ECONOMIC ANALYSIS

A New Era in Corporate Taxation

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Across Europe, corporate tax rates are falling. The usual explanation is that governments are competing for job-creating investment. But that is only part of the story.

To get the full picture, consider another fact: In Europe, corporate tax *revenue* as a percentage of profit is rising. Europeans have been able to counter the fiscal effect of rate cuts by closing loopholes and special tax breaks. Those trends, illustrated in the figure on the next page, have also been noted in a recent study[1] by economists working for the European Union:

> Cuts in the nominal statutory tax rates on corporations were often accompanied by measures that broadened the tax base (e.g., by reducing rates for capital depreciation allowances), offsetting at least to some extent the effects of the cuts in the statutory rate that most of the Member States have implemented in the 1995 to 2005 period.

That lower-the-rates-and-broaden-the-base approach suggests that attracting investment is not the primary objective of European corporate tax policy. As noted in another recent study,[2] this one by the U.S. Congressional Budget Office, accelerated depreciation and investment tax credits are the tools governments use to attract investment. If the goal is promoting *capital* formation, a cut in the corporate rate is not nearly as efficient.

However, the CBO study notes, a reduced corporate rate is the key to keeping *profits* of domestic companies from being shifted to foreign tax havens. If a country has enacted an investment incentive (like an investment credit for new spending on plants and equipment), that does little to reduce the benefit of shifting profits to a holding company in a tax haven. But with rate cuts, a government can directly reduce corporations' incentives to move profits to low-tax countries by paying their affiliates interest, royalties, and artificially high prices.

If you accept that logic, the next step is to conclude that by cutting tax rates, European governments are not motivated by the conventional conservative impulses to cut taxes, increase investment, and reduce the size of government. No, it seems that governments are trying to get as much revenue as they can out of the corporate tax under the circumstances. The days of 40 percent and 50 percent corporate tax rates may be over. But it does not mean — at least not yet — that the corporate tax is finished as an important revenue source.

The days of 40 percent rates may be over . . . but the corporate tax is not finished.

That interpretation of events in Europe is reinforced by the observation that corporate rate cuts are just as likely to come from liberal politicians as their conservative counterparts. Consider the following examples:

- Just two weeks ago, the socialist government of Spain finalized its plans to reduce the corporate tax rate from 35 percent to 30 percent.
- Left-leaning Scandinavian countries slashed their corporate tax rates over a decade ago: Denmark in 1987 (from 50 percent to 30 percent); Sweden in 1991 (from 60 percent to 28 percent); Norway in 1992 (from 51 percent to 28 percent); and Finland in 1993 (from 43 percent to 25 percent, with the rate currently at 26 percent).
- In the United Kingdom, conservatives lowered the corporate tax rate from 40 percent to 33 percent in the early 1990s. But it was Britain's Labour Party that in 1999 cut the corporate rate to 30 percent — its lowest rate ever — at which it still stands today.
- In Germany, the government, led by Social Democrats, reduced the top federal corporate tax from 40 percent to 25 percent in 2000. (Because of significant local taxes, the combined corporate rate is about 39 percent.) Before losing at the polls in September 2005, former Chancellor Gerhard Schroeder proposed in the spring of 2005 a further reduction in the federal corporate rate from 25 percent to 19 percent. How did the German government propose to finance the rate cut? Germany's former Finance Minister Hans Eichel explained at the time, ''As there is no room for tax giveaways in public budgets, we will have to offset the rate cut by broadening the tax base.

[1]European Commission, *Structures of the Taxation Systems in the European Union*, 2005 Edition, Table II-5.1 (http://www.epp.eurostat.cec.eu.int/portal/page?_pageid=1073,46587259&_dad=portal&_schema=PORTAL&p_product_code=KS-DU-05-001).

[2]Congressional Budget Office, ''Corporate Income Tax Rates: International Comparisons,'' November 2005 (http:/www.cbo.gov).

