Box 2.1

US tax reform and its possible implications for the US and global economy

"Tax Cuts and Jobs Act of 2017" [(1)] in the US was signed into law before Christmas last year. The bill has taken effect from this year and will not only affect the US economy but also have impacts on the global economy given the economic significance of the US. This article highlights the prominent elements of the US tax reform and discusses its possible macroeconomic implications for the US and the world.

Highlights of the US tax reform bill

The US tax reform bill is a lengthy and complicated document. A central theme surrounding it is tax alleviation. For individuals, the statutory federal income tax rates for most income brackets are lowered[(2)]. Other tax-saving measures, ranging from an increase in the child tax credit to a higher standard deduction for taxable income, are introduced. Yet, other measures such as a lower limit on the mortgage interest deduction and a newly imposed cap on the state and local income tax deduction may partially offset the impact. Overall, these changes would on balance reduce average tax rates on wage income by about one percentage point, according to the Joint Committee on Taxation of the US Congress (JCT)[(3)]. The impacts of tax cuts are spread unevenly across taxpayers, depending on such factors as income, geographic location and outstanding mortgage debt.

A core part of the tax reform lies on corporations. The statutory federal corporate tax rate is reduced drastically to a flat 21%, while previously, US corporations were subject to a top rate of 35% under a progressive tax scheme[(4)]. Moreover, a full expense deduction on certain capital asset acquisition is allowed for the coming five years[(5)], which helps firms realise immediate tax savings through accelerated depreciation in tax accounting. Smaller enterprises and non-corporates also enjoy tax deductions under the new tax law via provisions related to "pass-through" income[(6)].

The US approach to international taxation also sees revolutionary changes. Previously, US corporations paid taxes on their worldwide income, whether earned in the US or abroad. They were subject to a top rate of 35% whenever they received repatriated earnings from their foreign subsidiaries. Having weighed this and other relevant investment factors, US

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(1) Formal name of the act was "An Act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018", popularly referred as the "Tax Cuts and Jobs Act of 2017".

(2) The individual income tax rates for the seven income brackets were amended from 10%, 15%, 25%, 28%, 33%, 35%, and 39.6% previously to 10%, 12%, 22%, 24%, 32%, 35%, and 37% under the new tax law.

(3) JCT (22 December 2017). "Macroeconomic analysis of the conference agreement for H.R.1, The 'Tax cuts and jobs act'".

(4) Previously, the statutory federal corporate tax rates were 15% for taxable income not over US$50,000; 25% for between US$50,000 and US$75,000; 34% for between US$75,000 and US$10 million and 35% for over US$10 million. An additional five-percent tax was imposed on a corporation's taxable income in excess of US$100,000. The corresponding maximum additional tax was $11,750. Also, a second additional three-percent tax was imposed on a corporation's taxable income in excess of $15 million. The maximum second additional tax was US$100,000.

(5) Under the new law, generally, the bonus depreciation percentage is increased from 50% to 100% for qualified business assets acquired before 2023. Afterwards, the new law provides a phase down of the bonus depreciation percentage. Note that there are limitations on the types of assets.

(6) "Pass-through" is a general term for sole proprietorships, partnerships, limited liability companies and S corporations, as they are reported by the owners or shareholders on their individual income tax returns. Under the new law, individuals receiving income from certain pass-through businesses may deduct 20% of their "qualified business income" (QBI) from taxable income, subject to certain limits if annual QBI exceeds certain amounts (US$315,000 for married couples filing jointly, or US$157,500 for other individuals).

Box 2.1 (Cont'd)

