Economic Insight

# Macroeconomic consequences of US tax reform for Germany: greater need for action

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## Executive Summary

- We estimate the positive effect of the tax cuts on real economic growth in the US at more than half a percentage point in 2018 and between a quarter and half a percentage point in 2019. Additional economic effects could result from the Bipartisan Budget Act of 2018, which leaves room for considerable additional government expenditure. The global economic impact of any such additional growth in an economy as big as the US, which generates almost 25% of the world's economic output, is not negligible. Global economic growth is likely to benefit from the tax cuts by 0.1 - 0.2 percentage points each year. This range of figures should also apply to Germany.

- There are a number of channels through which the dollar exchange rate against the euro and the level of long-term interest rates in the Eurozone may be affected. Despite the current tendency to the contrary, we expect a slight strengthening of the dollar and a limited effect on long-term interest rates in Germany, raising them by up to a quarter of a percentage point.

- The US tax reform is likely to shift the balance of direct investment with the US further to the disadvantage of Germany. The outflow of capital from Germany in the direction of the US could increase significantly.

- The European response to the US tax reform should not be confined to harmonisation of the EU-wide corporation tax. Instead, the focus should be on a more attractive framework of conditions for investment. Measures of this nature could allow EU countries to enhance their appeal to multinational groups in particular, while maintaining relatively high standard rates of corporation tax.

- In Germany, the overall tax burden on companies has even risen further in recent years, contrary to the EU-wide trend. Nevertheless, purely introducing tax cuts would probably not be an adequate response to the US tax reform. Fine adjustment to the existing system of corporate taxation is not needed; instead, a real re-organisation of the company taxation levied through corporation and local business tax is required. It would be a brave step for tax policy if the increased pressure to act were to instigate re-organisation of municipal finances. Local business tax should be fundamentally put under the spotlight – and not just when revenues slump once again due to the economic cycle, rocking the financial position of municipalities.

# 1. Introduction

The US tax reform that was passed in December 2017 has given rise to divided opinions in Germany. Some see it as an impetus to growth, benefiting the global economy; others criticise its pro-cyclical effect and the accumulation of another mountain of debt; others again are concerned about the relative attractiveness of Germany as a business location. Over the longer term, international German companies expect predominantly positive effects on their earnings, although this is often not the case over the short term.

**US TAX REFORM: KEY POINTS**

| Business tax reform | Individual tax reform* |
|---|---|
| 21% Corporate tax rate | Tax relief through modification of rates and income thresholds<br><br>Deduction of qualified business income form total income |
| Full expensing of short-lived capital investment for five years | Increased standard deduction and child tax credit |
| Net interest deduction capped at 30% of EBITDA for four years, and 30% of EBIT thereafter | Repeal / limit various deductions and exemptions (lower caps for mortgage interest deduction and State and Local tax deduction) |
| International tax reform:<br>• One-time deemed repatriation tax on US corporations' offshore earnings at a rate of 8% (liquid assets) / 15,5% (liquid assets)<br>• Base erosion anti-abuse tax (BEAT) | Tax penalties for those that do not buy health insurance elimated |

* Many provisions expire after 2025 (i.e. return to previous legislation).

Germany's economy is running smoothly at the moment. No-one expects that potential repercussions of the US tax reform will change anything fundamentally in that respect at the present time. However, this should not lead to the conclusion that the effects of the reform on Germany are negligible. We intend to deal with the macroeconomic consequences in the discussion below, as well as outlining the need for action that results from this.

# 2. Direct macroeconomic implications

The impetus of the US tax cuts chiefly affect economic growth in the years 2018 and 2019, even though the revenue loss estimated at 1.4 trillion US dollars is mostly calculated over a ten-year timeframe. The tax relief for private households and companies is likely to be around 1.5% gross, relative to GDP, in each of the years 2018 and 2019. In terms of net tax relief, however, the government's additional tax revenues, in particular due to the taxation of previously non-repatriated foreign profits of American companies, have to be taken into account. We estimate that the net tax relief for 2018 will amount to around 1%, while in 2019 it will be significantly above 1%, relative to GDP. In addition, the tax payments of US corporations for profits earned abroad must not be assessed in isolation as a restrictive macroeconomic impetus; instead, the repatriation of earnings could tend to be accompanied by higher investments.

Further fiscal stimuli are provided by the Bipartisan Budget Act of 2018, which provides the scope for substantial additional government expenditure, particularly defence spending, in 2018 and 2019. This will also strengthen the economic momentum. In the following, however, we will only concentrate on the effects of the tax cut, as it will affect international location conditions.

