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RAHN: Corporate tax madness

Obama's insistence on high business taxes drives away opportunity

By Richard Rahn
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The United States already has the highest corporate tax rate in the world, but the Obama administration is proposing to make the U.S. even less competitive internationally by reducing the corporate tax deferral on income made abroad. Most countries have a territorial system of taxation in which they only tax income made within their borders. The United States is one of the few countries that taxes individuals and companies on their worldwide income. Companies have been allowed, however, to defer taxes on income earned in other countries until it is brought back to the U.S.

Assume for the moment that you have invented an improved LED for lighting. The finished product is small and lightweight and can be shipped anywhere from almost anywhere without transportation costs being a major factor. You are trying to decide where to set up your company and have made a list of countries that have the necessary skills among their workforces. A major factor that will influence your decision is the corporate tax rate. The accompanying table lists the corporate tax rates for selected countries.

Would you select the United States, knowing it has the highest corporate tax rate in the world, is fiscally unstable in that debt is growing far faster than national income, and future taxes are likely to be higher, particularly if President Obama is re-elected? (Note: the tax rates shown are the average for each country. The United States, for example, has a federal corporate tax rate of 35 percent, while state and local corporate income tax rates range from zero to 12 percent, giving a national average of about 40 percent for federal, state and local corporate income taxes.)

Advocates of higher corporate tax rates usually claim it will produce more tax revenue, but many good economic studies question that assumption.

Canada provides a very interesting example. Its experience supports those who think a government can reduce corporate tax rates without reducing tax revenue, up to a point, and that an increase in corporate tax rate would be likely to lose revenue. Canada has been reducing its federal corporate tax rate from almost 30 percent in 1999 to just 15 percent this year. The individual Canadian provinces also tax corporate income, giving Canada a combined average rate of about 28 percent. Rather than falling, corporate tax revenues rose after the rate cut and, more telling, resulted in an increase in federal corporate tax revenues as a percentage of gross domestic product (GDP). Canada on average produces approximately 25 percent more in corporate tax revenues as a percentage of GDP than does the United States, even though the Canadian federal corporate tax rate is less than half that of the U.S. (15 percent versus 35 percent). This is a perfect illustration of the Laffer Curve effect - the revenue-maximizing rate for the corporate income tax is clearly well below 35 percent.

What the high-tax-rate lobby fails to understand is that companies can charter themselves anywhere in the world, and their tax rate depends largely on where they are chartered. They do have to pay local tax rates where they conduct business, but that is only on the business done in the particular state. Companies increasingly have been moving out of the United States for tax reasons, and of greater concern is that many new businesses are deciding to choose a home other than the U.S. This is not good for future U.S. employment and economic growth.

Another thing that the high tax lobby does not seem to understand is that many businesses can choose the legal form under which they conduct business and do not necessarily have to charter themselves as corporations. A business can be a sole proprietorship, a partnership, a limited-liability company (LLC) or a corporation. If one form of business is taxed more heavily than another form, people will move to the more lightly taxed form and location.

As economists Gary Hufbauer and Martin Vieiro of the Peterson Institute for International Economics stated in a new paper: “Put simply, a territorial system taxes corporate income earned at home; it does not attempt to tax corporate income earned abroad. If the administration truly wanted to make U.S. firms more competitive, it likewise would move toward a true territorial tax system, one that only taxes income earned domestically. That way, U.S. firms operating in global markets would not be disadvantaged relative to their peers’ based in Canada, Germany, Japan and most other countries.”

All too many people in the Obama administration and in Congress view the world as a static place, believing that businesses and individuals will sit still and not react to ever-increasing taxes and regulations. More enlightened political leaders, who understand that the world is dynamic, see and act on the opportunity to attract businesses, jobs and capital that the United States is foolishly driving away.

Richard W. Rahn is a senior fellow at the Cato Institute and chairman of the Institute for Global Economic Growth.