HOW COMPETITIVE IS THE U.S. TAX SYSTEM?

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Summary

Discussion of taxes should always keep in mind that a free country with an open economy always faces competition from other countries. This report compares major taxes in the United States with taxes in a peer group consisting of the world's eight other largest advanced economies: Australia, Canada, France, Germany, Italy, Japan, Spain, and the United Kingdom. The report also shows U.S. tax rates in 2000, to show how the United States would have compared had the tax cuts of the last few years not been enacted. The effect of the tax cuts has been to improve the competitive position of the United States. However, the United States still lags behind in certain aspects of taxation compared to its peers among the large advanced economies.

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HOW COMPETITIVE IS THE U.S. TAX SYSTEM?

Discussion of taxes should always keep in mind that a free country with an open economy always faces competition from other countries. Countries differ widely in what proportion of the economy their governments take in taxes, which taxes they use to raise revenue, and what rates they levy on various taxes. This report compares major taxes in the United States with taxes in a peer group consisting of the world's eight other largest advanced economies: Australia, Canada, France, Germany, Italy, Japan, Spain, and the United Kingdom. The report also shows U.S. tax rates in 2000, to show how the United States would have compared had the federal tax cuts of the last few years not been enacted. The effect of the tax cuts has been to improve the competitive position of the United States.

I. A COMPARISON ACROSS COUNTRIES

Table 1 lists the main kinds of taxes on income and wealth in the peer group of countries. The information is from 2003. Tax codes can change considerably from year to year, so the table is only a snapshot. Some countries may adopt changes that will reduce or increase tax rates from their current levels before the end of 2004. Germany, for instance, is reducing the top rate of personal income tax from 47 percent to 45 percent, among other changes.

The table mainly considers taxes at the national level, but includes some information on taxes by states, provinces, or regions if they are significant. For each type of tax, the table shows the typical statutory tax rate (or, where specified, the top tax rate) and the amount excluded from taxation, if any.

The Appendix contains brief remarks on the individual taxes the table lists. At the bottom of the table are a few summary measures to facilitate comparison of total tax burdens. The *Forbes* index is based on *Forbes Global* magazine's comparison of estimated taxes in 2003 paid by a hypothetical single executive earning a gross annual salary of 100,000 euros (€), which currently is about \$120,000. Table 1 shows how much of the executive's income would be taken by certain taxes in each country. The index omits sales taxes, property taxes, the employer's share of payroll taxes, and so forth, so it overstates the amount of gross salary left after *all* taxes. "Government/GDP" measures the ratio of national, regional, and local spending government spending to gross domestic product. "Growth 00-03" is the average annual change in real gross domestic product per person from the end of 2000 to the end of 2003.

II. IMPLICATIONS

A concerted strategy on tax rates is rare. Under the day-to-day pressures typical of politics, few governments have explicitly tried to make their tax systems favorable to growth. In 2003, however, Italy made sweeping changes to its treatment of capital income, reducing the top rate to 12.5 percent in most cases.

Table 1. Tax rates in large advanced economies (2003)

Type of tax	*Australia*	*Canada*	*France*	*Germany*	*Italy*
Corporate Standard rate	30%	24.6-38.6% fed. + prov.	34.33%, territorial	27.9575%	34%
Capital gains	Standard Rate	Standard rate, 50% excluded	Standard rate	0%	Standard rate
Dividend tax	Standard rate	0%	0%	0%	Standard rate, 56.25% cred.
Personal Income tax, top rate	47% from A$60,000	39-48.2% fed. + prov. fr. C$103,000	49.58% from €47,131	47% from €52,293	45% from €70,000
Payroll tax on employee	1.5%	4.95%, max. C$1,802 fed.	10%	13.65%, max. €7,610	9.89% to €80,391
Payroll tax on employer	0% federal, ~6% state	7.05%, max. C$2,621 fed.	4.25-13.6%	13.65%, max. €7,610	23.81% to €80,391
Sales or value-added tax	10%	7% fed. + 0-10% prov.	19.6%	16%	20% natl. + 4.5% local
Interest tax	Income rate	Income rate	17.6%, €15,000 ex.	Income rate, €1,550 ex.	12.5%
Dividend tax	Income rate	24.1-37.3% fed. + prov.	Income rate	Income rate, 50% excluded	12.5%
Long term capital gains	Income rate, 50% ex.	Income rate, 50% excluded	17.6%, €15,000 ex.	0%	12.5%
Short term capital gains	Income rate	Income rate, 50% ex.	17.6%, €15,000 ex.	Income rate, 50% ex.	27%
Retirement savings tax	15% to A$109,924*, then 30%	0%	0%	Income rate, 70% average excluded	12.5% on capital gains
—limit on contribution	A$87,141	C$13,500	€24,000	€918	€5,165
Tax on retirement income	15% first A$1.12 mn. lifetime, then income rate	Income rate	Income rate	Income rate, sliding ex. (73% for 65-year old)	Income rate, 40% excluded
Inheritance tax, top rates	0%	0%	5-60%, €1,500 ex.	17-50%, €1,100 ex.	0%, but other taxes, €150,000 ex.
Wealth tax	0%	0%	0.55-1.8%, €720,000 ex.	0%	0%
***Forbes* index**	41.57%	38.07%	40.75%	50.47%	41.95%
Govt./GDP	36.4%	40.1%	54.4%	49.4%	48.5%
Growth 00-03	1.8%	1.6%	1.2%	0.7%	1.3%

