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The U.S. Corporate Tax and the Global Economy

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The corporate income tax is at the center of numerous policy debates today. First, the World Trade Organization has ruled that the U.S. Foreign Sales Corporation / Extraterritorial Income Exclusion (FSC/ETI) tax break given to exporters is illegal. The European Union has threatened the United States with trade retaliation unless it repeals FSC/ETI by the end of this year. Next, corporate tax avoidance has been in the news in the wake of the Enron scandal. Finally, there is growing concern that the corporate income tax damages business competitiveness and reduces U.S. economic growth.

In response to the WTO ruling, bills have been introduced to repeal FSC/ETI, including H.R. 2896 by Ways and Means chairman Bill Thomas (R-Cal.) and H.R. 1769 by Phil Crane (R-Ill.) and Charles Rangel (D-N.Y.). The Thomas bill, and a similar proposal by Senator Orrin Hatch (R-Utah), includes many useful tax reforms in exchange for repeal of the $5 billion per year FSC/ETI provision. However, more fundamental tax reforms are needed, including a large cut to the corporate tax rate.

Corporate Tax Reform Is Long Overdue

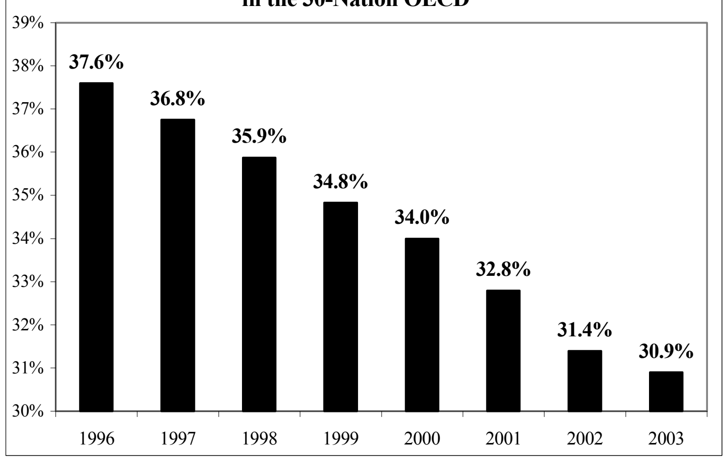
Global direct investment flows rose six-fold in the past decade, and research shows that these flows are increasingly sensitive to corporate taxes.[1] To attract capital and build the economy, the United States should have a neutral and low-rate corporate tax. Instead, the United States has perhaps the most complex corporate tax and the second highest corporate tax rate among major nations.

The U.S. statutory corporate tax rate is 40 percent, which includes the 35 percent federal rate and an average state rate of 5 percent. By comparison, Figure 1 shows that the average rate for the 30-nation Organization for Economic Cooperation and Development is 30.9 percent, down sharply from 37.6 percent in 1996.[2]

Aside from a high rate, the U.S. corporate tax has uncompetitive rules for firms that compete in foreign markets. The U.S. Treasury's assistant secretary for tax policy, Pam Olson, recently testified that "no other country has rules for the immediate taxation of foreign-source income that are comparable to the U.S. rules in terms of breadth and complexity."[3] The complexity of the U.S. rules on foreign income are infamous—Dow Chemical has calculated that 78 percent of its 7,800-page U.S. tax return relates to the rules on foreign income.[4]

Part of the problem is that Congress has viewed corporations as cash cows, and has shown little concern that high taxes reduce investment and drive capital and profits abroad. One example of how the demand for more tax revenue can backfire is the taxation of "foreign base company shipping income." It used to be that the foreign income earned by cargo ships and other vessels owed by U.S. subsidiaries was not taxed until repatriated to the United States. However, Congress changed the rules in 1975 and 1986 to tax that income immediately as earned. But rather than raising federal revenue, the changes reduced revenue as the U.S.-owned shipping fleet shrunk and the tax base disappeared. The U.S. share of the world's open-registry shipping fleet fell from 25 percent in

Figure 1. Average Top Corporate Income Tax Rate in the 30-Nation OECD



Source: Cato Institute based on KPMG data. Unweighted averages.

1975 to less than 5 percent today.[5] The Thomas and Hatch bills include a fix to this counterproductive tax provision.

Thomas Bill Includes Modest Reforms

The corporate tax reform bill introduced by Bill Thomas would reduce the double taxation of foreign income earned by U.S. multinational corporations (MNCs) and simplify the rules for foreign tax credits and subpart F income. Simplifying and reducing taxes on MNCs would benefit the U.S. economy in a number of ways. U.S. MNCs would be able to increase U.S.-based research and other headquarters activities if their foreign operations were larger and more profitable. Also, MNCs could better penetrate global markets with U.S. exports if their foreign affiliates were more competitive. Indeed, U.S. Department of Commerce data show that U.S. MNCs account for two-thirds of all U.S. merchandise exports. By making U.S. MNCs more competitive, the Thomas bill would boost U.S. exports, employment, and incomes. The Thomas bill also includes other useful but limited reforms, including faster depreciation for some equipment investment, liberalizing the subchapter S rules for small corporations, and changes to the corporate alternative minimum tax.

