Trump's corporate tax cut may prompt Europe to follow

by Edoardo Campanella (UniCredit Bank Milan)

- President Donald Trump has pledged to cut the corporate tax rate to 15% from 35%, while Republican congressmen are aiming at a drop to 20%. Both rates are below the European average of about 24%.
- In the past, the corporate tax rates set by European countries proved to be sensitive to policy changes in the United States. The Tax Reform Act adopted by Ronald Reagan in 1986 is a case in point.
- Some European governments are already thinking about countermeasures to a potential tax regime change. And the risk of a race to the bottom in corporate tax rates is non-negligible.
- However, historical patterns should be taken with a pinch of salt. The globalization reversal that is now underway, coupled with growing anti-establishment sentiments, might not trigger the same reaction observed over the last three decades.

1. Cutting the corporate tax rate

Within weeks, President Donald Trump will send Congress an outline for a comprehensive plan to overhaul the tax code for individuals and businesses. The details are not known yet, but the tax reform, especially on the corporate front, will likely be radical. In Trump's words, "it will be phenomenal". During his campaign, and as part of his plan to "make America great again", Mr. Trump pledged to cut the corporate tax rate to 15% from the current 35%. The primary goal is to dissuade large corporations from moving their legal entities or even their operations to more convenient fiscal jurisdictions. Republicans in the House of Representatives, instead, favor a tax rate cut to 20%. There is clearly plenty of room to negotiate an agreement that suits both the executive and legislative branches of the Republican Party.

Regardless of the final outcome, the reform will likely reshape international capital markets and affect the investment decisions of several multinationals. It will also inevitably trigger reactions from other advanced economies too. The prospect of losing tax revenues as a result of a less appealing tax system might induce other governments to revise their corporate taxation rules, in a sort of race to the bottom. Wolfgang Schäuble, Germany's finance minister, recently argued that Berlin should simplify its complex corporate tax system[1], and Viktor Orbán, Hungary's prime minister, went a step further. To lure foreign direct investment, he has promised to cut the rate to 9% from the current 19%, going even below Dublin's 12.5%.[2] But all European capitals are working out potential responses to Washington's aggressive moves.

[1] http://www.wsj.com/articles/germany-could-cut-corporate-tax-rate-finance-minister-wolfgang-schauble-says-1484565313
[2] https://www.ft.com/content/302fa4b4-acda-11e6-9cb3-bb8207902122

This is not the first time that a radical tax-regime change in the United States has forced European countries to adapt abruptly. Something similar happened in the 1980s under President Reagan. While today's macroeconomic and political environment is radically different from then, with globalization being in retreat and with bilateralism replacing multilateralism, the corporate tax battle between America and Europe is likely to resurface. With an eye on the historical evidence, we will see how it could unfold.

2. The corporate tax rate over time

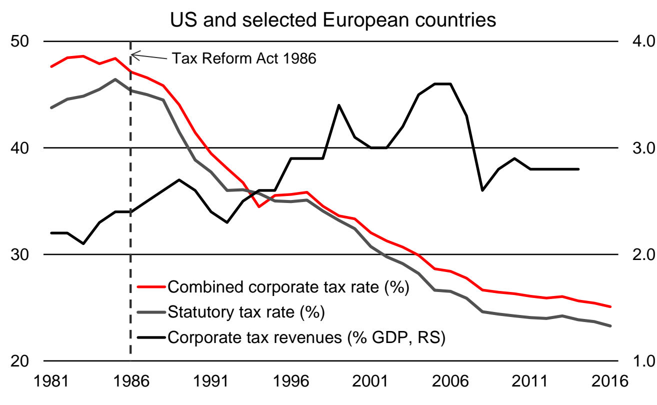
The debate about the reform of corporate taxation goes well beyond the setting of a new statutory tax rate. There are many issues on the table that complicate the negotiation. First, it remains to be seen whether the US will shift to a cash flow tax, which implies immediate deductions of capital spending and no deduction of net interest payments. This would be a far-reaching change that would make the tax system rather complicated, increasing the cost for firms to adjust. Second, there is the issue of border-adjustments – meaning whether imports, but not exports, should be included in the tax base. Alternatively, Congress and the White House may ultimately decide to stick to the current tax system, with minor amendments. Each party involved in the negotiations has different views about each of these issues. Therefore, the reduction of the statutory tax rate, which is widely supported within the Republican party, represents just a small part of the wider issue. Yet, the statutory rate gives a clear signal about the intrusiveness of corporate taxation, facilitating cross-country comparisons, without getting lost in the peculiar functioning of each tax system. And, despite all its technical limitations, this is the number that is more often discussed in international policy debates. For this reason, the rest of the analysis will take this specific angle.

