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Cutting Corporate Income Taxes: Is the Time Right ... Finally?

By W. Michael Cox and Richard Alm

Among the world's economically advanced countries, the United States levies corporate income taxes at the highest rate—39 percent. Seeing this heavy burden as a drag on economic growth and employment, the county's political leaders have for years vowed to chop it back. In the 2012 campaign, for example, President Obama called for a top corporate rate of 28 percent; Republican challenger Mitt Romney wanted to cut it to 25 percent and maybe even further.

Despite the seeming bipartisan appeal, cutting corporate income taxes has gone nowhere in recent years, and the top U.S. rate remains at 39 percent—35 percent at the federal level, plus an average of 4.1 percent for states.*

In 1993, the average corporate income-tax rate for 28 Organization for Economic Cooperation and Development (OECD) nations, plus China and five other economically important countries, was just under 38 percent, putting the United States just a percentage point above the global average. Back then, the high-tax countries were Germany at more than 59 percent, Italy and Japan at 52 percent and Canada at 44 percent (*see chart below*).

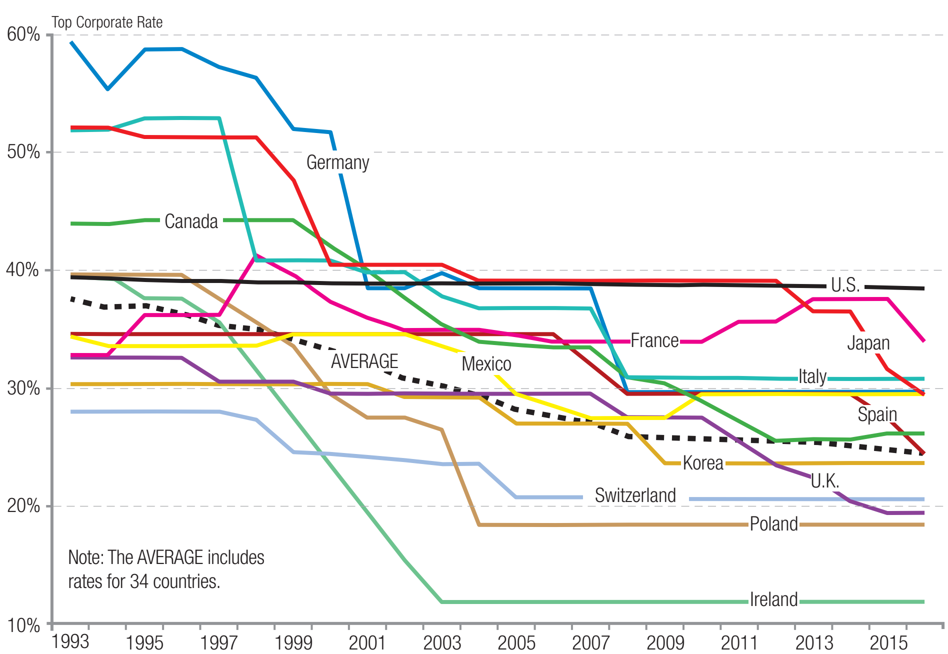
Other countries have since slashed corporate tax rates—with the goal of attracting more investment and boosting competitiveness. At 30 percent, Germany's top rate is about half what it was two decades ago. Japan and Italy are down to around 30 percent, too. Canada reduced its top corporate rate to 26 percent. Ireland was among the boldest tax-cutters, going from 40 percent in 1993 to 12.5 percent today.

By 2016, the global average top rate was slightly above 25 percent—half what it was in the early 1990s. By staying put at 39 percent, the United States went from the middle of the pack to outlier on the high side. The Tax Foundation scoured 163 countries, finding only one with a top corporate burden higher than the United States in 2016—the United Arab Emirates at 55 percent.

In November, Americans elected Republican Donald Trump as the next president. Like Obama and Romney, Trump has vowed to cut corporate taxes. The proposal Trump floated on the campaign trail calls for reducing the top federal rate from 35 percent to 15 percent. The Republicans control both houses of Congress, so the time may finally be right for the United States to join the rest of the world in lowering corporate income tax rates.

The politics of the issue are likely to remain uncertain at least until Inauguration Day in January; for now, this issue of *The MPACT Report* will stay on firmer ground by focusing on the economic aspects of

Other Countries Cut Corporate Rates, Leaving U.S. with World's Highest



Source: OECD and Tax Foundation

* According to the Tax Foundation, Iowa has the highest top corporate rate at 12 percent in 2016—so some companies pay a combined state and federal rate of 47 percent. Next comes Pennsylvania at 9.99 percent. Other jurisdictions at 9 percent or above are Minnesota, the District of Columbia, Alaska, Connecticut and New Jersey. Six states don't tax corporate profits—Nevada, Ohio, South Dakota, Texas, Washington and Wyoming.

