



Three Cheers for the Decline of the Corporate Income Tax

By Alan D. Viard

In recent years, governments around the world have slashed corporate tax rates—with the average rate falling from 38 to 27 percent from 1992 to 2006 in a large sample of countries—in response to global competitive pressures. Fearing that governments will lose a valuable revenue source, some observers have called for international cooperation to protect the corporate income tax from competitive pressures. These calls should be rejected. The corporate income tax causes needless distortions by penalizing saving for the future and penalizing particular kinds of financial securities issued by particular kinds of firms. Rather than colluding to maintain the corporate income tax, countries should switch to better-designed revenue sources.

The vulnerability of the corporate income tax to global competitive pressures arises from the tax's impact on the location of business investment. Consider country A, a typical nation that has adopted a corporate income tax. Because foreign firms—those chartered in country B—pay country A's corporate income tax only on their operations in country A, they can avoid the tax by investing at home or in country C. For now, assume that firms chartered by country A are also taxed only on their operations in country A, so that they too can escape the tax by operating abroad.

If country A imposes a higher corporate income tax than other countries, some firms that otherwise would have operated there are likely to locate elsewhere to escape its heavy tax. Conversely, if A has a lower corporate tax than other countries, or none at all, some firms that otherwise would have operated elsewhere are likely to be attracted to A.

If firms could not move across international borders, country A's government might view a high corporate income tax as an effective way to raise revenue from companies or investors

Alan D. Viard (aviard@aei.org) is a resident scholar at AEI.

without burdening workers. That view becomes untenable, however, when firms can readily move across borders, because it then becomes apparent that corporate tax increases raise limited revenue and burden workers.

If country A increases its corporate tax rate, for example, fewer firms operate in the country. Although the firms that remain pay higher taxes, that revenue increase is at least partly offset by the loss of the taxes paid by the firms that leave. On net, therefore, the tax increase may raise little revenue. Indeed, if the tax rate is already too high, the tax increase may actually result in a net revenue loss.¹

Also, if the tax increase causes firms to leave country A, the country's workers end up bearing part of the burden of the tax increase. With less business investment in the country, workers are less productive and earn lower wages. Conversely, if country A cuts its corporate income tax, its workers share in the gains, as their wages are pushed up by the influx of investment. Although the magnitudes remain controversial, economic simulations and statistical studies suggest that a significant portion of the burden from a country's corporate tax increases falls on its workers.²

It might seem that the adverse effects of the corporate tax could be mitigated by changing one of its features. Country A could tax the worldwide operations of firms with country-A charters, so that those firms could no longer escape the tax by operating abroad.³ Firms with foreign charters however, would still be taxed only on their country-A operations, so they could still escape the tax by operating abroad. Locking one exit cannot keep capital from fleeing if another exit remains wide open. Such a tax change would probably do little to prevent investment from going abroad, although it would certainly encourage investment abroad to be done through foreign-chartered, rather than country A-chartered, firms.⁴

In short, when firms can freely shift capital across countries, country A is likely to find a corporate tax increase unappealing. Conversely, it is likely to find a corporate tax reduction an attractive way to draw firms away from other countries, thereby strengthening A's economy and boosting its workers' wages while losing little revenue.

As governments have become more aware that corporate taxes can affect firms' locations, they have modified their tax systems accordingly. In the last ten to fifteen years, a striking worldwide decline in corporate taxes has occurred. Because the point is well established, I will discuss the trend only briefly before turning to its implications.

A survey by KPMG found that the average corporate tax rate in a sample of eighty-six countries had fallen from 38 to 27 percent from 1992 to 2006.⁵ The data in the AEI International Tax Database on a sample of ninety countries reveal that, from 1995 to 2004, forty-nine countries reduced rates while only eleven increased them, and the average tax rate fell from 32.2 to 27.7 percent.⁶

Rate reductions have been particularly common in Europe. A May 2006 European Union (EU) report found that twenty-two of the twenty-five EU countries had reduced their statutory rates between 1995 and 2004. The unweighted average of the countries' tax rates had fallen from 35 to 26 percent; when weighted by country size, the average rate had fallen from 43 to 33 percent.⁷ Observers expect the downward trend in European corporate tax rates to continue.⁸ While some of the rate cuts have been accompanied by limits on the deductions and tax

preferences that firms can claim, it seems clear that there has been an overall reduction in the corporate tax burden.

