A Macro Assessment of the DBCFT Costs and Benefits
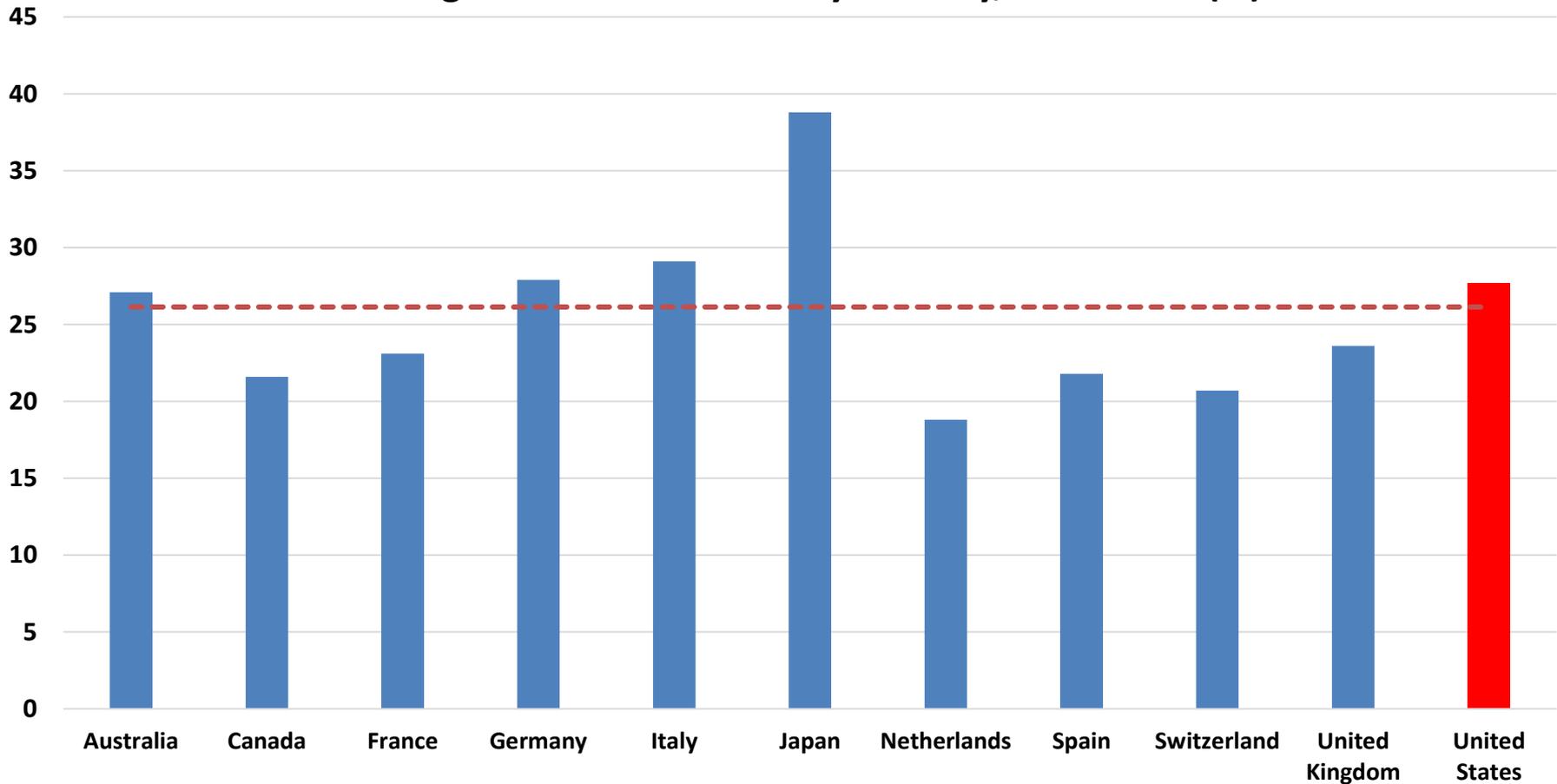
Adam Posen

