1 The United States: on its way towards historic (and potentially disruptive) reform of corporate taxation

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The corporate tax reform proposed by Republicans in Congress is very ambitious. By reducing corporate income tax, the reform aims at encouraging businesses to repatriate their earnings held in foreign countries, and more fundamentally, to move their production back to the United States. The main goal is to promote private business investment in the United States and, through this same channel, industrial employment. But there is much more at stake than reducing corporate income tax. **Republicans in the House of Representatives are planning to restructure a system that is an historic post-war milestone**.

Presented within the framework of the Ryan-Brady Plan[1] in June 2016 (also known as *"A Better Way")*, their tax proposals have not always received the attention they deserve because the debate is so polarised around the most emblematic proposals of candidate Donald Trump (customs barriers, expulsion of immigrants, infrastructure spending etc.), which are often very different from those of his party. The high cost of these proposals to public finances is not compatible with the doxa of the Republican Party, with which he has to deal.

Donald Trump's stance on taxes is still unclear. On the eve of his inauguration as President, examining the most controversial reform proposed by Congressional Republicans - the introduction of a plan to **adjust taxes at the border** (*border tax proposal*) - is necessary. In fact, this proposal appears to be compatible not only with Donald Trump's desire to tax imports and move production back to the United States, but his wish to considerably reduce tax on US corporations. Several members of Donald Trump's team have spoken out in favour of an adjustment of this kind. **The economic and financial consequences of such a measure go well beyond the confines of US taxation alone.**

In practical terms, the Republicans are proposing the introduction of a flat tax on corporations. They want to lower the corporate income tax rate from 35% to 20% (Donald Trump is proposing 15%) and to encourage US multinationals that are stockpiling cash in foreign countries to transfer it back to the United States by offering them an even lower tax rate (Donald Trump proposes a flat tax of 10%). Total earnings stockpiled abroad by US corporations that have not been repatriated due to confiscatory taxation (see box) are estimated at around USD 2.5 trillion. But the Ryan-Brady plan goes beyond a flat corporate income tax rate. It is also aims at introducing **border-adjusted tax**.

What is border-adjusted tax?

Under the current taxation system, corporate taxation is based on the geographical origin of production (tax is levied where the goods are produced). The Plan would move to **a destination-basis tax system** for manufactured goods[2].

In practice, corporations would no longer be able to deduct imports from taxable income and, as a consequence, imports would be taxed at the same rate as corporate income tax, 20% for example (under the current system, they are not taxed at all); conversely, exports (which are currently taxed) would become deductible (their price would drop by the same amount, i.e. 20%).

[1] *Named after Paul Ryan, Speaker of the House, and Kevin Brady, Chairman of the House Ways and Means Committee, which, among other things, has jurisdiction over taxation matters.*

[2] *Regarding profits, the US tax system is a hybrid system: profits earned in foreign countries are only taxed when they are transferred home.*

The essential

The Republicans in the House of Representatives are proposing to completely overhaul the corporate income tax regime. The proposed reform, which would be a milestone in history, is not without danger.

On the eve of Donald Trump's inauguration, examining the most controversial measure - the introduction of a plan to **adjust taxes at the border** (***border tax proposal***) - is necessary. It involves introducing a form of VAT in the United States on traded goods but not on wages. **The economic and financial consequences of such a measure go well beyond the confines of US taxation alone.**

In theory, this type of measure is neutral for trade, because it is supposed to trigger an appreciation of the dollar, which would neutralise the initial trade advantage (generated by taxing imports and subsidising exports). However, the fact that wages would be deductible changes the situation completely from a legal standpoint and goes against WTO regulations, which could potentially open the door to retaliation from trading partners.

Whatever happens, this type of measure is likely to be a source of confusion. In light of the uncertainty over its impacts (on the US economy, emerging markets and the dollar), investors' jitters would be very much apparent, at least initially.

