Destination-Based Corporate Taxes and the Ryan Blueprint

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Strengths and Weaknesses of the Plan

\+ DBCFT is an intriguing (if academic) idea

\+ Helps with profit shifting problems

\+ Removes debt/equity distortion

\- Risks the world trading system

\- Potential to create shocks, disruptions

\- Incoherent tax rate in GOP plan

\- Plan would lose revenue in a regressive manner

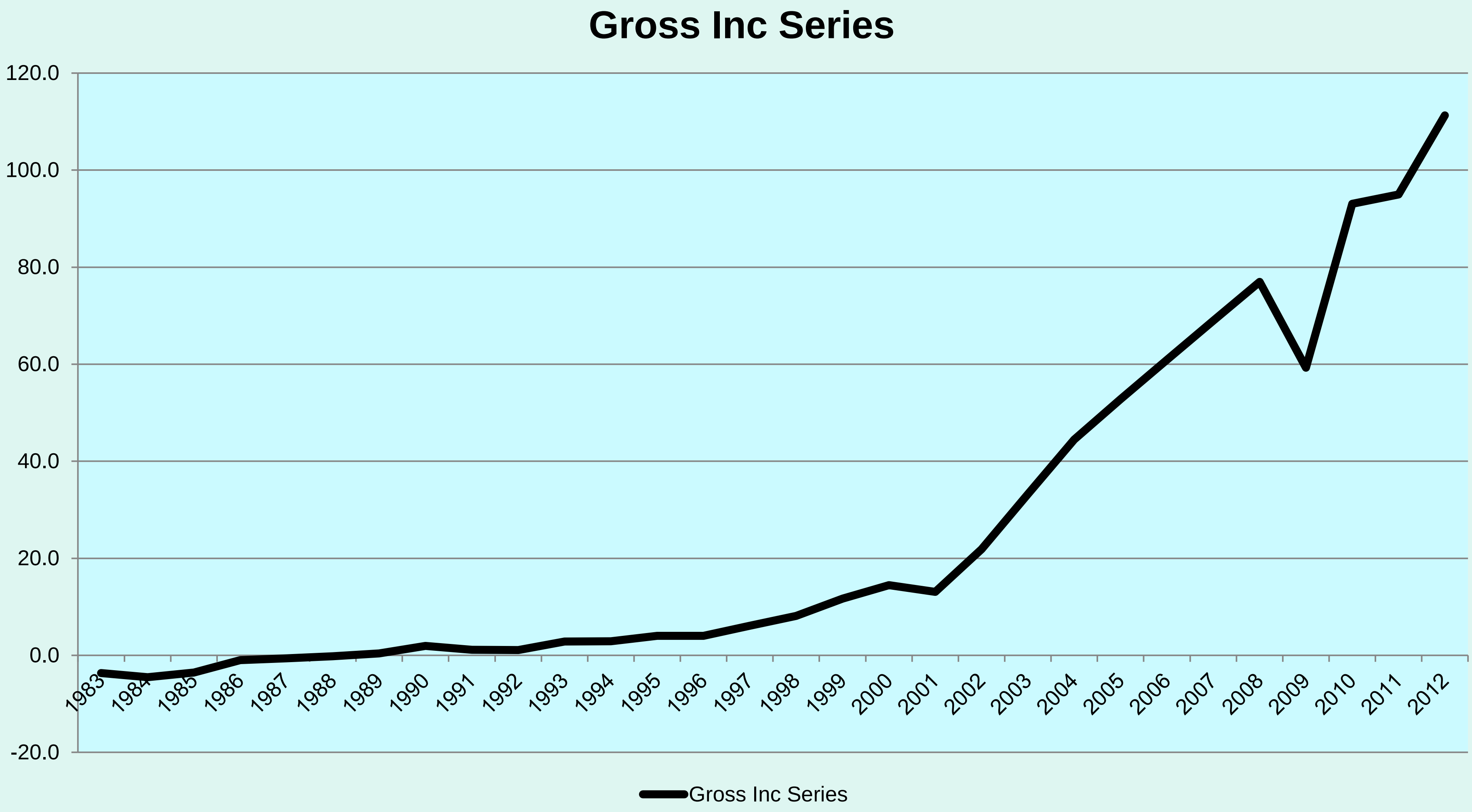
\- Not ready for prime time

Strength 1: Destination Based

- Eliminates income shifting if the consumer is in the United States and if the transaction can be observed
- Reduces tax competition pressures on U.S. tax base

Note: It also eliminates the logic behind a lower rate on business income than the top labor income bracket.