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corporate income taxes. We'll look at how America's high tax rates hinder investment and push business offshore. Then we'll raise the possibility that lowering rates might even benefit the U.S. Treasury.

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PUSHING OFFSHORE

The corporate and individual income taxes have a lot in common. They've both been a staple of U.S. tax law since ratification of the 16th Amendment in 1913, which settled any doubts about the constitutionality of income taxes.

In the ensuing century, both types of income taxes have been subject to incessant fiddling, either to suit taxpayers with political clout or conform to the moment's ascendant ideology. Rates have gone up and down, while exemptions, deductions and other breaks proliferated.

Finally, both income-tax regimes are bewilderingly complex—often the result of the jockeying among interest groups seeking to lower their own tax bills.

Whether corporate or individual, income taxes sap the economy. When government takes a portion of earnings, it reduces the rewards for productive activities—working, investing, expanding, starting businesses, improving skills, innovating and lowering costs. We get less of them, leading to slower growth and job creation. The higher the tax rates, the bigger the downside for the economy.

By themselves, America's high corporate income tax rates would be a significant drag on investment and job creation. Having rates that are high relative to other countries makes it worse by encouraging companies to send investment and production offshore. For every $100 in profits, U.S. firms that pay the top corporate rate keep only $61. By shifting operations and profits to Ireland, the after-tax gain jumps more than 43 percent to $87.50.

U.S.-based companies can't bring that $26.50 back home to expand U.S. operations. Washington's tax collectors claim it. The United States is one of a dwindling handful of countries that impose corporate income taxes on worldwide revenues, forcing American companies to pay U.S. taxes on overseas earnings. After paying 12.5 percent in Ireland, an American multinational would still owe U.S. taxes on its Irish earnings—the difference between Ireland's low rate and the much higher U.S. rate.

Most other countries use a territorial approach, taxing only the profits earned within their country. Great Britain switched to a territorial system in 2009, so British companies that operate in Ireland pay 12.5 percent on profits earned in that country—and that's all. They only pay British taxes on their British profits.

U.S. taxes on foreign earnings aren't due until the company brings the money home, creating a strong incentive to delay paying taxes by parking money overseas. In March, the Citizens for Tax Justice examined Fortune 500 financial reports, finding that 303 companies held a total of $2.4 trillion in profits overseas at the end of their 2015 fiscal years.

Apple's overseas stash exceeded $200 billion. For Pfizer, the figure was $193.6 billion; for Microsoft, it was $108.3 billion (*see table at left*).

The higher U.S. tax bite on worldwide revenues creates an incentive for companies to abandon the United States through so-called "corporate inversions." In the past five years, dozens of large companies moved their legal registry—but not necessarily operations—to low-tax countries as part of mergers with

Big Companies Stashing Profits Overseas to Avoid High U.S. Taxes

Company	Unrepatriated Income ($Millions) 2015	2014	2013	State Headquarters
Apple	200,100	157,800	111,300	California
Pfizer	193,587	175,798	162,264	New York
Microsoft	108,300	92,900	76,400	Washington
General Electric	104,000	119,000	110,000	Connecticut
International Business Machines	68,100	61,400	52,300	New York
Merck	59,200	60,000	57,100	New Jersey
Google	58,300	47,400	38,900	California
Cisco Systems	58,200	52,700	48,000	California
Johnson & Johnson	58,000	53,400	50,990	New Jersey
Exxon Mobil	51,000	51,000	47,000	Texas
Hewlett-Packard	47,200	42,900	38,200	California
Chevron	45,400	35,700	31,300	California
Citigroup	45,200	43,800	43,800	New York
Procter & Gamble	45,000	44,000	42,000	Ohio
PepsiCo	40,200	37,800	34,100	New York
Oracle	38,000	32,400	26,200	California
J.P. Morgan Chase & Co.	34,600	31,100	28,500	New York
Amgen	32,600	29,300	25,000	California
Coca-Cola	31,900	33,300	30,600	Georgia
United Technologies	29,000	28,000	25,000	Connecticut

Source: Citizens for Tax Justice

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foreign companies. The merging firms usually cite strategic reasons for these inversions, but the substantial tax savings tend to make bigger headlines.