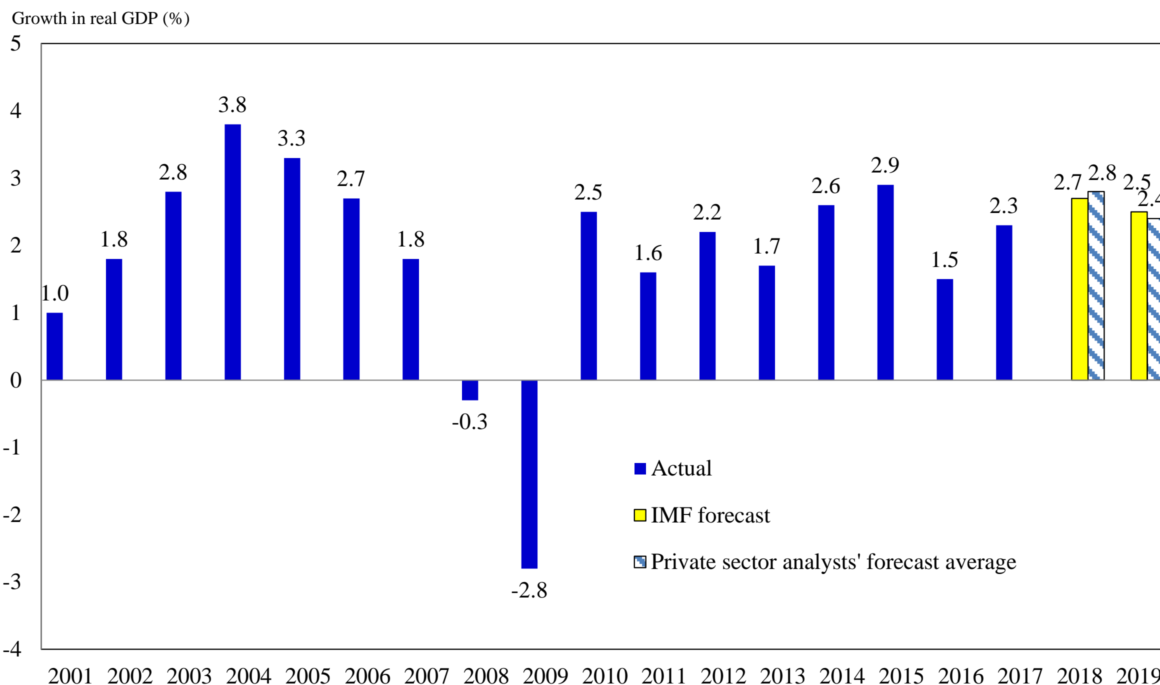
companies ended up accumulating huge amounts of undistributed earnings overseas over years, in cash or other forms of assets. Their value was estimated at as high as US$2.6 trillion in 2015[(7)].

Under the reform, US taxation shifts to a "territorial system", converging to a common practice of many high-income economies. US corporations' dividends from foreign subsidiaries are exempted from US taxation. To avoid abuses, base erosion prevention measures are introduced[(8)]. As a transition to the new system, past "undistributed earnings" are mandatorily taxed once and for all, albeit at reduced rates of 15.5% for earnings and profits in cash (or equivalent) and 8% for the remainder. This tax liability is payable over a period of up to eight years.

Impacts on US economic growth

The tax reform is widely expected to have some boosting effects from the demand side, mainly through stronger business investments, thereby spurring short-term US economic growth. In January 2018, the International Monetary Fund (IMF) upwardly revised its US economic growth forecasts in the coming two years. The US economy was expected to grow at faster paces of 2.7% in 2018 and 2.5% in 2019, up from 2.3% in 2017. Private sector analysts on average also came to similar conclusions ***(Chart 1)***.

Chart 1: US economic growth is generally expected to pick up in 2018



(7) See letter from Thomas Barthold, chief of staff of the Joint Committee on Taxation on 31 August, 2016.

(8) The new law provides for an exemption by means of a 100% deduction for the "foreign-source portion" of dividends that domestic US corporations receive from specified foreign corporations of which they own 10% or more. Separately, in order to reduce the erosion of the US corporate income tax base, the new tax law equalises the tax treatment of high return income from foreign sales whether they are earned through a foreign corporation or a domestic US corporation, and imposes a new minimum tax for certain related party transactions.

Box 2.1 (Cont'd)

Looking beyond the short term, whether the tax reform can spur potential growth in the longer run is more controversial. From a supply-side perspective, the increase in work incentive (substitution effect) should support an increase in labour supply, but the extent is uncertain, depending on the offsetting impact from higher demand for leisure (income effect) in tandem. The increase in capital stock accumulation is also difficult to predict, as firms can use the tax savings for other activities, such as mergers and acquisitions, debt reduction, share repurchase, special dividends or foreign investment, instead of investing locally. As explained later, the extent of international capital that would be lured to the US to create employment and lift productivity remains to be seen.

