13. International Tax Competition

Congress should

- cut the federal corporate income tax rate from 35 percent to 20 percent;
- pursue fundamental tax reform by replacing the individual and corporate income taxes with a consumption-based tax system;
- oppose policies that would make U.S. companies more uncompetitive in foreign markets, such as raising taxes on foreign subsidiaries and restricting the reincorporation of companies abroad;
- retain U.S. fiscal sovereignty by opposing international tax harmonization initiatives; and
- oppose anti-competitive regulations such as the IRS effort to mandate greater reporting of foreign investor deposits in U.S. banks.

Globalization is knitting separate national economies into a single world economy. That process is occurring through rising trade and investment flows, greater labor mobility, and rapid transfers of technology. As economic integration increases, individuals and businesses gain the freedom to take advantage of foreign economic opportunities. Individuals have more choices about where to work and invest, and businesses have more choices about where to locate production, research, and headquarters facilities.

Taxation is having an increasing impact on investment and location decisions. As a result, there is rising pressure on countries to reduce tax rates to avoid losing their tax bases. International ''tax competition'' is increasing as capital and labor mobility rises.

Some governments are pursuing misguided defensive measures in an effort to shield their tax bases from competition. Those measures include restrictive tax rules on the foreign operations of companies and attempts to harmonize taxes across countries. Such measures do nothing to reform inefficient tax systems, and they can increase tax complexity.

Cutting Tax Rates

High tax rates are more difficult to sustain in the new competitive global economy. That is particularly true for taxes on capital income, including taxes on business profits, dividends, interest, and capital gains. Taxes on capital income create an increasing drag on growth as capital mobility increases. High taxes on capital income both reduce domestic savings and investment and drive out foreign capital, with a negative impact on productivity, wages, and incomes.

Recognizing that fact, nearly all industrial nations have cut their personal and corporate income tax rates in recent years. Table 13.1 shows that the average statutory corporate tax rate for the 30-nation Organization for Economic Cooperation and Development was cut from 37.6 percent in 1996 to 30.0 percent by 2004. By contrast, the U.S. corporate tax rate is 40 percent, including the 35 percent federal rate and the average state corporate tax rate. The U.S. rate is the second-highest among the 30 nations.

The average top individual income tax rate for 26 OECD countries fell from 67 percent in 1980 to 44 percent by 2002, as shown in Table 13.2. The average rate for four newer OECD countries not in the table (the Czech Republic, Hungary, Poland, and the Slovak Republic) was 38 percent in 2002. Note that the top U.S. rate fell from 40 percent in 2000, to 39 percent in 2001 and 2002, to 35 percent in 2003 but is scheduled to rise to 40 percent again in 2011.

For each country, Table 13.2 includes the national government rate plus the rate in the lowest-tax state or province. For the United States, the table includes zero for the state part of the tax because a few U.S. states do not have individual income taxes. But note that the most populous state, California, has a top individual income tax rate of 9.3 percent.

Countries have cut other types of taxes on capital. Capital gains taxes have been cut; special taxes on wealth have been eliminated; and there has been a trend to cut withholding taxes, which are taxes on cross-border payments of interest, dividends, and other investment returns.

Imposing Defensive Tax Rules on Corporations

Tax competition has caused governments to adopt defensive rules to prevent businesses and individuals from enjoying lower tax rates abroad.

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Table 13.1
Top Corporate Income Tax Rates in the OECD
(Includes national and state/provincial taxes)