"Total earnings stockpiled abroad by US corporations that have not been repatriated are estimated at around USD 2.5 trillion"

To understand what is going on, it is worth recalling that the US economy is one of the few OECD countries that does not have a value added tax. **The proposed tax amounts to a form of VAT**[3], except that it would not apply to wages and salaries. The deduction for domestic wages that is proposed alters the situation entirely as it means that the labour content of goods and services produced in the United States would be exempt from corporate income tax while the labour content of imported goods would be taxed at the current rate.

How should we examine this tax reform?

The goals being pursued are multiple. Border-adjusted tax is part of a wider-reaching framework. The aim is to **combat tax optimisation** by eliminating incentives to move production[4] outside the United States, which the current system encourages. **In particular, tax inversion**[5] **would have no longer reason to exist.** The US Department of Treasury has noted that since the 1990s, the trend among US multinationals was to re-locate (or transfer their tax jurisdiction) to zones with lower tax rates. A number of foreign mergers and acquisitions have taken place for this reason. In fact, tax inversions grew in number as corporate income tax rates outside the United States fell below the US rate (unchanged at nearly 40% for the past 15 years). In the same vein, it seeks to avoid the manipulation of transfer prices.

Ultimately, by addressing this tax asymmetry, the proposed reform aims to align the US system with those in effect in the majority of OECD countries, in order to promote the relocation of certain production activities back onto US soil. US businesses would be immediately taxed less than foreign businesses, making the United States attractive to foreign companies. A possibility that some countries seem to be already apprehensive about, such as Ireland.

Moreover, **spending on capital goods would become deductible** during the year of investment – a measure that would replace the current accelerated depreciation system – in order to encourage business investment on American soil. Finally, by eliminating interest deductions, the reform aims at discouraging debt finance (many companies have taken on debt over recent years, either to buy back their shares or to finance M&A operations).

This is a complete overhaul of the corporate tax regime. The proposed tax ultimately falls midway between a value added tax (indirect tax) and income tax (direct tax). Due to the deductibility of investments made and wages, the new tax is a tax on corporate cash flow only.

A potentially disruptive tax reform

If implemented, it would be the most significant tax reform of the post-war era in the United States. Moreover, it is already being presented as such by its sponsors. The resulting increase in the cost of imports (assuming the dollar remains stable, which is not expected to be the case – we will return to this issue later) is potentially destabilising. On the one hand, because global value chains are highly integrated and, on the other, because of the absence of short-term imports substitution opportunities. In fact, even in the medium run, it is very unlikely that the United States will be able bring the production of goods that are being made at much lower prices elsewhere back home. A wide range of products are either not manufactured or no longer manufactured in the United States. The new arrangement would inevitably (in the absence of effects on the dollar) increase the domestic inflationary pressures that are already at work with full employment. As a result, domestic demand would suffer.

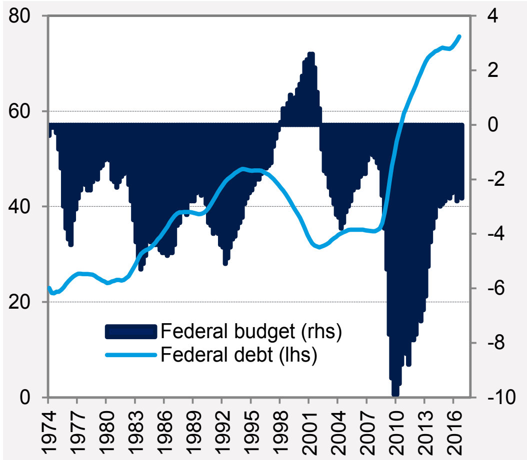
[3] *VAT is deductible from exports; under the proposed system, exports would no longer be taxed, which boils down to the same thing.*

[4] *Relocation not only concerns industrial goods: it also concerns high value added services (software development, R&D, etc.).*

[5] *Tax inversion is a procedure whereby tax jurisdiction is transferred abroad, via the purchase of a foreign company, in order to benefit from more advantageous local tax rates. In light of the scale of the phenomenon, in 2015 the US Treasury decided to limit the possibility for a company to transfer its tax jurisdiction to a country where it held few or no assets.*

