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Want to Boost the Economy? Lower Corporate Tax Rates

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President Obama has reached out to the business community with talk of lowering the corporate tax rate and improving the tax treatment of profits earned abroad by American companies. That would certainly be an important improvement in our tax system. Unfortunately, his desire to use the elimination of "loopholes" to avoid any loss of corporate tax revenue means that he cannot possibly go far enough in reducing corporate tax rates.

The U.S. corporate tax rate is 35% at the federal level and 39% when the average state corporate tax is included. The average rate in the other industrial countries of the Organization for Economic Cooperation and Development (OECD) is just 25%. Only Japan has as high a rate.

Eliminating every loophole in the taxation of domestic corporate profits identified by the administration's own Office of Management and Budget would raise less than $60 billion of extra revenue in 2011, enough to lower the combined federal-state corporate rate to 35%. The U.S rate would still be higher than in every other country but Japan, and a full 10 percentage points higher than the average in other industrial OECD countries.

This high corporate tax rate causes a misuse of our capital stock. More specifically, the high rate drives capital within the U.S. economy away from the corporate sector and into housing and other uses that do not increase productivity or raise real wages. And because interest payments by companies are deductible in calculating taxable profits, the high tax rate induces firms to use too much debt to finance their operations, increasing risks for them and the U.S. economy.

Moreover, the difference between the U.S. corporate tax rate and the lower rates abroad encourages U.S. firms to locate production in foreign countries and discourages foreign firms from producing in the U.S. unless absolutely necessary. The result is less capital at home, reduced productivity, and therefore lower real wages.

Our high corporate tax rate also makes the cost of capital higher for American firms than for their foreign competitors, forcing them to charge higher prices on American products. That makes U.S. producers less able to compete in global markets or with imports to the U.S. from abroad.

All this is compounded by the unusual way in which U.S. firms are taxed on overseas incomes. Firms in every country pay taxes on the profits they earn at home and pay taxes to foreign governments on the profits they earn abroad. Generally, however, foreign firms pay only a small token tax if they bring their after-tax profits back to their home country.

But that's not how it works for American firms. Our companies must pay the difference between the U.S. tax rate and the tax that they have already paid. For example, French and American firms that invest in Ireland pay a corporate tax of only 12.5% to the Irish government. The French firm can then

bring its after-tax profit back to France by paying less than 5% on those repatriated profits while an American firm would have to pay the 22.5% difference between our 35% corporate tax and the 12.5% Irish tax.

The extra tax that American firms must pay when they repatriate foreign profits encourages those firms to leave profits abroad, investing those funds to expand foreign operations instead of bringing that money back to invest in new plants and equipment at home. The extra tax paid by U.S. firms when repatriating profits also raises the effective cost of capital to American firms operating in other countries, making them less able to compete in those markets. That shrinks their scale of global production, reducing the cost savings that would result from spreading domestic R&D and other fixed costs over a larger volume of sales.

American firms are also at a disadvantage in obtaining new technology by acquiring high-tech firms abroad. Because of the high cost of capital of U.S. firms, foreign firms can often afford to pay more in bidding to acquire those firms and their technology.

Fortunately, shifting the U.S. method of taxing foreign profits to the "territorial" method used by all other industrial countries would have little adverse effect on corporate tax revenue. According to the 2010 Report on Tax Reform Options of the President's Economic Recovery Advisory Board, the Treasury estimates that a territorial system might cost only $130 billion over 10 years but could be structured in a way that actually raises revenue. Even the $130 billion estimate ignores the favorable revenue effect of the resulting increase in profitable corporate investment in the U.S.

The other harmful effects of the corporate tax could be reduced by bringing the U.S. rate into line with those in other industrial countries. The increased flow of capital to the U.S. and the increased productivity of American firms would generate new tax revenue that would offset some of the direct revenue loss caused by a lower corporate tax rate. And since the increased stock of capital in the U.S. would raise productivity and wages, closing personal tax loopholes to make up the remaining revenue loss could still leave individual taxpayers with a higher after-tax income.

President Obama has recognized the importance of reforming the corporate tax system. Passing such legislation this year would help to stimulate the recovery as well as improve our long-run growth prospects.

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