Country	1996	1997	1998	1999	2000	2001	2002	2003	2004
Australia	36.0	36.0	36.0	36.0	36.0	34.0	30.0	30.0	30.0
Austria	34.0	34.0	34.0	34.0	34.0	34.0	34.0	34.0	34.0
Belgium	40.2	40.2	40.2	40.2	40.2	40.2	40.2	34.0	34.0
Canada	44.6	44.6	44.6	44.6	44.6	42.1	38.6	36.6	36.1
Czech Rep.	39.0	39.0	35.0	35.0	31.0	31.0	31.0	31.0	28.0
Denmark	34.0	34.0	34.0	32.0	32.0	30.0	30.0	30.0	30.0
Finland	28.0	28.0	28.0	28.0	29.0	29.0	29.0	29.0	29.0
France	36.7	36.7	41.7	40.0	36.7	35.3	34.3	34.3	34.3
Germany	57.4	57.4	56.7	52.3	51.6	38.4	38.4	39.6	38.3
Greece	40.0	40.0	40.0	40.0	40.0	37.5	35.0	35.0	35.0
Hungary	33.3	18.0	18.0	18.0	18.0	18.0	18.0	18.0	16.0
Iceland	33.0	33.0	30.0	30.0	30.0	30.0	18.0	18.0	18.0
Ireland	38.0	36.0	32.0	28.0	24.0	20.0	16.0	12.5	12.5
Italy	53.2	53.2	41.3	41.3	41.3	40.3	40.3	38.3	37.3
Japan	51.6	51.6	51.6	48.0	42.0	42.0	42.0	42.0	42.0
Korea	33.0	30.8	30.8	30.8	30.8	30.8	29.7	29.7	29.7
Luxembourg	40.3	39.3	37.5	37.5	37.5	37.5	30.4	30.4	30.4
Mexico	34.0	34.0	34.0	35.0	35.0	35.0	35.0	34.0	33.0
Netherlands	35.0	35.0	35.0	35.0	35.0	35.0	34.5	34.5	34.5
New Zealand	33.0	33.0	33.0	33.0	33.0	33.0	33.0	33.0	33.0
Norway	28.0	28.0	28.0	28.0	28.0	28.0	28.0	28.0	28.0
Poland	40.0	38.0	36.0	34.0	30.0	28.0	28.0	27.0	19.0
Portugal	39.6	39.6	37.4	37.4	35.2	35.2	33.0	33.0	27.5
Slovak Rep.	n/a	n/a	n/a	n/a	n/a	29.0	25.0	25.0	19.0
Spain	35.0	35.0	35.0	35.0	35.0	35.0	35.0	35.0	35.0
Sweden	28.0	28.0	28.0	28.0	28.0	28.0	28.0	28.0	28.0
Switzerland	28.5	28.5	27.8	25.1	25.1	24.7	24.5	24.1	24.1
Turkey	44.0	44.0	44.0	33.0	33.0	33.0	33.0	33.0	33.0
United Kingdom	33.0	31.0	31.0	31.0	30.0	30.0	30.0	30.0	30.0
United States	40.0	40.0	40.0	40.0	40.0	40.0	40.0	40.0	40.0
Average—30 countries	37.6	36.8	35.9	34.8	34.0	32.8	31.4	30.9	30.0

SOURCE: Author based on KPMG data.
NOTE: Figures include the average state or provincial tax rate, as applicable.

For businesses, such defensive measures have generally increased the complexity of the tax code and reduced their ability to compete in foreign markets.

The tax rules that countries apply to the foreign operations of businesses are an important factor in tax competitiveness. According to a 2004 PricewaterhouseCoopers survey, most OECD countries have ‘‘territorial’’ tax systems that do not tax the regular business income of foreign subsidiaries. By contrast, the United States taxes corporations on their global income, although foreign business income is generally not taxed until repatriated to the United States. That is, taxation is ‘‘deferred’’ until profits are sent home.

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Table 13.2
Top Personal Income Tax Rates in the OECD
(Includes national and state/provincial taxes)

Country	1980	1985	1990	1995	2000	2002
Australia	62	60	49	47	47	47
Austria	62	62	50	50	50	50
Belgium	76	76	55	58	58	50
Canada	60	50	44	44	44	39
Denmark	66	73	68	64	59	59
Finland	65	64	57	54	51	51
France	60	65	53	51	54	53
Germany	65	65	53	57	56	51
Greece	60	63	50	45	43	40
Iceland	63	56	40	47	45	46
Ireland	60	65	56	48	42	42
Italy	72	81	66	67	51	47
Japan	75	70	65	65	50	50
Korea	89	65	64	48	44	40
Luxembourg	57	57	56	50	49	40
Mexico	55	55	40	35	40	35
Netherlands	72	72	60	60	52	52
New Zealand	62	66	33	33	39	39
Norway	75	64	51	42	48	48
Portugal	84	69	40	40	40	40
Spain	66	66	56	56	48	35
Sweden	87	80	61	46	51	52
Switzerland	31	33	33	35	31	31
Turkey	75	63	50	55	45	40
United Kingdom	83	60	40	40	40	40
United States	70	50	33	40	40	39
Average—26 countries	67	63	51	49	47	44

SOURCE: James Gwartney and Robert Lawson, *Economic Freedom of the World: 2004 Annual Report.*
NOTE: Figures include the lowest state or provincial tax rate, as applicable.