Notes: *In taxable income. All the countries listed tax personal income on a worldwide basis "Income rate" means that the rates of the income tax apply. Rates are for single filers and apply only to national taxes unless indicated. Abbreviations: cred. = credit; ex. = excluded; fed. = federal; fr. = from; max. = maximum; min. = minimum; mn. = million; natl. = national; prov. = provincial. Currency symbols: A$ = Australian dollar; C$ = Canadian dollar; € = euro; £ = British pound; ¥ = Japanese yen.

Table 1 (concluded). Tax rates in large advanced economies (2003 unless otherwise indicated)

Type of tax	*Japan*	*Spain*	*UK*	***USA 2003***	*USA 2000*
Corporate Standard rate	30%	35%	30%	**35% fed. + 0-12% state**	35% fed. + 0-9.99% state
Capital gains	Standard rate	Standard rate	Standard rate	**Standard rate**	Standard rate
Dividend tax	Standard rate, 50% ex.	Effectively 0%	0%	**Standard rate**	Standard rate
Personal Income tax, top rate	50% natl. + local from ¥18 mn.	35.1-45% natl. + local from €45,000	40% from £30,500	**35% fed. + 0-11% state fr. US$311,950**	39.6% fed. + 0-9.3% state fr. $288,350
Payroll tax on employee	0.7% no max. + 13.46%, ¥1.2mn. max.	6.35-6.4% to €31,824	11% to £30,420, then 1%	**fed. 1.45% no max. + 6.2% to US$87,000**	fed. 1.45% no max. + 6.2% to US$76,200
Payroll tax on employer	1.6% no max. + 13.46%, ¥1.2mn. max.	30.6-32.3% to €31,824	12.8%	**fed. 1.45% no max. + 6.2% to US$87,000**	fed. 1.45% no max. + 6.2% to US$76,200
Sales or value-added tax	5%	16%	17.5%	**0% federal + 0-7.25% state**	0% federal + 0-7 % state
Interest tax	20%	Income rate	Up to 40%	**Income Rate**	Income rate
Dividend tax	Income rate	Income rate	10%, 32.5% fr. £30,500	**5-15%; double taxed**	Income rate; double taxed
Long term capital gains	10%	15%	Income rate, £7,900 ex.	**5-15%**	10-20%
Short term capital gains	20%	Income rate	Income rate, £7,900 ex.	**Income rate**	Income rate
Retirement savings tax	0%	0%	0%	**0%**	0%
—limit on contribution	¥180,000	€8,000-24,250	UK£3,600-36,720	**US$3,000-3,500 (IRAs)**	US$2,000 (IRAs)
Tax on retirement income	Favorable rates, up to ¥3.49mn ex.	Income rate on interest	Income rate, 25% excluded	**Income rate**	Income rate
Inheritance tax, top rates	20-50%, ¥25mn. Excluded	7.65-81.6%	40% , £242,000 excluded	**18-49% fed., US$1.1mn. ex., + state**	18-55% fed., US$675,000. ex., + state
Wealth tax	0%	0.2-2.5%, €108,182 + house ex.	0%	**0% federal + 0-0.15% state**	0% federal + 0-0.15% state
***Forbes* index**	24.9	36.67%	33.03%	**28.93%**	
Govt./GDP	38.3%	39.3%	42.8%	**35.9%**	33.6%
Growth 00-03	1.4%	1.7%	1.9%	**1.4%**	1.4%

Sources: PriceWaterhouseCoopers (2003a, b) and Web sites of national tax and social security authorities (tax rates and other tax details), Forbes Global (2003) (*Forbes* index), OECD (government revenue and saving to GDP).

