Cut the Top U.S. Corporate Tax Rate to 22%

Cutting the corporate tax rate will boost the U.S. economy. But Trump's 15% target is too low.

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If President-elect Donald J. Trump and the new Congress are serious about firing up the U.S. economy, they will move swiftly to cut the corporate tax rate, now the highest in the world.

That one step would have far-reaching effects. It would make American businesses more competitive in the global arena. It would reduce the massive amounts of time and energy now wasted on tax-avoidance maneuvers. And it would bring home to these shores trillions of dollars of profits earned by U.S. corporations overseas and now housed in kinder tax jurisdictions.

Trump seems to appreciate all of that. On the campaign trail, he proposed slashing the rate that businesses pay on income from 35% to 15%. That might be too much—it could significantly reduce the government's tax haul and add to the nation's already unacceptable debt burden. *Barron's* recommends a cut to 22%, which would be revenue-neutral, allowing businesses to produce just enough additional taxable income to offset the effect of the lower rate. And getting a 22% cut through Congress would be easier than 15%.

The idea of a revenue-neutral cut in the corporate income tax harks back to 1978, when economist Arthur Laffer was first cited as arguing that some tax cuts could generate enough added economic growth that the government would not lose revenue over the long term. Laffer also noted that most tax hikes generate less revenue than a conventional "static" analysis indicates, and most tax cuts lose less.

Laffer's "dynamic" analysis covers all of the behavioral changes likely to result from a cut. To begin with, if the tax collector claims a lower share of income, there is an incentive to produce more income. Second, a lower rate means there's less incentive to spend time and effort avoiding the tax.

That second factor—less tax avoidance—applies with special force to a rollback in the corporate income tax.

While granting tax breaks to big corporations goes against the grain of American populism, so should ceding the economic advantage of lower corporate rates to every other major industrialized country. And given the huge sums involved, it's not hard to see why American companies operating abroad actively shop for low-tax jurisdictions.

Take corporate "inversions," which many lawmakers deride as un-American. In an inversion, a U.S. multinational company is acquired by a company domiciled in a low-tax country, such as Ireland or Canada, where top rates are 12.5% and 26.7%, respectively. Profits earned in the U.S. continue to be taxed at the domestic rate, while those made elsewhere are subject to lower rates.

Democrats have cynically sought to outlaw inversions, rather than lower domestic tax rates, which would solve the problem by eliminating the reason companies seek out other residences. In effect, it's a form of protectionism, and it doesn't work.

Another tax-avoidance strategy is to locate subsidiaries in low-tax jurisdictions and to keep accumulated profits offshore; hence the roughly $2 trillion held abroad by U.S. corporations that are loath to repatriate this money because it would be subject to high U.S. taxes. Here again, a lower rate would bring revenue back to the U.S., rather than stranding it abroad.

Then there is the tricky business of transfer pricing. For example, a U.S. company purchases materials from a subsidiary in Ireland, where the tax on corporate income is much lower. Within limits, the price of the purchased materials will be exaggerated, thus reducing the profits of the U.S.-based company and boosting the earnings of that firm's subsidiary in the low-tax jurisdiction.

Through transfer pricing, then, prices on intra-corporate sales and purchases are set too high or too low, depending on the direction of the transaction. While Washington has tried to deal with cheating in this area—a wasteful exercise in itself, leading to costly litigation—it is obviously impossible to determine "correct" prices.

A tax reduction would reduce all of these incentives, generating more revenue for the U.S. Treasury. And by encouraging greater investment in the domestic economy, it would generate more revenue by resulting in more profit.

The Washington, D.C.–based Tax Foundation has argued that Trump's tax-cut plan would result in a decline in government revenue because it "will encourage more investment and result in businesses deducting more capital investments, which would reduce corporate taxable income." But over a 10-year time horizon—which the Tax Foundation itself studies—more capital investment will yield more profit and hence more taxable income.

And in the shorter run, there is the tax revenue generated by secondary effects. More revenue would come from shareholders, as they benefit from greater dividends and capital gains. And more would come from corporate employees, as they benefit from higher wages and salaries generated by higher spending on capital investment.

Over time, and taken all together, the revenue effects from a tax cut could even be positive. Meanwhile, the boost to economic activity would be palpable. Most of America's trading partners have already discovered the dynamic supply-side effects of this tax cut.

Over the past 35 years, other countries have trimmed their top corporate rates by a far greater proportion than the U.S. Virtually every comparison between the burden of corporate taxes in the U.S., including state and local levies, and the rest of the world has shown that America's burden is higher than most.

For example, as the chart shows, the top rate in the U.S., which combines the federal rate of 35% with four added percentage points for states and localities, comes to 39%. That's higher than the combined rates for Germany (30.2%) and Japan (30%), and much higher than the United Kingdom's (20%) and Denmark's (22%).

Critics of corporate tax reductions point to the many loopholes that creative accounting already exploits. But according to one study, the effective corporate tax rate, which factors in these loopholes, still leaves the U.S. as No. 2 in the world in terms of its corporate tax burden, and noticeably higher than Canada and even "socialist" Sweden.

