



The Economic Consequences of Being Left Behind: A U.S. Business Tax System that is Out of Line Internationally

Fiscal Fact No. 123

By Robert Carroll

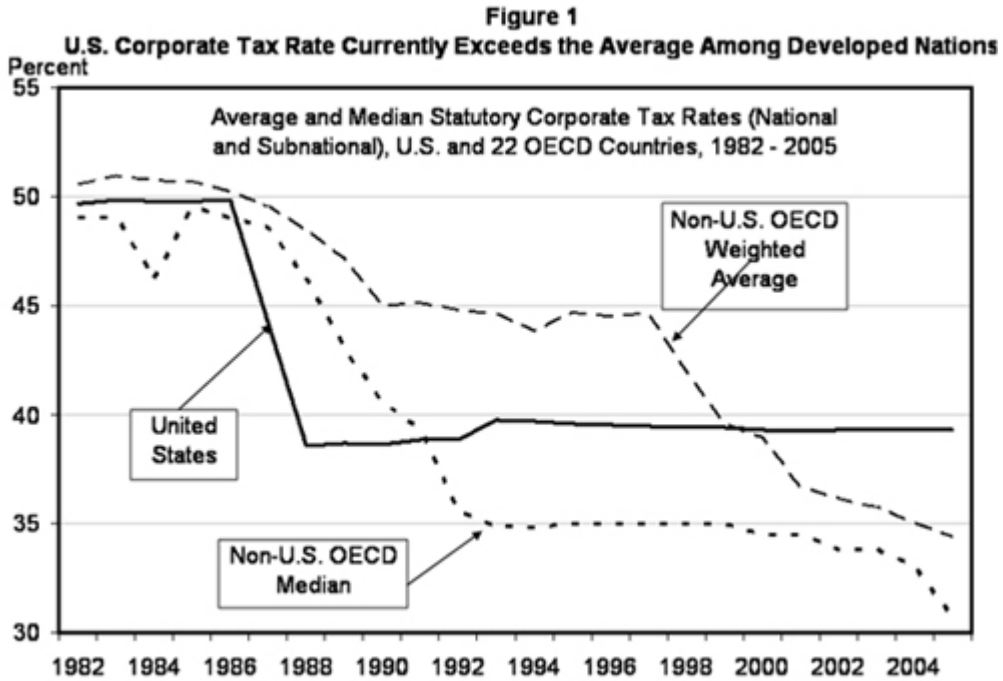
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The costly nature of the U.S. business tax system was underappreciated during the late 1980s and the 1990s, but now our corporate tax is coming in for some overdue and well deserved criticism. Proposals for reform have been offered by prominent leaders of both parties, and academics have also shown increased enthusiasm for major changes if not fundamental reform.

Currently, the U.S. business tax system imposes substantial economic costs by disrupting and distorting many business decisions. The result is less investment overall and an inefficient allocation of what investment we do have. Rather than letting investment flow to the sectors of the economy that produce the most value, tax considerations steer investments into less productive areas.

This relatively smaller, poorly allocated U.S. capital stock translates into an American workforce that has less capital to work with and therefore earns lower wages. As long as our political leadership ignores or fails to explain the inevitable connection between workers' wages and the taxation of capital income, our tax system will continue to cause unnecessary damage to our nation's economic performance and to the living standards of American workers.

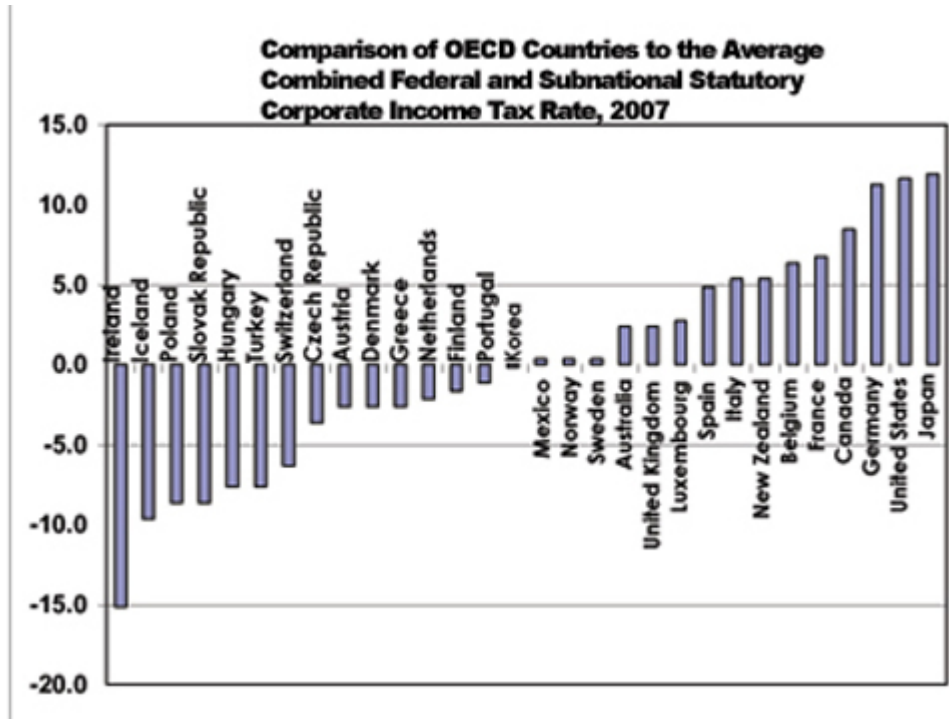
The costly nature of the U.S. business tax system is particularly alarming in light of the trends among our major trading partners. As shown in Figure 1, the U.S. dramatically lowered its corporate income tax rate in 1986—dropping the federal corporate tax rate from 46 percent to 34 percent. Despite its status as a low-tax rate country two decades ago, however, the United States has fallen behind due to the steady decline in corporate tax rates abroad.



