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Corporate Tax Reform: Kerry, Bush, Congress Fall Short

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In response to concerns about job outsourcing, Senator John Kerry has proposed changes to the corporate income tax. His plan includes a small cut to the corporate tax rate, but would impose higher taxes on the foreign subsidiaries of U.S. companies. Unfortunately, that would likely kill U.S. jobs, not create them. If taxes on subsidiaries were raised, U.S. firms would lose sales to less-taxed foreign competitors, and would have to cut back on U.S. headquarters jobs in research and other activities.

Nonetheless, Senator Kerry deserves credit for addressing the tax rules on foreign investment, which his campaign notes are "almost completely broken." President Bush promises to consider tax reform if re-elected, but he does not have a corporate tax plan, and he is letting expire a pro-growth tax provision that allows firms to deduct, or "expense," half the cost of qualified capital investments.

The Bush administration has also shown little leadership on the corporate tax bill being considered in Congress, which would repeal the Foreign Sales Corporation / Extraterritorial Income Exclusion tax break. The House and Senate have passed separate FSC/ETI bills that mix some good reforms with numerous distortionary tax changes. Passage of FSC/ETI would not alter the critical need for fundamental corporate tax changes.

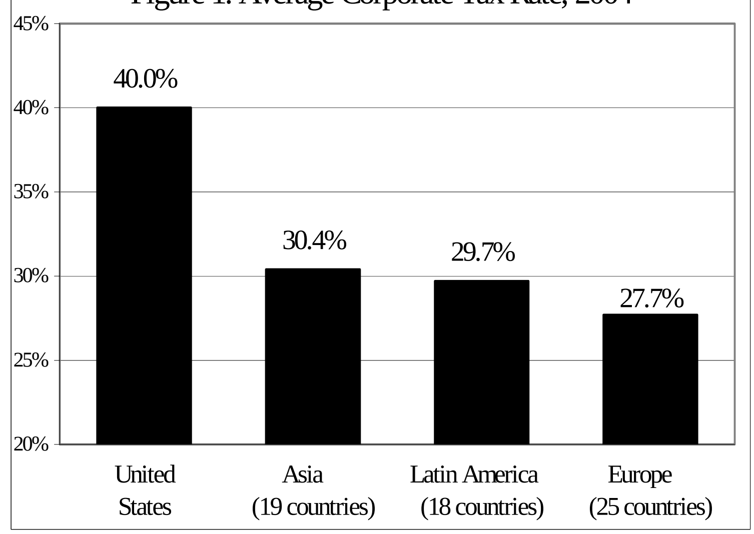
U.S. Policymakers Fiddle as Tax Competition Ignites

In 64 A.D. Emperor Nero was blamed for doing little as Rome was engulfed in flames. Similarly, federal policymakers have fiddled as U.S. tax competitiveness has gone up in smoke. While the U.S. led the world with a corporate tax rate cut in 1986, today it has the second-highest corporate tax rate in the 30-nation Organization for Economic Cooperation and Development. The U.S. corporate rate is 40 percent, including the 35 percent federal rate and the average state rate.

By contrast, Figure 1 shows that the average rate in Asia, Europe, and Latin America is 30 percent or less. The figure is based on data for countries listed in Table 1. The average corporate tax rate in the OECD fell from 37.6 percent in 1996 to just 30.0 percent in 2004.[1]

Many Eastern European countries have sharply slashed their tax rates to attract investment. Since the late-1990s, Poland cut its rate from 40 to 19 percent, Slovakia cut its rate from 29 to 19 percent, the Czech Republic cut its rate from 39 to 28 percent, Hungary cut its rate from 33.3 to 16 percent, and Russia cut its rate from 35 to 24 percent. In August, Greece announced that it will cut its corporate rate from 35 to 25 percent, and the Netherlands announced that it will cut its rate from 34.5 to 30 percent.

Figure 1. Average Corporate Tax Rate, 2004



Source: Author's calculations based on KPMG. See Table 1 for details.

U.S. Corporate Rate Should Be Cut to 20 Percent

Corporate tax rate cuts will continue because of the large benefits that countries can gain from attracting foreign investment inflows. As much as $1 trillion of direct investment crosses international borders each year, and research shows that these flows are increasingly sensitive to corporate taxes.[2]

Despite this global economic reality, U.S. policymakers seem to assume that America has a right to high growth and good jobs despite making little effort to create a competitive tax climate. But an unreformed U.S. corporate tax will have an increasingly negative effect on U.S. productivity, wages, and growth. In addition, the tax's high rate and excessive complexity creates an ideal breeding ground for Enron-style tax scandals.

