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Corporate Taxes: America Is Falling Behind

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Seven nations in the European Union cut their corporate income tax rates this year.¹ In the past five years, 16 EU nations have cut their corporate tax rates. And since 1995, 24 EU nations have cut their corporate rates.

Europe is on a corporate tax-cutting binge, with rates falling substantially since the 1990s. According to a recent survey by KPMG, the average corporate tax rate in the EU has fallen from 38 percent in 1996 to 24 percent in 2007.² Data from the European Commission confirm the tax-cutting trends in the EU's 27 member nations.³

The appetite for lower corporate tax rates has not yet been sated. Further corporate rate cuts are being implemented in Germany, Estonia, Spain, and the United Kingdom, and rate cuts are being discussed in the Czech Republic and France.

European nations are not the only ones cutting corporate tax rates. In 2002, Australia cut its corporate tax rate to 30 percent, and now New Zealand has announced that it will cut its rate to match Australia's. Singapore's rate is scheduled to fall from 20 percent to 18 percent. Canada is planning to drop its corporate rate by two percentage points, and Russia is considering a four percentage point reduction.

This shift to lower corporate tax rates is driven largely by tax competition. Thanks to globalization, it is much easier for capital to cross national borders, and investors naturally prefer lower-tax jurisdictions. This is prompting governments to cut tax rates on corporations and capital.

America Trails on Corporate Tax Reform

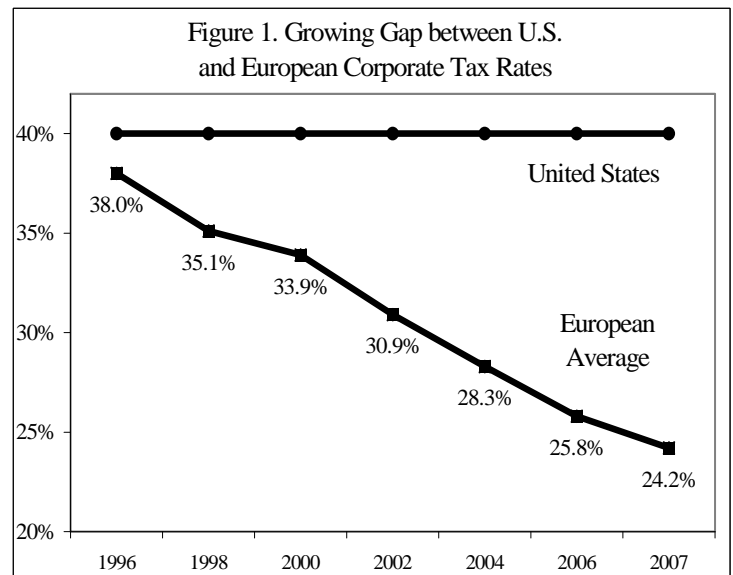
Unfortunately, America is falling far behind in the global trend of reducing corporate tax rates. This is ironic because the United States used to be a tax reform leader. Under President Ronald Reagan, the federal corporate tax rate was cut from 46 percent to 34 percent in 1986, which significantly improved America's competitive position.

But since the late 1980s other nations have jumped on the tax-cutting bandwagon, and the fiscal landscape has

changed dramatically. Our corporate tax advantage has become a big liability. Indeed, U.S. policy moved in the wrong direction in 1993 when President Bill Clinton pushed the federal corporate rate up to 35 percent. With the addition of state-level corporate taxes, America's average corporate tax rate is 40 percent.

Every developed nation except the United States has reduced corporate rates since the Reagan tax cut in 1986, such that the average top corporate tax rate in industrialized nations has fallen by nearly 20 percentage points. All European nations—even the bloated welfare states of France and Sweden—have lower corporate rates and generally better corporate tax systems than America.

The shift to lower corporate tax rates has been particularly pronounced since the mid-1990s. Figure 1 shows that the average corporate tax rate in Europe has dropped 14 percentage points since 1996. Meanwhile, the sum of the federal rate and average state rate in the United States has remained at 40 percent. That is a remarkable 16 percentage points above the European average.



Source: KPMG. Data include both national and subnational taxes.

Other Measures of the Corporate Tax Burden

The official statutory tax rates discussed so far are just one measure of the corporate tax burden. Government rules for the inclusion of receipts, the rules for expenses such as depreciation, and other items may result in effective tax rates being higher or lower than statutory rates. Another issue is the compliance burden of the corporate tax, which varies substantially across countries. If companies must spend large amounts of time and energy complying with the tax system, that imposes a serious burden that damages their competitiveness.

