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Republican Tax Plan Would Destabilize Global Trade and Taxation

A historic decision

Over the coming months President Trump will decide on whether to adopt the tax reform proposed by House Republicans. This decision could have a historic impact on international corporate taxation, with wide-reaching yet unpredictable knock-on effects on trade, exchange rates, industrial competitiveness, investment decisions, and tax revenues. If the House Republican plan is implemented, it would make the United States an outsider in the global system of corporate taxation. It would fatally undermine the OECD's efforts to combat the offshoring of profits with coordinated tax policies. Furthermore, it would incite industrialised nations to enact protectionist countermeasures.

What are the Republicans proposing?

The Republican model: taxation of domestic revenue only

The centrepiece of the Republican plan is the „destination-based cash flow taxation" (DBCFT) of businesses. As the name suggests, this model combines cash-flow taxation with country-of-destination taxation for good and services. It represents a departure from the existing principle that corporate earnings should be taxed in the country where production takes place. Instead, earnings are taxed solely in the nation where goods and services are actually sold. Furthermore, in accordance with the cash-flow principle, all operating expenses, including capital expenditures, are fully tax deductible in the country of origin, i.e. where the goods and services are produced. Under this approach, taxable earnings are equal to all revenues minus expenditures, including wage costs and other inputs. The idea is simple on its face, but its implementation would have significant consequences for international trade. The adoption of a destination-based cash flow tax would mean that all revenues generated by US companies through exports would be tax free. Conversely, all imports from abroad to the US would be subject to a „border adjustment tax" (BAT) that would equal the new corporate tax rate (currently, 20 per cent is being considered). The advocates of the DBCFT model are eager to highlight the advantages of such a system if it were introduced internationally in a coordinated fashion. They argue that it would „take the wind out of the sails" of the tax avoidance strategies used by internationally active companies while also

Final Thoughts

Clearly, if the advocates of the DBCFT get their way, it would be a revolutionary moment in international taxation. It would take many years to re-establish a stable international tax regime that reliably encourages trade and investment. Indeed, the shock effects to key trading partners with the US would be likely to cast the international taxation system into chaos. It would force companies to completely rethink decisions about where to locate production while also encouraging countries around the world to enact protectionist countermeasures. This would imperil the global free market for goods, services, and capital.

defusing tax competition between nations because consumer spending is relatively immobile, and taxation would only take place in the country where goods and services are sold.

Proposed Tax Plan Could Lead to Global Fiscal Chaos

Republican plan could be fatal for EU

While this argument is theoretically consistent, the hopes that DBCFT would usher in a harmonious new international tax regime would almost certainly be bitterly disappointed when it came to its practical implementation. For even if the EU were ready to adopt such a model, the transition to the new system would create massive problems. Advocates of the DBCFT argue that divergence in BAT rates (i.e. import taxes) would be counterbalanced by exchange rate and wage adjustments, and, as a result, would not distort competition. This argument cannot be applied to the eurozone, however, due to the absence of adjustable exchange rates and labour market inflexibility. Furthermore, the coordinated introduction of the DBCFT system would be fatal for the European Single Market, as the level of imports entering high-tax countries would be significantly reduced due to high customs duties. In Europe, this would increase rather than decrease tax competition between countries while also lowering trade flows between member states.

As a result, the effects of such a system on tax revenues would be hard to predict, significantly augmenting the uncertainty associated with the proposal. Due to the tax liability of imports and tax exemption of exports, countries running trade deficits would initially be the biggest winners. Countries such as Germany, which has a large current account surplus, would see a significant reduction in their tax base. This would force net-exporting countries to adopt higher BAT rates than net-deficit countries.

DBCFT incompatible with conventional income taxation system

Thus, even given the coordinated introduction of such a system – which is highly improbable – we could expect many years of painful adjustment. And if the US were to unilaterally introduce such a system, the effects would be even more disastrous. DBCFT in the US alone would in no way harmonise with the existing international corporate taxation system. European and other non-US companies that export goods to consumers in United States would face massive impacts. Their export earnings would remain fully tax liable in their countries of origin, yet they would also be subject to import taxes on all revenues generated in the US. Foreign companies would thus have a serious competitive disadvantage in relation to their American counterparts, as the domestic revenues of US companies would be tax liable, yet only after deduction of domestic inputs and wages. This competitive disadvantage could only be offset if wage increases in the US were accompanied by the appreciation of the US dollar. Nevertheless, non-US companies would face the threat of double taxation, as current tax rules would not allow the import taxes paid on sales in the US to be deducted from the tax due domestically on export earnings. And if they were deductible, this would mean that non-US taxpayers would be helping to finance the US government.

Double taxation creates incentive to shift production and profits to US

The unilateral introduction of the DBCFT model in the US, including a BAT, would pull the carpet from beneath the feet of non-US companies doing business in the US. To maintain their sales activities in the US, foreign companies would be forced over the long term to relocate production facilities to the United States. Countries maintaining the old system of corporate taxation (e.g. EU member states) would not impose taxation on export revenues from US companies. Indeed, US companies exporting to Europe would not be taxed in the US or in Europe. Clearly, the unilateral introduction of the DBCFT model in the US would create strong incentives for non-US companies to relocate their activities to the United States.

Political pressures cause further distortions

US retail sector and consumers lose out

However, an additional complicating factor is that the introduction of the system in its pure form, as envisioned by some academics, is completely unrealistic politically. In the legislative process from proposal to law, companies that stood to lose from the reform would lobby Congress heavily. Retailers such as Walmart would be hit hard due to the taxes levied on the imports required for their domestic sales. Retailers would be quick to highlight the disadvantages for consumers, who would suddenly be required to pay 20% more for imported products. This is an argument against the reform that legislators would be unlikely to ignore. As a result, the DBCFT reform bill would almost certainly be weighed down by diverse special exceptions and rules, which would lead to further distortions to competition.

The current plan being championed by the Republicans already diverges from the theory on an important point: Companies that produce primarily for export would accrue large deductions they would be unable to apply for in the absence of domestic sales revenues. The Republican plan does not foresee companies receiving tax refunds for these deductions; rather, they would be carried forward indefinitely as net operating losses.

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Further information

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