

Corporate Tax Laffer Curve

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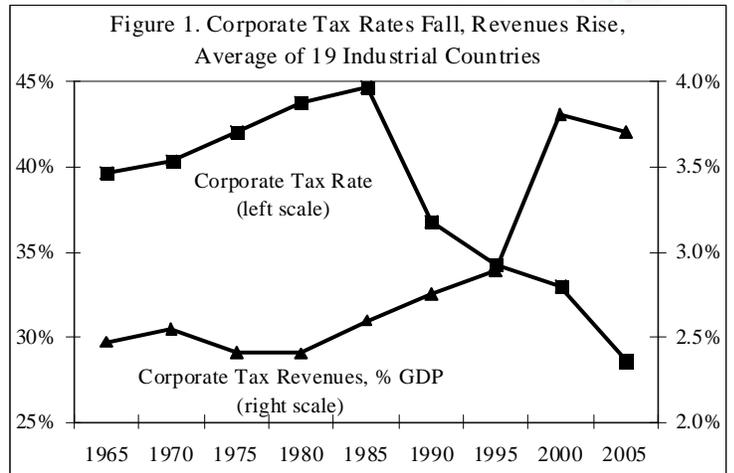
Amid growing concerns about U.S. competitiveness, policymakers are awakening to the fact that America has one of the world's most inefficient corporate income taxes. Charles Rangel, chairman of the House tax committee, has proposed reducing the federal corporate tax rate from 35 percent to 30.5 percent. Henry Paulson, Secretary of the Treasury, is also promoting a corporate rate cut. These efforts should gain wide support because both businesses and workers would benefit as rate cuts spurred rising investment and improved productivity.

However, Rangel and Paulson seem to be assuming that a corporate rate cut needs to be matched with tax increases to ensure that government revenue isn't reduced. But there is growing evidence that a corporate rate cut would generate strong dynamic responses that would produce higher, not lower, federal tax revenues.

Tax Rates and Tax Revenues

Britain and the United States launched the corporate tax cut revolution in the mid-1980s. Since then, every major nation has cut its corporate tax rate. In the European Union, the average corporate tax rate has fallen from 38 percent to 24 percent since 1996.¹ Further cuts are in the pipeline in Britain, Germany, and other countries. Canada has announced a cut to its federal corporate rate from 22 percent to 15 percent. The United States is lagging behind with a combined federal and state rate of about 40 percent.

In most countries, corporate rate cuts have coincided with rising tax revenues. For a group of 19 advanced economies with data back to 1965, I calculated the average statutory tax rate and average corporate tax revenues as a share of gross domestic product.² Figure 1 shows that the average rate was 40 percent or more prior to the mid-1980s. But then supply-side tax policies gained support, and tax rates plunged. The average rate in the 19 countries fell from 45 percent in 1985 to 29 percent by 2005. During the same period, corporate tax revenues soared from 2.6 percent to 3.7 percent of GDP.³



Source: Author, based on data for 19 OECD countries. See endnote 2.

Why have corporate tax revenues risen? One reason is that many countries broadened their corporate tax bases during the late-1980s, often by reducing depreciation deductions. But since then, most countries have not broadened their corporate bases by much, if at all. Indeed, the average value of depreciation deductions across major countries has been roughly unchanged in 15 years.⁴ Also, effective tax rates, which include features of the tax base, have fallen with statutory rates in recent years.⁵

Dynamic Responses to Corporate Tax Cuts

The main factor causing the surge in corporate tax revenues appears to be taxpayer responses to reduced tax rates. Lower rates generate real and financial responses from businesses, prompting them to report higher profits. Research has found that corporations are increasingly responsive to taxes in the global economy across many dimensions. The University of Michigan's James Hines concludes: "Evidence indicates that taxation significantly influences the location of foreign direct investment, corporate borrowing, transfer pricing, dividend and royalty payments, and research and development performance."⁶

Countries that raise corporate tax rates increase the pre-tax returns that are required of new projects because after-tax returns tend to be equalized across countries. The result is that fewer investment projects will be undertaken and capital will emigrate. With a smaller capital stock, labor productivity and wages will fall, and government revenues will be reduced. The University of Toronto's Jack Mintz notes that "economic studies show conclusively that business taxes significantly affect investment in a country."⁷ His analyses show that "high effective tax rates on capital result in less foreign direct investment and therefore less economic growth."⁸