Estimates of Revenue Loss to U.S. Government from Profit Shifting, $ billions

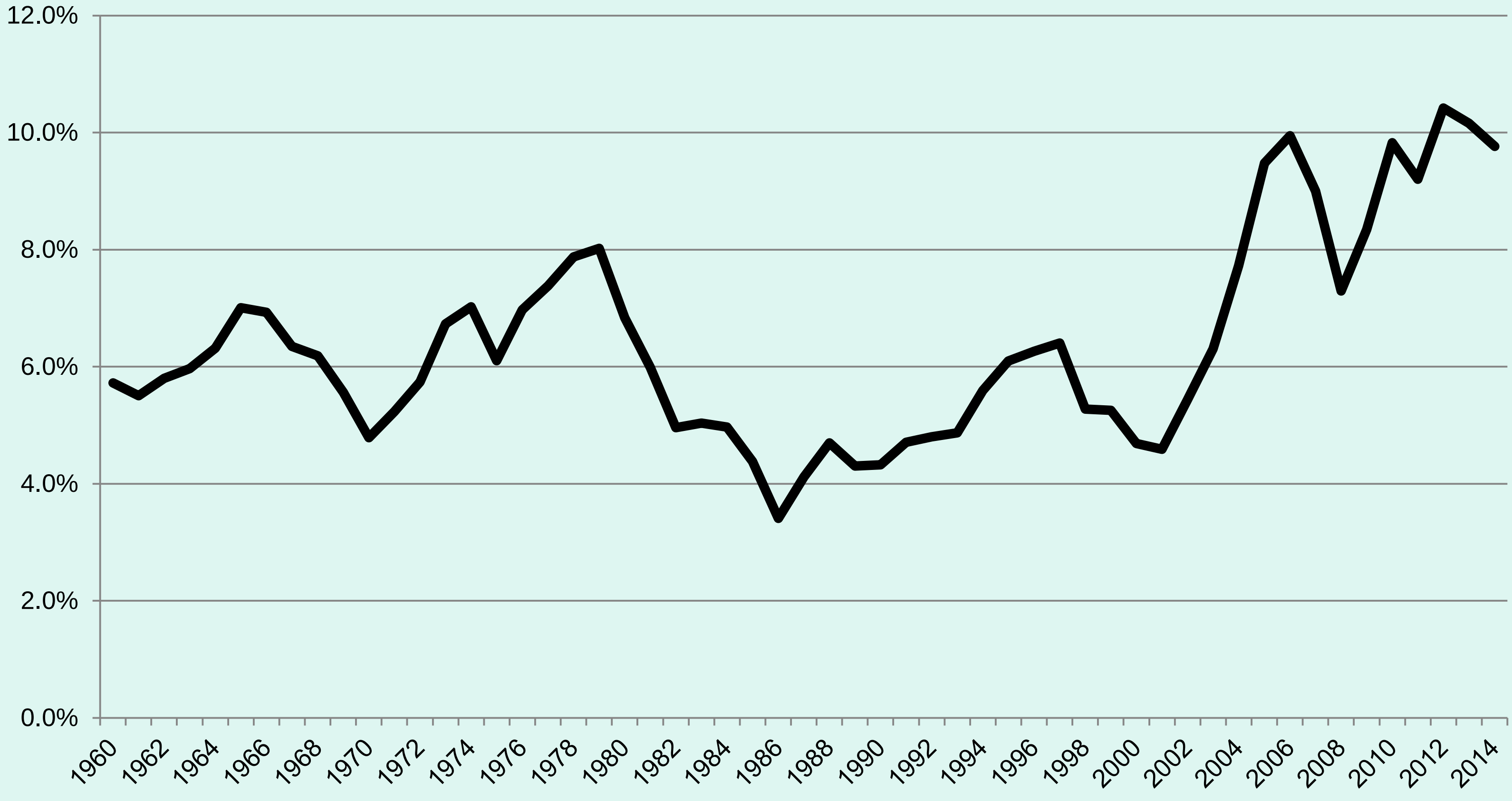


Strength 2: No Debt/Equity Distinction

- At present, debt-financed investments are actually subsidized through the tax system.
- This would remove the bias toward debt in the tax system; no interest deduction.
- Reduces leverage and fragility.
- The normal return to capital is exempted from taxation by expensing investment.