In 2014, Florida-based Burger King Worldwide created a furor by taking up Canadian residency as part of an $11 billion buyout of Tim Hortons, an iconic coffee and donuts chain. Epi-Pen maker Mylan, a Pennsylvania-based generic drug giant, became a Dutch company in 2015. Medtronic, a producer of medical devices, moved its headquarters from Minnesota to Ireland in 2015.

Obama branded these tax-avoiding relocations unpatriotic in 2014. His administration has tried to thwart the inversions with new regulations—an effort that slowed the practice but didn't stop it. Earlier this year, Wisconsin-based Johnson Controls, a maker of parts for cars and air-conditioners founded in 1885, became an Irish company through a merger with Tyco International.

Having the developed world's highest corporate tax rates harms the U.S. economy and its workers by discouraging productive activity in the United States. The obvious remedy is a U.S. tax regime that's more like other countries, with lower top tax rates, imposed on a territorial basis. One objection: It would drain revenues from a federal government already running huge deficits year after year. Let's take a closer look at that.

TREASURY MAY GAIN

Corporate income taxes hit their post-World War II peak of 32.1 percent of federal receipts in 1952, and they've been gradually shrinking as a share of revenues over the decades. The Office of Management and Budget estimates that corporate income taxes will bring in $501.7 billion this fiscal year, or 14.1 percent of all receipts.

We shouldn't automatically assume that lower tax rates would dry up a substantial part of this revenue stream. Economist Arthur Laffer famously advanced the idea that excessively high tax rates choke off economic activity and actually *reduce* government tax revenues. If so, lower rates end up yielding higher tax revenues.

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This could very well be the case for U.S. corporate taxes. In 2007, American Enterprise Institute economists Kevin Hassett and Alex Brill calculated the revenue-maximizing corporate tax rate, finding it has been going down in a period of decreasing corporate tax rates in so many countries. The magic number went from 34 percent in the late 1980s to 26.7 percent in 2005.

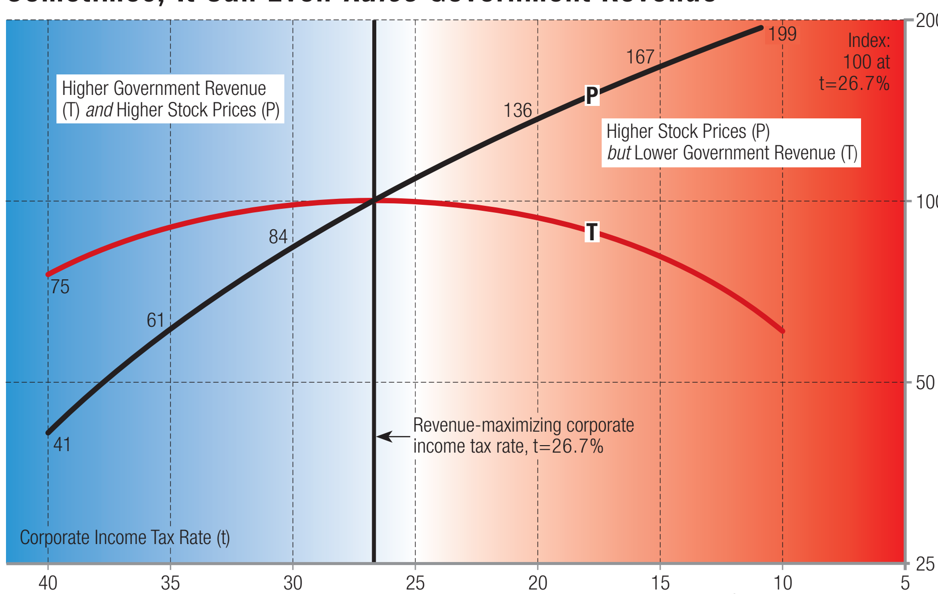
Let's see where that takes us. For the United States, moving down to the revenue maximizing rate would add about a third to corporate tax receipts (*see chart below*). Why? Lower taxes reduce the incentives for moving abroad and stashing profits overseas. More important, they would encourage both American and foreign companies to invest and expand in the United States, raising overall economic growth, employment, corporate earnings and tax receipts.

Cutting U.S. corporate tax rates would raise both before- and after-tax earnings. The before-tax kick comes from the faster economic growth that's likely to produce higher corporate revenues. After-tax gains are more direct: For every $100 in profits, firms would now keep $73 rather than $61.

Higher earnings will almost surely lead to higher stock prices. The size of the gains will depend on a number of factors—for example, how much actual tax relief U.S. companies get and whether other countries respond with new tax cuts. Our calculations suggest stock prices would get a substantial boost if the United States cut its rate to 26.7 percent.

