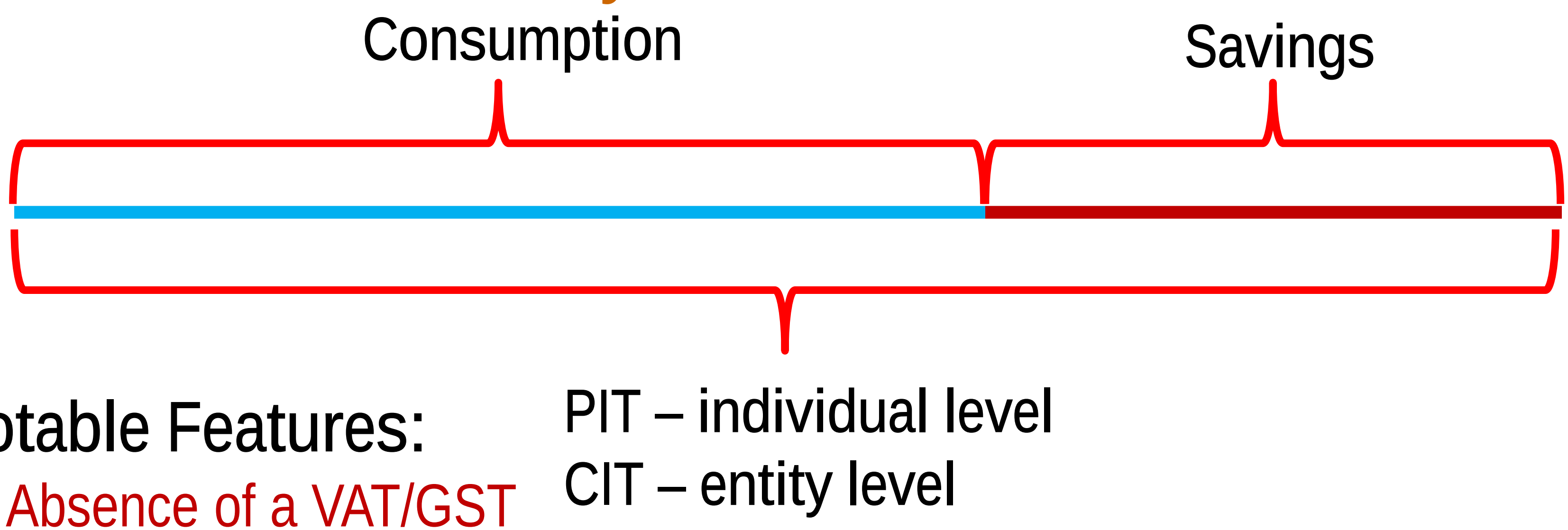
Current US Tax System



Notable Features:

- Absence of a VAT/GST
  - 48% of revenue (across all levels of govt) from income taxes v. 34% OECD average
- Revenue:
  - 26% (across all levels of govt) v. 34% OECD average
- Significant structural Federal deficit ≈ 3% of GDP
  - Federal outlays 21% v. Federal revenue ≈ 18%
  - Projected to grow in the future

Brady Plan ("A Better Way" June, 2016)

Consumption

Savings

PIT – individual level
CIT – entity level

→

PIT – individual level: retained
CIT – essentially abolished
(zero rate on the normal return to capital)

Border adjustment tax ("BAT") ≈ a modified
"destination-based cash flow tax" DBCFT

Destination-based Cash Flow Tax

(Auerbach, 2010; Auerbach, Devereux and Simpson, 2010)

- Change corporate tax base from income to cash flow
  - Full “expensing” of investment
- Switch from source and/or residence to destination basis
  - Border adjustment (as with destination-based VAT)
- Equivalent to a subtraction-method VAT with a deduction for wages
  - Remitted by firms, but burdens consumption out of pure profits

Distortions from Corporate Income Taxation

Payout
Organizational form
Debt bias
Locational choices
Location of IP
Income shifting
Asset ownership
M&A
Portfolio investment
Lockout

Destination-Based Cash Flow Tax

But there are serious concerns about unilateral adoption . . .

