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42. International Tax Competition

Congress should

- cut the federal corporate income tax rate from 35 percent to 15 percent;
- take steps toward replacing the individual and corporate income taxes with a low-rate flat tax;
- oppose policies that would make U.S. companies uncompetitive in global markets, such as raising taxes on foreign subsidiaries; and
- oppose efforts to impose global taxes or limit international tax competition.

Globalization is transforming separate national economies into a single world economy. This process is occurring through rising trade and investment flows, greater labor mobility, and rapid transfers of technology. As integration increases, individuals and businesses are gaining 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 their production, research, and headquarters facilities.

Many governments have responded to rising globalization with tax cuts to attract investment and spur growth. Individual income tax rates have plunged in recent decades, and more than two dozen nations have replaced their complex income taxes with simple flat taxes. At the same time, nearly every major country has slashed its corporate tax rate, recognizing that business investment has become highly mobile in today's economy.

That is the good news. The bad news is that some governments and international organizations are trying to restrict tax competition. A battle is unfolding between those policymakers who want to maximize taxation and those who understand that competition is leading to beneficial tax reforms. If plans to stifle tax competition gain ground, growth will be undermined, governments will grow larger, and economic freedom will be curtailed.

Cutting of Tax Rates

High tax rates are difficult to sustain in the competitive global economy. That is particularly true for taxes on capital income, including taxes on dividends, interest, capital gains, business profits, and wealth. High taxation of capital income reduces domestic savings and investment and drives out capital, which reduces a nation's productivity, wages, and income levels over time.

All major industrial nations have cut their income tax rates in recent years. Table 42.1 shows that the average statutory corporate tax rate for the 30-nation Organisation for Economic Co-operation and Development has fallen from 38 percent to 27 percent since the mid-1990s. By contrast, the U.S. corporate tax rate is 40 percent, including the 35 percent federal rate plus the average state corporate tax rate. The U.S. rate is the second highest in the OECD.

Table 42.2 shows that the average top individual income tax rate for the OECD countries fell from 68 percent in 1980 to 42 percent by 2007. The top U.S. rate is about 39 percent, based on a federal rate of 35 percent plus the average of state rates. After 2010, the top federal rate is scheduled to increase from 35 percent to 40 percent. That would push the overall U.S. rate to at least 44 percent, which would be above the average among these nations.

Many countries have also cut their tax rates on dividends, capital gains, estates, and inheritances in recent years. Numerous countries have abolished annual taxes on wealth, which used to be popular in Europe. Further, withholding taxes on cross-border investments have been cut sharply around the world in recent years. All those types of taxes have mobile tax bases, and policymakers have figured out that imposing high rates on mobile tax bases is very counterproductive.

The international tax landscape has become remarkably dynamic. After reforms in 1986, the United States had one of the lowest corporate tax rates. But since then, U.S. policymakers have fallen asleep at the switch on corporate tax reform as other countries have continued to cut. In today's global economy, if a country stands still, it falls behind.

Consider tax rates on dividends. The average tax rate in the OECD—including the burden at both the individual and the corporate levels—fell from 50 percent in 2000 to 43 percent in 2007, according to OECD data.

Table 42.1
Top Corporate Income Tax Rates in the OECD (percent)