> "The proposed tax amounts to a form of VAT, except that it would not apply to wages and salaries"

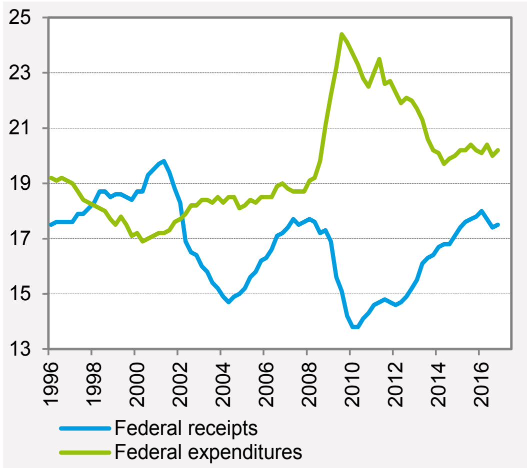
1 US: Federal debt vs. federal budget balance (% of GDP)



Source: Datastream, Amundi Research

> "The aim is to combat tax optimisation by eliminating incentives to move production outside the US"

2 Budget balance: Receipts vs. expenditures (% of GDP)



Source: Datastream, Amundi Research

But above all, the **reform would severely destabilise some sectors and production processes**. The retail sector, the largest importer of goods, would be the big loser, which explains why it has stepped up its lobbying efforts to block this proposal[6]. This would also destabilise production chains in other sectors (especially electronic goods). Without mentioning the fact that at the international level, it would open the gates to a debate on compatibility with WTO rules.

A reform that conflicts with WTO rules

For the WTO, border-adjusted tax resulting from VAT would not be a distortion of trade because it is a direct tax on consumption (whether it concerns imported goods or locally-produced goods). By contrast, when the introduction of a new tax relates exclusively to traded goods, the WTO regards this as a direct tax (just like income tax). This tax measure would inevitably be seen as a protectionist measure. The United States may be condemned by the WTO, opening the way to potential retaliatory measures by trading partners. The proliferation of protectionist measures would be disastrous for everyone.

In fact, the debate on the compatibility of the proposed tax with WTO rules is putting legal experts and economists at odds. The former abide strictly by the distinction between direct taxation and indirect taxation to justify potential retaliatory trade measures. The latter argue that it is fair to correct tax asymmetry between the United States and its trading partners which, over time, has proven to be harmful to the US production system. In economic terms, the proposed tax is equivalent to implementing VAT, combined with a simultaneous cut in payroll tax of the same magnitude[7]: a reform over which the WTO would have no complaints! In terms of international law, the economic arguments will presumably fade into the background[8]. The question has not yet been settled due to the hybrid nature of the proposed tax. Furthermore, Trump cabinet members are already hard at work to convince the WTO that it is not a protectionist measure.

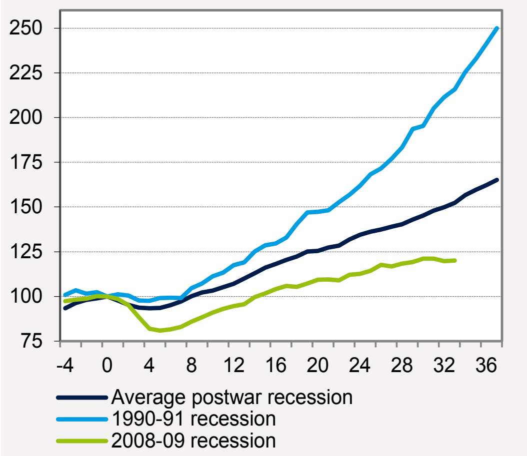
A revenue-neutral measure for public finances?