Peterson Institute for International Economics

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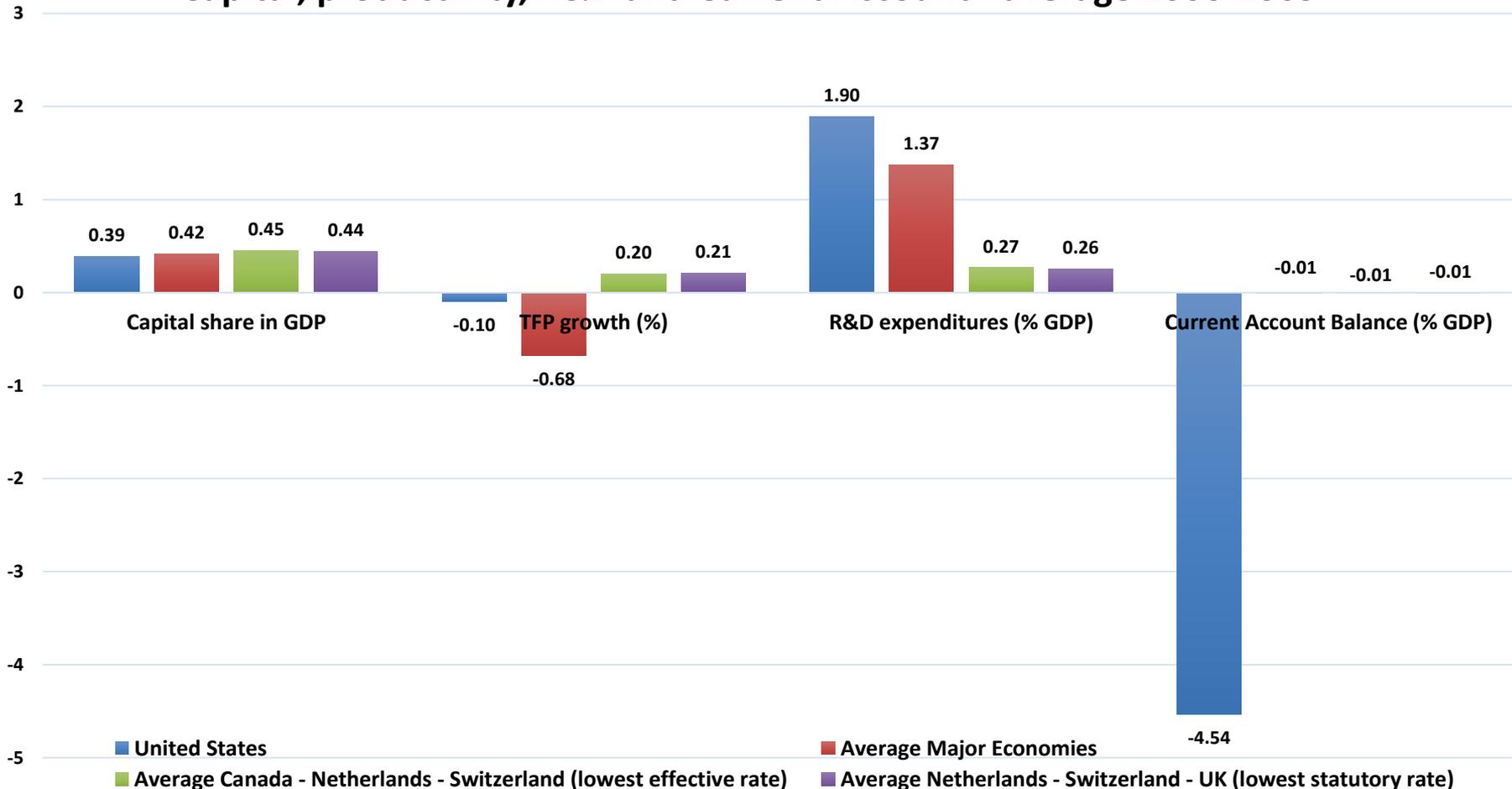# The gains from tax reform are finite, so the costs matter

Average Effective Tax Rate by Country, 2006-2009 (%)

Source: PWC, "Global Effective Tax Rates".
The effective tax rate is defined as total income taxes divided by pretax income

The gains from tax reform are finite, so the costs matter

Capital, productivity, R&D and Current Account - average 2006-2009

Bar chart showing four groups: Capital share in GDP, TFP growth (%), R&D expenditures (% GDP), and Current Account Balance (% GDP).