Payout

Organizational form

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Depend on whether the PIT is retained

The most natural approach would pair a DBCFT (or VAT) at the business level with a (potentially graduated) wage tax at the individual level

→ multilateral adoption would provide an attractive alternative tax architecture

Brady Plan

- A DBCFT has real virtues, but the BAT's inclusion in the Brady Plan has little to do with those virtues
- Rather, a BAT is attractive to Congress because of some arcane budget rules:
  - US uses a 10-year budget window
  - As the US has a significant trade deficit, over 10 years, the border adjustment raises significant revenue (≈ $1 trillion) that can be used to "pay for" PIT cuts
  - In the long run, trade deficit = 0, so these revenue gains will be offset by revenue losses
  - . . . but this occurs beyond the 10-year budget window

Brady Plan: Structural Incoherence

- Inconsistency between PIT on dividends and capital gains v. consumption-type taxation at the firm level → opportunities for deferral of PIT
- No country has an effective PIT without also imposing a CIT
- Primarily a domestic US problem, but illustrates the important general lesson that the company tax regime shapes individuals’ tax planning opportunities, and thus constrains the PIT

Brady Plan: Structural Incoherence

- **Well-known result:** the only difference between income-type and consumption-type taxes:
  - The former (but not the latter) tax the normal return to capital

- Abolishing the CIT entails also abolishing the PIT:
  - Logic: if one decides not to tax the normal return to capital at the company level, why try to do so at the personal level?
  - Practical: opportunities to shift income from personal → corporate base

    ≈ consumption tax, but with deadweight costs of tax planning

Brady Plan: Spillovers

Some commentators argue that the plan entails potentially catastrophic “tail risks”

- *If US $ appreciates to eliminate any trade distortions from the BAT*:
  - Arbitrary redistribution of wealth from holders of non-US assets to holders of US assets
  - Global financial crisis due to sovereign default?
- *If US $ does not fully appreciate*:
  - Trade distortions
- Collapse of the WTO-based trade regime?

Brady Plan: Spillovers

Tax rate = 35% (initially)
"BAT" reform → zero CIT

Tax rate = 35%

US Affiliate

$28 ←

F Affiliate

(using "consensus" 0.8 semi-elasticity – see Dharmapala (2014))

True Income = $100
Reports $128

True Income = $100
Reports $72

Spillover: loss of tax revenue for non-US govts
↑ transfer pricing activity and ↑ deadweight costs of tax planning
Effects on "real" investment?

But, the consequences are very difficult to predict

- US would be a tax haven of unprecedented size and economic importance

Brady Plan: Some (Minor?) Suggestions

- BAT: Eliminate the wage deduction
  - Price v. currency adjustment
- BAT: introduce a credit-invoice system
  - WTO-compliant border adjustment
- Obviously, this begins to resemble a (destination-based, credit-invoice method) VAT
- Also, either eliminate PIT on nonwage income, or retain CIT (albeit at a lower rate)

DBCFT v. VAT

- A DBCFT is attractive relative to a CIT, but its superiority to a VAT is less clear

Problems:

- CFTs are “naïve” (McLure, 1987): system is not “closed” by invoices as in a “sophisticated” VAT
  - Evasion/fraud is easier under a CFT
  - CFTs create avoidance opportunities (Weisbach, 2017)
    - Transfer pricing between tax-exempt and taxable entities

Distribution: CFTs allow wages to be taxed at the individual level at progressive rates

DBCFT v. VAT

But, a combination of a wage tax and a VAT can be as progressive as the combination of a wage tax and CFT

- Suppose a worker earns pretax wage = $100, and her firm sells the output for $120

Desired tax rate on pretax wage = $100	**DBCFT System**		**VAT System**	
	DBCFT on wage	Wage tax	VAT on wage	Wage tax
0%	0	0	$20	-$20
40%	0	$40	$20	$20

White House "Plan" (April, 2017)

Business tax reform "proposal" consists of 4 bullet points:

- "15% business tax rate
- Territorial tax system to level the playing field for American companies
- One-time tax on trillions of dollars held overseas
- Eliminate tax breaks for special interests"

15% Business Tax Rate

Applies to corporate income and to income from pass-through entities

- Obvious tax planning opportunities for individuals to recharacterise wage income as “business” income
  - Could be curbed by anti-avoidance rules, but at the cost of ↑ complexity
  - Evidence from dual income tax systems suggests taxpayers are highly responsive to such opportunities
    - Harju and Matikka (2016): use a reform in Finland that reduced the dividend tax relative to the wage tax rate, and find an elasticity of 1.4 for the shifting of wages → dividends

“One-Time” Tax on Overseas Cash

- 2004: Congress enacted a “one-time” holiday for repatriations by US MNCs
  - Dharmapala, Foley, and Forbes (2011)
  - Frequent attempts to repeat this in subsequent years
- Congress cannot commit to not repeating a “one-time” levy on foreign cash holdings
- Potential inefficiency: excessive repatriations by US MNCs in anticipation of future levies
  - Dharmapala (2017)

Conclusion

- The US tax reform process may resemble a comedy of errors, but has potentially serious implications for the rest of the world

- Important general lessons from this debate
  - Company tax shapes tax planning opportunities for the PIT
  - Its future is thus inextricably linked to the future of income taxation more generally

- Ultimately, fundamental tax reform in the US requires overcoming its unique political obstacles to a VAT/GST
  - Current political machinations around taxation are a distraction from this goal