Harvard University's Greg Mankiw and Matthew Weinzierl examined the government revenue impact of tax cuts to capital, such as corporate income tax cuts.⁹ They found that tax cuts would only lose about half of the revenue otherwise expected because rising investment generates offsetting revenues over the long run. In a 2006 study, German economists Mathias Trabandt and Harald Uhlig estimated similar dynamic revenue responses.¹⁰

In addition to these real investment effects, corporate tax changes prompt an array of financial or tax avoidance responses. At the domestic level, corporate tax cuts can induce noncorporate businesses to switch to taxable corporate status. At the international level, tax cuts can induce companies to change their policies on dividend repatriations, transfer pricing, debt financing, foreign affiliate structure, intellectual property, and other items.

Laffer Curve

Considering the range of real and financial responses to corporate taxes, it is likely that cutting the high U.S. corporate tax rate would induce a large expansion of the tax base over time. Both U.S. and foreign firms would invest more in the United States, and they would have less incentive to shift reported profits to other countries.

The Laffer curve illustrates the idea that above a certain tax rate, cuts to the rate cause the tax base to expand sufficiently for revenues to increase. The U.S. corporate tax rate seems to be above that rate, and thus in a strong Laffer zone. The U.S. *statutory* rate is the second highest of the 30 nations in the Organization for Economic Cooperation and Development, and by one estimate, the *effective* rate is the highest.¹¹ Yet U.S. corporate tax revenues as a share of GDP are below average.

Economists Alex Brill and Kevin Hassett looked at these relationships in the OECD for 1980 to 2005. They found that increases to corporate tax rates in the OECD above 26 percent tended to reduce government revenues.¹²

The U.S. corporate tax rate is 14 percentage points above that rate, and thus probably far into the Laffer zone.

In another recent study, Jack Mintz found similar results for Canada using a sample of OECD countries.¹³ He calculated that the revenue-maximizing corporate tax rate is about 28 percent. Note that the revenue-maximizing tax rate is falling as globalization continues to intensify.

Conclusions

A modest corporate tax rate cut would likely result in no government revenue losses in the long-term. However, the goal of policy should be to maximize growth, not revenues, and thus a much larger rate cut is in order. I've proposed that the corporate rate be cut to 15 percent within a major overhaul of the tax code.¹⁴ That wouldn't quite match Ireland's 12.5 percent corporate rate, but it would reduce tax avoidance, make the United States a premier location for international investment, and supercharge American growth and innovation.

¹ KPMG, "Corporate and Indirect Tax Rate Survey," 2007. The KPMG data includes national and subnational taxes.

² Revenue data from the Organization for Economic Cooperation and Development, "Revenue Statistics, 1965–2006," 2007. Rates are for national governments from the University of Michigan Office of Tax Policy Research, as corrected by the author. I choose the same countries as Michael Devereux in "Developments in the Taxation of Corporate Profit in the OECD since 1965," Oxford University, December 2006, except I excluded Norway because its oil revenues distort the data.

³ OECD, p. 81.

⁴ Devereux, Figure 5. See also Rachel Griffith and Alexander Klemm, "What Has Been the Tax Competition Experience of the Last 20 Years?" *Tax Notes International*, June 28, 2004.

⁵ Devereux, Figures 7 and 9.

⁶ James Hines, "Introduction," in *International Taxation and Multinational Activity* (Chicago: University of Chicago Press, 2001), p. 1.

⁷ Jack Mintz, "2007 Tax Competitiveness Report," C. D. Howe Institute, September 2007, p. 8.

⁸ Mintz, p. 11.

⁹ Greg Mankiw and Matthew Weinzierl, "Dynamic Scoring: A Back-of-the-Envelope Guide," Harvard University, December 12, 2005.

¹⁰ Mathias Trabandt and Harald Uhlig, "How Far Are We from the Slippery Slope?" Humboldt University, April 3, 2006.

¹¹ For the effective rate, see Mintz, p. 9.

¹² Alex Brill and Kevin Hassett, "Revenue-Maximizing Corporate Income Taxes," American Enterprise Institute, July 31, 2007.

¹³ Mintz, p. 15.

¹⁴ Chris Edwards, "Options for Tax Reform," Cato Institute, February 24, 2005.