However, the United States limits such tax deferral more aggressively than other countries. In 2003 the Treasury's assistant secretary for tax policy, Pam Olson, testified to Congress that ''no other country has rules for the immediate taxation of foreign-source income that are comparable to the U.S. rules in terms of breadth and complexity.'' Dow Chemical testified to Congress in 2003 that 78 percent of its 7,800-page U.S. tax return relates to the rules on foreign income. Those complex tax rules impose a high burden on foreign subsidiaries and cause U.S. companies to lose out in global markets.

That became an issue during the 2004 election because John Kerry proposed that the United States further increase taxes on U.S. foreign subsidiaries. If such a policy were enacted, U.S. companies would lose sales to foreign competitors that had lower tax costs. Over time, U.S. subsidiaries would be closed or sold off to foreign companies, and U.S. firms would have to downsize their U.S. operations. Domestic headquarters jobs in research, marketing, management, and other fields would be lost.

The mistake made by Senator Kerry and other corporate critics is to assume that foreign subsidiaries hurt the U.S. economy. In fact, foreign subsidiaries mainly complement U.S.-based production. For example, subsidiaries are a main conduit through which U.S. goods are exported abroad. By damaging the competitiveness of subsidiaries, the Kerry plan would have damaged the U.S.-based activities that depend on expanded foreign business opportunities.

Policymakers who support legislation to prevent U.S. companies from moving their place of incorporation to lower-tax countries make a similar mistake. The Treasury announced in 2002 that there had been a marked increase in the number of companies pursuing this option because of the unattractive U.S. tax system. Those companies are seeking to reduce taxes paid to the U.S. government on their foreign operations. They would, however, continue to pay U.S. taxes on their U.S. operations even if they are incorporated abroad.

Rather than try to ban such transactions, Congress should fix the underlying problem. The problem is that the United States is a bad place, from a tax perspective, to locate the headquarters of a multinational corporation. However, the corporate tax bill enacted in October 2004 takes a few positive steps to improve the competitiveness of the U.S. tax code.

Instead of trying to penalize U.S. companies that have succeeded in foreign markets, policymakers should pursue tax reforms to create a consumption-based territorial tax system that would not tax companies on their foreign operations at all. That way, U.S. companies could increase their global sales and profitability, which would boost U.S. job creation and economic growth.

International Tax Harmonization

Some governments have responded to rising tax competition by trying to coordinate tax systems across countries to limit competition in the manner of a cartel. The European Union has been a leader in that approach and has pushed its member countries to harmonize their tax systems. For example, in 1992 the EU imposed a minimum standard value-added tax rate of 15 percent for member countries.

The EU and some European leaders have tried to get EU countries to harmonize corporate income tax rates. In 2001 France's prime minister condemned tax competition as ''fiscal dumping'' and said that corporate taxes should be harmonized to prevent companies from moving to low-tax areas. Some European leaders have called for integrating European taxation to fully end tax competition.

Those developments are important for the United States because the arguments used to support European tax harmonization are being heard in global forums. For example, a United Nations panel in 2001 proposed creating an International Tax Organization that would develop norms for tax policy, engage in surveillance of tax systems, and try to get countries to desist from so-called harmful tax competition. The UN has also called for creating a ''global source of funds'' from a ''high yielding tax source,'' that is, a world tax imposed by the UN.

The Paris-based OECD launched a drive to squelch ''harmful tax competition'' in an influential 1998 report, *Harmful Tax Competition: An Emerging Global Issue*. It has tried to get the United States and other countries to take action against low-tax countries. The focus has been on indirect methods of nullifying tax competition, such as greater sharing of tax information between governments. The idea is to give tax collectors access to data on the economic activities of citizens abroad to eliminate the attractiveness of low-tax countries.