Competitive pressures have clearly played a major role in pushing down corporate tax rates. For example, when German political parties reached an agreement to cut the corporate tax rate, the chief negotiator for the Christian Democrats explained the agreement by saying, "Today, we're exposed to international and European tax competition."⁹

The Backlash against Reducing Corporate Taxes

The downward trend in corporate tax reductions has not been greeted warmly in all circles. It is easy to see why.

Suppose that country A were to lower its corporate income tax and that the tax cut were to pull in firms that otherwise would have located in country B.

A would lose relatively little revenue, and its workers would earn higher wages. But because firms would leave B, that country would raise less revenue from its unchanged corporate tax system, and its workers' wages would fall. Of course, B could respond by lowering its own corporate tax rate, thereby drawing firms back from A. In that case, though, A would lose the gains that it would have garnered from its initial tax cut. If A were to respond by cutting its tax again, the cycle would continue.

At first glance, this process seems destructive and self-defeating. Aren't A and B engaged in a futile attempt to gain an advantage over each other and thereby profit at each other's expense? Don't both countries ultimately lose by sacrificing a valuable revenue source? Some governments and commentators think so. In their view, A and B should end their destructive competition by agreeing to both maintain high corporate taxes.

In May 2004, for example, French and German officials denounced the "unfair competition" posed by new EU members' low corporate tax rates and urged the EU to set a minimum corporate tax rate for all members, but they were unable to secure the unanimous support required for adoption of their proposal.¹⁰ The idea was not a new one in European discussion. In 1975, the European Commission published a draft directive suggesting harmonization of corporate tax rates in the 45–55 percent range; in 1992, a committee appointed by

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the commission recommended harmonization in the 30–40 percent range.¹¹

Former treasury secretary Lawrence Summers embraced this viewpoint in a December 18, 2007, speech, in which he advocated international cooperation and tax harmonization. While acknowledging that countries like Ireland have benefited by lowering corporate taxes, he contended that their gains have come at the expense of other countries.¹²

These arguments presuppose that the corporate income tax would otherwise be a good revenue source and that its only problem is its vulnerability to global competition. If global competition were the problem, maybe global coordination would be the answer. But that is not the case. The corporate tax has fundamental flaws that are unrelated to global competition. Despite appearances to the contrary, the corporate tax would not be an effective way to raise revenue, and it would burden workers, even if firms could not move across international boundaries.

The Corporate Income Tax Is Nonneutral

It is generally agreed that the rich should pay more taxes than the poor and that many people with capital income are rich. Even so, the corporate income tax is not a good way to tax the rich because it is needlessly nonneutral.

Clearly, not all taxes targeted at the rich are sensible. For example, the tax on yachts that the United States enacted in 1990 was not a good way to tax the rich, even though most buyers of yachts are rich. Such a tax creates a needless economic distortion, as the rich avoid buying yachts. Because of this change in behavior, the tax is less effective as a revenue source relative to the burden that it imposes. Those individuals who would otherwise have bought yachts but refrained from doing so due to the tax did not provide any additional revenue for the government. The yacht tax was misguided; fortunately, the United States repealed it in 1993.

The problem with a yacht tax is that it is nonneutral. Rather than applying uniformly to all goods and services purchased by the wealthy, it applies to only one good, interfering with consumer decisions between that good and others.

The corporate income tax is nonneutral in several important aspects. Like other taxes on capital income, it penalizes saving for future consumption relative to current consumption. It also penalizes corporate firms relative to noncorporate firms and equity securities relative to debt securities.

Current Consumption versus Future Consumption.

A corporate income tax is one type of tax on capital income. Taxes on capital income are nonneutral because they impose a heavier tax on those who save to consume in the future than on those who consume today. This nonneutrality is present even if the tax applies uniformly to all capital income and even if capital income is taxed at the same rate as labor income. At first glance, such a tax may seem neutral because it applies whether the capital income is used to buy yachts or other goods. But people choose when—as well as what—to consume, and the capital income tax distorts that choice.

Consider two workers, Patient and Impatient, both of whom earn \$1,000 in wages today. Impatient has no desire to consume in the future, and Patient has no desire to consume today. Suppose that savings earn a 100 percent return between today and the (somewhat distant) future. With no taxes, Impatient would consume \$1,000 today. Patient would save the \$1,000, earn a \$1,000 return, and consume \$2,000 in the future.

