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REVIEW & OUTLOOK

Corporate Tax War

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Word is that the Bush Administration will soon propose a cut in the U.S. corporate income tax, following House Democrat Charlie Rangel's proposal this fall to cut the rate to 30.5% from 35%. As a new study makes clear, such a reduction would give a lift to the U.S. economy when it really needs it.

The study, from the National Bureau of Economic Research, looked at corporate taxes in 85 countries from 1996 to 2005. Economists from the World Bank and Harvard University calculated the effective business tax rate for each country, because some nations have so many tax loopholes that the rate paid by companies can be one-half to one-third the statutory tax rate. The study found that corporate taxes have a statistically significant negative effect on economic performance.

High business taxes were found to reduce a nation's domestic capital investment, the amount of foreign investment into that country, and its overall growth in GDP. The authors conclude that "corporate taxation reduces the return on capital and thus discourages investment" and "reduces the cash flow of the firm" in such a way as to reduce the after-tax capital available for reinvestment.

The researchers also found that high corporate levies reduce entrepreneurship, which drives new industries and job growth. In many nations the corporate tax rate is paid both by large corporations and small businesses. In the U.S., small businesses are often organized under Subchapter S of the tax code and thus pay the personal income tax rate. However the tax is imposed, the study found, "a 10 percentage point rise in a nation's effective corporate tax rate causes a decline in the number of firms by 1.8 per 100 people (the average is 5 per 100 population)."

The clear implication is that raising the U.S. personal income tax rates would also stunt small business entrepreneurship. Yet this is precisely what all of the Democratic Presidential candidates, and even Mr. Rangel, propose. In Mr. Rangel's case, the benefits of his cut in the corporate tax for big business to 30% would be offset by the damage he'd do by raising the top marginal tax rate on individuals and small businesses to as high as 44%. The NBER research suggests this could discourage hundreds of thousands of small businesses from being formed in the next few years.

This study supports research earlier this year by economist Kevin Hassett of the American Enterprise Institute, which found that high business taxes also result in lower wages for workers. The higher rate means less capital investment in making workers productive, which translates into smaller pay checks.

What American CEOs understand, but most in the media and political class so far refuse to acknowledge, is that the U.S. is far behind the rest of the world in reducing corporate tax rates. The U.S. corporate income tax rate is the world's second highest after Japan's among developed nations. Even Mr. Rangel's proposed reduction would leave the U.S. well above the OECD average of 25%. In recent years, Germany, France, the United Kingdom, Vietnam, Poland and Singapore, among many other nations, have either cut or proposed to cut their business tax rates. These lower rates are attracting more investment and capital, and they pose a threat to America's economic competitiveness if Washington fails to act.

The NBER study is a reminder of how out-of-touch America's current political debate is with global economic trends. American politicians are proposing new barriers to trade, as well as new obstacles to capital formation, even as the rest of the world is welcoming more of both. The study is also a reminder that because workers don't *see* a tax does not mean that they don't *feel* its impact. If America is going to remain the developed world's leading job creator and economic engine, corporate tax rates are going to have to fall -- and by more than even Mr. Rangel has suggested.

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