Capital share in GDP: 0.39, 0.42, 0.45, 0.44
TFP growth (%): -0.10, -0.68, 0.20, 0.21
R&D expenditures (% GDP): 1.90, 1.37, 0.27, 0.26
Current Account Balance (% GDP): -4.54, -0.01, -0.01, -0.01

Legend:
- United States
- Average Major Economies
- Average Canada - Netherlands - Switzerland (lowest effective rate)
- Average Netherlands - Switzerland - UK (lowest statutory rate)

Source: University of Groningen

The gains from tax reform are finite, so the costs matter

Total Corporate Income Tax Revenue (% GDP) - average 2000-2014
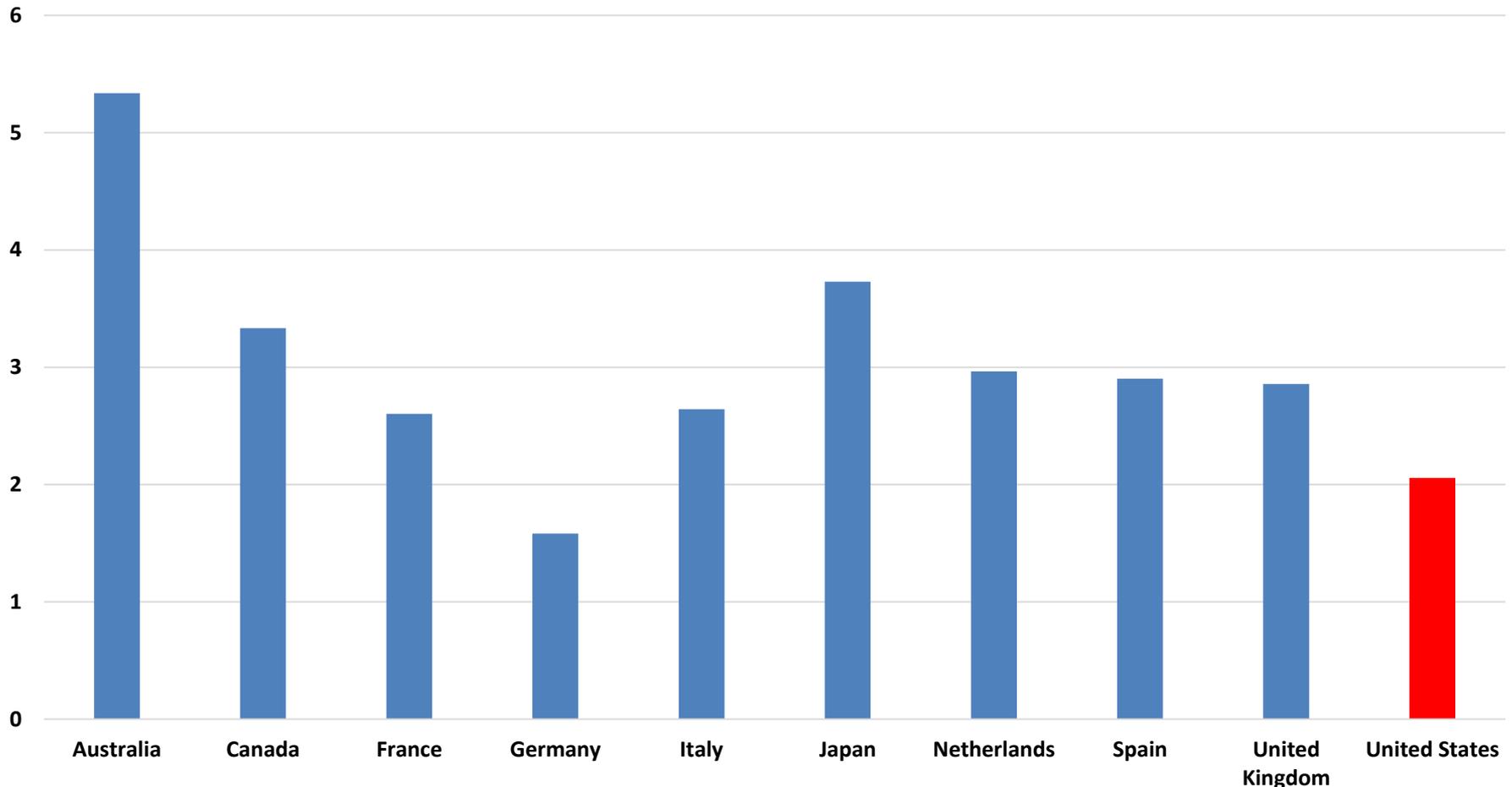
The gains from tax reform are finite, so the costs matter