Therefore, it is no surprise that opinions about the tax reform's ability to lift long-term growth are highly divided. Many are of the view that there will be little lasting positive impact. In particular, US Fed officials in mid-December 2017 left their median forecast of longer-run US real GDP growth unchanged, at 1.8%. While the JCT estimated that the tax reform package would lift the level of US GDP by an average of 0.7% relative to the baseline forecast over the 10-year budget window, it added that the increase would fall to only 0.1-0.2% at the end of its 10-year window. Similarly, according to the IMF, the level of US GDP will be spurred by the tax reform in the short term, cumulating to 1.2% through 2020, but the boosting effects will be reversed from 2022 onwards, paring down earlier gains as the temporary tax measures are phased out according to the current bill.

On the other hand, some economists suggested a larger boosting effect, estimating that the changes to the corporate taxation could raise the level of US GDP in the long run by just over 3%, thereby translating into a 0.3 percentage point increase in annual growth over a 10-year horizon(9). The US Treasury Department was particularly optimistic, envisaging that the tax reform, together with some other measures, will bolster US real GDP growth in the coming 10 years by 0.7 percentage point on average, to 2.9% per year(10).

Implications for US fiscal and monetary policies

On the fiscal front, tax cuts could potentially lower US government revenue and worsen its budget deficit. This is a troubling issue, as its public finance has weakened visibly after the 2008 global financial crisis, with federal government debt estimated to have risen to 77% of its GDP by end-2017 ***(Chart 2)***. Moreover, government spending is under mounting pressure to rise amid an aging population, a common challenge confronting most advanced economies. The prospect of lower US government revenue in the longer run due to tax cuts would also compress its fiscal space for investment and countercyclical measures when needed.

Most available studies so far point to a net reduction in US federal government revenue over the 10-year budget forecast horizon, although the extent would hinge on the increase in the level of output brought by the reform and the attendant additional revenue that could make up the losses of revenue from the tax cuts. For examples, the JCT estimated that the US federal government revenue will be reduced on net by nearly US$1.1 trillion over a decade, and Moody's suggested a net increase of US$1.5 trillion to the US federal debt(11).

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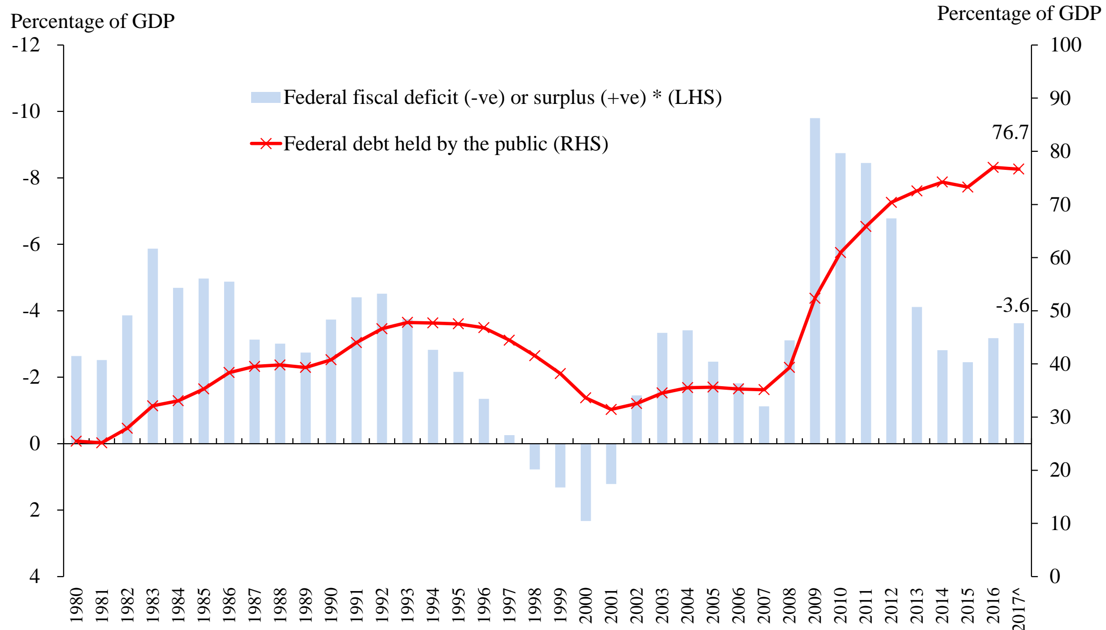
(9) Robert J. Barro, Michael J. Boskin, John Cogan and others (25 November 2017). "How tax reform will lift the economy". The estimated just-over-3% boost cited in this box refers to the estimate based on the 5-year expensing proposal of business assets in the letter.

