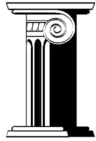

INSTITUTE BRIEF

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You and I Shouldn't Have to Pay Such High Corporate Income Tax Rates

by Brad Cook

When most Americans hear of a corporation moving their operations overseas, we have an automatic tendency to blame cheap labor and unregulated workplaces for the loss of American jobs. Some of us even go to our Congressmen and ask that they invoke high tariffs or higher taxes on those companies that move overseas. However most Americans would be shocked to learn that with the exception of Japan, the United States has the highest average corporate income tax rate of the 30 Organization for Economic Cooperation and Development (OECD) countries. What may be even more shocking is that while many "high tax" European countries have been slashing their corporate income tax rates, the U.S. has plans to increase its top rate to 40 percent in 2011.

One country in particular has seen great success since slashing corporate rates to 12.5 percent. Unbeknown to most, Ireland has become the second richest country in the European Union. The business friendly tax structure has attracted some of the world's most influential industries. Nine of the world's top ten pharmaceutical companies have operations there, along with 16 of the top 20 medical device companies and seven out of ten software designers.[1] On the heels of its new worldwide investment, Ireland's GDP has grown from 70 percent of the EU per-capita average in 1990 to 136 percent in 2003.[2]

In the past, the U.S. has been the trendsetter when it came to tax reform. So why has the U.S. been slow to reform corporate income taxes? American voters are often too concerned with whether their individual taxes are greater than or less than business taxes and fail to recognize that individuals bear a large burden of business taxes. A corporation is a legal entity that can be taxed in a legal sense, however a corporation is not one single individual who bears the entire burden of the tax. Instead the tax is borne by many individuals in their role as laborers through lower wages or loss of employment, consumers through higher prices, or investors through lower rates of return. Most economists now recognize that the corporate tax is in fact a legal fiction. One economist estimates that U.S. labor bears seven-eighths of the corporate tax.[3]

Despite what many may think, the cost of labor isn't the only incentive for a corporation to relocate overseas. In fact, for many industries it isn't even the top reason. A recent report released by the National Association of Manufacturers found that, "As of 2002, unit labor costs in U.S. manufacturing industries were lower than four of the nine largest U.S. trading partners and only marginally higher than three others."[4] The report listed the five primary structural costs that hamper U.S. manufacturers: excessive corporate taxation, escalating costs of health and pension benefits, increasing tort litigation costs, escalating compliance costs for regulatory mandates, and rising energy costs. The report calculates that among the five structural costs listed, the cost burden of the corporate income tax is the most severe. "Expressed as a trade-weighted average, the U.S. corporate-tax burden reduces U.S. cost competitiveness by 5.6 percentage points."[5]

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So why is the U.S. corporate-tax system so burdensome and what can be done to keep American companies? The problem with the U.S. system is not necessarily that it collects an onerous percentage of corporate income, but instead it is how that money is collected in a global economy. The U.S. operates under a worldwide tax system whereby U.S. registered corporations are taxed on income earned globally. Typical with most worldwide systems, the business profits of foreign subsidiaries are not taxed until repatriated back to the U.S. Alternatively, many other industrialized countries' tax systems are territorial whereby income earned by foreign subsidiaries and branch operations is exempt from the corporate income tax. U.S. corporations are given a tax credit for taxes paid to foreign tax authorities, up to the U.S. tax rate. If the foreign tax rate is less than the U.S. tax rate, than U.S. corporations have an incentive to keep their profits overseas, because they would be forced to pay taxes on any income earned not subject to the foreign tax.

Most other countries have also lowered corporate income tax rates and adopted a Value Added Tax (VAT). The European Union countries have an average VAT of 19 percent, and OECD countries have an average VAT of 17.7 percent. By adopting a VAT, these countries have essentially enacted a perfectly legal tariff on foreign products that come from a country with a higher corporate tax rate.

The U.S. should do one of two things: Either completely eliminate the corporate income tax and replace it with a consumption tax, or enact a territorial corporate-tax system, drastically slash corporate-tax rates, and enact a consumption tax at a lower rate. Ideally the U.S. would become a global leader again by eliminating all corporate income taxes and adopting a Retail Sales Tax (RST). Unlike a VAT which imposes a sales tax on all levels of production, a RST would impose a sales tax only on the sale of the final product. The RST is preferred to the VAT because the RST tax rate is seen first hand by the taxpayers, whereas the VAT rate is seen by the producer and then passed along to the unknowing consumer. Since the consumer does not see the ticket price of the tax, VAT rates are more easily increased by greedy "tax-eaters".

The U.S. faces the challenge of once again becoming the global leader for tax reform. The American voters must realize that when a politician says he believes in increasing corporate taxes so as not to increase yours, the corporation is a false entity in terms of being able to pay taxes, and instead the taxes are paid by you the laborer, consumer, or investor.

(Endnotes)

[1] Thomas L. Friedman, "The End of the Rainbow," *The New York Times,* June 29, 2005, <http://www.nytimes.com/2005/06/29/opinion/29friedman.html?th&emc=th, June 29, 2005> (6/29/05).
[2] "Taxing times," *The Economist,* March 21, 2005.
[3] Arnold C. Harberger, "The ABCs of Corporation Tax Incidence: Insights into the Open-Economy Case," *Tax Policy and Economic Growth*, American Council for Capital Formation, Washington, D.C., 1995, p. 41.
[4] Jeremy A. Leonard, "How Structural Costs Imposed on U.S. Manufacturers Harm Workers and Threaten Competitiveness,"
Manufacturers Alliance/MAPI, prepared for The Manufacturing Institute of the National Association of Manufacturers, 2003, p. 1.
[5] *Ibid.*, p. 12.

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