TAX FOUNDATION Since 1937

FISCAL FACT

August 2009
No. 184

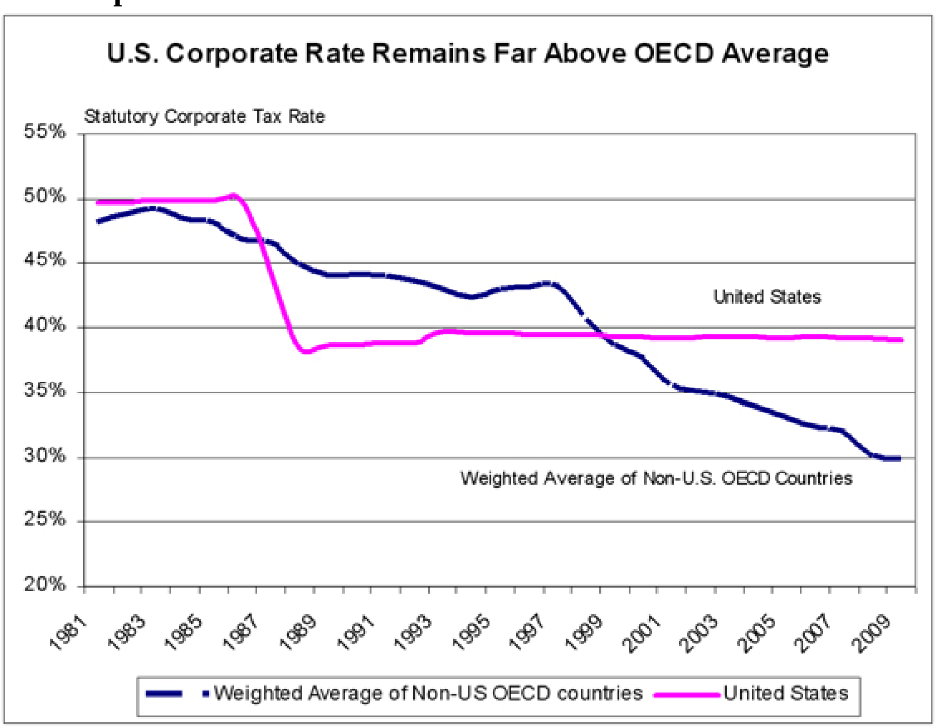
U.S. Lags while Competitors Accelerate Corporate Income Tax Reform

by Scott A. Hodge and Andre Dammert

Fiscal Fact No. 184
New data from the Organization for Economic Cooperation and Development (OECD) shows that the U.S. corporate tax rate has fallen even further out of step with the rest of the industrialized world as countries such as Canada, the Czech Republic, Korea, and Sweden have cut their corporate rates in 2009, lowering the average statutory corporate tax rate of all OECD nations to 26.5 percent.

With a combined federal and state corporate tax rate of 39.1 percent, the U.S. continues to impose the second-highest overall corporate rate among industrialized countries. Only Japan's 39.5 percent combined rate is higher. As the chart below indicates, the weighted average (accounting for country size) corporate rate of non-U.S. OECD nations is now below 30 percent for the first time in history. 2009 marks the 12th consecutive year in which the average corporate tax rate of non-U.S. OECD nations has been below the U.S. rate.

Figure 1
U.S. Corporate Tax Rate Remains Far Above Non-U.S. OECD Average



As Table 1 shows, below, Korea enacted the largest rate cut this year of 3.3 percentage points. Meanwhile, Sweden cut its corporate rate 1.7 points and Luxemburg cut its rate 1 point. After the cuts, Korea's ranking fell to 22nd (down from 16th) and Sweden's fell to 16th (down from 13th). The United States' corporate income tax is now roughly 50 percent higher than that of a mid-ranked country such as Sweden.

America's high corporate tax rate should be a red flag to U.S. lawmakers worried about the country's flagging economic growth, slow wage growth, and overall global competitiveness. An important study released last year by economists at the OECD found that of the various taxes a country can impose, "corporate taxes are the most harmful tax for economic growth." [1] High personal income taxes were found to be the second most harmful, followed by consumption taxes, with property taxes being the least harmful.

Why are corporate income taxes so harmful to economic growth? Simply, corporate taxes have a negative effect on capital accumulation, which can retard productivity, which, in turn, eventually affects GDP per capita.

OECD economists found that:

> Corporate income taxes appear to have a particularly negative impact on GDP per capita. This is consistent with the previously reviewed evidence and empirical findings that lowering corporate taxes raises TFP *(total factor productivity)* growth and investment. Reducing the corporate tax rate also appears to be particularly beneficial for TFP growth of the most dynamic and innovative firms. Thus, it seems that corporate taxation affects performance particularly in industries and firms that are likely to add to growth.[2]

Many pundits and lawmakers are quick to point out that the U.S.'s high corporate tax rate is not that significant a concern because our effective rate tends to be much lower than the statutory rate due to the plethora of deductions in the corporate tax code. But the OECD report finds that statutory tax rates do matter, especially to what might be called "new economy" firms that are the most innovative and profitable: "Evidence in this study suggests that lowering statutory corporate tax rates can lead to particularly large productivity gains in firms that are dynamic and profitable, *i.e.* those that can make the largest contribution to GDP growth."[3]

To many "new economy" firms that produce ideas and services, and whose profits are derived from intellectual property and licensing, the statutory tax rate *is* the effective rate because these firms don't have large plant and equipment costs to depreciate. They are highly sensitive to the statutory rate and, because they are not capital-intensive, can most easily locate their operations in jurisdictions with the lowest tax rate.