- $2.6 trillion of US MNC profits held overseas (Joint Committee on Taxation - September 2016)

- In 2004, it was estimated that $804 B of profits had been accumulated abroad (IRS 2008), $362 B repatriated then

- Therefore, the net accumulation of profits abroad between 2004 and 2016 is a flow of $1.4 trillion
  - → about $40 billion per year of lost tax revenue

- Average total tax revenue for the US government between 2005-2016: $2.6 trillion per year (CBO)

# The costs of DBFCT revenues Distortions to the real economy

- At the projected 2016 trade deficit level of $500 billion, a 20 % BTA supposedly would lead to $100 billion revenue annually

- But the coverage is uneven and gapping:
  - US hotels, restaurants serving foreign tourists?
  - Hospitals and universities receiving income from foreign residents?
  - US residents paying foreign hospitals and universities?
  - Internet services?

- What if Congress exempts favored industries (e.g., oil refining) as it its wont to do deals?
  - Further distortions and lower revenues

The costs of DBFCT revenues
Distortions to the real economy

Value Added vs imported Value Added by sector

Source: BEA, OECD
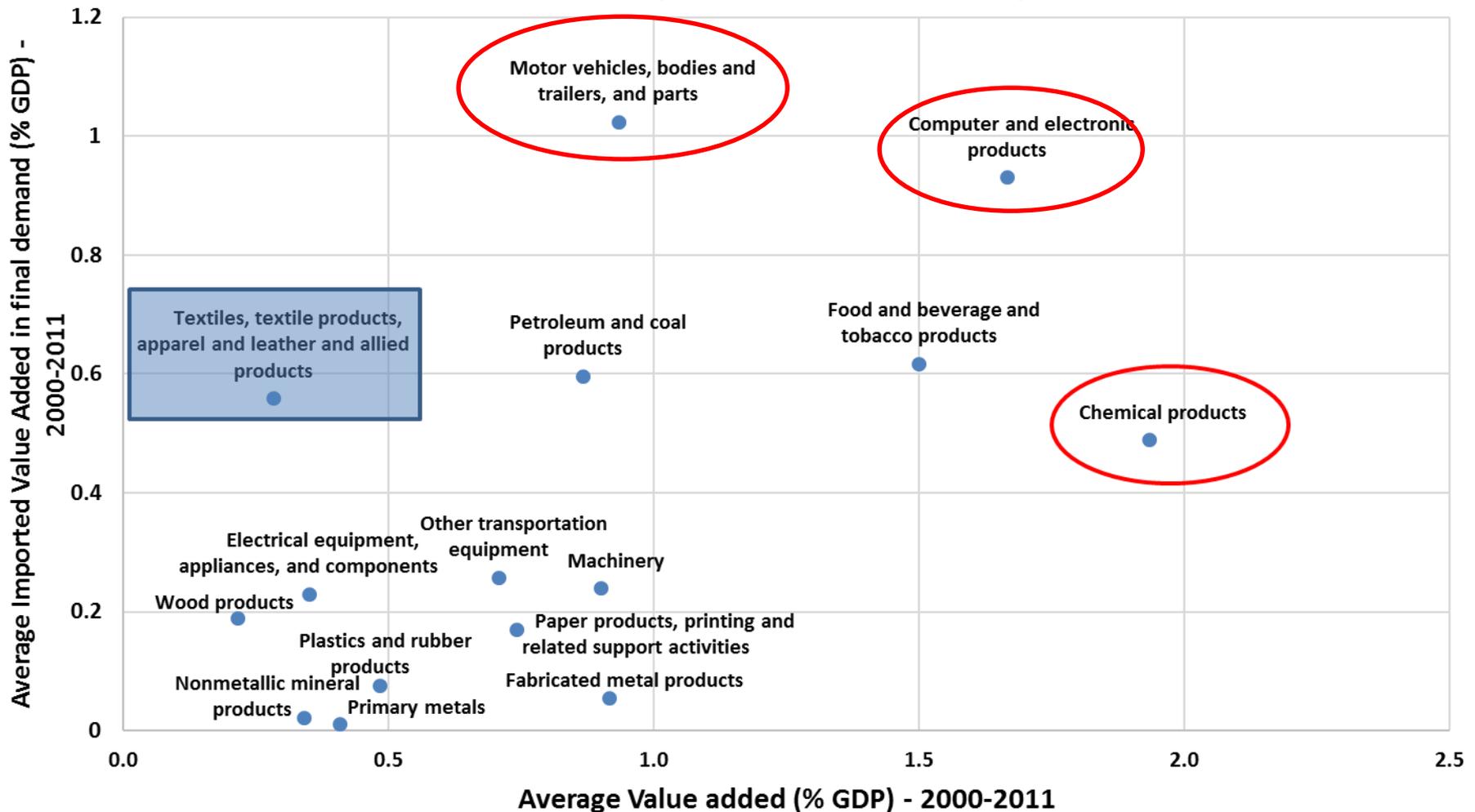
The costs of raising tax revenues International retaliation