(10) US Department of Treasury (11 December 2017). "Analysis of growth and revenue estimates based on the US Senate Committee on Finance tax reform plan".

(11) Moody's (21 December 2017), Announcement. "Tax reform will boost corporate profits, but is negative for the US sovereign and mixed for other sectors".

Box 2.1 (Cont'd)



Notes: (*) Deficit is inverted in scale for easier comprehension.
(^) 2017 figures are forecasts by the Congressional Budget Office, US.
Source: Congressional Budget Office, US. (June 2017 report: An Update to the Budget and Economic Outlook: 2017 to 2027).

On monetary policy, the US output gap has basically returned to positive territory, while the unemployment rate hovers at a 17-year low. Thus the room for accelerating growth due to the tax reform without raising inflation pressure is getting smaller. While core inflation in the US has stayed moderate of late, the Fed would have to tighten monetary policy at a faster pace, leading to faster-than-expected interest rate hikes, if inflation goes up. This could enlarge global financial volatility.

Impacts on the global economy

The IMF in January 2018 revised its global economic growth forecast upward by 0.2 percentage point to 3.9% in both 2018 and 2019. According to the IMF, half of its upward revision was attributed to the US tax reform, as a pick-up in demand in the US due to the tax reform in the upcoming two to three years will likely raise US imports from major trading partners, thereby spurring world trade and the global economy as a whole. That said, the demand-boosting effect of the tax reform could widen US current account deficits, and growing external imbalances could in turn fuel protectionist sentiments, aggravate international trade frictions and add global uncertainties.

The influences of US tax reforms on global capital flows also warrant attention. Tax cuts and changes in international taxation rules in the US provide incentives for foreign subsidiaries to repatriate earnings to their US parent companies. A more appealing tax landscape in the US may also draw foreign investments which otherwise would have flowed elsewhere. Given that the US is the largest economy as well as the biggest source of and destination for foreign direct investment in the world, the potential implications for global capital flows should not be ignored. That said, on top of tax factors, there are many other factors at play such as market size, supply chains, infrastructure, availability of skilled labour, and the regulatory environment when firms make decisions on new investments or alter their existing ones. Hence, whether the US tax reform would materially alter global capital flows remains to be seen.

Box 2.1 (Cont'd)

In a highly inter-connected world, another concern arising from a drastic tax cut initiated by the world's largest economy is the possibility of knock-on effects leading to a new wave of competitive tax cuts. Separately, there are also questions whether the US tax bill might constitute an unfair trade practice and whether it would contravene international trade treaties. How all this will eventually play out needs to be closely monitored.

Conclusion

In sum, the impacts of the US tax reform on the global economy are multi-faceted. As far as the Hong Kong economy is concerned, a brighter near-term global economic outlook led by faster US growth would be conducive to our economic growth this year. However, possible drawbacks such as faster interest rate hikes in the US, a reversal of global capital flows and rising protectionist sentiments stemming from growing external imbalances should not be overlooked. While Hong Kong is underpinned by sound economic fundamentals with strong buffers against external shocks, the Government will not be complacent and will monitor the developments closely.

On taxation, the Government recognises that the design of a tax regime is instrumental to our competitiveness. Hong Kong's simple tax system with low tax rates is highly competitive. Yet, the Government will proactively adopt a multi-pronged approach to unleash new sources of productivity growth, including the use of tax measures. A two-tiered tax system is expected to be rolled out this year, which should help alleviate the tax burden of small and medium enterprises as well as encourage entrepreneurship. A bill for an enhanced tax deduction for eligible research and development expenditure is also being drafted, with an aim to encourage research and development investment by enterprises. Also important is that the Government will observe international tax obligations to ensure that the new tax measures are not viewed as damaging to other economies in the world.