It is difficult to estimate the multiplier effect, i.e. the effects of the fiscal boost on GDP in real terms, over the short and medium term. It is often pointed out, and not unjustly, that the multipliers will be turn out to be quite small due to the nature of the tax relief: high-income households, which receive the most relief through the reform, have a lower propensity to consume that low-income households. In an economy with high capacity utilisation as in the US now, the additional potential for growth is limited in any case. Not least, higher multipliers are often attributed to additional government expenditure than to tax cuts. The latter may be doubted, however, at least over the medium term. Reductions in corporate tax may promote willingness to invest and enhance the attractiveness of the business location. This in turn increases the growth potential of an economy. We expect that the total short-term multiplier of the US tax reform will be close to 0.5. Overall, we estimate the positive effect of the tax cuts on growth in US gross domestic product in real terms at more than half a percentage point in 2018 and between a quarter and half a percentage point in 2019. This will not trigger a lasting economic boom in the US as, in view of the late phase of the upturn, effects tending to curb economic growth are also gaining importance. These include market saturation, for example in the demand for cars.

The global economic impact of additional growth of a good half a percentage point in an economy as big as the US, which generates almost 25% of the world's economic output, is not negligible. A key aspect is not only the pure effect on demand, but also that an improvement in the economic outlook in the world's largest economy stabilises economic expectations globally. Global economic growth is likely to benefit from this by 0.1 - 0.2 percentage points this year and next. This range of figures should also apply to Germany.

The impact of the US tax reform on inflation outside the US is likely to be very limited. Although the sustained robust economic growth in the US could strengthen the already existing upward pressure on commodity prices to some extent, it will probably not set off a surge in commodity prices. The slight increase in global growth resulting from the US tax cuts is also unlikely to have much influence on the process of determining wages. In any case, the Phillips curve – the inverse correlation of unemployment rate and wage inflation – now only shows low elasticity in most industrialised countries. A rise in the inflation rate in Germany appreciably above 2% is not very probable in 2018 and 2019, despite increasing capacity utilisation.

The tax cuts could result in higher interest rates in two ways. The US national debt will probably rise substantially. Experience has shown that self-financing effects resulting from higher economic growth fall far short of compensating for lower tax revenues. However, the interest rate effects of higher government issuing activity in an international investment currency such as the dollar are likely to be only moderate, at least as long as the monetary policy does not take any really restrictive path. The expansive financial policy could nevertheless be a reason for the Fed to normalise its policy somewhat faster than it had planned. All in all, long-term US interest rates could increase by a quarter of a percentage point to maximum half a point in the next two years as a consequence of the tax cuts, more sharply than the rates would have risen without the cuts. Due to the inter-connection between interest rates in an international context, this would also impact on the level of yields in the Eurozone. For the yield on ten-year German government bonds, however, this probably means a level higher by a quarter of a percentage point at most.

A question that is both fascinating and difficult is the effect of the tax reform on the exchange rate of the dollar against the euro. A previous case of tax incentives, in which the US government attempted to repatriate foreign earnings by US companies (the Homeland Investment Act of 2004), suggests a positive albeit quite small effect on the dollar. We estimate that, during the period of repatriation at that time, this led to the dollar being a few cents higher against the euro. In addition to the tightening of monetary policy being pursued by the Fed and the wide interest rate gap between the US and the Eurozone, this is a further argument in support of the dollar's tendency to be stronger against the euro. This, however, is contrary to the trend on the foreign exchange market in recent weeks. We do not see any fundamental reasons for the current dollar weakness. For this reason, we do not consider it to be lasting.

# 3. Effect on competitiveness and Germany as a business location

## Is the US a new low-tax country?

German international tax relations law stipulates a threshold of 25% as the minimum taxation of foreign portions of earnings. Below this level, taxation of foreign sourced income is imposed by the German tax authorities. As the new tax rates in the US are now below this threshold, the US could be classified as a tax haven according to German rules. In view of the general international trend towards lower corporate taxes, this would of course be a misclassification. It merely illustrates the need for reform of German international tax relations law.

In any case, when making an international comparison of corporate taxation, it is not so much the tax rates that should be given special emphasis, but the effective tax burden. A comparison of the effective burden on corporations in the US and Germany was made in a study authored by Jarass, Tokman and Wright[1]. They conclude that the entire tax burden of corporations on earnings in the US was just under 20% in 2015, while in Germany it was below 15%. Even if the effective tax burden on US companies falls slightly below the German level as a result of the tax cuts, as is expected, there can be no question of the US as a tax haven. It should not be overlooked, however, that the tax relief on companies in the US is substantial and it significantly increases the attractiveness of the US as a business location.