The solution is to cut the 35 percent federal corporate tax rate to 20 percent. After a rate cut, Congress should proceed with tax reform to replace the income tax with a consumption-based tax, which would boost investment and make U.S. firms more competitive in global markets.[3]

Table 1.
Corporate Income Tax Rates, 2004

		Asia / Pacific	
United States	40.0	Australia	30.0
		Bangladesh	30.0
Europe		China	33.0
Austria	34.0	Fiji	31.0
Belgium	34.0	Hong Kong	17.5
Croatia	20.3	India	35.9
Czech Rep.	28.0	Indonesia	30.0
Denmark	30.0	Japan	42.0
Finland	29.0	Malaysia	28.0
France	34.3	New Zealand	33.0
Germany	38.3	Pakistan	35.0
Greece	35.0	Pap. New Guin.	30.0
Hungary	16.0	Philippines	32.0
Iceland	18.0	Singapore	22.0
Ireland	12.5	South Korea	29.7
Italy	37.3	Sri Lanka	35.0
Luxembourg	30.4	Taiwan	25.0
Netherlands	34.5	Thailand	30.0
Norway	28.0	Vietnam	28.0
Poland	19.0		
Portugal	27.5	**Latin America**	
Romania	25.0	Argentina	35.0
Slovakia	19.0	Belize	25.0
Spain	35.0	Bolivia	25.0
Sweden	28.0	Brazil	34.0
Switzerland	24.1	Chile	17.0
Ukraine	25.0	Columbia	35.0
U.K.	30.0	Costa Rica	30.0
		Dominican Rep.	25.0
		Ecuador	36.3
Other		El Salvador	25.0
Canada	36.1	Guatemala	31.0
Cyprus	15.0	Honduras	25.0
Israel	36.0	Mexico	33.0
Russia	24.0	Panama	30.0
South Africa	37.8	Paraguay	30.0
Turkey	33.0	Peru	30.0
		Uruguay	35.0
		Venezuela	34.0

Source: KPMG. Includes subnational taxes.

Kerry Corporate Tax Plan

The Kerry tax plan notes that other nations have corporate taxes that are one-third lower than ours, on average. But the Kerry plan would cut the U.S. rate by just 1.75 percentage points. To fund that small cut, Kerry would increase taxes on U.S. foreign subsidiaries. Under current rules, the regular business profits of subsidiaries are not taxed until repatriated to the United States. That treatment is standard in countries that have "worldwide" tax systems like ours. Most OECD countries have "territorial" tax systems that generally do not tax foreign business profits at all. The Kerry plan would break from these norms by immediately taxing subsidiaries on their sales to other countries. For example, a U.S. electronics firm selling goods from its Taiwanese subsidiary to Japan would face a punitive new U.S. tax burden.

If these rules were enacted, U.S. companies would lose market share to foreign competitors that had lower tax costs, and some subsidiaries would be sold to foreign companies. As their global sales declined, U.S. firms would downsize their U.S. operations, such as their U.S. research, marketing, and management staffs. Some U.S. firms would move their headquarters to more tax-friendly countries, or they would be taken over by foreign companies. All these effects would likely kill U.S. jobs.

Kerry's mistake is to assume that foreign subsidiaries hurt the U.S. economy. In fact, they mainly complement U.S. production—for example, by being a main conduit through which U.S. goods are exported abroad. By damaging the competitiveness of foreign subsidiaries, the Kerry plan would damage the U.S.-based activities that depend on expanded foreign business opportunities.

Congress Should Look Beyond FSC/ETI

Regardless of whether Congress agrees to a FSC/ETI bill this year, it needs to pursue larger corporate reforms next year. The first reform should be to cut the corporate tax rate to 20 percent. That would reduce the economic distortions caused by the tax, and it would eliminate any fears that jobs were moving abroad as a torrent of new investment poured into the United States to take advantage of its newly competitive tax climate.

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[1] KPMG, "Corporate Tax Rates Survey," January 2004.
[2] Chris Edwards and Veronique de Rugy, "International Tax Competition: A 21st-Century Restraint on Government," Cato Institute Policy Analysis no. 431, April 12, 2002.
[3] Chris Edwards, "Replacing the Scandal-Plagued Corporate Income Tax with a Cash-Flow Tax," Cato Institute Policy Analysis no. 484, August 14, 2003.