In the eyes of the Republicans, one of the big advantages of the measure is that it would lead to a dramatic cut in corporate income tax (the centrepiece of their electoral platform) without affecting tax revenue. In fact, a lower income tax rate would be mostly financed by a broadening of the tax base, generated from imports being taxed. **The Tax Policy Center estimates that a plan such as this would reduce federal revenue by USD 1.2 trillion over the first decade of implementation** (*i.e.* nearly one-third of federal revenue from corporate income tax at the current tax rate). **Simultaneously, the loss of federal revenue resulting from reducing the corporate income tax rate to 20% is estimated at USD 1.8 trillion over 10 years.**

This is a static estimate (*i.e.* one that does not take into account spillover effects). Loss of revenue over 10 years, measured ex ante (USD 600 billion) would be reduced ex post. It should be noted that the approach for estimating the impact of a tax measure on public funds within the legislative procedure has changed: the cost to public finances is now measured ex post. In other words, if the spillover effects on growth (estimated using models) are sufficiently positive, the measure could be presented as "revenue-neutral", in line with what Congressional Republicans are clamouring for. Everything depends on the calculations made with the macroeconomic models used.

> "The reform would severely destabilise some sectors and production processes"

3 US: Business Investment (Level indexed to 100 at each business cycle peak, nb of quarters to peak)



Source: Datastream, Amundi Research

> "The debate on the compatibility with WTO rules is putting legal experts and economists at odds"

> "A revenue-neutral reform for public finances"

[6] *Notably, Walmart has made it known that this tax, which exceeds it profits, would be reflected in the sales prices of its products.*

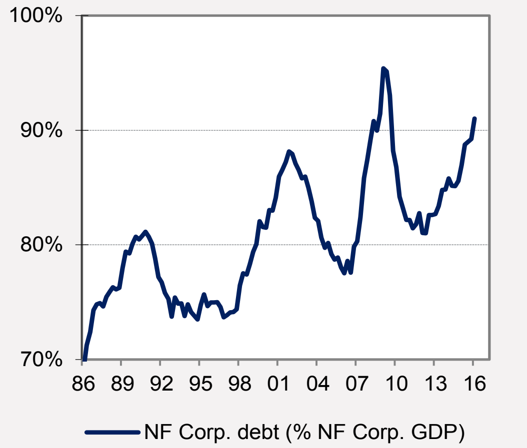
[7] *This equivalence between the two measures is important because it shows that the United States has the resources to go in the direction it wants, if necessary, without suffering any retaliation from a trade perspective. This would, however, be at the cost of increased complexity.*

[8] *Note that the United States could avoid the debate by introducing a proper value added tax. It is the hybrid nature of the proposed tax (deductibility of wages) that is a problem for the WTO from a legal standpoint.*

What would the impact be on the US trade balance and the US dollar?

As far as its sponsors are concerned, it is not a measure aimed at improving competitiveness. And this is where the misunderstanding lies. In theory, a border-adjusted tax is neutral for competitiveness and world trade. Ex ante, such an adjustment would have the same effects on foreign trade as a currency devaluation. In a fixed exchange rates regime (or in a monetary union), such a measure is deemed to be "fiscal devaluation"[9]. **But under a flexible exchange rate regime, the currency of any country that applies such an adjustment can be expected to appreciate immediately** through the effects of the expected changes in the currency demand/supply balance. On the one hand, higher prices for imported products reduces demand and hence the supply of dollars to foreigners, which causes the currency to appreciate. On the other, the subsidy received by exporters would allow them to lower their prices, which would increase external demand in the direction of that country and increase the currency demand. In theory, the appreciation of the currency of any country that applies such an adjustment offsets the increase in competitiveness achieved ex ante. With a 20% tax at the border, the dollar should appreciate to the same extent (under flexible exchange rates), leaving the relative price unchanged.

4 **US: non-financial corporate debt**



Source: Datastream, Amundi Research

> The United States: corporate tax that is substantially higher than in the rest of the world

With an average corporate income tax rate of 38.9% (federal tax rate of 35% + state income tax), the United States has one of the highest corporate income tax rates in the OECD and the 3rd highest worldwide. The average corporate income tax rate in 188 countries is 22.5%, or 29.5% if the rate in each country is weighted by its economic power (GDP weight):

- The G7 countries have an average corporate tax rate of 30.2% (33.75% if the GDP weighting is applied);
- The average of the 33 other countries of the OECD is 24.8% (28.3% if the GDP weighting is applied);
- The BRICS (Brazil, Russia, India, China and South Africa) have an average corporate tax rate of 28.3% (27.4% if the GDP weighting is applied).