Country	1996	1998	2000	2002	2004	2006	2008	Change 1996–2008
Australia	36	36	36	30	30	30	30	−6
Austria	34	34	34	34	34	25	25	−9
Belgium	40	40	40	40	34	34	34	−6
Britain	33	31	30	30	30	30	28	−5
Canada	45	45	45	39	36	36	34	−11
Czech Rep.	39	35	31	31	28	24	21	−18
Denmark	34	34	32	30	30	28	28	−6
Finland	28	28	29	29	29	26	26	−2
France	37	42	37	34	34	33	33	−3
Germany	57	57	52	38	38	38	30	−27
Greece	40	40	40	35	35	29	25	−15
Hungary	33	18	18	18	16	16	16	−17
Iceland	33	30	30	18	18	18	18	−15
Ireland	38	32	24	16	13	13	13	−26
Italy	53	41	41	40	37	37	31	−22
Japan	52	52	42	42	42	41	41	−11
Korea	33	31	31	30	30	28	28	−5
Luxembourg	40	37	38	30	30	30	30	−11
Mexico	34	34	35	35	33	29	28	−6
Netherlands	35	35	35	35	35	30	26	−10
New Zealand	33	33	33	33	33	33	30	−3
Norway	28	28	28	28	28	28	28	0
Poland	40	36	30	28	19	19	19	−21
Portugal	40	37	35	33	28	28	25	−15
Slovakia	n.a.	n.a.	29	25	19	19	19	−10
Spain	35	35	35	35	35	35	30	−5
Sweden	28	28	28	28	28	28	28	0
Switzerland	29	28	25	25	24	21	21	−7
Turkey	44	44	33	33	33	30	20	−24
United States	40	40	40	40	40	40	40	0
Average	38	36	34	31	30	28	27	−11

SOURCE: KPMG, ''Corporate and Indirect Tax Rate Survey,'' 2007. Updated to 2008 by the authors. Data includes both national and subnational taxes. Some numbers have been rounded.

NOTE: n.a. = not applicable.

That means that the U.S. rate of 49 percent is now substantially higher than average as a result of recent tax cuts abroad. Even worse, the U.S. tax rate on dividends is scheduled to rise to 64 percent in 2011, which would be easily the highest rate among major countries.

Table 42.2
Top Individual Income Tax Rates in the OECD (percent)

Country	1980	1985	1990	1995	2000	2005	2007	Change 1980–2007
Australia	62	60	49	47	47	47	45	−17
Austria	62	62	50	50	50	50	50	−12
Belgium	76	76	58	61	60	53	53	−24
Britain	83	60	40	40	40	40	40	−43
Canada	64	57	49	49	48	44	44	−20
Czech Rep.	n.a.	n.a.	n.a.	43	32	32	32	−11
Denmark	66	73	68	64	59	59	59	−7
Finland	68	67	60	57	54	53	52	−16
France	60	65	60	62	61	56	49	−11
Germany	65	65	53	57	56	44	47	−18
Greece	60	63	50	45	43	40	40	−20
Hungary	n.a.	n.a.	50	44	40	38	36	−14
Iceland	63	56	40	47	45	39	36	−27
Ireland	60	65	58	48	42	42	41	−19
Italy	72	81	66	67	51	44	44	−28
Japan	75	70	65	65	50	50	50	−25
Korea	89	65	64	48	44	39	39	−50
Luxembourg	57	57	56	50	47	39	39	−18
Mexico	55	55	40	35	40	30	28	−27
Netherlands	72	72	60	60	52	52	52	−20
New Zealand	62	66	33	33	39	39	39	−23
Norway	75	64	51	42	48	40	40	−35
Poland	n.a.	n.a.	n.a.	45	40	40	40	−5
Portugal	84	69	40	40	40	40	42	−42
Slovakia	n.a.	n.a.	n.a.	42	42	19	19	−23
Spain	66	66	56	56	48	40	39	−27
Sweden	87	80	65	50	55	56	56	−32
Switzerland	38	40	38	37	36	34	34	−4
Turkey	75	63	50	55	45	40	40	−35
United States	73	55	38	43	43	39	39	−34
Average	68	64	52	49	47	43	42	−26

SOURCE: James Gwartney and Robert Lawson, *Economic Freedom of the World* (Vancouver: Fraser Institute, 2007), as updated to 2007 by the authors. Data includes the national and average subnational tax rates.

NOTE: n.a. = not applicable.

Flat Tax Revolution

In the 1980s, the big story in tax competition was the reduction in individual and corporate income tax rates in major industrial countries, such as Britain and the United States. In the 1990s, tax rate cuts intensified and spread to a broader group of countries. In the 2000s, the most exciting tax competition story is the flat tax revolution. By 2008, 25 jurisdictions had adopted single-rate individual income taxes, as shown in Table 42.3.