## Effects on capital flows and direct investment

The attractiveness of a location for corporate investments depends on a number of factors. The tax burden is just one of these factors, although an important one. Despite the previously quite high rates of corporate tax in the US, the country was a preferred location for direct investment. For example, German companies had direct investments of EUR 290 billion in the US in 2015, while US firms with parent company in the US only invested EUR 85 billion in Germany.

The US certainly benefits as a location for investment from the fact that it has the world's largest domestic market and the most important international currency for investment and transactions. It also has a reputation for a low level of bureaucratic obstacles and

[1] Lorenz J. Jarass, Anthony E. Tokman, Mark L. Wright, The burden of taxation in the United States and Germany, Chicago Fed Letter, 2017 Number 382.

high innovative capability, as well as facing smaller demographic problems than other industrialised countries. If there is also an improvement in the tax regime, this could also develop into an investment magnet in the direction of the US. An extensive study by the Centre for European Economic Research (ZEW)[2] has examined the effect of the tax cuts on the flows of foreign direct investment. Not surprisingly, the study found that the reform increases the incentive to move taxable earnings to the US. It follows accordingly from tax planning that foreign direct investment in the US from a high-tax jurisdiction such as Germany should logically be financed using equity capital, while direct investment by US firms in Germany should also be taxed in the US by means of company-internal credit financing. A further conclusion of the study is that the lowering of US corporate taxation is likely to boost both foreign investment in the US and investment by US corporations abroad. Based on estimated elasticities, German foreign investment in the US could increase by almost EUR 40 billion, while US direct investment in Germany could rise by only EUR 6 billion. The result of the study, that the effects of the reform are considerable for the trend in capital flows from and to the US, appears plausible to us. Possibly the elasticities derived from the past even underestimate the consequences. Germany must reckon on an even greater outflow of capital than is already the case.

## European response to US tax reform: is intensified tax harmonisation in the EU the right way to go?

In recent years there have been repeated attempts within the EU to harmonise corporate taxation. At the same time, however, there is also real competition between the countries for the most attractive tax framework conditions for companies. This competition is characterised by cuts to the rates of corporation tax while also extending the tax basis, intended to compensate for the resulting tax losses at least to some extent. In recent years, for example, Italy reduced its corporation tax rate from 27.5% to 24% and Croatia cut its rate from 20% to 18%. In Hungary, the progressive tariffs of 10% and 19% were replaced by a flat rate of only 9%. In the near future, too, the downward spiral among tax rates will continue within the EU. For example, France plans to reduce the corporation tax rate from the current level of 33.33% to 25% by 2022. The UK also intends to cut its rate to 17% after it leaves the EU, the lowest rate of corporation tax among the 20 largest economies in the world. The tax rate is 20% at present.

There is no doubt that the position of EU Member States in international tax competition is deteriorating relative to the US as a result of the US tax reform, along with their competitiveness. But how should Europe respond appropriately? In the past year the EU adopted a directive with provisions on combating tax avoidance practices (Anti-Tax Avoidance Directive, ATAD). It provides for various initiatives, such as the introduction of a limitation on interest deduction, ultimately resulting in an extension of the tax basis. There are also similar initiatives at the level of the OECD (BEPS project; Base Erosion and Profit Shifting). In itself, the implementation of all these measures results in a position where, from a purely tax viewpoint, the comparative disadvantage of the EU states in relation to the US is even strengthened further as a consequence of the broader tax basis. Although EU states could use the resulting leeway to cut corporation tax rates, the sustainability of ever lower tax rates could be questioned at the very least. It is simply the case that, sooner or later, the potential for extending the tax basis more and more in order to compensate for tax losses will reach its limits.