- Potential retaliation measures from WTO:
    - If BAT being interpreted as an import restriction: trading partners could be authorized to retaliate by eliminating $220 billion of US exports
    - If BAT interpreted as an export subsidy: trading partners could be authorized to retaliate by eliminating $165 billion of US exports
    - If BAT interpreted as both an import restriction **and** export subsidy: trading partners could be authorized to retaliate by eliminating $385 billion of US exports

The costs of DBFCT revenues Harming Low Income Americans

- Shifting the tax mix away from progressive taxes to consumption taxes can promote growth but raises inequality. However the OECD finds that targeted transfers, however, can reduce the severity of this trade-off.

- However the US is the OECD country, which through the tax revenue/transfer payments reduces its market income Gini the least - only 22%.

The costs of DBFCT revenues
Harming Low Income Americans

Potential impact of border adjustment tax per year as a percentage of pre-tax income
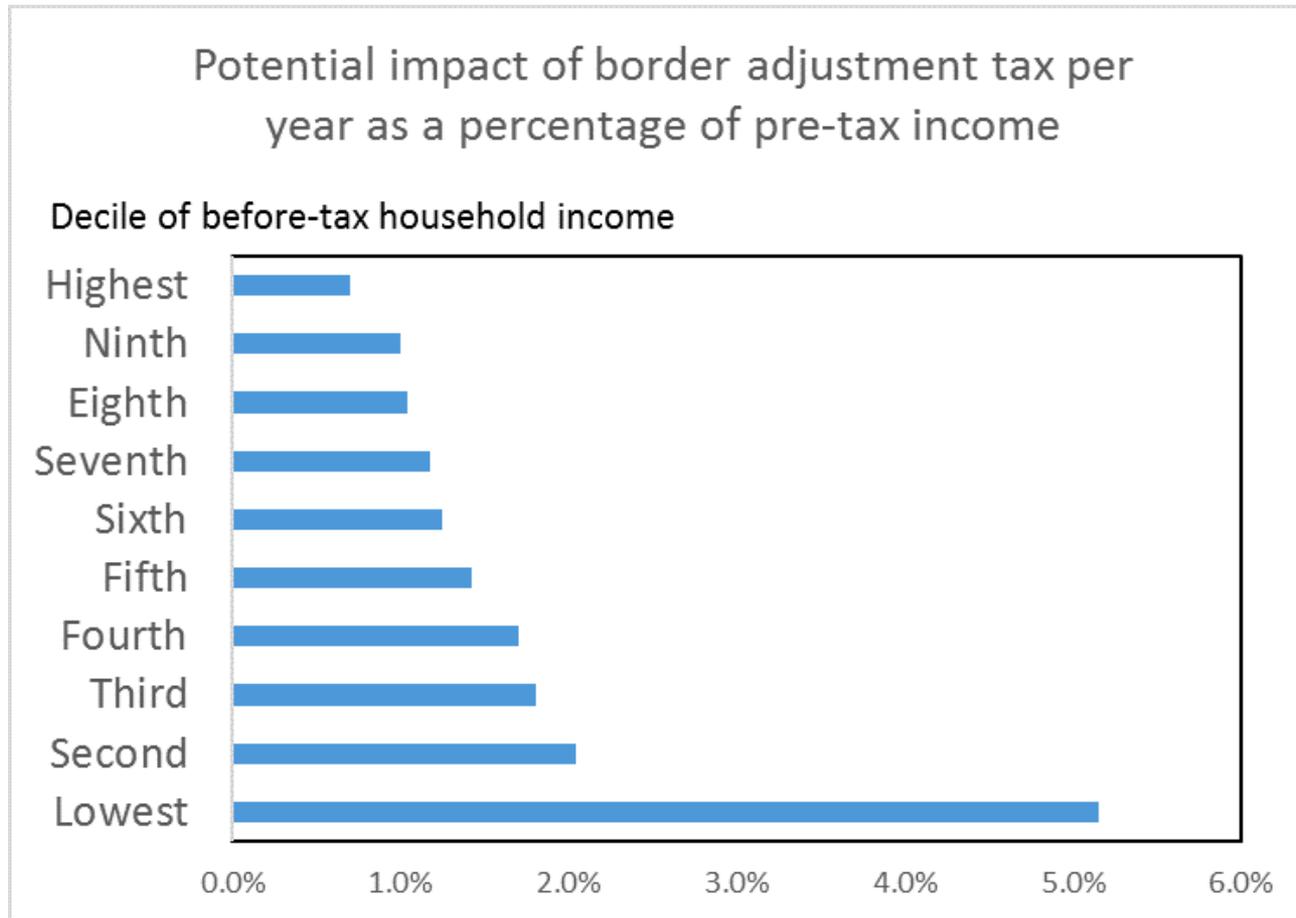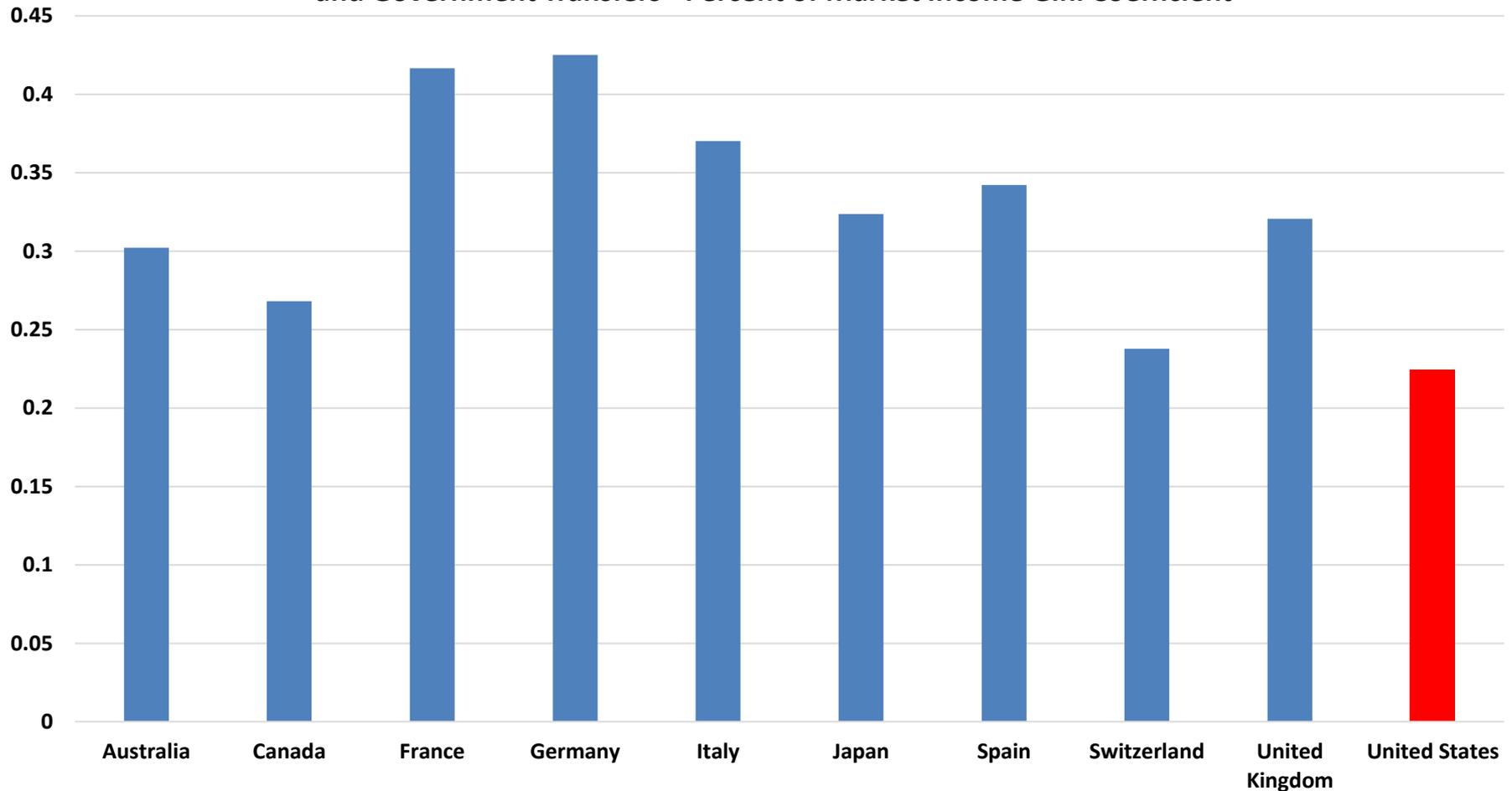
Russ (2017) estimation of impact of a 20% BTA on households (assumes leading to pass through of half of the 20% tax on prices. Builds on database created and analysis by Furman, Russ and Shambaugh (2017) of tariff impacts.

