Last June the Republican majority in the United States House of Representatives presented a plan for an overhaul of the country's tax system. The feature of the plan that has sparked off most debate is the reform of corporate income tax.[1] Enacting the proposals for this tax would result in a radical shift in philosophy, turning this tax into a destination-based cash-flow tax (DBCFT), levied on cash flow generated by companies' operations in the United States.[2]

The plan aims to simplify the existing corporate income tax and eliminate the alleged discrimination against goods manufactured in the United States by countries whose tax systems include a form of value-added tax (VAT).[3] Key features of the reform are:

— The new tax would be levied on the cash flow generated by companies in the United States, with no deduction for purchases from non-residents (imports) but excluding income from sales to non-residents (exports) from taxable income. Corporate income tax is currently levied on US companies' profits regardless of where they are generated, although taxes on profits paid in other countries can be deducted in the United States.

— Reduction of the federal tax rate from 35% to 20%. The current rate is one of the highest among OECD countries, although there are numerous exemptions (such that the effective rate is 28.1%)[4, 5] and is not applicable to many businesses whose owners opt for their income to be taxed under personal income tax.

— Immediate total deduction (expensing) of the cost of capital investments. Nevertheless, deductions for capital goods acquired in the past that remain pending depreciation and amortisation would continue to be governed by the existing rules.

— Elimination of the deductibility of interest payments on all new loans. Consequently, interest on outstanding debt would continue to be deductible. The aim would be for funding decisions to be determined on the basis of economic rather than fiscal reasons.

— Limitation of the deduction for losses to 90% of taxable income, rather than the current 100%, with the possibility of indefinite carry forwards, updated at an appropriate rate. Also, elimination of all deductions, except those for R&D expenditure.

— Repatriation of accumulated foreign profits at a tax rate of 8.75% on cash profits or 3.5% on other profits, with the liability payable over eight years. It is estimated that US subsidiaries currently hold some $2 trillion in profits abroad. If companies decided to repatriate these profits under current legislation they would have to pay a tax rate of 35%, deducting taxes paid in the country in which the profits were generated from this amount.

Table 1 shows the estimate of the static[6] effect of this proposal on tax revenues over the coming decade (according to calculations by the Tax Policy Center)[7] broken down by the different aspects of the reform. The most significant impacts come from the revenue shortfall caused by the lower tax rate and the increase in revenue due to the "border adjustment", resulting from the fact that as the United States has a trade deficit, the increased revenues from taxes on imports would outweigh the drop in revenue caused by excluding exports from the tax base. The effect of eliminating the deductibility of interest is relatively modest as it only affects new debt and the calculations refer to the coming decade. On these estimates, the total net effect on tax revenues would be negative.

There is considerable uncertainty, however, as to whether the plan will ultimately be enacted, as it may lack sufficient support in the US congress. The plan also faces other obstacles: the highly heterogeneous effects on specific sectors may in some cases be negative, and parts of it may be on a collision course with World Trade Organization (WTO) rules.

To illustrate the controversy raised by the proposal in the US business world, due to the widely varying effects the reform could have on different types of companies, Table 2 shows the estimated static impact on post-tax profits and the taxes collected in two extreme hypothetical cases: a company highly dependent on imported inputs selling entirely to the domestic market, and an export-driven firm that does not buy inputs from abroad. Assuming that exchange rates remain constant, changes in post-tax profits show how the Republican proposal adversely affects imported goods, whose total value is considered taxable. By contrast, wage costs are tax deductible in the case of goods produced in the United States and exports are also excluded from the tax.[8] As a result, the hardest-hit companies would be those manufacturing

1 Among other measures, the reform also envisages changes to personal income tax, establishing three tax brackets instead of the current seven, and cutting the top tax rate from 39.6% to 33%. Half of all income from interest and dividends, as well as capital gains, would be exempt, and the top rate on this form of income would be 16.5%, instead of the 23.8% currently applicable to dividends and capital gains, and the 43.4% applicable to interest payments.

2 The source usually cited as the inspiration for this proposal is A. Auerbach (2010), "A modern corporate tax", Center for American Progress/The Hamilton Project.

3 The United States tax system does not envisage a tax equivalent to VAT. All states (except five) and some local governments collect taxes on the sale of final goods and services.

4 Seehttp://www.actontaxreform.com/wp-content/uploads/2016/09/International-Comparison-of-Effective-Corporate-Tax-Rates_FINAL_20160926.pdf, which includes a comparison of various studies on effective corporate income tax rates. The figure mentioned in the text comes from a study by the World Bank using 2014 data.