In the last few years, the United States has taken steps toward a concerted strategy. Since 2001, President Bush and the Congress have adopted a strategy of reducing tax rates broadly, not just in one or two areas. The U.S. approach contrasts with the more selective approach in most other advanced economies, where governments tinker with one or two tax rates at a time.

Along with broad reductions in federal taxes in the United States, there have also been some changes in emphasis. The Jobs and Growth Tax Reconciliation Act of 2003 (Public Law 108-27) reduced the tax rate on long term capital gains from 18 or 20 percent (depending on how long an asset was held) to 5, 10, or 15 percent (depending on what income bracket a taxpayer is in). The tax rate on dividends fell from the rate applying to wages and salaries to 5 or 15 percent (again, depending on what income bracket a taxpayer is in).

These changes should help U.S. economic growth. There is abundant research across countries connecting low tax rates and other forms of economic freedom to economic growth.[1] It should be noted that such research examines long-term relationships. In the short term, much can happen to cloud long-term trends. From the end of 2000 to the end of 2003, average economic growth per person for the United States was only in the middle of the pack among the large advanced economies. The reason is that the United States had the slowest-growing economy in the group in 2001, when the terrorist attacks of September 11 delivered a shock not shared by any other country. In 2002 and 2003 the United States was among the best performers among the large advanced economies, and it looks set to remain so in 2004.

In addition to general arguments connecting low tax rates and other forms of economic freedom to economic growth, there are arguments from economic theory that suggest cutting taxes on capital income is particularly beneficial for long-term growth.[2] Capital investment is highly mobile; it tends to flow to places where it is most lightly taxed. Accumulation of capital tends to raise productivity and increase living standards and wages. From a tax standpoint, the United States is now more attractive than it was several years ago as a destination for capital. On top of that, the United States now has lower income tax rates than it would have without tax cuts.

Labor has not been neglected, though. Income tax rates are lower than they would have been without the tax cuts of the last few years. The combination of lower personal income taxes and lower taxes on certain kinds of capital income is powerful because it encourages both work and investment.

Overall, the tax climate in the United States is at or near the top among large advanced economies. Overall, the United States is at or near the top among the large advanced economies in terms of how favorable its tax climate is for economic growth. The United States has the lowest top rate of tax on personal income and the second-

[1] For much data and analysis, see Economic Freedom Network.
[2] See Bartlett (2001). One study (Judd 1997) even argues that the tax rate on capital income should be negative, that is, subsidizing investment would increase economic growth.

lowest rates, after Italy, on dividends and long-term capital gains. It is also the only country without a national sales or value-added tax, although most states impose sales taxes.

However, **corporate taxation is less favorable in the United States than elsewhere.** There are particular areas where the United States lags behind other countries. One area is the corporate tax rate. The top federal rate of 35 percent is the highest among the large advanced economies, along with Spain. State corporate taxes, which exist in most states, push the combined rate above Spain.

Corporations that have operations in many countries also have many countries where they could chose to have their headquarters. When considering tax policy, then, it is important to realize that the group of close competitors to the United States is wider than the list of countries in Table 1. Some smaller advanced economies that have low rates of corporate tax include Ireland, where the standard rate is 12.5 percent; Hong Kong, where it is 17.5 percent; Singapore, which has a top rate of 22 percent; and Switzerland, which has combined national and lower-level taxes whose effective rates range from 17 to 30 percent.

Corporations are vehicles for individuals to work together. Ultimately, the income a corporation earns and the assets it holds are always claimed or held by specific individuals—employees, creditors such as bondholders and suppliers, and stockholders. (Some of these individuals may be using other corporations as intermediaries; an example is an investor in a mutual fund that owns a corporation's stock.) Imposing taxes on corporations does not change the reality that ultimately people bear the burden of taxation. The economic rationale for taxing corporations is not that it shifts the burden of taxation off individuals, but that it may be less costly to collect some kinds of taxes at the corporate level than at the individual level, mainly because the number of corporate taxpayers is smaller than the number of individual taxpayers.