The costs of DBFCT revenues Harming Low Income Americans

The Percentage Reduction in Gini Coefficient From Combination of Tax Revenue Collection and Government Transfers - Percent of Market Income Gini Coefficient
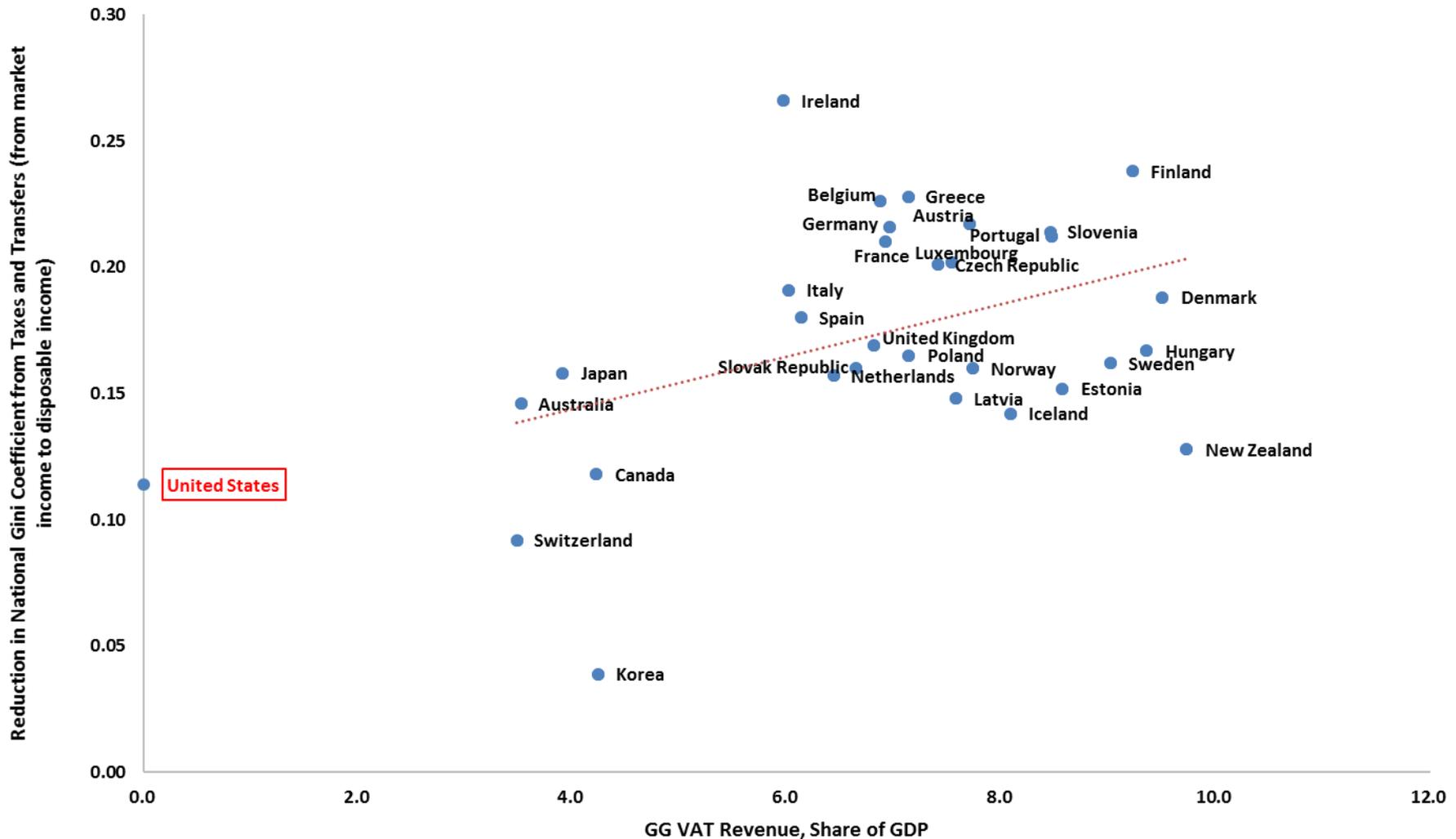
Categories (left to right): Australia, Canada, France, Germany, Italy, Japan, Spain, Switzerland, United Kingdom, United States