Ironically, it is the former communist world that is the hotbed of flat tax reforms. From the Czech Republic in the west to Mongolia in the east, 17 nations in the former Soviet bloc have joined the flat tax club. Those nations have adopted flat taxes to spur growth, reduce tax avoidance, and attract foreign investment. Reform leaders, such as Estonia and Slovakia, inspired a broader group of countries to join the flat tax revolu-

Table 42.3
The Flat Tax Club: Income Tax Rates, 2008

Jurisdiction	Year Individual Flat Tax Adopted	Individual Flat Tax Rate	Corporate Tax Rate
Jersey, Channel Islands	1940	20.0%	20.0%
Hong Kong	1947	15.0%	16.5%
Guernsey, Channel Islands	1960	20.0%	20.0%
Jamaica	1986	25.0%	33.3%
Estonia	1994	21.0%	21.0%
Lithuania	1994	24.0%	15.0%
Latvia	1995	25.0%	15.0%
Russia	2001	13.0%	24.0%
Slovakia	2004	19.0%	19.0%
Ukraine	2004	15.0%	25.0%
Iraq	2004	15.0%	15.0%
Romania	2005	16.0%	16.0%
Georgia	2005	12.0%	15.0%
Kyrgyzstan	2006	10.0%	10.0%
Pridnestrovie	2006	10.0%	10.0%
Trinidad	2006	25.0%	25.0%
Iceland	2007	35.7%	18.0%
Kazakhstan	2007	10.0%	30.0%
Mongolia	2007	10.0%	25.0%
Macedonia	2007	10.0%	10.0%
Montenegro	2007	15.0%	9.0%
Albania	2007	10.0%	10.0%
Mauritius	2007	15.0%	15.0%
Czech Rep.	2008	15.0%	21.0%
Bulgaria	2008	10.0%	10.0%
Average of 25 jurisdictions		16.6%	17.9%

SOURCE: Authors. Figures include national and subnational rates. Estonia's corporate rate for retained earnings is zero.

tion. In numerous countries, political parties on both the right and the left have supported flat tax reforms.

A ''flat tax'' generally refers to a direct tax on individuals with a single statutory rate. The flat tax concept also embodies the ideas that special tax preferences should be abolished, people should be treated equally, and income should be taxed only once. Today, the average individual tax rate in the 25 flat tax countries is just 17 percent. Most of the flat tax countries have also cut their corporate tax rates, and the average corporate rate in those nations is just 18 percent.

The flat tax revolution will likely continue to spread, perhaps into western Europe where countries are feeling competitive pressures from the flat tax nations to the east. In the United States, the flat tax has been debated for years but not enacted. Hopefully, further reforms abroad will provide U.S. policymakers the encouragement they need to jump on board the flat tax express.

Corporate Tax Reforms

A key issue for tax policy in the global economy is how to deal with multinational corporations. Corporate taxation is important to investors, but also to the living standards of average Americans. In a globalized economy, the burden of the corporate income tax falls mainly on workers in the form of lower wages. If corporations are not investing in the United States due to high taxes, labor productivity will fall, and that will drag down American wages.

Compared with foreign-based corporations, U.S. multinational corporations are subject to particularly high tax rates and complicated tax rules. The United States taxes corporations on their worldwide income, even though that income may also be subject to taxes in the foreign nations where it is earned. The U.S. tax code provides credits to minimize double-taxation, but this is a complex and uncompetitive method of business taxation. The worldwide system discourages the repatriation of foreign earnings, and it puts U.S. businesses at a disadvantage in foreign markets. By contrast, two-thirds of major nations tax corporations on a territorial basis, which means that they generally do not tax business income earned outside their national borders.

There would be two key advantages of the United States' switching from a worldwide to a territorial system of business taxation. First, it would end the current tax barrier to the repatriation of foreign earnings. Currently, repatriated foreign earnings are subject to the 35 percent federal corporate tax, which suppresses profit repatriation and thus investment in the United States. Under a territorial system, business profits earned abroad would be repatriated free of a U.S. tax burden.

