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Corporate Taxes Are Self-Defeating

By Richard W. Rahn
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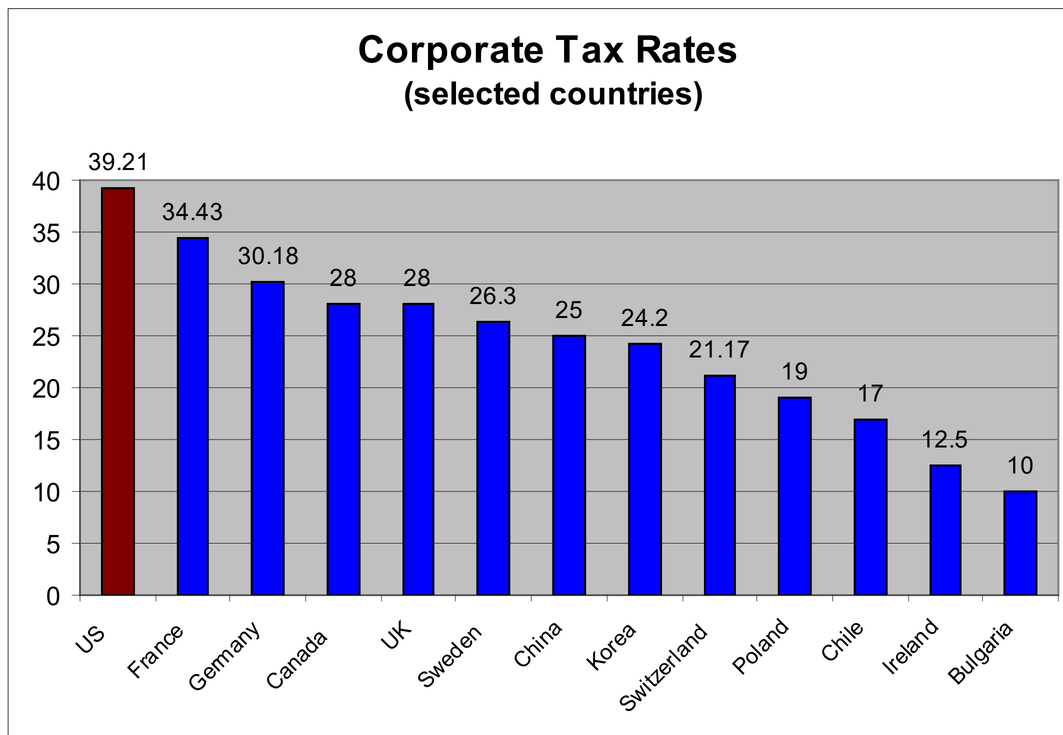
America's anti-business taxes have put it at a competitive disadvantage

If you were establishing a new business whose products would be produced and sold worldwide, would you set it up in the United States, which now has the world's highest corporate-tax rate?

There is a growing realization that the U.S. is at an increasingly competitive disadvantage when it comes to taxing corporations. (See accompanying chart.) Even the Obama administration said it is open to a corporate-tax rate cut, and it is expected that President Obama will propose some rate reduction in his forthcoming State of the Union address.



Sources: OECD, KMPG LLP

From a purely economic standpoint, it makes no sense to tax corporations at all, because only people pay taxes, not legal entities. The corporate tax is paid by customers in terms of higher prices, by suppliers in terms of lower volumes of business, by employees in terms of lower wages and by stockholders in terms of lower returns. Many countries used to have higher corporate-tax rates than the United States, but, over time, they realized they were losing business - and jobs - to countries with lower rates; so most countries have been reducing their corporate-tax rates to attract new businesses and global firms.

The Obama administration has said that any corporate-tax rate reduction must be "revenue neutral," by which it means that rates can only be lowered if corporate "loopholes" are closed. It is true that some companies do benefit from certain deductions that have little or no economic benefit (except to the companies); hence, eliminating the "loophole" and reducing the corporate rate by an equivalent amount would be a tax-revenue wash. There are other so-called "loopholes," such as accelerated depreciation and foreign-tax deferral, which, if eliminated, would do far more economic damage by discouraging new investment and job creation than any benefit from the short-term revenue gain that might be obtained by their elimination.

The way the administration and some in Congress are formulating the conditions for a revenue-neutral corporate-rate cut means the effort will be both a political and economic failure. Tax-revenue projections are provided by the Joint Tax Committee of Congress. The committee uses largely static, rather than fully dynamic, revenue analysis. When it prepares estimates of proposed corporate-tax changes, it will largely ignore the fact that if the U.S. rate remains the highest or one of the highest in the world, increasing numbers of U.S. businesses will migrate elsewhere, and new or existing foreign businesses will choose not to come to the United States - all of which will have a significant negative impact on U.S. job and economic growth. As a result, the United States will continue to lose global market share of the economic pie. The predictable response of the American left will be to demand more transfer payments to the unemployed and higher taxes to pay for them, which will become increasingly self-defeating.

Japan, up to this year, had a corporate-tax rate slightly higher than the U.S. rate, but it has announced it will reduce its rate by 5 percentage points. The Canadians have been steadily reducing their corporate rate and have said they will continue to do so. Toronto, Canada, and Buffalo, N.Y., are less than a couple of hours' drive from each other, and, thanks to the North American Free Trade Agreement, there are no trade barriers between the cities. Canada is becoming increasingly business friendly, with lower corporate income taxes, and New York is increasingly business hostile. It's not hard to figure out why Toronto is booming and Buffalo is dying.

Insisting that any corporate-rate cut be revenue neutral on a static basis also means that it will not pass Congress, because in a zero-sum game, the likely losers most often fight harder than the potential winners. Tax reform, whether it is corporate or personal, is almost impossible unless there seem to be more winners than losers. If tax-revenue projections were properly done - by using dynamic analysis - a proposed rate cut would show the revenue feedbacks from higher growth and more employment. Static revenue analysis, the current method employed by Congress, ignores most of the growth effects, thus it biases the exercise toward higher tax rates for the same tax revenue.

Wise members of Congress understand that the existing congressional tax-revenue estimating process is close to useless. Realizing that most countries are learning that the corporate tax is destructive and will slowly continue to reduce their corporate tax rates, members of Congress should make sure that the U.S. total tax rate (combining federal and average state rates) is lower than the average international rate (approximately 25 percent) so that the U.S. will not continue to lose market share. If the United States establishes and maintains a rate that is always internationally competitive, it is likely that such a rate will be close to the long-run revenue-maximizing rate.

Businesses - and hence, jobs - over time tend to migrate, other things being equal, from high-tax to lower-tax jurisdictions - and this is true both among states and countries. Many politicians - particularly those from California, Illinois and New York - seem unable to grasp this simple economic concept.

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