Over the last three decades, corporate tax rates have been trending down across the advanced world. Chart 1 shows that the unweighted average corporate tax rates[3] for a selected sample of advanced economies[4] has softly declined from about 50% in 1981 to about 25% now, but the drop in the rate has not led to a fall in corporate tax revenues. These have actually increased slightly from 2% of GDP in 1981 to about 3% now, thanks to base-broadening reforms through reductions in incentives or other deductions as well as to the untamed increase in the GDP share of corporate profits across the advanced world.[5]

[3] The combined tax rate is given by the sum of the statutory rate and the taxation charged on firms by local governments.
[4] Austria, Belgium, Czech Republic, Denmark, Finland, France, Germany, Greece, Hungary, Italy, Latvia, Luxembourg, Netherlands, Poland, Slovakia, Slovenia, Spain, Sweden, Switzerland, United Kingdom, United States.
[5] Devereux, Griffith, and Klemm (2002), "Corporate income tax: reforms and tax competition", *Economic Policy*

These diverging movements highlight the complexity of the corporate tax system. At a minimum, it comprises a statutory tax rate, which is applied to taxable profit. The definition of taxable profit, however, is typically far from being straightforward or homogenous across countries.[6]

CHART 1: CORPORATE TAX RATES DOWN, REVENUES UP

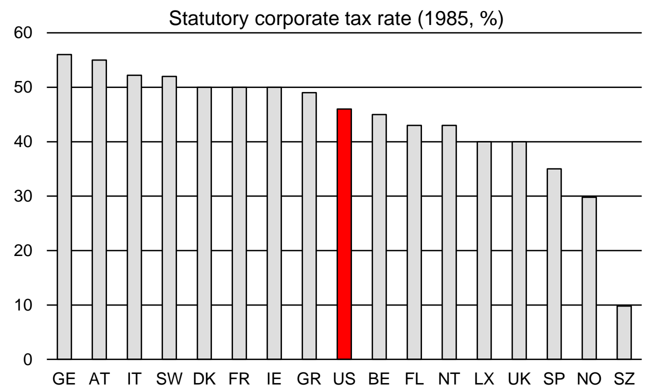


Source: OECD, UniCredit Research

Financial globalization, which has provided increased room for international tax arbitrage, is the prime suspect for the decline in the average corporate tax rate over this period.[7] When capital became increasingly more mobile at the end of the 1980s and beginning of the 1990s, governments started to revise down their corporate tax rates for fear of losing investments, jobs and eventually more tax revenues. One trigger of the downward trend in corporate tax rate was the decision of the Reagan administration to adopt the Tax Reform Act of 1986, which slashed the corporate tax rate in the US from 46% to 34%. At that time, as shown in chart 2, the statutory tax rate in the United States was high in absolute terms but below the rates charged by other large European economies like Italy, Germany and France. Reagan's decision was motivated more by ideological considerations aimed at boosting the economy through supply-side policies than by a desire to attract foreign investments or to retain domestic ones at the expense of other Western competitors.

The main European countries reacted to Washington's decision by cutting their corporate tax rates as well, albeit in an uncoordinated manner. In 1985, when financial capital was not too mobile and the labor force was not globalized at all, it was still possible for economies that were smaller and less competitive than the United States to set corporate tax rates that were slightly above the American one, without experiencing major capital hemorrhages. Yet, the 25% reduction in the tax rate caused by the Tax Reform Act of 1986 demanded a response.