Contrary to a widespread misunderstanding, having a high rate of corporate income tax, raising the rate, or reducing exemptions in a way that increases the effective rate, does not benefit the average person at the expense of "fat cats." Rather, it adds to the overall burden of taxation that individuals ultimately bear, and it discourages entrepreneurship and job creation that would bring important benefits across the board.

A longstanding provision in the corporate income tax allows U.S. corporations to defer income earned by foreign subsidiaries until the income is brought into the United States. For U.S. companies that have important foreign subsidiaries, eliminating the deferral provision would reduce the attraction of having their corporate headquarters in the United States. The result could be the outsourcing of some of America's highest-paying jobs, which generate the most tax revenue for federal and state governments.

The treatment of capital income is also less favorable than elsewhere. The United States has less consistent treatment of capital income than some other countries. Dividends and long-term capital gains are taxed at 5 to 15 percent at the federal level, while interest and short-term capital gains are taxed at income rates, which in 2003 were as much as 35 percent at the federal level. Moreover, dividends are taxed both at the corporate and individual level; the United States is the only large advanced economy that does so.

The United States is less generous than some other countries in offering incentives to save for retirement. Here the leaders are Australia and Japan. Australia has a high limit on contributions (Australian $87,141 in 2003, equivalent to roughly US$55,000 at the average exchange rate for the year). Australia taxes retirement savings both when deposited and when withdrawn, but at relatively low rates for most contributors, and retirement savings not used when a person dies incurs no inheritance tax because Australia has no inheritance tax. President Bush has proposed to simplify the tax treatment of savings by replacing about a dozen types of savings accounts with three types: Lifetime Savings Accounts, Retirement Savings Accounts (for individuals), and Employer Retirement Savings Accounts. Encouraging more saving is especially important in light of the impending retirement of the large "baby boom" generation over the next 30 or so years.

Rolling back recent tax cuts would reduce the competitive advantage of the United States. A recent Joint Economic Committee study estimated that for a family of four persons earning $36,400 a year or more, three significant provisions in tax cuts since 2001 have provided a total saving of $5,480 in federal taxes for the period 2001 to 2004. [3]3 This estimate of taxes saved is conservative, because it does not take into account many additional provisions available to many taxpayers. Moreover, tax relief begins accruing at incomes as low at $10,750, although the dollar amount of the taxes saved is lower because people at those levels of income pay few dollars in taxes than people at higher levels.

A comparison of U.S. tax rates in 2003 with those in 2000 shows that rolling back the tax cuts of the last few years in an attempt to reduce the federal budget deficit, as some people advocate, would change the tax climate from the most favorable or nearly the most favorable among large advanced economies to only mediocre. The United States would become correspondingly less attractive as a destination for investment. Increasing tax rates would also reduce incentives for Americans to work and save, and hence generate taxes from doing so. A better approach to reducing the federal budget deficit would be to restrain government spending so that it grows less fast than the economy as a whole over the next several years.

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[3] Miller (2004)

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University of Michigan Retirement Research Center, <http://www.mrrc.isr.umich.edu>.

Web sites of national tax and (where relevant) social security authorities:

Australia: Australian Taxation Office, <http://www.ato.gov.au>.

Canada: Canada Customs and Revenue Agency, <http://www.ccra-adrc.gc.ca/menu-e.html>; Canada Pension Plan, <http://www.cpp-rpc.ca/rates/1999_e.html>.

France: Administration Fiscale, <http://www.impots.gouv.fr>.

Germany: Bundesamt für Finanzen, <http://www.bff-online.de>; Bundesversicherungsanstalt für Angestellte, <http://www.bfa.de>.

Ireland: Office of the Revenue Commissioners, <http://www.revenue.it>.

Italy: Agenzia delle Entrate, <http://www.agenziaentrate.gov.it>; Istituto Nazionale della Previdenza Sociale, <http://www.inps.it>.

Japan: National Tax Agency, <http://www.nta.go.jp/category/english>.

Spain: Agencia Tributaria, <http://www.aeat.es>; Seguridad Social, <http://www.seg-social.es>.

United Kingdom: Inland Revenue, <http://www.inlandrevenue.gov.uk>.