Unfortunately, a variety of measurements of the corporate tax burden show that the U.S. tax code is hostile to investment. A 2006 study by tax scholar Jack Mintz for Canada's C.D. Howe Institute compared effective tax rates on capital across a range of countries.⁴ Table 1 shows that among advanced economies, U.S. investments faced the second highest effective tax rate.

A number of countries in the table—including top-place Germany—have recently cut, or plan to cut, their rates. The result will be that the United States will soon have the most unambiguously punitive business tax regime among advanced economies.

Other measures paint an equally bleak picture for U.S. tax competitiveness. According to the World Economic Forum, the United States was tied (along with Moldova and the Kyrgyz Republic) for 107th out of 117 nations in terms of tax efficiency.⁵ More bad news came in a World Bank study, which found that the United States had the fifth longest tax code for businesses among 175 nations.⁶

Table 1. Effective Tax Rates on Capital, 2006

Germany*	38.1%	New Zealand*	25.4%	Sweden	17.8%
United States	38.0%	Australia	23.6%	Switzerland	16.5%
Canada*	36.6%	Italy	23.2%	Denmark	15.4%
Japan	32.2%	Finland	23.0%	Ireland	14.0%
France*	32.1%	Norway	22.3%	Portugal	13.8%
Korea	31.5%	Netherlands	20.6%	Singapore*	11.5%
Spain*	30.2%	Luxembourg	20.5%	Hong Kong	6.1%
United Kingdom*	28.5%	Greece	20.1%	Belgium	-4.4%
Iceland	25.7%	Austria	19.2%		

* Nations that have further lowered, or are planning to lower, their rates.

Source: Jack Mintz, C.D. Howe Institute.

The Laffer Curve at Work

The complicated and high-rate U.S. corporate tax does not even benefit the politicians who favor big government because high tax rates often result in less tax revenue. The World Bank, which is hardly a bastion of free market thinking, explains in its study that “high tax rates do not

always lead to high tax revenues. Between 1982 and 1999 the average corporate income tax rate worldwide fell from 46 percent to 33 percent, while corporate income tax collections rose from 2.1 percent to 2.4 percent of national income . . . A better way to meet revenue targets is to encourage tax compliance by keeping rates moderate.”⁷

Even the European Commission—a bureaucracy that seeks to harmonize corporate tax rates at high levels—recently confessed that “it is quite striking that the decline in corporate income tax rates has not resulted, so far, in marked reductions in tax revenue, [with] both the euro area and the EU-25 average actually increasing slightly from the 1995 level.”⁸

The U.S. corporate tax system is an anachronism that discourages growth and undermines job creation. High tax rates are driving jobs and investment abroad. That's the bad news. The good news is that other nations are providing valuable reform lessons for American policymakers. Places such as Ireland, Estonia, Hong Kong, and Switzerland illustrate that lower tax rates boost growth and improve tax compliance. They show that tax systems that are simpler and have lower rates liberate businesses to focus on creating jobs and wealth.

America generally does a good job at attracting capital because of its stable currency, dynamic economy, favorable tax rules for individual foreign investors, and lower overall burden of government. But the corporate tax system is one area that needs radical improvement, one where lawmakers can learn lessons from Europe. The longer that policymakers wait to cut the corporate tax rate, the greater the likelihood that the geese that lay the golden eggs will fly across the border.

¹ KPMG, “KPMG’s Corporate and Indirect Tax Rate Survey, 2007,” www.kpmg.com/NR/rdonlyres/89E7B050-9654-4C7A-8A6E-A05158793CD5/0/CorporateTaxRateSurvey2007.pdf.

² Ibid.

³ European Commission, “Taxation Trends in the European Union, 2007 Edition,” June 2007, p. 34,

http://ec.europa.eu/taxation_customs/resources/documents/taxation/gen_info/economic_analysis/tax_structures/Structures2007.pdf.

⁴ Jack Mintz, “The 2006 Tax Competitiveness Report: Proposals for Pro-Growth Tax Reform,” C.D. Howe Institute, 2006, www.cdhowe.org/pdf/commentary_239.pdf.

⁵ World Economic Forum, *Global Competitiveness Report, 2005-06*, Switzerland, 2005.

⁶ World Bank and PricewaterhouseCoopers, “Paying Taxes: The Global Picture,” 2006, p. 13,

www.doingbusiness.org/documents/DB_Paying_Taxes.pdf.

⁷ World Bank and PricewaterhouseCoopers.

⁸ European Commission, p. 35.