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International tax cooperation in danger

Is Trump's tax reform bad for developing countries?

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The Current Column

of 12 February 2018

Is Trump's tax reform bad for developing countries?

The first successfully implemented project of US President Donald Trump, who has been in office for a year now, is one that will have global implications. The main criticism levelled at the largest US tax reform since 1986 concerns its effect on domestic distribution, as it greatly relieves the burden on higher earning households and companies, but does little or nothing to ease the load on low earners and the middle class. But at the same time, the reform also has ramifications internationally, because it is set to be financed largely through the repatriation of overseas assets, something for which it offers relevant incentives.

Known as the Tax Cuts and Jobs Act, the reform firstly cuts the US corporate tax rate from 35 per cent to 21 per cent of corporate income, reducing in one fell swoop what was one of the highest such rates internationally to below the global average of 23 per cent.

Secondly, it sees the US switch from a worldwide model employing the credit method, to a territorial system. This means that, in future, profits generated abroad by US companies will no longer be taxed at the US rate, but rather at the foreign rate, even if the latter is lower (though a minimum tax rate is set to be employed to prevent extreme abuses).

Thirdly, a special ruling will see all profits previously held abroad taxed at a particularly low rate of 15.5 per cent or 8 per cent. It is estimated that at least some of the over USD 2.5 trillion held abroad until now will be returned to the US. Companies such as Apple have already announced plans for such repatriations.

This has wide-ranging implications for all other nations. With a total stock of around USD 6 trillion, US corporations are by far the largest holder of foreign direct investment in the world, including in many developing countries So what can these nations expect from the tax reform?

We see three main effects. Firstly, developing countries could benefit from the expected surge in worldwide growth. The IMF has just revised upwards its 2018 growth forecasts for the US and the global economy, making explicit reference to the tax reform. However, many experts fear that this growth stimulus could prove to be relatively short-lived, since several aspects of the reform, such as growing budgetary deficits (there is talk of an additional USD 0.5 to 1.5 billion over the coming decade), its regressive impact on distribution in the medium term, and rising production costs of an increasingly nationalised US economy, serve to dampen domestic demand.

Secondly, while the tax reform will change the investment behaviour of many large companies, this will affect other industrialised nations and low-tax countries such as Ireland and Luxembourg to a greater extent than most developing countries. Nonetheless, it is possible that a number of countries with close links to the US economy could see slower growth in direct investment, and even outflows, in their manufacturing industry.

Thirdly, the world now needs to gear up for a new round of global tax competition. A race to the bottom on the corporate tax front would not be good news for many developing countries, as they are often particularly dependent on such taxes, the lion's share of which is often borne by a small number of multinational companies. At the same time, there is already barely likely to be any investment in the manufacturing industries of developing countries that does not enjoy several years of tax exemptions. By contrast, in capital-intensive sectors such as natural resources, energy and telecommunications, tax competition between countries does not play such a major role.

Consequently, the more relevant question for developing countries is how the US Government will position itself in regard to international tax avoidance and tax evasion, issues that affect these nations particularly adversely. While Trump's reform does seek to combat a number of tax avoidance practices in the US, the US Government's unilateral approach gives reason to fear that internationally agreed approaches to issues such as sharing tax-related information will remain a low priority in future too.

In summary, the additional growth stimulus generated by the US tax reform may be good news for developing countries in the short term, but global economic risks are more likely to increase in the medium term. The re-channelling of global financial flows and the threat of another round of international tax competition on the horizon will barely have any direct impact on most developing countries, but where they do, the effects will be negative.