The Economics and Politics of Destination-Based Cash-Flow Taxation

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Outline

- **What is it?**
- **Motivation**
- **Potential economic effects**
- **Political considerations**

DBCFT – What is It?

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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 (and only upon repatriation, giving rise to "lock-out" effect)

DBCFT – What is It?

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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 <u>territorial</u> tax
  4. But also effectively ignore cross-border activities, by having border adjustments offset business export revenues and import expense deductions

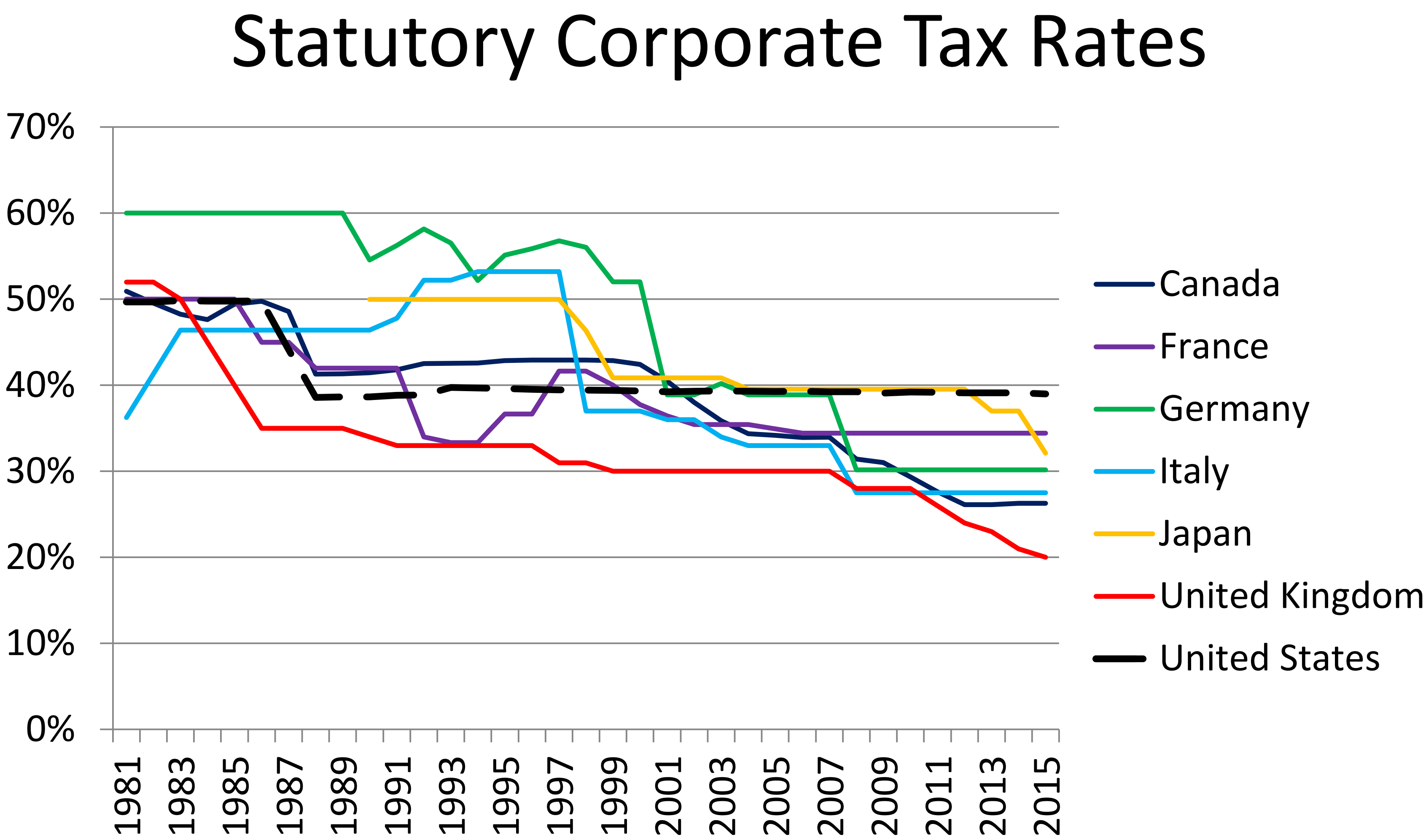
History of Thought

- **Cash-flow taxes discussed since 1970s**
  - With border adjustments since 1990s
- **Part of House Republican "Blueprint" (6/16)**
  - 20% tax rate (25% for pass-through entities)
  - Treatment of financial companies/services unspecified
  - Fully detailed proposal still in the works