As drawn, the chart below indicates that Trump's proposed 15 percent top rate would produce lower government corporate-tax revenues. The analysis, however, uses Hassett and Brill's 26.7 percent. After the past decade's global rate-cutting, the U.S. corporate rate that produces the most government revenue has probably fallen into the low-20 percent range—so the area of rising

Cutting Corporate Income Tax Rates Benefits Investors; Sometimes, It Can Even *Raise* Government Revenue



Source: Authors' calculations

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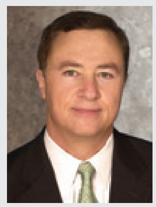
receipts has moved to the right.

From the perspective of companies, workers and even the government, the case for cutting U.S. corporate tax rates is sound—and it has been for years now. So why has the United States failed to muster the political will to reform its corporate income taxes in ways that so many other developing countries see as beneficial?

Two political obstacles stand in the way. First, much support for high corporate rates rest on the shaky but popular notion that taxing fat-cat corporations relieves ordinary people of the cost of government. However, companies pass their taxes onto their shareholders in the form of smaller dividends; onto their customers in the form of higher prices; or onto their U.S. workers in the form of lower pay or jobs shifted abroad. In the end, individuals end up shouldering the burden of corporate taxes—and many of these Americans aren't wealthy.

Second, decades of high corporate tax rates have given companies and industries plenty of incentives to win special favors in the tax code. The ones that have succeeded often pay corporate rates well below the statutory mandates. Protected companies are likely to stand in the way of a corporate tax overhaul that lowers rates but clears out the inequities of special-interest tax provisions.

Donald Trump will soon get his turn at trying to unravel America's corporate tax mess. He'll have the advantage of an allied Congress, but he'll face the same obstacles that have frustrated other presidents. If Trump manages to overcome them, the time will finally be right for cutting America's high corporate tax rates.



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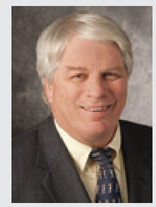

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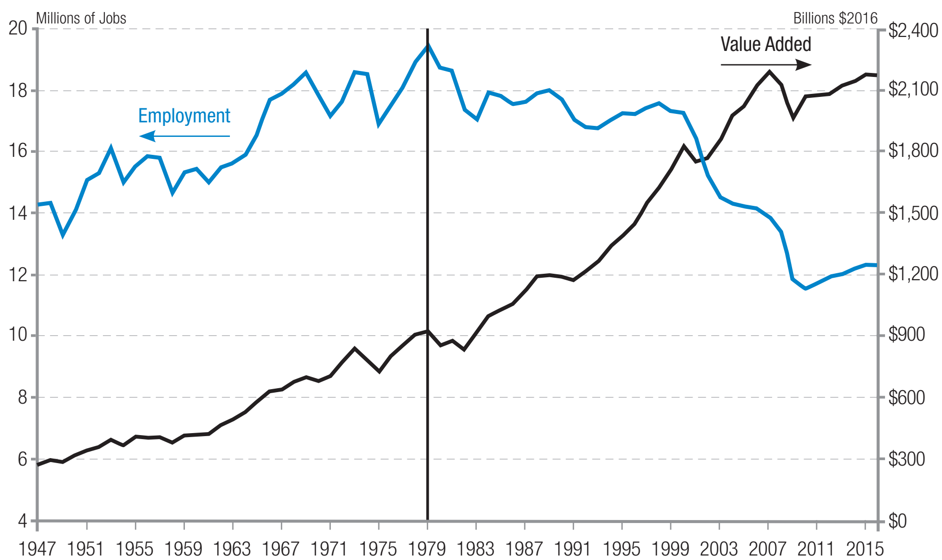
CHARTING THE ECONOMY

American Factories Produce a Lot More With a Lot Fewer Workers

Many Americans yearn for the good old days when this country made things. The angst about the country's declining manufacturing, however, doesn't square with data that shows the substantial strength of the country's factories.

America still makes a lot of things. According to the Bureau of Economic Analysis, U.S. manufacturing output climbed steadily for decades, but it took a big hit in the Great Recession of 2008-09 (*see chart, black line*). It bounced back in the past six years to an inflation-adjusted value of nearly $2.2 trillion in 2015—up 136 percent since 1979.

That was the peak year for manufacturing jobs, with 19.4 million workers. The country now has 7.1 million fewer factory jobs than it did in 1979—even after a rebound of 700,000 since 2011 (*blue line*). Rising productivity is the key to U.S. factories churning out more with less labor. Output per worker rose from $47,450 in 1979 to $179,542 in 2010.



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