Harvard University economist Gregory Mankiw argues that corporations themselves are not the beneficiaries of tax cuts, contending that they are not really taxpayers, but rather tax collectors. It's therefore an open question as to which of the corporate stakeholders is bearing the main burden of the tax. Many would say that it's the company's stockholders, with bondholders also contributing; others might say that the company's customers pay up, as well.

Cato Institute senior fellows Chris Edwards and Daniel J. Mitchell take that idea a step further in their 2008 book, *Global Tax Revolution*, where they make the plausible argument that, in today's world, the taxpayers are mainly the workers. "The burden of corporate taxes in the globalized economy," they observe, "mainly falls on average workers in the form of lower wages. If U.S. and foreign semiconductor and pharmaceutical companies are not building factories in America because of higher taxes, it is American workers who lose."

But if you can run, you can't hide. Companies have to pay taxes to some jurisdiction. If corporate rates across countries have been lowered over the years, then those who doubt the Laffer effect will expect that revenue from this tax has declined, especially given the tendency for companies to flee to lower-tax jurisdictions.

Barron's tested this idea by updating a statistical run originated by Cato fellows Edwards and Mitchell. The results not only confirmed the Laffer effect but also, if anything, showed that a decline in the corporate tax rate seems to bring a rise in revenue, rather than a fall. In other words, instead of being revenue-neutral, the proposed cut might even be revenue-positive.

For 19 countries in the Organization for Economic Cooperation and Development—including the U.S., the U.K., Ireland, France, Japan, Germany, Switzerland, Denmark, Sweden, New Zealand, and Australia—*Barron's* used that organization's numbers to calculate a simple average, over time, of the top rate on corporate income, as tracked by the first line in the nearby chart.

In 1981, the earliest year for which data are available, the average top rate was 47.6%. By 2014, the most recent year for which data are available, the average had plunged to 27.4%. This decline of more than 20 percentage points came with only partial participation by the U.S., whose top rate, including state and local, fell by only 10.6 points over this period, to 39.1% in 2014 from 49.7% in 1981.

The decline in the average over each of these intervals was widespread. Fifteen out of 19 nations had lower top rates in 1995 than in 1981, and 18 of the 19 had lower top rates in 2014 than in 1995.

This collective race to the bottom conceivably could have brought a decline in revenue, but it seems to have brought just the opposite. The OECD provides figures for each country on revenue from the corporate tax, as a percentage of each country's gross domestic product. From these figures, *Barron's* calculated a simple average for the 19 countries for each snapshot year.

The figures are sensitive to the strength in the global economy; slow growth tends to lower revenue as a share of GDP, while faster growth leads to higher revenue. But the pattern is unmistakable. In 1981 and 1985, when the average tax rates were highest (47.6% and 47.8%, respectively), the tax takes as a share of GDP were at their lowest (2.1% and 2.3%). In 2000 and 2005, the tax takes were at their highest (3.5% and 3.3%, respectively), while the rates were among the lowest (35.4% and 31.1%).

Perhaps most decisively, the average tax rate in 2014 was at its lowest, at 27.4%. The tax take in 2014, at 2.7%, reflects slow growth. But in 1995, the take was also at 2.5%, even though the average tax rate was more than 10 percentage points higher, at 37.5%.

"Despite complaints that corporate tax cheating is rampant and getting worse, these trends show the reverse. Tax avoidance seems to have fallen, which is one of the beneficial effects of rate cuts that all sides of this issue can support," says Cato's Edwards.

What sort of reduction works best? Out of concern for rising debt and deficits, and for the need for the White House and Capitol Hill to focus on the much harder task of cutting spending, *Barron's* proposes a conservative approach.

In their Sept. 29 white paper, "Scoring the Trump Economic Plan," Trump economic advisors Peter Navarro and Wilbur Ross propose reducing the top federal rate on corporate income to 15% from 35%. However, if the tax is meant to pay for itself, that 15% target may be too low.

A 2007 study by American Enterprise Institute scholars Alex Brill and Kevin Hassett ("Revenue-Maximizing Corporate Income Taxes") found that there is indeed a Laffer effect with respect to lowering corporate income taxes. They estimated "about 26%" as the "revenue-maximizing point," where revenue would actually run positive.

Barron's favors this 26% target, which translates into 22% on the federal level, factoring in the extra four percentage points for corporate income taxes levied by states and localities. In order to bring the overall corporate tax rate to 26%, then, this means lowering the top federal rate to 22% from its current 35%, assuming the extra four percentage points remain unchanged.

Advisors Navarro and Ross address another issue: They propose a one-time "amnesty rate" of 10% to induce repatriation of the $2 trillion in profits that U.S. corporations are keeping offshore.

Since these companies have already paid taxes in the host countries where the money was earned, a case can be made for a zero rate. However, given concerns about possible revenue losses over the short term from a cut in the top rate, *Barron’s* favors the compromise of a 10% charge.

Last week, The Wall Street Journal reported that U.K. Prime Minister Theresa May endorsed a move to lower her nation’s top corporate rate from 20% to 17% by 2020. Other countries might respond with further cuts in their rates, which could give Trump support to get to 15%. Meanwhile, we favor 22%, because it encourages companies to invest more, while not reducing tax revenue.