Second, it would help make the United States a good home for the headquarters of multinational corporations. Currently, a high tax rate and the worldwide tax system make the United States a poor choice for locating corporate headquarters. If the United States switched to a territorial system, companies could earn profits abroad without a U.S. tax burden placed on top of the foreign taxes paid. That would make it easier for firms to expand their foreign sales, which in turn would lead to expansion in firms' U.S. headquarters activities, such as management, finance, and research.

Reducing the U.S. corporate tax rate is also a crucial reform because of the mobile nature of the corporate tax base in the globalized economy. Because of the high U.S. tax rate, companies put large efforts into moving their investments and reported profits abroad to low-tax nations, such as Ireland. America's high corporate tax rate is a loser for the U.S. economy, and it is also a loser for the government because it causes the tax base to shrink dramatically.

Recent experience shows that governments lose little, if any, revenue when they cut their corporate tax rates. Corporate tax cuts create strong dynamic responses that offset reductions in revenues. In our book *Global Tax Revolution*, we calculated the average corporate tax rate and average corporate tax revenues as a share of gross domestic product for 19 industrial nations. The average corporate tax rate across countries was 40 percent or more until the mid-1980s. But then tax rates plunged, with the average rate falling from 45 percent in 1985 to 29 percent by 2005. Interestingly, corporate tax revenues did not decline as rates fell. In fact, tax revenues soared from 2.6 percent of GDP in 1985 to 3.7 percent in 2005, which is a 42 percent increase.

Corporate tax revenues have surged in most countries that have cut tax rates. Lower rates generate more real investment and higher incomes in subsequent years. In addition, tax rate cuts result in increases in reported profits as companies reduce their tax avoidance and tax evasion activities. The bottom line is that a corporate tax rate cut is a winner for the economy, for workers, and potentially for the government as well as the tax base expands over time.

Backlash against Tax Competition

The global tax revolution is a supply-side revolution. Supply-side tax cuts are those that reduce the costs of productive activities, such as working, investing, and starting businesses. If the costs of production are reduced, output will increase and incomes will rise. Tax competition creates pressure to cut precisely those taxes that are the most damaging to the economy. More tax competition means more productive economies and higher living standards.

Alas, many politicians and pundits do not see it that way. They claim that tax competition causes distortions in the private sector. The idea is that if investment flows are driven in any way by taxation, it is ''inefficient'' for the world economy. Ireland is receiving ''too much'' investment because of its low business taxes, for example. Others argue that tax competition creates distortions in the public sector. Any reduction in government revenue that results from capital and labor emigrating to lower-tax nations is supposed to be an inefficient ''fiscal externality.'' Government revenues will fall below the supposed optimal size as a ''race to the bottom'' in tax levels ensues.

There are many theoretical flaws in those arguments. For one thing, they are premised on the ''public interest theory of government,'' the idea that government officials always act for the general welfare of citizens. But it is naive to assume that if policymakers had monopoly fiscal power without tax competition, they would set tax rates at the optimal level for the good of the people.

Another mistake of tax competition opponents is to think of tax competition as a zero-sum game. In fact, tax competition drives down tax rates on the most inefficient types of taxes, and thus helps to expand the global economic pie. All nations that enact supply-side tax reforms can generate greater economic growth. Countries are not competing to divide a fixed pie, but to create the least burdensome government and the most prosperity for citizens.

On a practical level, there has not been a race to the bottom in tax revenues around the world, as the critics fear. Fiscal conservatives might wish that there had been, but tax competition has not yet ''starved the beast'' of bloated government. But looking ahead, tax competition will impose a valuable barrier against government growth. In coming decades, the rising costs of retirement and health programs for the elderly in the United States and elsewhere will generate large pressures to increase taxes. Vigorous tax competition will be a crucial tool to preserve limited government in the 21st century.

