Trump races to the bottom with dynamic models

Blog post by Head of UK Leo Ringer, 26 April 2017

The NASDAQ reached an all-time high yesterday as Donald Trump announced he wants to more than halve the US corporation tax rate, from 35% to 15%. But he knows that doing so comes with a big price tag – one that, in the context of a fraught debate about the US national debt and deficit, is an almost impossible sell to Congress. The solution? Dynamic modelling: counting the economic growth gains that the cut might create when calculating its cost, to show that in fact there is a net *benefit* to the Treasury's coffers.

Cue speculation over whether Trump will succeed, legislatively, in this fiscal sleight of hand. The Congressional Budget Office (CBO), which provides budgetary analysis and forecasts, will be at the heart of resistance on the Hill. But if he does, the big question is what this means for global tax competition. Trump's move will fuel concerns about a "race to the bottom" – the one-way downward ratchet corporate income tax rates as economies compete for mobile economic activity.

The advent of dynamic modelling in the US would drive a sharp choice for finance ministries elsewhere, including in Europe. Do they follow Trump, and in doing so take the fiscal risk that tax cuts do not yield the banked-upon growth dividend that dynamic modelling shows? Or do they hold fast to fiscally prudent static modelling, but potentially lose access to lower rates of business tax and therefore compromise their competitiveness? Of course, cutting tax rates in response to a slash in the US is still possible and indeed likely for those that stick to static approaches – but is a much harder sell politically, particularly where deficits and debt are high.

The UK could become a test case. Despite being regarded as fiscally conservative, Her Majesty's Treasury has shown an appetite for adventurous tax policy since the financial crisis, slashing corporation tax and introducing a number of innovations, such as the Patent Box regime, which have drawn stern criticism from the international community. Two further developments increase the likelihood of Theresa May following Donald Trump.

The first is that the groundwork has been done. HMRC has built the economic model that would be necessary to deliver defensible dynamic costings, published quietly in 2013. George Osborne, former Chancellor, talked up the prospect of more modelling of this sort in the UK Parliament in 2014.

Second, the political context of Brexit has already led to speculation that the UK might use lower corporation tax as both a negotiating threat with the EU, and a core plank of economic policy post-Brexit. Dynamic modelling would make it much easier for May and Chancellor Phillip Hammond to square substantial corporate tax cuts with their continued (albeit more relaxed) version of fiscal consolidation.

Weighing against these is the influence of the Office for Budget Responsibility (OBR), an independent body charged with forecasting the UK economy. While dynamic modelling might be politically attractive for the May administration, the OBR has a purely technocratic mandate - it checks, approves and can change all policy costings supplied to it by the government. The OBR has gone as far as saying that dynamic modelling would in theory be the most economically comprehensive way of assessing tax policy change, but does not believe that it can be done accurately enough to be relied upon[1] – a view that the CBO in the US will no doubt express in resisting Trump.

There would be substantial implications for the business communities in jurisdictions that did follow the US in adopting dynamic tax modelling. Cuts to corporate income taxes, business property taxes, and other indirect business taxes could suddenly be argued for in much less costly terms, fiscally, with a much greater emphasis on their growth-enhancing benefits. The fiscal imperative to cut, rather than raise business taxes would become structurally strengthened.

By contrast, the losers would be the households that bear the burden of non-business taxes – income taxes, sales taxes, and social security contributions. These are harder to justify economically through dynamic modelling and so would be comparatively more attractive places for finance ministries in need of cash to look. The politics of raising household taxation while cutting business taxation would be challenging, but the economics would be more attractive.

It is Congress which will ultimately decide whether Trump's push for dynamic modelling is acceptable. But if it does, it is finance ministries around the world that will have to judge the right response.

[1] pages 20-21, *Briefing Paper No. 6: policy costings and our forecast,* OBR, 2014 http://cdn.budgetresponsibility.org.uk/27814-BriefingPaperNo_6.pdf