



Tax Competition and the DBCFT

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Outline



- **Key provisions of the DBCFT**
- **How it may affect international tax competition**

Two Key Elements of Proposal



- **Cash flow tax**
 - Replace depreciation deductions with expensing
 - Eliminate interest deductions
- **Destination basis**
 - Drop foreign-source income from base, as under a territorial system.
 - Border adjustments effectively take export receipts and import costs out of business tax base
- **Result: a tax on domestic cash flows**
 - Like a VAT, but with a deduction for labor costs

Properties of DBCFT



- **Much simpler to administer**
 - No need to keep track of asset bases
 - Offshore & cross-border transactions ignored
- **No tax on US-source income**
 - Expensing means tax only on returns above normal return to capital (e.g., rents)
 - Destination basis means rents taxed based on location of purchaser, so no tax on rents based on source

Many Issues to Deal With



- **Financial companies**

- Can also use border adjustments for financial flows, and limit domestic financial company taxation to transactions with individuals and entities not subject to the DBCFT:

<http://eml.berkeley.edu/~auerbach/CBTWP1701.pdf>

- **Losses and border adjustments**

- **Transition provisions, including interest on existing debt, depreciation & dollar contracts**

Economic Responses



- **Border adjustment should be offset by dollar appreciation**
 - No direct change in competitiveness for exports or imports
 - No significant impact in the trade balance
- **But important changes in international competition in other dimensions**

Elements of Tax Competition



- 1. No longer any US tax on foreign source income**
- 2. US tax rate no longer relevant for decisions regarding location of profits and activities**
- 3. Interest no longer deductible in the US**

Effects on Firm Behavior



Elimination of tax on offshore income should

1. Encourage repatriations to the US
 - No longer any tax on such repatriations

2. End tax-induced corporate inversions out of US
 - Residence no longer relevant to US tax calculation
 - Residence-based features in other countries' tax systems should induce inversions into US

Effects on Firm Behavior



Zero tax on US-source income should encourage companies to

1. Make new investments in the US rather than elsewhere, for existing operations
 - Cash flow tax means zero tax rate on additional investments

Effects on Firm Behavior



Zero tax on US-source income should encourage companies to

2. Locate profitable activities in the US rather than elsewhere
 - Border adjustment means a zero US tax on profits relocated to the US

Effects on Firm Behavior



Zero tax on US-source income should encourage companies to

3. Use transfer pricing to shift profits into US (even from Ireland)
 - Border adjustment means understatement of US imports from or overstatement of US exports to related parties has no effect on US tax base, but reduces foreign tax base

Effects on Firm Behavior



Elimination of interest deduction should encourage companies to

1. Use more equity finance in US
 - Debt and equity now on an equal footing

2. Shift borrowing to other countries where at least some deduction may be possible
 - Any deduction is better than none

A Leap in the Tax Competition Game



- **The DBCFT is approximately equivalent to repealing the corporate income tax, introducing a subtraction method VAT plus a wage subsidy**
- **Little incentive for US to compete by lowering its corporate tax, since it's now based on customer location**
 - Only reason would be to compete for consumers

The Perspective from Abroad



- **Further pressure on their tax systems**
 - Note: they are already ahead of the US right now in the tax competition game, with VATs and lower corporate tax rates
 - But lower than 35% can still be a lot higher than 0.
- **Little incentive for US to help them protect their tax bases**
 - E.g., we no longer have any incentive to crack down on tax havens

The Choice: To Fight or Switch



- **Switch**

- Other countries can adopt the DBCFT
- Response can also be done incrementally, by raising VAT, lowering employment taxes, and reducing corporate tax rate

- **Fight**

- Complain to the WTO and hope that they will honor form over substance

Which Outcome is Likely?



- **For an individual country, the decision should depend on whether it benefits more from keeping the current US system rather than reforming its own**
 - For example, small, low-tax countries have little to gain by adopting DBCFT themselves, but a lot to lose if the US does

Which Outcome is Likely?



- **But initial inclination to fight may also arise from other factors**
 - Desire to maintain status quo with respect to international agreements
 - Misunderstanding of the DBCFT as trade intervention
 - Reaction to the decision of US to act unilaterally, rather than through cooperation via international organizations