CHART 2: REAGAN'S DAYS



Source: OECD, UniCredit Research

Chart 3 looks at the evolution of the statutory rate for the United States and for a sample of European countries[8]. The unweighted average rate in Europe declined from 46% to 35% between 1986 and 1994[9]. In France, it dropped from 45% to 33%, while in Germany, it fell from 60% to 53%. In Austria, it declined from 50% to 30%. As a result of the public-finance vulnerabilities experienced in those years, Italy was instead forced to raise the rate from 46% to 53%. Then, in 1993, the United States brought the rate to 35% and left it there until now, while the other European countries continued to reduce their own rates to levels well below the American rate; these have now stabilized around an average of 25%.

Chart 3 should be taken with a pinch of salt. The decline depicted might be due to factors other than US tax policy, like the financial globalization process, and this might just be a simple correlation, with no causal relationship. However, empirical studies have shown that, even controlling for financial integration, the decline in the European average rate between 1986 and 1993 was mostly driven by the Reagan administration policies.

[6] This is why the statutory tax rate is not a fully reliable indicator when it comes to measuring the intrusiveness of corporate taxation. In theory, it would be better to use the effective tax rate, which is determined by the ratio of taxes paid divided by profits, but this data is not readily available and there are no reliable historical series to draw international comparisons. Despite its drawbacks, the statutory tax rate sends a simple and clear signal of how corporate friendly a tax-system is.

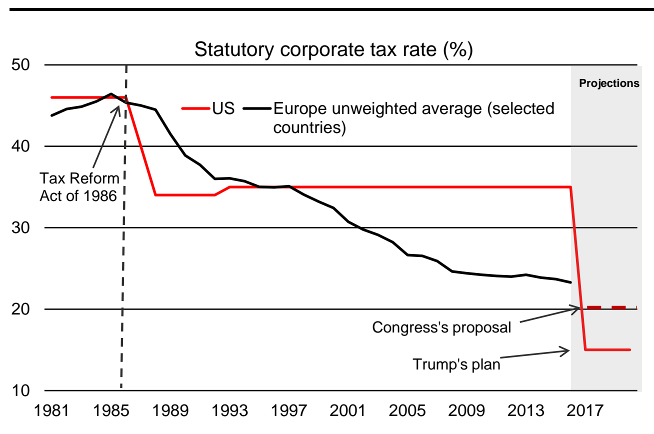
[7] See, for instance, Razin Assaf and Efraim Sadka (2004), "Capital Income Taxation in a Globalized World", NBER #10630.

[8] It is important to highlight that the chart and the subsequent analysis would have told a similar story if, instead of the statutory corporate tax rates, we had considered the combined corporate tax rate, which includes also subnational tax rates besides the one set by the central government.

[9] If we had used the weighted average, with GDP shares as weights, we would have obtained a very similar result. The decline in the nineties would have been just slower, mostly because smaller economies reacted sooner and faster to Reagan's policy. In the literature, there is no consensus on whether it is better to use one measure or the other. Since we want to show how individual countries react to tax changes in the US, we believe that the unweighted average is better suited for our analysis and for the sake of it we just report this measure.

In particular, a 10% decrease in the US tax rate led to an average 6.1% decline in the tax rate of European countries.[10] In game theory jargon, the United States acted as a Stackelberg leader, i.e. a large enough economy that sets its tax rate first and then compels the rest of the advanced world to follow suit and adapt.[11] While the removal of trade and investment barriers would have likely forced European countries to revise their corporate tax system anyway, regardless of the reform of the American tax system, Reagan's move likely set the timing for the rest of Europe.