However, effects on capital stock and wages are likely to be far smaller than advertised.

Corporate Profits as a Share of GDP, 1960-2014



Weakness 1: This is not a good time to undermine the world trading system.

- This is inconsistent with both WTO rules and US tax treaties.
- Risk alienating trading partners.
- WTO inconsistency is no mere technicality. Wage deduction component acts as incentive to use US labor.
- Also hurts trading partners by eroding their tax base due to easier profit shifting for foreign firms.

Will dollar appreciation save the day? Will it occur as suspected?

- Dollar appreciation *can* counter trade effects of border adjustment, but there reasons to worry.
- Possible short term shock and disruption. Do we want to bet large sectors of the economy?
- Is the equilibrium trade balance truly unchanged?
- Fixed exchange rates; not all currencies adjust.
- Exchange rate predictions are notoriously bad.
  - $5 trillion a day in exchange rate trading
  - Large speculative component

Evidence

- There is very little evidence, and what there is is qualified.
- What about the business community? Do they simply not understand economic theory?
- Or is life more complicated?

Four Case Studies

- Four rich countries that have adopted VATs under floating rates since Bretton Woods.
- Consider +/- 2 and 3 year exchange rate changes from date of adoption.

		+/- 2 years	+/- 3 years
Canada	1991	-6.7%	-2.7%
Australia	2000	-27.0%	-33.6%
New Zealand	1986	13.6%	-12.1%
Switzerland	1990	-4.0%	5.4%

If US Dollar appreciates, is all OK?

- Huge wealth effects. Large hit to the net international investment position of U.S.
- Large risks to the world economy. Emerging market crisis.
- Political problems of trade deficits.
  - Budget deficits will compound this problem.
  - As will monetary policy.

Uncertainty

- What happens when WTO rules against U.S.?
- Will we change policy or risk retaliation? (large!)
- Trade sanctions and the hit to world trading system are not a good outcome.
- Remove border adjustment => large revenue loss and massive opportunities for avoidance.
- Remove wage deduction => much less progressive.
- In the meantime, an uncertain tax/trade environment.
- Does not go well with other USG policies.

Weakness 2: The Wrong Tax Rate

- No logic or incoherence behind a low rate on rents.
- If this solves distortions, why not a higher rate?
- Discrepancy between top labor income rate and business tax rate (pass-through or corporate) will lead to revenue loss in the broader tax system.
- Incentive to move wage income to capital income.
- Instead, should match top rate on labor income.
- BUT, the correct rate makes the case for multilateralism even larger.

Weakness 3: Revenue Loss

- The business tax features of the proposal are a large share of the ten-year $3 trillion revenue loss (TPC).
- Will the BAT generate the revenue we think?
- Where does this revenue come from?
- Shifting away from wage income will hurt revenue elsewhere in the tax system.

Expanding the budget deficit worsens the trade deficit; will pressures for protectionism increase?

Weakness 4: Distribution

- The top 1% get a tax cut that averages $213,000. The tax cut of the bottom 80% averages $210. (TPC)
- Other sources confirm.
- Is this the right time for regressive tax policy?
  - Trade and technology shocks hurt workers
  - Income inequality
  - Middle class wages stagnant
  - Labor share of income falling, capital rising
  - Capital income more concentrated than labor income.

Weakness 5: Technical Problems

- Unclear to the public. To Congress. Even experts.
- Many profitable firms will show losses and need large refunds from Treasury. Optics problems.
- Tax driven mergers are likely and inefficient.
- Carve outs, exceptions dangerous.
- Dealing with financial flows, financial firms tricky.
- Effects on state tax systems non-trivial.
- Serious transition issues.

BUT, there is nothing wrong with this plan that 3 changes wouldn’t fix.

1. Multilateralism
2. Higher Rates
3. Years of Careful Implementation Work

In the Meantime, Other Options

1. **Worldwide Consolidation (or Abolish Deferral)**
   - Solves profit shifting
   - Works with global economy
   - More stress on residence but there are solutions
   - Concerns re. competitiveness combated with lower rate
2. **A Lower Rate with a Minimum Tax** (ready to go)
3. **Anti-Inversion Laws** (ready to go)
   - Exit tax
   - Earnings Stripping Rules
   - Management and Control test
4. **Baby Steps (BEPS)**