Supporters of big government know that expansive welfare states are in jeopardy from tax competition, which is why they are trying to limit it. Their strategy is for governments to impose international agreements to equalize taxes and to share information about each other's taxpayers. Efforts are under way through the European Commission, the United Nations, and the OECD to control tax competition and eliminate downward pressures on tax rates. There are also proposals to create a permanent world tax organization, which would help enforce limits to competition.

Such efforts to restrict tax competition are bad economics, and they also raise privacy and human rights concerns. A goal of tax competition opponents is the adoption of extensive sharing of personal financial information between countries. But governments have a very poor record on keeping personal data private. In one recent British scandal, for example, a low-level tax official lost two computer disks containing the detailed tax, financial, and banking records of 25 million individuals. When less savory governments are involved, the issues can be even more serious. The security of many people will be at risk if governments create a global network of tax police to collect and swap personal financial information.

Tax haven jurisdictions, which have strong privacy laws, are being pressured by groups such as the OECD to make sweeping policy changes to dilute their high standards. But privacy rights are a crucial freedom in the digital age. Tax havens are specialists in privacy, they generally have very high governance standards, and most are economic success stories. It makes no sense for the OECD and other international organizations to run roughshod over their ability to set their own pro-market economic policies.

To defend tax competition, U.S. policymakers should do the following:

- Use American influence to stop the OECD's anti-tax competition project;
- Reject European Union invitations to participate in cartel-like tax initiatives, such as the savings tax directive;
- Block possible schemes of the United Nations to create global taxes, global tax standards, or a global tax organization;
- Oppose efforts to change U.S. policies to reduce tax competition, such as imposing new requirements for the reporting of interest paid to nonresidents; and
- Reject the various efforts of U.S. policymakers to blacklist low-tax nations.

America's Challenge

U.S. tax policy has fossilized, while many other countries are making pro-growth tax reforms. The last major U.S. tax reform was in 1986, which is prehistoric given the fast pace of the modern economy. More bad news is that recent tax cuts enacted in 2001 and 2003 are scheduled to expire at the end of 2010.

America's tax system has both pros and cons compared with other countries. On the plus side, America has:

- A lower overall tax burden than many countries; federal, state, and local taxes are 27 percent of GDP in the United States, compared with an average 36 percent in the 30 OECD nations; and
- No value-added tax; in every other major country, VATs impose a substantial tax burden in addition to income and payroll taxes.

On the minus side, America has:

- The second-highest corporate tax rate in the world at 40 percent, which includes the 35 percent federal rate plus the average state rate;
- The eighth-highest dividend tax rate in the OECD;
- The third-highest estate or inheritance tax rate in the OECD;
- One of the highest tax rates in the world on corporate capital gains;
- Tax rates on individual income, capital gains, dividends, and estates that are scheduled to rise in 2011 when current tax cuts expire; and
- State-level corporate tax rates that have not been cut in decades.

In sum, the overall tax burden in the United States is lower than in many other nations, but our tax system has important negatives, such as high tax rates on savings and investment. Why shouldn't the United States have the simplest and most pro-growth tax system in the world? Ireland has a corporate tax rate of 12.5 percent, and many advanced countries have capital gains and death tax rates of zero. Meanwhile, 25 jurisdictions have installed simple flat taxes. There is no reason why these reforms could not be implemented in the United States.

To that end, Chapter 41 proposes some major tax reform steps. Individual income tax rates should be cut to 15 to 25 percent, and narrow tax breaks abolished. The corporate tax rate should be cut from 35 percent to 15 percent, and the corporate tax system should be made territorial to help U.S. companies compete abroad. These changes would give America a far more competitive tax system. The United States would become a magnet for global investment and would likely enjoy a long-term economic boom. Such reforms would be a big step toward the ultimate goal of enacting a simple, low-rate flat tax that treats taxpayers equally and maximizes growth.

Suggested Readings

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—Prepared by Chris Edwards and Daniel J. Mitchell

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