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The International Consequences of US Tax Reform

Sep 27, 2017 | **MARTIN FELDSTEIN**

CAMBRIDGE – The United States Congress is likely to enact a major tax reform sometime during the next six months. Although the new rules will apply only to American taxpayers, they will have important consequences for companies and markets around the world.
The most important changes will apply to US corporations rather than to individual taxpayers. Of these reforms, the one with the most obvious and direct international impact will be the change in the taxation of US corporations' foreign subsidiaries.

The current US rule is unique among all major advanced economies. Consider the example of a subsidiary of a US corporation that earns profits in Ireland. That subsidiary pays the Irish corporate tax at Ireland's low 12% rate. It is then free to reinvest the after-tax profits in Ireland, in financial securities, or in operating businesses anywhere in the world – except the US.

If the foreign subsidiary's parent company brings the after-tax profits back to the US to invest or distribute to its shareholders, it must pay the current US corporate tax rate of 35% on its original pre-tax Irish profits, with a credit for the 12% that it has already paid.

Because of this 23% penalty on repatriation, US companies generally choose not to repatriate the profits of their foreign subsidiaries. The Treasury Department estimates that these subsidiaries have accumulated $2.5 trillion of offshore profits.

Congress is now likely to adopt the "territorial" method of taxing the profits of US corporations' foreign subsidiaries. Under the territorial method, which virtually every other advanced economy uses, US corporations will be able to repatriate their foreign subsidiaries' after-tax profits with little or no extra tax.

Congress is also likely to enact a “deemed repatriation tax” on the $2.5 trillion of profits that have been accumulated abroad but never subject to US tax. Although the details of this provision have not been decided, the basic idea would be to levy a tax of about 10% on the untaxed overseas profits, to be paid over a period of years. In exchange for this new tax liability, a US corporation could repatriate those accumulated profits whenever it wanted to do so.

The shift to a territorial tax system is likely to have important effects on US corporations’ behavior. A large share of their foreign subsidiaries’ future profits, which would be retained abroad under current law, are likely to be returned to the US, reducing investment in Europe and Asia. A portion of the $2.5 trillion of past profits now held abroad would be repatriated as well.

Moreover, US corporations will no longer have an incentive to shift their country of incorporation to other countries in order to be able to distribute their foreign-earned profits to their shareholders. At the same time, foreign companies will have an incentive to shift their headquarters to the US, where they could enjoy the advantages of being a US corporation without incurring the current tax penalty.

Although the shift to a territorial system of taxation would have the most obvious foreign impact, the planned reduction in the corporate tax rate may have an even larger effect. The 35% statutory tax rate on corporate profits is one of the highest among all developed countries. The congressional proposal would reduce the corporate rate to 20%. President Donald Trump has called for a 15% rate.

A lower corporate tax rate and the shift to a territorial system would increase the flow of capital to investment in US corporations from abroad and from capital investments in owner-occupied housing and in agriculture. This would raise productivity and GDP, leading to increases in tax revenue that would partly offset the direct effect of the corporate rate reduction.

But, because corporate tax revenue is now about 1.6% of GDP, the direct effect of halving the tax rate would reduce revenue by about 0.8% of GDP, or $160 billion a year at the current level of output.

The US cannot afford such a large increase in the fiscal deficit. And, because few features of the corporate tax law can be changed to reduce that revenue loss, I think the corporate tax rate will be reduced to about 25%. That would still be substantially less than the current rate and in line with the OECD average.

Corporate tax rates have been declining around the world in recent decades. The US rate was previously 50%, and rates in the other OECD countries were substantially higher than the current 25% average. It is certainly possible that the reduction of the US rate will cause other developed countries to reduce their corporate tax rates to improve their relative attractiveness to internationally mobile capital.

In short, the congressional legislation that is likely in the months ahead will change the tax rules for US companies, but it will also have important effects on international capital flows. It could also have significant effects on tax rules around the world.

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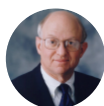

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Martin Feldstein, Professor of Economics at Harvard University and President Emeritus of the National Bureau of Economic Research, chaired President Ronald Reagan's Council of Economic Advisers from 1982 to 1984. In 2006, he was appointed to President Bush's Foreign Intelligence Advisory Board, and, in 2009, was appointed to President Obama's Economic Recovery Advisory Board. Currently, he is on the board of directors of the Council on Foreign Relations, the Trilateral Commission, and the Group of 30, a non-profit, international body that seeks greater understanding of global economic issues.

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