What happens if a uniform 20 percent tax on labor and capital income is introduced? Impatient pays \$200 tax on the \$1,000 of wages and consumes the remaining \$800 today. Compared to the no-tax world, he suffers a 20 percent reduction in consumption. Patient also pays \$200 tax on his wages and saves the remaining \$800. He earns an \$800 return on his savings, on which he pays \$160 tax, leaving him with \$1,440 to consume in the future. Compared to the no-tax world, he suffers a 28 percent reduction in consumption.

Capital income taxation imposes a heavier burden on Patient—28 rather than 20 percent—solely because he consumes in the future. Just as the yacht tax singled out yachts for heavier taxation than other goods, the capital income tax singles out consumption in the future for heavier taxation than consumption today. The tax therefore interferes with consumer decisions, causing people to consume today rather than save to consume in the future.

The tax penalty on saving has another important implication. Capital income taxes, including the corporate income tax, would burden workers even if investment could not move across international boundaries. By penalizing saving, capital income taxes reduce the volume of investment, making workers less productive and lowering their wages.

The corporate income tax would therefore be nonneutral even if it applied uniformly to all capital income.

In actuality, though, the corporate tax is worse because it does not apply uniformly to all capital income.

Corporate versus Noncorporate Firms.

Any business firm, whether it has one owner or many, can be chartered as a corporation. In a corporation, owners have limited liability, meaning that they are not personally responsible for the firm's debts. But firms can also operate in noncorporate form, as a sole proprietorship if there is one owner or as a partnership with two or more owners. Owners of such firms are personally liable for the firms' debts.

The corporate income tax generally does not apply to noncorporate firms. To be sure, corporations enjoy a partly offsetting advantage at the individual level. Unlike owners of noncorporate firms, stockholders are generally not taxed each year on the firms' reinvested earnings, allowing them to defer tax until they sell their stock and receive capital gains that reflect the value added by the reinvestment. On the whole, though, investment done by corporations is taxed more heavily than investment done through noncorporate firms. This arbitrary penalty on corporations causes more production to be done through noncorporate firms and less through corporations.¹³

Because the distinction between corporate and noncorporate firms has no coherent rationale, it is unsurprising that it has been modified over time, as illustrated by the U.S. experience. Congress decided in 1958 that some small firms should be allowed to avoid corporate income tax even if they operated as corporations. Congress limited the number of allowable shareholders in these firms—called S corporations—and imposed stringent rules about who could be shareholders and how income could be divided among owners.

The lack of a coherent rationale also left the rules ill-equipped to deal with changes in the kinds of firms in the economy. First, states created limited partnerships, in which some, but not all, partners enjoy limited liability. The Internal Revenue Service (IRS) decided that limited partnerships were not subject to the corporate income tax if they observed certain restrictions. Then, states created limited liability companies (LLCs), in which all owners enjoy limited liability but which operate under slightly different rules than corporations. For some time, the IRS struggled to decide how much different from a traditional

corporation an LLC must be to avoid corporate income tax. In 1997, the IRS threw in the towel and adopted the check-the-box rules, allowing many LLCs and other firms that are not labeled as corporations to opt out of the corporate income tax.

For newly established firms, the main restriction is that publicly traded firms must pay corporate income tax. Almost all other new firms can opt out of the tax by abandoning the corporate label, even if they operate in a manner similar or identical to corporations. Firms that are already subject to the corporate income tax may be trapped, however, because they would encounter capital gains taxes if they adopted noncorporate forms.¹⁴

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Debt versus Equity. The corporate income tax also arbitrarily distinguishes between different types of financial securities. Not all of the income generated by a corporation is subject to tax. The firm is allowed to deduct interest that it pays on debt but not dividends that it pays on equity. In other words, the corporate tax applies only to the income paid to equity holders, not the income paid to debt holders. Of course, there is no logical justification for taxing the one kind of income but not the other.

Like the incoherent distinction between corporate and noncorporate firms, the incoherent distinction between debt and equity has also been modified over time. Securities are normally considered debt if they promise payments that are independent of the firm's performance and are normally considered equity if they promise a share of any profits the firm may earn. The traditional view is that unlike debt holders, equity holders bear the risk of the firm's possible poor performance and receive a higher expected return to compensate for that risk.