Source: OECD

The costs of DBFCT revenues Harming Low Income Americans

General Government VAT Revenues and Impact of Taxes and Transfers on Inequality, 2014

Source: OECD

The costs of DBFCT revenues
Too little compensation by dollar

- Dollar appreciation assumes DBFT neutrality, S-I is fixed, and therefore dollar offsets mechanically – but this is completely unrealistic
  - Savings changes because government revenues go up
  - Investment also should change, or else why bother?
  - Significant differences in the impact of the BAT across sectors
  - Regressive tax incidence will alter consumption patterns
  - Most households would not see this as leaving their purchasing power unchanged
  - At least in the Japanese case, when they have made significant increases in VAT in recent decades, the Yen has not offset

The costs of DBFCT revenues
Too little compensation by dollar

- Dollar exchange rate is not determined in a vacuum
  - As global reserve currency, different forces and scale at work [*see also Cline (2017)*]
- Daily turnover in foreign exchange markets is a large multiple (> 300x) of the amount involved in trade related transactions
  - In April 2016, USD FX turnover averaged $4.4 trillion per day (BIS, 2016)
  - In comparison, the sum of US imports and exports average $408 billion *per month* in 2016 (BEA, 2017)
- Furthermore, the dollar could be moved in reaction to the entire tax package or political interpretation of policy change
- Strange that this argument seems to imply that by not having a VAT, dollar has been consistently <u>undervalued</u> for decades
- But if no offsetting compensation by dollar, all other costs grow (income loss, distortion across sectors, retailiation)

Better ways to raise revenue exist

- The CBO publishes every year *Options for Reducing the Deficit* and lists ways to raise revenue
- My preferred tax efficient options to raise $50-100 B pa:
  - Reduce the mortgage interest deduction/convert to tax credit
  - Limit the value of itemized deductions
  - Tax carried interest as ordinary income
  - Increase the maximum taxable earnings for Social Security Payroll Tax
  - Make high-end employment based health insurance taxable
  - Increase excise taxes on motor fuels/index tax for inflation
- What is politically feasible depends upon awareness of costs and which response to middle class anger is taken

Macro costs of DBCFT outweigh the benefits

1. Impact of tax efficiency on US macro outcomes is only of secondary importance
2. Revenues to be gained thru DBCFT are limited
3. Costs of DBCFT are multiple and high
   - Punishes most advanced industrial sectors
   - Likely international retaliation close to 1:1
   - Harms lower income Americans
   - Insufficient $ appreciation to compensate
4. Congress has less costly alternatives for raising tax revenue and should pursue those instead