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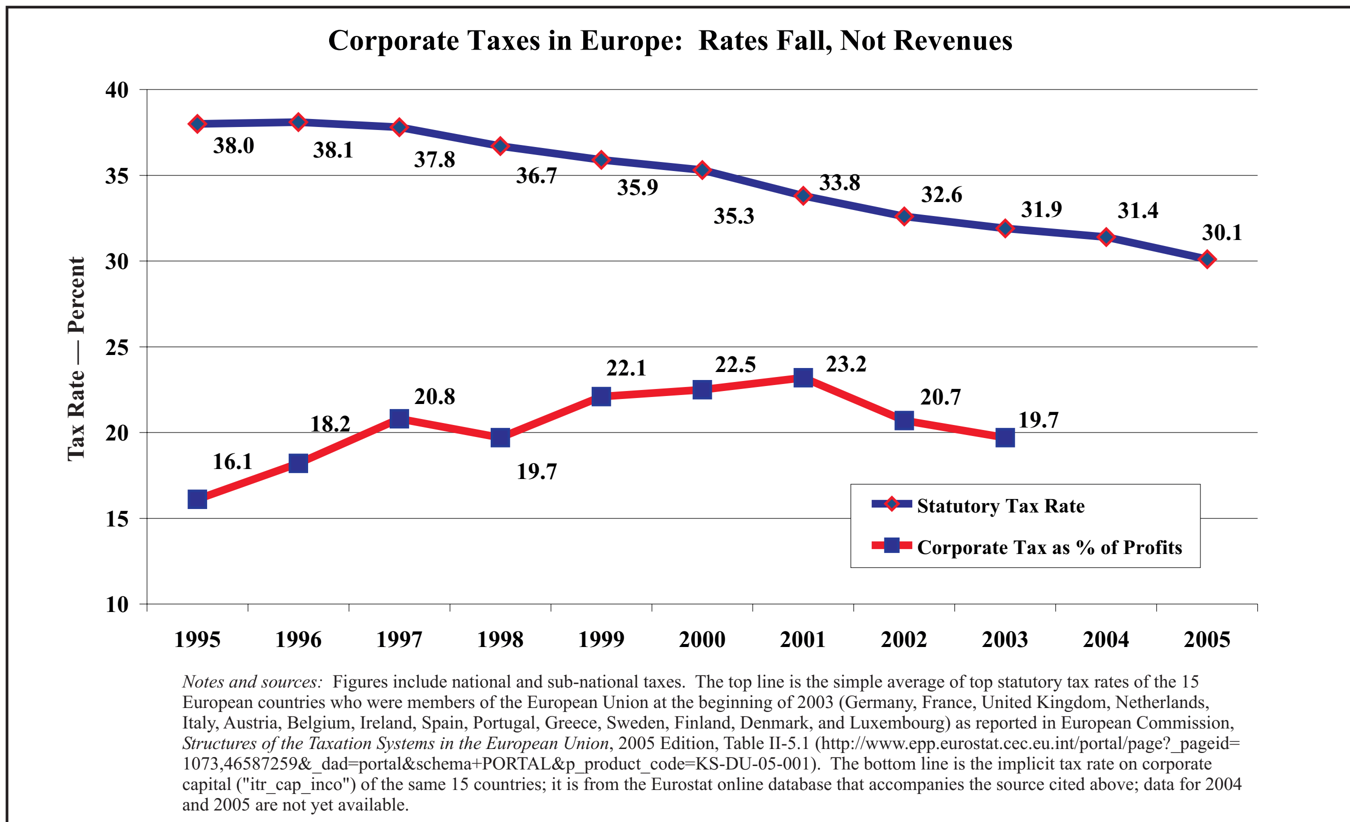

Notes and sources: Figures include national and sub-national taxes. The top line is the simple average of top statutory tax rates of the 15 European countries who were members of the European Union at the beginning of 2003 (Germany, France, United Kingdom, Netherlands, Italy, Austria, Belgium, Ireland, Spain, Portugal, Greece, Sweden, Finland, Denmark, and Luxembourg) as reported in European Commission, *Structures of the Taxation Systems in the European Union*, 2005 Edition, Table II-5.1 (http://www.epp.eurostat.cec.eu.int/portal/page?_pageid=1073,46587259&_dad=portal&schema+PORTAL&p_product_code=KS-DU-05-001). The bottom line is the implicit tax rate on corporate capital ("itr_cap_inco") of the same 15 countries; it is from the Eurostat online database that accompanies the source cited above; data for 2004 and 2005 are not yet available.