Source: Institute for Fiscal Studies (www.ifs.org) and the Organisation for Economic Co-operation and Development (www.oecd.org)

The U.S. now has the second-highest statutory corporate tax rate among developed nations, exceeded only by Japan (see Figure 2). Moreover, the distance between the U.S. corporate tax rate and the lower corporate tax rates abroad is growing, further disadvantaging the United States as a place to invest. In just the past two months, at least six countries have announced plans to cut their corporate tax rates: Canada, Hong Kong, Korea, South Africa, Spain and Taiwan.

Figure 2
The U.S. Has the Second-Highest Statutory Corporate Tax Rate Among OECD Nations



Source: Organisation for Economic Co-operation and Development, www.oecd.org

What is the effect of U.S. government inaction while other nations continue to reform their business tax systems? In a world of greater economic integration and increased trade and capital flows, a firm's decision about where to locate and expand its operations will be increasingly influenced by factors such as a country's statutory corporate tax rate and overall investment climate.¹

By standing still, the United States can expect to see reduced inflows of foreign capital and investment because the United States will be a less attractive place in which to invest, innovate and grow. U.S. firms will face a higher cost of capital than foreign firms, making it more difficult to compete in foreign markets. In the near-term, this would translate into slower economic growth, a slower advance in labor productivity, and less employment. The industries that are being hurt the most are those that manufacture or buy capital-intensive products.

The recent Treasury report, *Approaches to Reform of the U.S. Business Tax System for the 21st Century*, found that wholesale replacement of the U.S. corporate income tax with a consumption-based tax would increase economic output by between 2.0 percent and 2.5 percent in the long-run.²

Importantly, because this estimate does not fully capture the positive effects of free-flowing capital in a global setting, it is likely to be a conservative estimate of the potential benefits of reforming the U.S. business tax system.

Taxes also influence the level and location of investment decisions made by foreign firms. Research has suggested that a 10 percent increase in taxes reduces a country's inflow of foreign direct investment (FDI) by 6 percent. One might expect multinationals' location decisions to be similarly sensitive to tax rates, but the economic literature on that issue is mixed.³

A more disturbing possibility emerges as the disparity grows between corporate taxation in the United States and its trading partners: a slower pace of innovation in the U.S. A key determinant of economic growth, innovation tends to take place where the investment climate is best.

Firms and their workers reap no benefits from technological advances until they're brought into production. For example, new technologies are often "embedded" in new types of capital; an important innovation such as a much faster computer chip does not confer any benefit on firms until they purchase new computers. Higher investment spurs innovation by raising the demand for these new technologies. This interplay between innovation and capital accumulation makes failure to reform the U.S. business tax system more damaging to the economy. As the U.S. corporate tax becomes ever more burdensome, the United States may fall behind in innovation and productive capacity.

The creation of new business enterprises is also an important avenue for bringing new ideas and products to the market, and higher business tax rates are also associated with less rapid business formation. Just as entrepreneurship can be expected to thrive where taxes are lower, higher taxes generally impede entrepreneurship. The importance of entrepreneurship to innovation and risk-taking, and the detrimental effects of high business taxes, represent yet another way in which our business tax system can damage innovation.

Another important consideration is whether the United States' other advantages outweigh the damage caused by our tax system. In the past, U.S. levels of education and training provided distinct advantages to the United States. As emerging countries begin to approach U.S. levels of education and training, other imbalances, such as a business tax system that is out of line with other nations, becomes more important.

In summary, the United States has lagged behind in reforming its business tax system. Such reform, if enacted along sound principles of corporate taxation, will increase capital formation, speed the pace of technological innovation, and increase entrepreneurship. All of this can be expected to ultimately lead to a higher GDP and higher real wages for American workers.

Notes

1. See Altshuler, R.H., H. Grubert and T. S. Newlon (2001).
2. See U.S. Department of the Treasury, December 2007. Similar to other broad-based consumption taxes, the Business Activities Tax (BAT) analyzed by the Treasury report, would impose a zero tax on the return to saving and investment.
3. James R. Hines, "Lessons from Behavioral Responses to International Taxation." *National Tax Journal* 52(2), June 1999, pages 305-322.

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