Some firms have issued hybrid securities that blur this distinction. Firms treat these securities as debt on their tax returns and deduct interest payments, even though they may treat them as equity in regulatory filings and for other nontax purposes. The hybrid securities resemble equity in that they expose holders to risks of the firm's poor performance and carry higher interest rates to compensate for that risk. For example, there may be a long maturity term before holders can receive repayment of their principal, the firm may be allowed to delay interest payments if it encounters financial difficulties, and holders may not be

entitled to any payments until holders of the firm's traditional debt have been paid.

The IRS and the courts have struggled with whether to accept these securities as debt or to reclassify them as equity. Notably, one court listed sixteen factors that must be weighed against each other to determine the proper classification. In the early 1980s, the IRS proposed regulations that were intended to clarify the issue but ultimately withdrew its proposal in the face of intense controversy. A leading legal textbook concludes that "the courts are applying an amorphous and highly unsatisfactory 'smell test'" to classify securities and speculates that the IRS may issue clarifying regulations sometime in the twenty-second century.¹⁵

Moving Beyond the Corporate Income Tax

To summarize these arbitrary distinctions, the corporate tax is best described as a tax on saving for the future when that saving is done by holding equity securities in a firm that is either publicly traded or that is locked into the corporate form by its history. The limitation of the tax to certain types of firms and securities is a core element of its definition, not a minor detail. The tax therefore inevitably causes economically wasteful changes in firms' organization and financing.¹⁶ Since 2003, the United States has reduced, but not ended, these distortions by providing a 15 percent top individual tax rate for dividends and long-term capital gains on corporate stock.

Rather than trying to prop up the corporate income tax against competitive pressures, countries around the world should celebrate its decline and work for its demise. The celebration should be joined even by those who support highly progressive taxation and extensive redistribution to the less fortunate. They should realize that the corporate tax is not a sensible way to achieve their goals.

There is no shortage of progressive taxes that would be superior to the corporate income tax. Even people wedded to capital income taxation should support uniform taxation of capital income at the individual level, with measures to prevent corporate stockholders from unduly deferring tax on reinvested corporate earnings. Such a tax would avoid the corporate tax's puzzling penalties on publicly traded firms and equity securities.

Of course, such a tax would still have one major drawback: it would penalize saving for the future. That problem could be eliminated by abandoning income taxation and adopting a consumption tax, which would be

neutral between current consumption and saving for future consumption. Consumption taxation can be progressive. In fact, the President's Advisory Panel on Federal Tax Reform recently described a consumption tax plan that matched the progressivity of the current federal tax system, although a majority of the panel did not endorse that plan.¹⁷

Regardless of exactly which tax is chosen as a replacement, the demise of the corporate income tax should be hastened rather than delayed. The tax does not accomplish its objectives and imposes numerous inefficiencies on the economy. Its initial adoption was misguided. International collusion to preserve it would be utterly pernicious. Three cheers for the decline of the corporate income tax!

AEI research assistant Cindy Soo worked with Mr. Viard to produce this Tax Policy Outlook.

Notes

1. Some tentative evidence suggests that corporate tax rate increases above the levels currently observed in many countries may well lose revenue. See Alex Brill and Kevin A. Hassett, "Revenue-Maximizing Corporate Income Tax Rates: The Laffer Curve in OECD Countries" (working paper 137, AEI, July 2007), available at www.aei.org/publication26577/. For a critical view of the study, see Jane G. Gravelle and Thomas L. Hungerford, *Corporate Tax Reform: Issues for Congress* (Washington, DC: Congressional Research Service, October 2007).

2. For empirical evidence that corporate taxes decrease wages, see Kevin A. Hassett and Aparna Mathur, "Taxes and Wages" (working paper 128, AEI, June 2006), available at www.aei.org/publication24629/; Mihir A. Desai, C. Fritz Foley, and James R. Hines Jr., "Labor and Capital Shares of the Corporate Tax Burden: International Evidence" (unpublished paper, December 2007); and R. Alison Felix, "Passing the Burden: Corporate Tax Incidence in Open Economies" (PhD dissertation chapter, University of Michigan, 2007). For a critical view, see Jane G. Gravelle and Thomas L. Hungerford, *Corporate Tax Reform: Issues for Congress*. These papers also discuss and cite economic simulations of the impact of the corporate tax on wages.