The Crane-Rangel bill provides a targeted tax break for manufacturing. A new deduction would reduce the tax rate for domestic manufacturing by 3.5 percentage points, but would not cut taxes for other types of businesses. This is poor policy compared to a broad-based tax cut because it would increase tax complexity and divide the business sector even further into separate lobbying camps, each wanting narrow breaks rather than overall reforms.

More Fundamental Reforms Needed

Rather than provide narrow breaks, Congress should cut the 35 percent corporate tax rate to 20 percent so that the United States becomes a tax reform leader, not a laggard (see Table 1). In order not to increase the deficit, a rate cut could be paired with cuts to federal spending on business subsidies, which currently total about $90 billion per year.[6] Such a reform package would increase investment and employment incentives for all firms and reduce government favoritism and business distortions.

Beyond a rate cut, Congress should consider full repeal of the corporate tax or replacement with a cash-flow tax.[7] A cash-flow tax would increase domestic investment and make U.S. firms more competitive in global markets because firms would not be taxed on their foreign business income. A cash-flow tax would also reduce wasteful tax sheltering. Indeed, most of Enron's tax shelters would not have been possible under a cash-flow tax.

Table 1. Top Corporate Income Tax Rates in the OECD

Country	1996	1997	1998	1999	2000	2001	2002	2003
Australia	36.0	36.0	36.0	36.0	36.0	34.0	30.0	30.0
Austria	34.0	34.0	34.0	34.0	34.0	34.0	34.0	34.0
Belgium	40.2	40.2	40.2	40.2	40.2	40.2	40.2	34.0
Canada	44.6	44.6	44.6	44.6	44.6	42.1	38.6	36.6
Czech Rep.	39.0	39.0	35.0	35.0	31.0	31.0	31.0	31.0
Denmark	34.0	34.0	34.0	32.0	32.0	30.0	30.0	30.0
Finland	28.0	28.0	28.0	28.0	29.0	29.0	29.0	29.0
France	36.7	36.7	41.7	40.0	36.7	35.3	34.3	34.3
Germany	57.4	57.4	56.7	52.3	51.6	38.4	38.4	39.6
Greece	40.0	40.0	40.0	40.0	40.0	37.5	35.0	35.0
Hungary	33.3	18.0	18.0	18.0	18.0	18.0	18.0	18.0
Iceland	33.0	33.0	30.0	30.0	30.0	30.0	18.0	18.0
Ireland	38.0	36.0	32.0	28.0	24.0	20.0	16.0	12.5
Italy	53.2	53.2	41.3	41.3	41.3	40.3	40.3	38.3
Japan	51.6	51.6	51.6	48.0	42.0	42.0	42.0	42.0
Korea	33.0	30.8	30.8	30.8	30.8	30.8	29.7	29.7
Luxembourg	40.3	39.3	37.5	37.5	37.5	37.5	30.4	30.4
Mexico	34.0	34.0	34.0	35.0	35.0	35.0	35.0	34.0
Netherlands	35.0	35.0	35.0	35.0	35.0	35.0	34.5	34.5
New Zealand	33.0	33.0	33.0	33.0	33.0	33.0	33.0	33.0
Norway	28.0	28.0	28.0	28.0	28.0	28.0	28.0	28.0
Poland	40.0	38.0	36.0	34.0	30.0	28.0	28.0	27.0
Portugal	39.6	39.6	37.4	37.4	35.2	35.2	33.0	33.0
Slovak Rep.	n/a	n/a	n/a	n/a	n/a	29.0	25.0	25.0
Spain	35.0	35.0	35.0	35.0	35.0	35.0	35.0	35.0
Sweden	28.0	28.0	28.0	28.0	28.0	28.0	28.0	28.0
Switzerland	28.5	28.5	27.8	25.1	25.1	24.7	24.5	24.1
Turkey	44.0	44.0	44.0	33.0	33.0	33.0	33.0	33.0
U.K.	33.0	31.0	31.0	31.0	30.0	30.0	30.0	30.0
U.S.	40.0	40.0	40.0	40.0	40.0	40.0	40.0	40.0
Average	37.6	36.8	35.9	34.8	34.0	32.8	31.4	30.9

Source: Cato Institute based on KPMG. Includes subnational taxes.

Congress should aim to give this country the best possible corporate tax environment, not one of the worst. A good first step would be to simplify and reduce taxes for U.S. MNCs, and then follow up with a reduction of the corporate tax rate to 20 percent.

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[1] Chris Edwards and Veronique de Rugy, "International Tax Competition: A 21st-Century Restraint on Government," Cato Policy Analysis no. 431, April 12, 2002.
[2] KPMG, "Corporate Tax Rate Survey," January 2003. Data include both national and average subnational income taxes.
[3] Pam Olson, Testimony to the Senate Finance Committee, July 15, 2003.
[4] Charles J. Hahn, Director of Taxes, Dow Chemical, Testimony to the Senate Finance Committee, July 15, 2003.
[5] National Foreign Trade Council, "The NFTC Foreign Income Project," March 25, 1999, p. 6-5.
[6] Chris Edwards and Tad DeHaven, "Corporate Welfare Update," Cato Tax & Budget Bulletin no. 7, May 2002.
[7] Chris Edwards, "Replacing the Scandal-Plagued Corporate Income Tax with a Cash-Flow Tax," Cato Policy Analysis no. 484, August 14, 2003.