The OECD has also pressed to create international tax standards and agreements. A 2000 report, *Towards Global Tax Co-operation: Progress in Identifying and Eliminating Harmful Tax Practices,* stated that ''harmful tax competition is by its very nature a global phenomenon and therefore its solution requires a global endorsement and global participation.'' But the United States should not participate in tax agreements and information exchanges that reduce U.S. citizens' financial privacy, threaten U.S. sovereignty, or restrict the ability of countries to cut taxes.

The efforts to suppress tax competition are partly driven by the politics of redistribution. The primary tax used for redistribution, the income tax, has the most mobile of tax bases and is thus the most affected by tax competition. Because tax competition is a threat to highly graduated income taxes, some politicians are trying to squelch competition any way they

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can. But graduated, or ‘‘progressive,’’ income taxes are very inefficient. Tax competition is beneficial if it can limit the use of those taxes and act as a constraint on government redistribution. The United States should make sure that international groups do not push for global standards that lock in inefficient income tax systems and prevent consumption-based tax reforms.

IRS Regulations on Foreign Investment in the United States

Efforts to stifle tax competition are not just occurring overseas; some efforts are being pushed domestically. Interest earned on U.S. bank deposits paid to foreign investors has been tax-free for decades, as affirmed by Congress on a number of occasions. That pro-competition policy has worked to the U.S. economy’s advantage because it has drawn billions of dollars of foreign investment into the U.S. financial system.

However, in 2002 the IRS issued a proposed regulation (REG-133254-02) that would force U.S. banks to report on interest paid to account holders from certain other countries. The proposed regulation is designed to help foreign governments collect their taxes and would not affect U.S. taxes. There is roughly $2 trillion held in U.S. bank deposits by foreigners, with about $0.5 trillion vulnerable to flowing out of the country if the IRS imposes this regulation. Some of those funds would be shifted to low-tax countries that have greater protections for financial privacy. Congress should oppose this regulation and other policies that risk driving investment capital out of the U.S. economy.

Responding to Tax Competition with Tax Cuts and Tax Reform

The United States led the world in 1986 by cutting the federal corporate tax rate from 46 to 34 percent. Most major countries followed suit and continued cutting in the 1990s, with the result that the United States now has a higher corporate tax rate than all other major countries except Japan.

It is time for the United States to regain the lead in tax reform by cutting the federal corporate rate from 35 percent to 20 percent. That would greatly improve U.S. competitiveness and generate large flows of investment into the United States. Such a cut would all but end the problems of U.S. companies reincorporating abroad and companies engaging in Enron-style tax sheltering.

To not increase the deficit, a corporate rate cut could be paired with cuts to federal spending on business subsidies, which currently total about

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$90 billion per year (see Chapter 34). Such a reform package would increase investment and employment incentives for all firms, while reducing government favoritism and economic distortions.

Beyond a rate cut, Congress should consider repealing the corporate income tax, or replacing it with a consumption-based cash-flow tax. The business portion of former house majority leader Dick Armey's flat tax is an example of a cash-flow tax. A cash-flow tax would allow full expensing of capital investment, which would make the United States a great place for global corporations to locate their production facilities.

A cash-flow tax would be a territorial tax and thus would not impose U.S. taxes on the foreign operations of U.S. companies. That would allow U.S. companies to compete in global markets on a level playing field with foreign companies. A territorial system would also be much simpler than the current worldwide tax system. With a low-rate territorial cash-flow tax, global corporations would be encouraged to move their headquarters, operations, and profits to the United States.

If the United States pursued such tax reforms, other countries would likely follow suit. As tax rates on capital income fell around the world, economic distortions caused by taxes would be cut and global growth would increase. If governments or international agencies do not block tax competition, and countries around the world compete to adopt more efficient tax systems, citizens in every nation will be winners.

Suggested Readings

Center for Freedom and Prosperity at www.freedomandprosperity.org. This site provides an extensive collection of articles on tax competition.

de Rugy, Veronique, and Richard W. Rahn. ''Threats to Financial Privacy and Tax Competition.'' Cato Institute Policy Analysis no. 491, October 2, 2003.

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KPMG. ''Corporate Tax Rates Survey.'' January 2004. www.kpmg.com/Rut2000_prod/Documents/9/2004ctrs.pdf.

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