3. A corporate tax system that taxes the foreign operations of domestically chartered firms is called a "worldwide" system; one that does not tax such operations is called a "territorial" system. Note that "worldwide" is a misnomer since, as explained in the text, foreign-chartered firms are not taxed on their worldwide operations. The United States, like some other countries, uses a watered-down version of the worldwide system.

4. The shift toward investment abroad through foreign-chartered firms may take many forms. Individuals living in country A may choose to invest abroad by buying stock in foreign-chartered firms rather than in country A-chartered firms with foreign operations. Also, A-chartered firms may undertake “inversion” transactions in which they swap their country A charters for foreign charters, and newly established firms may take foreign charters from the start. As A-chartered firms use more of the investment opportunities in country A, foreign-chartered firms are likely to concentrate on investment opportunities abroad.

5. The November 2006 report is summarized by Lisa M. Nadal, “Global Tax Rates Lower, U.S. Rates Still High, KPMG Reports,” *Tax Notes*, November 13, 2006. A November 2007 update found further, albeit small, reductions during the intervening year. (KPMG International, *KPMG’s Corporate and Indirect Tax Rate Survey 2007*, available at www.kpmg.com/Services/Tax/Business/IntCorp/CTR [accessed March 25, 2008].)

6. *AEI International Tax Database*, February 2008.

7. The report is summarized in Martin A. Sullivan, “On Corporate Tax Reform, Europe Surpasses the U.S.,” *Tax Notes*, May 29, 2006. See also European Commission (EC), Directorate-General for Taxation and Customs Union, *Structures of the Taxation Systems in the European Union: 1995–2004* (Brussels: EC, 2006), available at http://ec.europa.eu/taxation_customs/resources/documents/taxation/gen_info/economic_analysis/tax_structures/Structures2006.pdf (accessed March 25, 2008).

8. Marcus Walker, “Europe Competes for Investment with Lower Corporate Tax Rates,” *Wall Street Journal*, April 17, 2007.

9. Roland Koch, quoted in Carter Dougherty, “Germany to Lower Corporate Tax Rate,” *International Herald Tribune*, November 2, 2006.

10. David Fairlamb, “Tax Harmony, EU Fracas,” *BusinessWeek*, May 31, 2004.

11. European Parliament, “Personal and Company Taxation” (fact sheet 3.4.8, October 19, 2000), available at www.europarl.europa.eu/factsheets/3_4_8_en.htm (accessed April 2, 2008). Since 1996, the Organisation of Economic Co-operation and Development has pursued an initiative against “harmful tax competition” by “tax havens,” but the initiative has focused on persuading countries to exchange bank information and to improve transfer pricing enforcement rather than to raise corporate tax rates. See Martin A. Sullivan, “Lessons from the Last War on Tax Havens,” *Tax Notes*, July 30, 2007.

12. Randall Jackson, “Former Treasury Secretary Calls for International Tax Cooperation,” *Tax Notes*, December 24, 2007.

13. For an economic model of this distortion, see Jane G. Gravelle and Laurence J. Kotlikoff, “Corporate Tax Incidence and Inefficiency When Corporate and Noncorporate Goods Are Close Substitutes,” *Economic Inquiry* 31, no. 4 (October 1993): 501–516.

14. For a review of the discussion of the distinction between corporate and noncorporate firms, see Stephen A. Lind, Stephen Schwarz, Daniel J. Lathrope, and Joshua D. Rosenberg, *Fundamentals of Corporate Taxation: Cases and Materials* (New York: Foundation Press, 2002), 37–43.

15. *Ibid.*, 118–32.

16. These distortions are further discussed in U.S. Department of the Treasury, “Treasury Conference on Business Taxation and Global Competitiveness” (background paper, July 23, 2007), 23, available at www.ustreas.gov/press/releases/reports/07230%20r.pdf (accessed April 3, 2008).

17. President’s Advisory Panel on Federal Tax Reform, *Simple, Fair and Pro-Growth: Proposals to Fix America’s Tax System* (November 2005), 185–90, available at www.taxreformpanel.gov/final-report/TaxReform_Intro.pdf (accessed April 3, 2008).