Over the past 10 years, the difference in tax burden between the United States and the rest of the world has sharply increased. The global average has fallen from 34.1% to 29.5% while US corporate tax rate has remained unchanged. Asia is where the reduction in tax has been the most dramatic (with the average rate falling from 31% in 2003 to 20% in 2016).

However, in practice, US businesses benefit from exemptions and deductions that significantly reduce their effective tax rate. In particular, companies that relocate do not pay taxes as long as income is not repatriated to the United States. The effective tax rate for US companies does not exceed 27%, i.e. a level lower than the average effective tax rate of the OECD countries (27.7%).

This is what the proposed reform seeks to remedy by proposing a tax rate lower than the average tax rate of the OECD countries, while limiting the impact on the US Treasury's revenue thanks to the broadening of the tax base.

"In theory, the resulting appreciation of the dollar must offset the positive impact on the trade balance"

The dollar's appreciation is expected to neutralise the impact of the tax measure on the trade balance. In fact, this is the argument used by the defenders of this measure to claim that the WTO would have no reason to sanction the United States. Nonetheless, it is a market mechanism that has nothing automatic about it. Even though, in the case of the US, the dollar's appreciation would most likely be underpinned by monetary policy. The Fed would raise its interest rates further than forecast, with a likely increase in domestic inflationary pressures (from other budgetary stimulus measures announced by the Republicans).

"The shockwave would extend well beyond the US borders"

[9] *This type of fiscal devaluation has received much attention in the eurozone. Germany and France used this strategy (in 2006 and 2012, respectively), increasing their rate of VAT and, at the same time, reducing corporate income tax.*

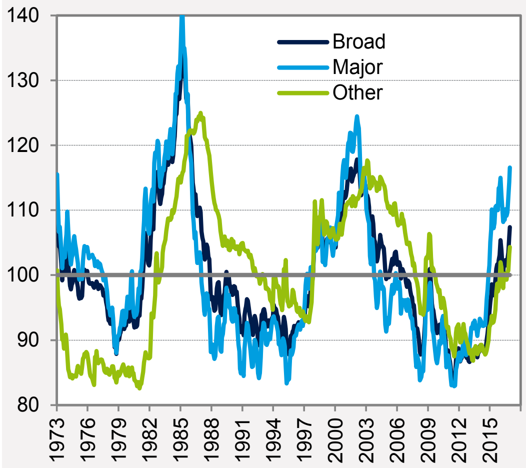
A very sensitive measure for emerging markets

In any case, its trade partners, especially the emerging countries, are likely to take a very negative view of tax adjustment at the US border. There are two reasons: either the dollar appreciates slightly or not at all (contrary to what the theory predicts) and results in a sharp loss of competitiveness for those partners. Or the dollar appreciates as forecast (by 20%), and the adjustment could be fiscally painful. This is because many corporations have increased their dollar-denominated debt very substantially over the past few years (in emerging countries, non-financial corporate debt has more than quadrupled in 10 years, with a growing portion denominated in US dollars).

Regardless of the basis of the proposed reform, the resulting shockwave would extend well beyond the US borders. It could weaken sectors that import to the United States, destabilise production chains, exacerbate inflationary pressures and thereby speed up the Fed's normalisation or even increase financial fragility in emerging markets (everything would ultimately depend on the dollar's reaction). Notwithstanding that, were it to be misunderstood, such a development would clearly open the Pandora's box of protectionism.

Against this backdrop, it is difficult to see the proposed tax reform benefiting the US economy in the short term. In light of the uncertainty over its impacts, it would exacerbate investors' jitters, at least initially.

5 **Real trade-weighted dollar (1973-2016 average = 100)**



Source: Datastream, Amundi Research

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