Joint Economic Committee
Republicans
Senator Sam Brownback *Ranking Member*
Representative Kevin Brady *Senior House Republican*

Republican Staff Commentary

High Corporate Tax Rates: Threat to U.S. Competitiveness

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> *...the past decade is a lost one for U.S. business tax reform. Unlike most OECD countries that cut their corporate income tax rates or reduced other taxes on business investment, the United States enacted some targeted preferences while maintaining a very high federal corporate rate. The United States imposes additional tax burdens on investment as a result of state and local sales taxes on capital purchases and asset-based taxes on capital goods. These taxes increase the overall effective tax rate and create an additional disincentive for new investment.*
>
> –Duanjie Chen and Jack Mintz[i]

Corporate Taxation and Distribution

The U.S. has some of the highest corporate income tax rates in the world; the average combined federal and state corporate tax rate is 39.3 percent, rivaled only by Japan.[ii] As the U.S. has become a comparatively less profitable place for businesses to locate, the U.S. government and the citizens it serves are losing out on jobs and revenue. According to the Congressional Budget Office (CBO), "Domestic workers are more likely to bear a burden because workers cannot move readily between countries. Domestic wages will fall when capital is reallocated abroad and domestic workers cannot move to take advantage of a higher foreign wage rate."[iii] While it is true that the wealthiest quintile of income earners is liable for the greatest amount of corporate taxes, the corporate tax burden still falls upon the greater population through lower wages and stunted economic growth. Furthermore, the year 2011 will bring about the largest tax hike in U.S. history, affecting all income quintiles if Congress does not act.

Background

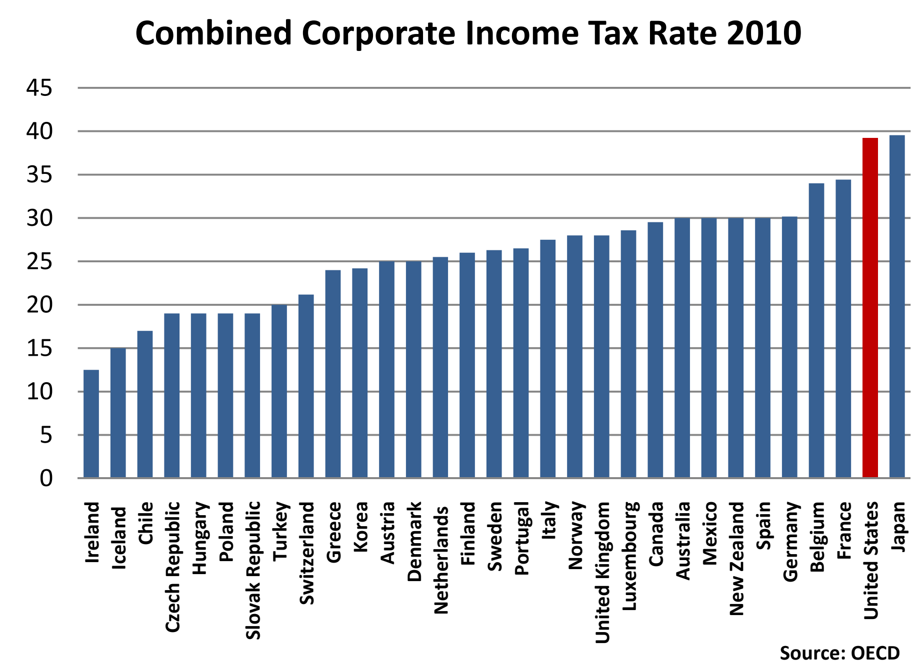
Economic theory explains that if a good or service is taxed, less of it will occur. Not only is corporate income in the U.S. taxed at one of the highest rates in the world, but it is taxed twice—first at the corporate level and then again at the individual level as dividends or capital gains. Corporations employ a great number of people and produce an immense amount of goods and services. As such, the taxes applied to corporations also affect the people employed by corporations and the individuals and businesses that use corporations' products and services. A report by the CBO recognizes corporate income taxes as affecting investment (including investment by foreigners in the U.S.), economic growth, innovation, and international competitiveness.[iv] The CBO acknowledges that the corporate income tax is "one of the most destructive forms of taxation."[v] By distorting the otherwise natural pattern of activity, corporate taxes lead to a misallocation of resources and inefficiencies in the economy as economic and entrepreneurial activities are redirected away from the most valuable and profitable opportunities. This seems particularly counterintuitive when the current Administration has stressed the importance of keeping jobs and business growth on U.S. soil.

Evidence of the Corporate Tax Burden

A 2009 study conducted by Robert Carroll, a top tax economist and former Deputy Assistant Secretary for Tax Analysis at the U.S. Treasury, showed that the corporate income tax rates and real average earnings in U.S. states are negatively correlated. The results find that a $1.00 increase in state and local corporate tax revenues results in a roughly $2.50 decline in wages.[vi] On the flip side, a study by the American Enterprise Institute finds a one percentage point *decrease* in corporate tax rates is correlated with a 0.8 percent *increase* in real manufacturing wages.[vii] These studies provide evidence that the effects of taxes on businesses are not limited to the businesses themselves, but are passed on to the employees of those businesses. In fact, if the effect of corporate taxes is to significantly reduce investment, capital, and savings, the corporate tax could have such a large impact on labor that it would be regressive, rather than progressive.[viii]