CHART 3: THE RACE TO THE BOTTOM



Source: OECD, UniCredit Research

In addition, it is interesting to highlight that the empirical evidence suggests that tax policy changes in Germany and the United Kingdom, instead, had no impact on the tax choices made by the rest of the continent – despite the fact that London adopted a major tax reform in 1984 that was not too dissimilar from what Mr. Reagan did two years later. In other words, European countries are affected by Washington's tax competition more than by competition among their continental neighbors. This is also partly due to the efforts of the European Commission, which has no authority on the fiscal policy mix of individual countries, to dissuade member states from adopting tax policies that might be harmful for the rest of the union. In 1997, for instance, the Ruding Committee asked (partly unsuccessfully) governments to set the corporate tax rate at a minimum of 30%. More recently, in the wake of Dublin's questionable tax deals with some top American corporations, Brussels has started to work on enacting proposals that aim to harmonize the definition of tax base.

In short, over the last three decades, falling trade and investment barriers, coupled with a sustained process of deregulation in a number of sectors, likely put downward pressure on corporate tax rates across the advanced world.

[10] Altshuler, Rosanne, and T.J. Goodspeed (2015), *Follow the leader? Evidence on European and U.S. tax competition*, Public Finance Review vol. 43, 4: pp. 485-504.

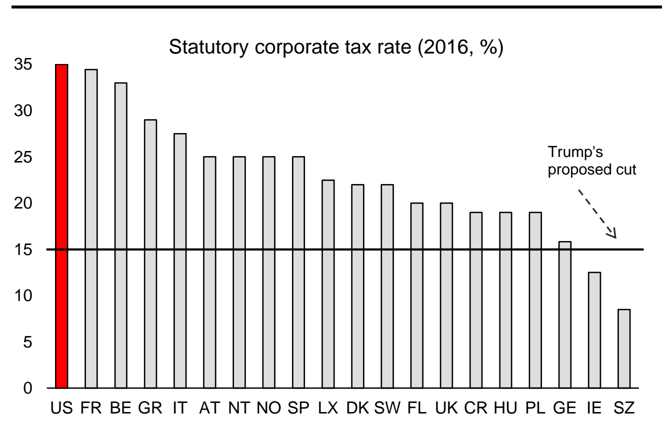
[11] Gordon, Roger H. 1992. "Can Capital Income Taxes Survive in Open Economies?" *Journal of Finance* 47(July):1159-80.

The tax reform implemented by the Reagan administration, which was partly motivated by the globalization process itself and partly reinforced it, forced European economies to rapidly adjust to these changing structural conditions. Since the mid-nineties, corporate tax rates have continued to decline even below the US level, again driven by the financial globalization process or by country-specific factors, such as the size of the economy or the level of income per capita.

3. The corporate tax rate now

Recent proposals by the Trump administration and Republican congressmen hint at a corporate tax rate that is well below the European average – similar to what happened with Mr. Reagan in 1986. Unlike then, these proposed reforms are less motivated by ideological considerations and more by the conviction that lower corporate tax rates can improve the competitiveness of the United States, whose statutory rate is currently the highest among advanced economies (chart 4). After all, for smaller economies, it is strategically wise to set their rates at levels slightly below those of the leader. If Mr. Trump manages to bring the US rate down to 15%, only Ireland and Switzerland would tax their corporations in a more favorable way.

CHART 4: MR. TRUMP HAS A POINT (I)



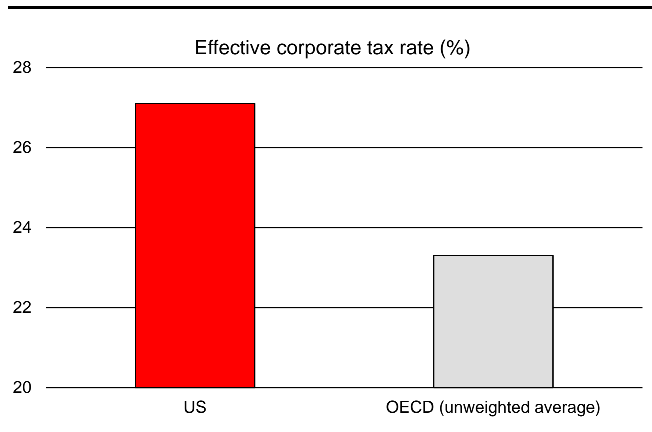
Source: OECD, UniCredit Research

Even when we look at the effective corporate tax rate, which takes into account all the loopholes of the tax system and standard tax deductions, but is extremely hard to be measured, the US rate is higher than that of other OECD countries.[12] According to some studies, a reduction in the American corporate tax rate to 15% would cause the effective tax rate to fall to 21.2%.[13] Whether or not a similar tax reform will significantly boost American GDP is open to debate. If history is of any guide though, Europe will likely react in an aggressive way to keep up with Washington's move – a bit like it did thirty years ago.