5 Some states have also established a complementary corporate income tax, which, according to 2012 estimates by the OECD, raises the effective federal tax rate by 4.1 pp.

6 The concept of «static effect» refers to the case where economic agents do not react to policy changes. This criterion is commonly used by the US Congressional Budget Office as a starting point in its analysis of the impact of legislative changes.

7 The Tax Policy Center is a think-tank that aims to provide independent analyses of tax issues. Document available at: http://www.taxpolicycenter.org/sites/default/files/alfresco/publication-pdfs/2000923-An-Analysis-of-the-House-GOP-Tax-Plan.pdf.

8 The World Trade Organization allows the use of border adjustments for indirect taxes, such as VAT, but not for direct taxes, such as corporate income tax. Therefore, numerous cases could be brought before the WTO by other countries on the basis of unequal treatment of the costs of internal and external inputs. Some countries may also opt to raise tariffs on US products.

Table 1
COMPARISON BETWEEN REPUBLICAN PROPOSAL AND CURRENT CORPORATE INCOME TAX LEGISLATION AND EFFECTS ON TAX REVENUE

	Current legislation	Republican proposal
Tax rate	35%	20%
Effect on tax revenue (10 years, $ billion)		-1,850
Border adjustment/tax base	No/total company profit	Cost of imported goods non-deductible and export revenue excluded/cash flow
Effect on tax revenue (10 years, $ billion)		+1,200
Profits abroad after entry into force of proposal (tax rate)	35% upon repatriation (taxes paid where subsidiary is located tax deductible)	0%
Effect on tax revenue (10 years, $ billion)		-90
Repatriation of retained foreign earnings built up before entry into force of proposal (tax rate)	35% upon repatriation (taxes paid where subsidiary is located tax deductible)	8.75% on liquidity positions; 3.5% on remainder
Effect on tax revenue (10 years, $ billion)		140
New capital expenditure	(Accelerated) depreciation over several years	100% depreciation at time of investment
Effect on tax revenue (10 years, $ billion)		-450
Elimination of exemptions	No	Yes
Effect on tax revenue (10 years, $ billion)		170
Net effect		
Effect on tax revenue (10 years, $ billion)		-880

SOURCES: Tax Policy Center and Banco de España.

Table 2
EXAMPLE UNDER DIFFERENT CORPORATE INCOME TAX REGIMES AND FOR DIFFERENT TYPES OF FIRMS (MANUFACTURING EXPORTERS AND RETAIL IMPORTERS)

	Sales in USA (I)	Exports (II)	Revenues (I + II)	Imports (III)	Costs (excluding imports) (IV)	Tax base	Tax revenues (tax rate x tax base)	Post-tax profits
Current corporate income tax (tax rate = 35%)						(I + II – III – IV)		
Manufacturing exporter	400	600	1,000	0	800	200	70	130
Retail importer	1,000	0	1,000	400	400	200	70	130
Current corporate income tax (but with tax rate = 20%)						(I + II – III – IV)		
Manufacturing exporter	400	600	1,000	0	800	200	40	160
Retail importer	1,000	0	1,000	400	400	200	40	160
Republican proposal (tax rate = 20%)						(I – IV)		
Manufacturing exporter	400	600	1,000	0	800	-400	-80	280
Retail importer	1,000	0	1,000	400	400	600	120	80

SOURCE: Banco de España.

products with a large import content and low proportion of wage costs, such as those in the automotive sector.

The anticipated effect of the introduction of this corporate income tax on the exchange rate is also a matter of considerable debate. Some people think that this measure could cause the dollar to rise by as much as the tax rate,[9] such that companies' costs would remain unchanged. In this case, there would be no competitiveness gains associated with changes in the terms of trade or any sector-specific differences in impact. However, although it is not the same type of tax, past experience from the introduction of VAT in certain countries has showed that adjustments in the nominal exchange rate are not immediate and prices are affected over the relatively long term.[10] There may, therefore, be transitory competitiveness gains that might improve the trade balance and, possibly, lead to a degree of sectoral reallocation of activity. This is without taking into account possible trade retaliation by other countries under the aegis of the WTO.

9 For example, let us suppose that the exchange rate between the dollar and the euro is parity ($1/€1) and that an importer purchases a product outside the United States at a price of €1. As a result of the tax the cost for the importer would be $1.2 (given that the tax rate is 20%). For the price to remain the same in dollar terms, the exchange rate would therefore need to rise to $0.83/€1.

10 See C. Freund y J. Gagnon (2017), "Consumption taxes, real exchange rates, and trade balance", Peterson Institute for International Economics, https://piie.com/system/files/documents/gagnon20170201ppt.pdf.