


U.S. Tax Reform and Its Implications for Korea



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The U.S. economy is on the verge of experiencing the most dramatic tax cut since the 1986 tax reform. The tax reform bill has passed Congress and President Trump has signed it into law, most of which will take effect from the start of 2018. The tax reform will not just impact the domestic economy of the United States. In its current form, it would also have substantial consequences on the global economy. This short article discusses the international implications of the tax reform, focusing its analysis on Korea.

There are many provisions that characterize this reform but it is the change in the corporate tax system that could have the most direct impact on the global economy. The reform will not only reduce the corporate tax rate from 35% to 21%, it will also change the taxation of American companies' foreign earnings to a "territorial system." Under the current system, all earnings of American corporations' foreign subsidiaries that are brought back to the U.S. become subject to the tax rate of 35%, minus the rate that they have to pay to the countries they are operating in. This unique system, in addition to the high tax rate, generated an incentive for U.S. firms to move abroad and manage their foreign profits

offshore. This, arguably, has had an adverse impact on domestic job creation, investment and economic growth.

The reform will reduce the rate to no more than 15.5%. Tech giants like Apple and Microsoft will benefit most from the reform as a major portion of their profits is generated abroad. According to the Financial Times, it is estimated that Apple would immediately save up to \$47 billion if it were to bring back the profits currently held in foreign cash and investments. "Apple will see up to \$47bn potential benefit from tax reform." Financial Times (Dec. 6, 2017)¹ It is also estimated that American companies altogether hold about \$1.3 trillion of offshore profits in cash and marketable investments. Thus this reform measure could significantly increase fund flows into the U.S. from the rest of the world. It is hard to track how much of these profits are invested in Korea and Korea also has a relatively stable financial market. However, given the high share of foreigners and their influences in the Korean stock and bond market, it is a possible risk that cannot be overlooked.

Moreover, with a lower corporate tax rate, the U.S. will become a more attractive destination for investment including FDI. Not only will American companies re-shore but also more foreign multinationals are likely to relocate to the U.S. to benefit from these tax reductions. Korea's FDI in the U.S. has been increasing since the establishment of the KORUS FTA. It increased threefold from \$4.8 billion in 2011 to \$12.9 billion in 2016. Also, Korean companies are planning to invest an additional \$17.3 billion in the U.S. in the next five years. The tax reform can accelerate this trend. Outward FDI entails job concerns in the giving country but this does not necessarily mean that FDI always results in domestic job loss. Companies make FDI decisions based on many factors. Mainly they make investments to utilize resources and endowments that are unique to the receiving country as well as to gain market access.

Recently Korea's investments in the U.S. are mainly concentrated in the automobile, semiconductor, software and IT sectors. Samsung's recent acquisitions of American companies that possess cutting-edge technologies are particularly notable. With the fourth industrial revolution approaching, this kind of investment by Korean tech companies looking to take advantage of frontier American technologies will likely increase and the tax reform could accelerate the momentum of this investment. It remains uncertain as to what effect this will have on domestic jobs, but these are (human and physical) capital-intensive sectors, imply-

¹ "Apple will see up to \$47bn potential benefit from tax reform." *Financial Times* (Dec. 6, 2017)

ing that the effects can be marginal. Also, at the least it would positively contribute to the productivities of these companies.

Next, the tax reform can contribute to a stronger U.S. dollar. This could happen initially as the foreign profits of American companies return to the U.S. But from a longer perspective the lower corporate tax rate would attract more investment capital to the U.S., increasing demands for U.S. dollars. This would have the effect of improving the terms of trade for Korea and likely increase the U.S. trade deficit with Korea. In fact, it is likely to increase the overall trade deficits of the U.S. as this terms of trade improving effect would apply to other trading partners as well. This is not good news for Korea. The Trump administration's trade policy is heavily focused on reducing trade deficits and Korea is one of the main targets. If faced with growing deficits, the administration could employ more direct and harsher measures toward its trading partners.

It will be hard to predict and quantify the impacts of the U.S. tax reform on Korea. The magnitudes of impacts could be marginal in the end. But at this stage it is important to understand all the possible consequences and risks generated by this policy change and be prepared with measures that can counteract the risks. **KIEP**