> This is the only way we can finance all the necessary measures without taking on new debt.''

U.S. Rate to 25 Percent?

Here is a prediction: In the 2008 presidential election, some forward-looking Democratic candidate will follow the lead of the European left and propose a major cut in the corporate tax rate — from its current level of 35 percent to somewhere in the neighborhood of 25 percent.

In today's tax environment, a rate cut would not merely be Democrats trying to out-Republican the Republicans — like they tried during their infamous ''bidding war'' with the Reagan administration in 1981. The big difference is that now, instead of half-heartedly following those who want to eliminate corporation taxation, Democrats can take the lead in an effort to save the corporate tax.

Around the world, companies have eased their tax burdens by shifting profits into low-tax countries. The two main ways companies do that is through adjusting prices on ''transactions'' with their affiliates and by ''borrowing'' from affiliates. Despite decades of trying, governments have not stemmed the tide. In the United States, nothing — not increased enforcement, new penalties, new regulations, or advanced rulings — has helped. When it comes to preserving the profit tax base, it may be time for Uncle Sam to say uncle. Instead of using the stick of increased enforcement, the United States should consider the carrot of lower rates.

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How would Democrats, who bemoan the explosion of federal debt, pay for the rate cut? There are two ways. First, if there was ever a circumstance in which a tax cut could at least partially pay for itself, this is it. Unlike plant and equipment, taxable profits are easy to move across borders. Lower rates would reduce the corporations' appetite for artificial income shifting and — as an added bonus — for tax shelters. The resulting increase in taxable profits would partially offset the revenue loss from a lower rate.

Second, as in Europe, rate cutting can be accompanied by a reduction in tax breaks and loopholes. Much of the same political dynamic that took hold during passage of the 1986 Tax Reform Act would have to come into play. Once-unthinkable cuts in special-interest tax breaks become politically feasible. Many in the business community support

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Corporate Tax Policy: What Is Changing?		
	Old Era	**New Era**
Implementation:		
Favorite Policy	Tax credits, accelerated depreciation	Lower rates
Competitors	Large economies	Tax havens
Background:		
Stated Objective	Competitiveness	Competitiveness
Real Objective	Attract investment	Preserve revenue
Political Philosophy	Destroy the corporate tax	Save the corporate tax
Politics:		
Business Response	Favorable	Favorable
Liberal Response	Unfavorable	Initially reluctant
Conservative Response	Wild enthusiasm	Support
Reform Potential	Antireform	Pro-reform
Economics/Funding:		
Economic Response	Small — Investment is not responsive because of costs of moving and because of many nontax factors	Large — Profits are easily shifted because costs of moving are low and there are few implications for real business activities
Potential to "Pay for Itself"	Some small revenue offset	Significant offset (but by no means total)
Other Sources of Funding	Deficit	Base broadening

changes because they gain more from rate cuts than they lose from jettisoned benefits.

For any Democrat proposing a corporate rate cut, the hardest part will be convincing fellow Democrats to go along. They will need to be reminded of the loophole closing, the precedent set by European liberals, and the need to be proactive on reform of the corporate tax and not wait — like they did with the estate tax — until opposition to the tax becomes overwhelming.

More than anything, Democrats should resist the temptation to romanticize Clinton-era tax policy. President Clinton's tax policy was antireform. In 1993 he proposed a 2 percent corporate rate *increase* (he eventually got 1 percent) and a whole bunch of new targeted incentives. That was 13 years ago, and that "new Democrat" stuff has gotten old. There is still a need for Clinton-like efforts at deficit reduction. But the former president's penchant for raising rates and narrowing the base has much less appeal in today's more integrated world economy.

In this new era of corporate taxation (see the table above), rates go down. Tax competition means that bells and whistles — like credits and special deductions — have to be held at a minimum. And nothing is going to bring back the "good old days" — like the 1960s, when corporate tax revenue often exceeded 4 percent of gross domestic product. (It's now less than 2 percent.) The sooner Democratic old-timers get over that, the better. ■

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