U.S. Rates Are Less Competitive

Other countries, especially the OECD countries, prove more competitive in their corporate tax rates relative to the U.S. Five economists from the World Bank and Harvard University recently completed a study in 2009 that compiled data on effective corporate income tax rates for 85 countries. They found a statistically significant relationship between corporate taxes, aggregate investment, and entrepreneurship. Their findings indicate that raising the effective corporate income tax rate by 10 percentage points leads to a two percentage point reduction in the ratio of aggregate investment to GDP.[ix] If applied to the most recent data in the U.S., a 10 percentage point increase in the corporate tax rate would result in a $292 billion reduction in investment.[x] Furthermore, the study revealed that a 10 percentage point increase in the effective corporate tax rate reduces the number of business establishments by 1.9 firms per 100 people (based on the U.S. population of roughly 307 million, this would amount to a reduction of approximately 5.8 million business establishments), and reduces the average rate of new business registrations by 1.4 percentage points (based on 2009 data, this would cut the number of new business establishments by more than half).[xi] Case in point: if you tax an activity less of it will occur.



The Year of the Tax Man

As the economic and jobs growth tax relief measures of 2001 and 2003 are set to expire at the end of 2010, and as new taxes under the new Patient Protection and Affordable Care Act (PPACA) take effect in 2013, the top tax rates on dividends and capital gains will rise from 15% to 20% for capital gains and 39.6% for dividends in 2011, and then to 23.8% and 43.4%, respectively, in 2013. Allowing taxes on capital gains to rise by 59% and dividends to rise by 189% will cause the U.S. to lose out on business growth and investment opportunities and will threaten overall economic growth prospects and the overall standard of living in the United States. Even if low and middle income earners are spared from direct tax increases, the effect of rising tax rates on both income and investment for upper income earners—who are responsible for a significant portion of employment in the United States—will nevertheless drive down wages and reduce employment across all income groups.

Proponents of allowing the biggest tax hike in history to occur argue that the additional boost to government revenue is necessary to prevent further increases in deficits and debt, but long-run fiscal imbalances in the U.S. are primarily driven by increased government spending. A recent report by the Heritage Foundation based on CBO data finds that, in 2014, 92 percent of projected rising budget deficits are attributable to above-average spending, not below-average revenues, and by 2017, 100 percent of projected rising budget deficits are attributable to above-average spending.[xii]

Conclusion

Although directly born by corporations, higher corporate income taxes reduce employment, sales, and profit opportunities for individuals in all income quintiles. As other countries' corporate tax rates have become increasingly attractive relative to the U.S., the shift of businesses abroad will continue to shrink the opportunities for jobs and economic growth in the U.S. Furthermore, if taxes on investment income increase in 2011 and then again in 2013, the U.S.'s global competitive edge will continue to deteriorate as other countries welcome economic growth opportunities through more viable, business-friendly environments.

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[i] Chen and Jack Mintz, "U.S. Effective Corporate Tax Rate on New Investments: Highest in the OECD," The Wall Street Journal, May 14, 2010, http://online.wsj.com/article/SB10001424052748704635204575242241281902852.html

[ii] Scott A. Hodge, "U.S. States Lead the World in High Corporate Taxes," Fiscal Fact No. 119, Tax Foundation, March 18, 2008, http://www.taxfoundation.org/publications/show/22917.html

[iii] William C. Randolph, "International Burdens of the Corporate Income Tax," *Working Paper Series*, Congressional Budget Office, August 2006, http://www.cbo.gov/ftpdocs/75xx/doc7503/2006-09.pdf

[iv] "Corporate Income Tax Rates: International Comparisons," Congressional Budget Office, November 2005, http://www.cbo.gov/ftpdocs/69xx/doc6902/11-28-CorporateTax.pdf

[v] Congressional Budget Office, 2005.

[vi] Robert Carroll, "Corporate Taxes and Wages: Evidence from the 50 States," Tax Foundation Working Paper No. 8, The Tax Foundation, August 2009, http://www.taxfoundation.org/files/wp8.pdf

[vii] Kevin Hassett and Aparna Mathur, "Taxes and Wages," Working Paper No. 128, American Enterprise Institute, June 2006, http://www.aei.org/paper/24063

[viii] Jane G. Gravelle, "Distributional Effects of Taxes on Corporate Profits, Investment Income, and Estates," Congressional Research Service, May 7, 2007, http://www.crs.gov/Pages/Reports.aspx?Source=cli&ProdCode=RL32517

[ix] Investment was represented by gross fixed capital formation and foreign domestic investment both as a percentage of Gross Domestic Product (GDP). They examined entrepreneurship with two measures: the number of business establishments (business density) and the rate of new business registration (average entry rate). See: Simeon Djankov, et al., "The Effect of Corporate Tax Rates on Investment and Entrepreneurship," Working Paper 13756, National Bureau of Economic Research, January 2008, http://www.nber.org/papers/w13756.pdf

[x] Data from the Bureau of Economic Analysis via Haver Analytics.

[xi] Data from the Bureau of Labor Statistics via Haver Analytics.

[xii] Brian Riedl, "The Three Biggest Myths About Tax Cuts and the Budget Deficit," *Backgrounder*, The Heritage Foundation, June 21, 2010, http://www.heritage.org/research/reports/2010/06/the-three-biggest-myths-about-tax-cuts-and-the-budget-deficit