Great Britain has found this out the hard way. Last year, Google moved its European operation from London to Switzerland to lower its tax bill and McDonald's recently announced that it was doing the same. Great Britain's relatively high corporate tax rate combined with its world-wide tax system has caused an exodus of domestic firms to lower-taxed countries such as Ireland and Switzerland. This forced British lawmakers to reexamine their corporate tax structure and take steps toward a more "territorial" tax system that taxes firms only on the profits earned within the country's borders.

Even Ireland, which has benefited the most from capital flight from high-tax countries, has discovered that it is not immune to capital flight. Earlier this year, Dell announced that it was moving its European operations, and 1,900 jobs, from Ireland to Poland in order to cut its overall costs. Dell had been Ireland's largest exporter and accounted for 5 percent of the country's GDP. Great Britain is not the only country to reevaluate the way it taxes business. Recently, Japan also took steps toward changing its corporate tax system to a more territorial system that largely exempts foreign profits from domestic taxation.[4] This change was prompted in part by reluctance of Japanese firms doing business in lower-tax countries to repatriate those profits to Japan.

Finally, Canada is aiming to make its corporate tax system the most competitive among G7 countries. Last December, the Finance Department's Advisory Panel on Canada's System of International Taxation issued a report recommending that Canada continue with its goal of making its effective corporate tax rates the lowest among G7 nations while expanding its system of exempting Canadian tax on foreign earnings.[5]

In stark contrast to these global trends toward lower corporate tax rates and "territorial" systems that don't tax foreign profits, the Obama administration is proposing to raise more than $220 billion in new corporate taxes by making the U.S. world-wide tax system tougher. Currently, U.S. companies can defer paying U.S. tax on foreign-earned profits until those profits are returned home. Obama's plan seeks to expose more of those foreign profits to immediate U.S. tax regardless of whether the firm intends to return those profits to the U.S. or reinvest them abroad.

As Great Britain discovered too late, companies that earn more abroad than domestically will take steps to protect those foreign profits from high domestic taxes. Moving to a lower-tax jurisdiction was the method of choice for U.K. firms because companies are as free to move within the European Union as U.S. firms can move between states. After a number of high-profile U.S. firms relocated to low-tax countries during the 1990s, U.S. lawmakers enacted legislation that effectively established an economic "Iron Curtain" around the American border. As a result, the easiest way for an American company to protect its foreign profits from high U.S. taxes is to be taken over by a foreign-owned company.

Japan's move to a territorial system should also be instructive to U.S. lawmakers. A high corporate income tax on repatriated profits acts as a deterrent to reinvesting those profits back home. This of course deprives the domestic economy of needed capital and investment.

U.S. lawmakers must take note of these global trends and take steps to make the U.S. corporate tax system competitive with its major trading partners. If they don't, we risk continuing to fall behind in the global race to attract capital, jobs, and economic growth.

Table 1
Lower Corporate Tax Rates in OECD Nations: The U.S. Still Imposes the Second-Highest Rate (Combined Federal-State Corporate Tax Rate)

Rank	Country	Combined Corporate Income Tax Rate, 2009	Combined Corporate Income Tax Rate, 2008	Change from 2008 to 2009
1	Japan*	39.54	39.54	0.00
2	**United States**	39.10	39.25	-0.16
3	France	34.43	34.43	0.00
4	Belgium	33.99	33.99	0.00
5	Canada	31.32	31.72	-0.40
6	Germany	30.18	30.18	0.00
7	Australia	30.00	30.00	0.00
8	New Zealand	30.00	30.00	0.00
9	Spain	30.00	30.00	0.00
10	Luxembourg	28.59	29.63	-1.04
11	Mexico*	28.00	28.00	0.00
12	Norway	28.00	28.00	0.00
13	United Kingdom	28.00	28.00	0.00
14	Italy	27.50	27.50	0.00
15	Portugal*	26.50	26.50	0.00
16	Sweden	26.30	28.00	-1.70
17	Finland	26.00	26.00	0.00
18	Netherlands	25.50	25.50	0.00
19	Austria	25.00	25.00	0.00
20	Denmark	25.00	25.00	0.00
21	Greece	25.00	25.00	0.00
22	Korea	24.20	27.50	-3.30
23	Switzerland	21.17	21.17	0.00
24	Czech Republic	20.00	21.00	-1.00
25	Hungary	20.00	20.00	0.00
26	Turkey	20.00	20.00	0.00
27	Poland	19.00	19.00	0.00
28	Slovak Republic	19.00	19.00	0.00
29	Iceland	15.00	15.00	0.00
30	Ireland	12.50	12.50	0.00
	OECD Average	26.29	26.55	-0.26
*Data not updated for 2009 by the OECD				

Notes

1. Asa Johansson, Christopher Heady, Jens Arnold, Bert Brys and Laura Vartia, "Tax and Economic Growth," Economics Department Working Paper No. 620. ECO/WKP(2008)28, Organization for Economic Cooperation and Development, July 11, 2008.

http://www.olis.oecd.org/olis/2008doc.nsf/LinkTo/NT00003502/$FILE/JT03248896.PDF

2. Ibid. p 43.

3. Ibid. p 9.

4. http://www.pwc.com/ja_JP/jp/taxnews/pdf/Outline_of_2009_Tax_Reform_E.pdf

5. The Panel's final report, *Enhancing Canada's International Tax Advantage,* is available at: www.apcsit-gcrcfi.ca

Ph: (202) 464-6200
www.taxfoundation.org