Relation to Other Policies

- **Equivalent to a "subtraction-method" VAT plus a wage deduction (or an equal-rate payroll tax credit)**
  - Border adjustments as under a VAT
- **Equivalent to an "origin-based" cash flow tax plus an export subsidy and import tariff at the same rates**

Motivation


Statutory Corporate Tax Rates
70%
60%
50%
40%
30%
20%
10%
0%
1981
1983
1985
1987
1989
1991
1993
1995
1997
1999
2001
2003
2005
2007
2009
2011
2013
2015
Canada
France
Germany
Italy
Japan
United Kingdom
United States

Top Five US Companies

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1964:

1. AT&T
2. GENERAL MOTORS
3. EXXON MOBIL
4. IBM
5. TEXACO

2014:

1. APPLE
2. EXXON MOBIL
3. BERKSHIRE HATHAWAY
4. ALPHABET
5. MICROSOFT

A Changing Economic Setting

In half century ending in 2014 in US:

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

Implications

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

- With multinational activity greater, 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

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

Traditional Approaches

1. **Lower corporate tax rate**
   – Revenue loss
2. **Strengthen worldwide taxation (Obama)**
   – Reduces profit shifting and offshoring – <u>by US companies</u>
   – Makes inversion problem worse
3. **Move toward territorial taxation (Camp)**
   – Increases profit-shifting and offshoring by US companies

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 doing so 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

DBCFT as an Alternative

Other properties:

- Cash flow tax eliminates tax on intensive margin investment decisions
- Eliminating interest deduction reduces distortion of corporate debt-equity decision
- Much simpler tax system
  - No measurement of income
  - Only domestic transactions
  - No need for complex rules to prevent shifting of income, activities and residence