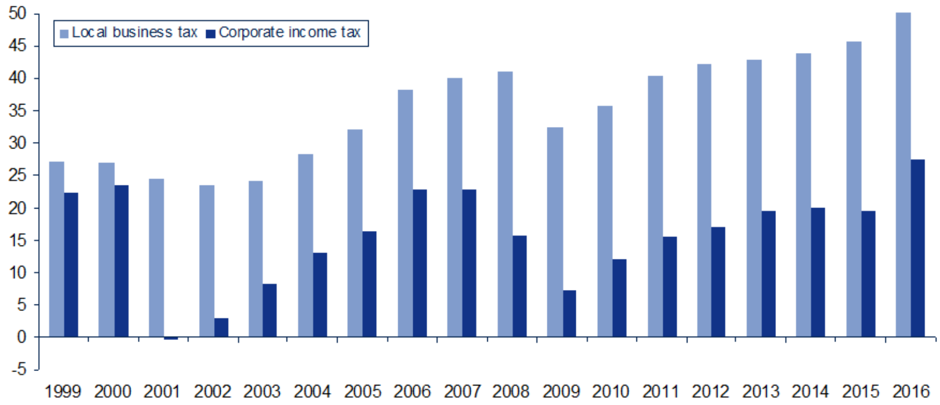
[2] ZEW, Analysis of US Corporate Tax Reform Proposals and their Effects for Europe and Germany, December 2017.

We believe that the European response to the US tax reform should not be confined to harmonisation of the EU-wide corporation tax. Instead, the focus should be on a more attractive framework of conditions for investment. This includes, for example, more tax incentives for R&D expenditure. Measures of this nature could allow EU countries to enhance their appeal to multinational groups in particular, while maintaining relatively high standard rates of corporation tax.

## German response: courage needed for fundamental changes to corporate tax law

Since the last reform in 2008, nothing has basically changed in Germany with regard to corporation tax, apart from the elimination of unconstitutional clauses. Since local busniness tax rates have risen in the meantime, however, the overall tax burden on companies has even increased, contrary to the EU-wide trend. The latest US tax reform has undoubtedly further intensified the need for action in relation to German corporate taxation. By cutting the rate of corporation tax, Germany could try to enhance once again the attractiveness of Germany in the international competition revolving around tax and business location. Tax rates in Germany are now significantly above the EU average, both in the case of the effective average tax rate and the standard rate: 28.2% versus 20.9%, and 31% versus 23%, respectively (taxes imposed by the central government and at municipal level).

Revenues from local business tax and corporate income tax (EUR bn)




A step of this nature would nevertheless probably not be an adequate response. In our view, fine adjustment to the existing system of corporate taxation is not needed; instead, a real re-organisation of the company taxation levied through corporation and local business tax is required. A simple lowering of the corporation tax rate would also push the tax revenue generated from corporation tax further into the background in comparison with the revenue obtained from local business tax. As a comparison: in 2016 the German tax authorities collected somewhat more than EUR 50 billion through local business tax, while revenue from corporation tax totalled just EUR 27.4 billion. It would be a brave step for tax policy if the increased pressure to act were to instigate re-organisation of municipal finances. For decades there has been criticism of various aspects of local business tax. This has resulted in a number of proposals for extensive reforms, including a municipal added value tax, a surcharge on corporation tax, direct income taxation of citizens by municipalities, a four-pillar model of municipal finances (model proposed by the Market Economy Foundation (Stiftung Marktwirtschaft, a

German economic think tank)) with a limited right to levy income taxes on the part of the municipalities, a property tax, a municipal business tax and a share of the municipalities in wage tax revenues. However, the debate surrounding all these reform models has become quieter in recent years. The need to maintain Germany's status as a business location would be a good reason to revive the debate surrounding reform of the local business tax. The municipalities' strong interest in preserving their (limited) financial autonomy could be taken into account in this respect. It would therefore be appropriate to put local business tax fundamentally under the spotlight – and not just when revenues slump once again due to the economic cycle, rocking the financial position of municipalities.

In addition to this admittedly ambitious major shift for corporate taxation, there is also a whole series of further measures for enhancing the attractiveness of Germany as a business location in international competition. These include:

- Neutrality of finance in corporate taxation: introducing the deductibility of equity capital costs would eliminate the tax disadvantage of equity compared to debt capital.

- Depreciation concessions: better depreciation options make Germany more attractive as a place to invest. One possibility would be, for example, the re-introduction of degressive depreciation. If appropriate, this could be limited in time and/or targeted to specific fields of investment, such as digital infrastructure.

- Tax-based promotion of research: tax incentives so that companies, especially quite small and medium size enterprises, invest more in research and innovations. An example would be tax relief for the cost of research staff.

- Deregulation and reduction of bureaucracy: this is a broadly-based and challenging area, but here especially there should be room for improvement in Germany.

In conclusion, economic policy must not rest on its laurels due to the very solid economic performance in Germany. One of its basic tasks is to improve the framework conditions for investment. Although failure to maintain the appeal of a location is often not avenged until some years later, it does indeed get its revenge.

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