[12] Gravelle, Jane (2014), *International corporate tax rate comparisons and policy implications*, Congressional Research Service

[13] http://www.zew.de/en/presse/pressearchiv/effektive-steuerlast-fuer-us-unternehmen-sinkt-auf-eu-durchschnittsniveau/

CHART 5: MR. TRUMP HAS A POINT (II)



Source: Congressional Research Office, UniCredit Research

To assess the magnitude of this reaction, table 1 reports an econometric panel estimate from the IMF[14], focused on OECD countries and, so, not just Europe.[15] The dependent variable is the change in the combined corporate tax rate[16] for country *i* at time *t*, while the explanatory variable is the differential in the corporate tax rate between country *i* and the United States one period before to take into account a time lag in the policy response. The IMF controls for a number of variables that might affect the setting of corporate tax rate. It explicitly introduces variables for financial globalization, the size of the economy, the dominant political ideology in one country at a specific moment in time, and the level of income per capita.

While all these control variables play a role in explaining changes in corporate tax rates, we focus on how governments react to tax-policy differences with Washington (table 1). The negative coefficient means that, if European countries have a higher rate than the United States, they will drop their rate the year after.[17] In particular, if we assume that the US Congress approves, in 2017, a cut in the corporate tax rate to 15%, then we expect a cumulated drop in the average European rate by about 3pp over a five-year horizon – in line with the recent statements by some governments.

TABLE 1: TESTING THE MAGNITUDE OF THE RESPONSE TO THE US TAX CUT

	Changes in the combined corporate tax rate (*t, i*)
Differential with American corporate tax rate (*t-1, i*)	-0.311**
Constant	-10.990*
Time/cross section fixed effects	Yes
Countries	OECD-ex US
Control variables	Yes
R^2	74%
Number of observations	152

*significant at 1%, **significant at 5%

Source: IMF, UniCredit Research

4. Differentiated reaction

The forecast decline in European corporate tax rates looks contained in terms of size and is likely to be implemented slowly. There are several reasons for this. Even if Mr. Trump were to bring the tax rate down to 15%, the difference with the average European rate would be less than 10pp and only few countries would need to go through a major adjustment – hence the average change would be contained. And since any rate cut would be accompanied by the closing of loopholes in the tax system, then the decline in the effective tax rate (what matters from the perspective of a firm) would be more contained. Second, fiscal policy always reacts with a time lag and the political process might significantly slow down the transition to a new tax regime, especially when governments have to honor budget commitments with the European Commission.

Third, the tax differential with the United States is only one of the many factors that affect the tax rate. The openness of the economy, its size and the health of public finances are more important factors. Therefore, it is entirely plausible that not all countries will react in the same way. Fiscally constrained economies, like those of Spain and Italy, will be slower to adapt to a new American tax regime. For countries like Belgium and Norway, where corporate taxation represents an important source of fiscal revenues (chart 6), it might be more difficult to adjust, running the risk to lose the battle. Countries like the United Kingdom, which is in search of a new post-Brexit economic model, are more likely to act swiftly and decisively. Among Europe's largest economies, both France and Germany have strong incentives to reduce their corporate tax rates. Germany is an interesting case. Its statutory rate is pretty low, at 15.8% (chart 4), but its combined rate, which includes subnational taxation, is at 30.2%. This explains why Mr. Schäuble is concerned about Mr. Trump's move.

