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# The Trump tax reform plan is likely to negatively affect developing countries

**By Yuefen LI**

**The Trump administration has proposed a tax reform framework to the US Congress. Major components are a large reduction in the corporate tax rate, changes to the way US profits currently earned abroad are taxed, and how past profits parked abroad are treated if brought home. All these reforms if accepted by Congress, will most likely have adverse effects for developing countries, including by increasing capital flows from and reducing FDI to them.**

The Trump administration unveiled the unified framework for tax reform (framework hereafter) on 27 September 2017. If the US Congress endorses it, the framework would likely have not only a significant impact on the US economy, but also profound international repercussions including a negative impact on developing countries. In particular, the tax reform is likely to lead to an increase in capital outflows from and reduce FDI in developing countries.

The elements in the tax reform likely to have important ramifications beyond the US borders would include the reduction on corporate tax rate, the change from a worldwide tax system to a "territorial based tax system", the granting of a 100% exemption for dividends received from foreign subsidiaries for the US parent companies which own at least a 10 percent stake in the subsidiary.

The corporate tax rate cut is straight-forward. The Framework calls for a tax reduction from the current 35% to 20%, not as much as halving the tax rate as promised by President Trump, yet it is a very significant cut. This tax cut would certainly increase the global competitiveness of US products as costs to the companies would be reduced. In addition, it makes the United States a more attractive destination to invest in for both foreign and US companies.

According to the Tax Foundation, in 2015 the average corporate tax rate of OECD countries is about 25%, BRICs about 28% and Africa about 29%.(1) It is fair to say that the current US corporate tax rate at 35% is high by world standards. But a dramatic slashing of the tax rate by a world leading economy to a level lower than major economic powers including France, China, Spain, Italy would likely trigger reactions from other countries. As a matter of fact, a race of competitive tax reduction is already starting. The United Kingdom government has expressed the intention to reduce the corporate rate from 20% to 17% by 2020 or even lower. Some other developed and developing countries have also started their tax reform including France and the Netherlands. “A race to the bottom” in tax rate would hurt developing countries, especially those with a narrow tax base and relying on tax revenue for their general budget. Whether the large corporate tax cut in the US will trigger a tax reduction war is a concern that countries should follow closely.

The shift by the US to a territorial corporate tax system, especially the treatment of the huge retained earnings currently remaining outside the US, would also have a far-reaching international impact. This is a sweeping change of the methodology for taxing foreign-sourced income of US multinationals. The proposed new system only taxes income earned in the US while the old tax system is a worldwide system under which profits of corporations are taxed regardless where they are earned. If the profits accrued abroad are not repatriated back to the United States, corporates do not need to pay the present 35% corporate tax as the US law allows them to keep the profits abroad indefinitely and treat them as deferred earnings paying minimum to zero tax.

Various reports estimate that there is more than $2.6 trillion dollars stashed overseas. For instance, Apple has accumulated $216 billion of returns overseas. Some of this huge amount is kept in tax havens. Developing countries also host part of this kind of accumulated profits of US multinationals.

Under US laws, earnings which have been reinvested abroad do not need to be taxed. As a result of this policy, an important part of the FDI by the US multinationals is financed by retained earnings on investment abroad. It is especially so in developing countries where the rate of return on FDI is relatively higher in these economies than that in mature economies ranging from 8-13 %. Thus the potential impact of the US tax reform on FDI flows to developing countries and on the future behaviour of US multinationals should be carefully analysed and anticipated.

The framework gives special incentives for foreign subsidiaries to send their profits back to the United States. For the profits earned abroad and repatriated as dividends to shareholders, there will be a 100% exemption on paying tax if the parent company owns at least a 10 percent stake in the foreign subsidiary; most of the parent companies can easily meet the threshold. Obviously, this is a powerful incentive not to keep profits outside the United States, making the sending of profits back to the United States a preferred choice.

As a transition for moving to the new system, a “deemed repatriation tax” is proposed to enable the $2.6 trillion of profits stockpiled abroad to be repatriated back to the United States over a number of years. The basic principle is to request corporations to pay a one-time tax first at a low specified rate to be decided by the Congress, and then the deferred earnings will be deemed as already repatriated, but space will be given to companies to phase in the repatriation process and the payment of the tax. The taxation rate and time duration have still to be fleshed out.  The “deemed repatriation tax” is meant to make sure that the huge amount of profits will not be shifted to tax havens and erode the tax base. The Trump administration has high hopes on this tax for paying the deficit to be created by the tax reduction.

The United States is the world’s largest economy and also the largest FDI outward-investing country, thus the significant tax reform of the United States as proposed by the Framework will definitely affect the future investment strategies and policies of the US multinationals. The tax rate cut and the territorial tax system would mutually reinforce each other and significantly reduce the incentives of multinationals to invest abroad.

This is in line with the election promises made by President Trump, namely to revitalize American manufacturing industries and create more jobs domestically. In addition, the reform will mostly likely lure the US capital parked abroad back to the United States as well as  the profits to be earned in the future by US foreign subsidiaries.  The outflow of capital from developing countries will be accelerated when the repatriation of deferred earnings takes place. The US foreign direct investment in developing countries is expected to be reduced owing to these disincentives to invest abroad. On top of this, as many developing countries have higher corporate tax rates than the 20% the framework proposes, their large corporations may also try to invest in the United States to benefit from all the tax incentives.

Currently the Framework is still being deliberated in the US Congress and further details need to be fleshed out. Meanwhile, a debate is going on about how the US Treasury is to finance the resultant fiscal deficit.  But it is time for developing countries to analyze the impact of the Trump tax reform and prepare for the possible passing of the framework into law with minor changes by the US Congress, even though there is not likely to be a final outcome before the end of 2017.

(1) Kyle Pomerleau, Corporate Income Tax Rates around the World, 2015 (1 October 2015). Available from https://taxfoundation.org/corporate-income-tax-rates-around-world-2015/.

***Author:*** ***Yuefen Li is the Special Advisor on Economics and Development Finance of the South Centre.  She formerly worked in UNCTAD as Head of the Debt and Development Finance Branch.***

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**For more information, please contact Vicente Paolo Yu of the South Centre: Email** yu@southcentre.int**, or telephone +41 22 791 80 50.**