Potential Economic Effects

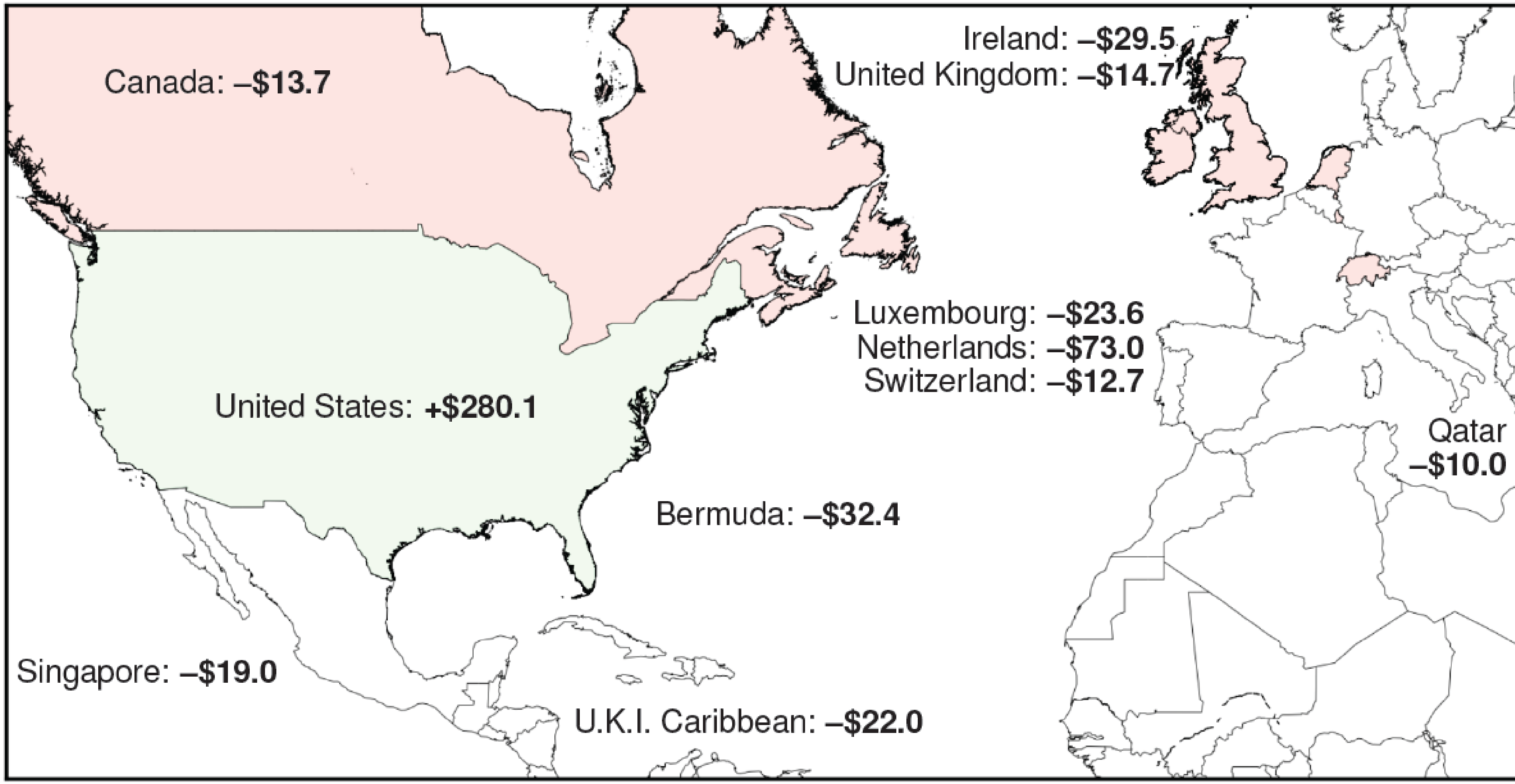
Tax Revenues

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

Tax Revenues

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

- 2016:
  - US IIP = -$8.1 trillion
  - US Net investment income = +$192 billion
- Guvenen, Mataloni, and Rassier (2017): based on payroll & sales locations, in 2012 US resident companies shifted $280b of income out of US


Canada: –$13.7
Ireland: –$29.5
United Kingdom: –$14.7
Luxembourg: –$23.6
Netherlands: –$73.0
Switzerland: –$12.7
United States: +$280.1
Qatar
–$10.0
Bermuda: –$32.4
Singapore: –$19.0
U.K.I. Caribbean: –$22.0

Tax Revenues

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

- 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; so 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

- Dollar invoicing
- Portfolio rebalancing
- Inbound real investment flows
- Currency pegs

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

Exchange Rates

If dollar appreciates fully

- Loss in value of US assets held in foreign currencies
  – Roughly $2t/2% of US wealth
- But
  – This is how a consumption tax is supposed to work
  – The same <u>real</u> loss would occur if the real exchange rate adjustment came via domestic prices and wages

Exchange Rates

If dollar appreciates 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 <u>marginal</u> investment could go up or down, depending on**
  - Investment mix (structures/equipment/intangible)
  - Debt-equity ratio
- **But after-tax profitability of <u>inframarginal</u> investment increases due to shift from source-based to destination-based taxation**
  - Strong evidence of international location response (Devereux-Griffith, 1998)

Politics: International

Adoption of DBCFT would put considerable pressure on other countries' tax systems, as it would lead companies to

- Shift deductible interest from US
- Shift taxable profits to US
- Shift profitable production to US

Alternatives: Fight or Switch

Politics: International

If fight, likely via WTO

- Is DBCFT WTO compatible?
  - VAT + payroll subsidy are WTO compatible
  - DBCFT is (1) a direct tax and (2) has a wage subsidy
- Different opinions on how this would play out

If switch, will mute but not fully offset US gains

Politics: Domestic

Original plan:

- Repeal ACA via 2017 budget reconciliation
- Do tax reform via 2018 budget reconciliation

What now?

- Whether there is a viable alternative depends on willingness to
  - Involve Democrats; or
  - Give up on budgetary responsibility