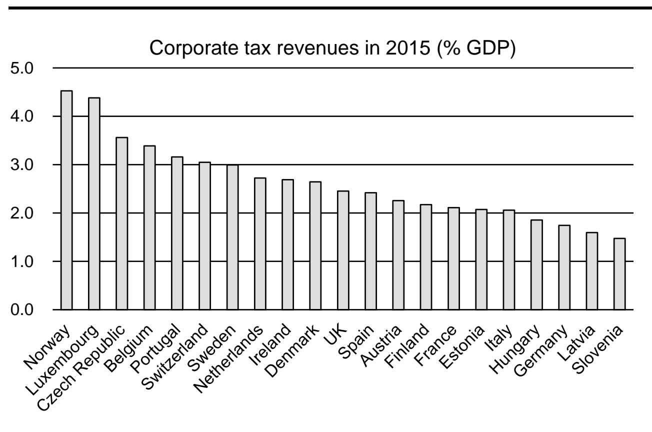
[14] Kumar Manmohan and Quinn Dennis (2012), "Globalization and corporate taxation", *IMF Working Paper* (12/252)

[15] The IMF looks at all the OECD countries from 1980 to 2009. Since there are many holes in the IMF databases, they use 5-year averages.

[16] The combined tax rate includes also the taxes charged by local governments, and not just the statutory one. This measure is a bit more volatile and add some additional variation in our database that is helpful for our estimates.

[17] The econometric model implies that in case of a negative differential with the US the corporate tax rate in country *i* should go up. Clearly, over the last twenty years (chart 3), especially for smaller countries, there was a bias in bringing the tax rate down rather than up, regardless of the American tax policy, mostly because of the financial globalization process.

CHART 6: THE VARYING IMPORTANCE OF CORPORATE TAX REVENUES



Source: OECD, UniCredit Research

Especially for smaller jurisdictions like, for instance, Luxembourg, lowering the corporate tax rate does not necessarily lead to greater economic activity, but simply to the springing-up of more shell companies. Therefore, it is unclear whether the eurozone periphery, which as a result of binding budget constraints will struggle more than the core to adjust to Trump's tax choices, will see its growth gap within the eurozone widen or will simply see its tax revenues marginally fall as a result of corporate profits moving to another country. Either way, the economies more in need to boost their GDP or to strengthen their public finances would be unable to reform their corporate tax rate in time. For this reason, the European Commission might consider intervening in order to avoid a "race to the bottom" taking hold on the European continent, proposing some form of policy coordination like at the time of the Ruding Committee.

However, one caveat is warranted. The estimates refer to a time when globalization was in full swing, while now we are in the midst of a major regime change that might completely reverse the global liberal order of the previous decades. The reversal of the globalization process means that governments might introduce barriers not just to limit the flow of goods and services but also to make capital and profits less mobile through, for instance, border-adjustment accounting rules. If this is the case, then international tax competition would become much less intense and countries would be free to set their corporate tax rates independently, irrespective of what other countries, such as the United States, do. At the same time, growing populist attitudes might prevent governments from adopting reforms that are perceived to favor corporations to the detriment of ordinary people, as shown by the recent Swiss referendum on Bern's corporate tax reform.

5. Concluding remarks

The effects of the forthcoming corporate tax reform in the United States will likely reverberate through Europe. Like it did in the 1980s, Washington is about to carry out a tax-regime change that will force Europe to adapt, with a forecast decline in its average rate of about 3pp over a five-year horizon – unless a populist takeover or a full globalization reversal materialize. However, while the benefits of such a move look very limited, especially with a mature business cycle, its costs might be extremely high. If countries dropped their tax rates altogether, tax revenues might be negatively affected at a time of exorbitant public debt. And those countries that fail to adjust their tax rates due to fiscal or political constraints might see their competitiveness decline. In the worst-case scenario, the tax battle might reinvigorate protectionist attitudes in order to confine tax base within national borders.

While Mr. Trump might have a valid point in reducing tax pressure on American corporations, it would be much wiser to pursue some form of international policy coordination at the OECD level, to shelter tax revenues, avoid a "race to the bottom" and better regulate tax havens. However, this multilateral approach is miles away from Mr. Trump's unilateral way of seeing the world.

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