United States: Internal Revenue Service, <http://www.irs.gov>; Social Security Administration, <http://www.ssa.gov>.

APPENDIX: REMARKS ON TABLE 1

The table is a tool for rough comparisons rather than an exact description of national tax systems. Because taxes are complex, comparisons of a large number of national tax systems must sacrifice some detail for the sake of clarity. For example, the table omits mention of the exclusion from capital gains tax of the first $250,000 from selling a house in the United States (for a single filer; $500,000 for married couples filing joint returns). Similarly, in France 5 percentage points of a property's capital gain is excluded every year, starting two years after purchase, so after 22 years no capital gain applies. The table also omits Germany's local trade tax on corporations. The rate of tax is around 18 percent for most large cities, but the trade tax is deductible as an expense from the corporation tax. Examples could be multiplied. The result is that "effective" rates—what taxpayers actually pay—can differ substantially from statutory rates. Determining effective rates is beyond the scope of this report because it is quite complex. Even so, statutory tax rates are useful because not all taxpayers can take advantage of the special provisions, so they indicate how much taxes might take.

Corporate (income) tax: The "standard rate" is the rate applying to most medium and large corporations; in many countries, small businesses receive special tax treatment, as do corporations in specially favored industries.

All the countries listed in the table except France in principle tax the worldwide income or corporations. However, many tax provisions exist that avoid or reduce double taxation. In general, the effect is to approach a territorial system of taxation, whereby national taxes apply only to income earned or assets held within a particular country.

Corporate capital gains tax: "Standard rate" means that corporate capital gains are taxed as ordinary corporate income.

Personal income tax: The personal taxes listed are those applying to a single filer. All the countries in the table tax worldwide personal income, though as at the corporate level, many tax treaties exist. The table focuses on top rates because, most typically, people with the highest incomes can most easily move to countries with more favorable tax treatment. A phrase such as "47% from A$60,000" indicates that the top rate is 47 percent, and it applies for taxable income exceeding Australian $60,000.

Payroll tax paid by employee: Most of the countries listed have an upper limit either on the amount of payroll tax an individual taxpayer pays or on the amount of salary on which they levy a payroll tax. A phrase such as "13.65%, max. €7,610" indicates that the rate of tax (in this case, for Germany) is 13.65 percent, to a maximum tax of 7,610 euros. A phrase such as "23.81% to €80,391" indicates that the rate of tax is 23.81 percent, up to salaries of 80,391 euros a year (in this case, for Italy). Euros in excess of 80,391 are not subject to the tax. Some countries also have exemptions, not listed in the table, for people who earn low salaries.

Payroll tax paid by employer: In many countries, payroll taxes are divided into a so-called employer's share and a so-called employee's share. No matter how tax law divides the payroll tax between employer and employee, the economic effect is to drive a wedge between what the employer pays before taxes and what the employee receives after taxes. Employees in effect pay for *both* shares of a payroll tax in the form of lower after-tax wages than they would otherwise receive.

Value added or sales tax: A value added tax is levied on the value added to products at every stage along the way to the ultimate consumer, whereas a sales tax is only levied at the final stage, when goods are sold to the consumer. A value added tax leaves a longer paper trail and is harder to evade than a sales tax.

Now we come to personal taxes on savings and capital income (income derived from investments).

Tax on interest: The phrase "income rate" in this and subsequent rows means that for tax purposes, income from this source is added to wages and salaries. The total is taxed at the rate applying to personal income, the top rate of which is shown earlier.

Tax on dividends: Most countries have arrangements so that corporations and individuals do not both pay taxes on the same dividends. Only Ireland and the United States have double taxation of dividends.

Tax on long term capital gains; tax on short term capital gains: The definition of how long an asset has to be held to qualify for the "long term" rate differs from country to country.

Tax on retirement savings: The savings plans listed are those available to all or most workers in each country, such as Individual Retirement Accounts in the United States. In addition, in all countries, some or most employers offer retirement savings programs to employees, such as 401(k) plans in the United States.

Limit on retirement contributions: Many countries have higher limits for people nearing retirement age than for younger people. These provisions give people who saved little earlier in their careers an opportunity to catch up.

Tax on retirement income: In the context of Table, 1, retirement income means income from private retirement savings such as Individual Retirement Accounts in the United States. Different rules may apply to government social security programs.

Inheritance tax: The table lists the top range of rates, which usually apply to assets not donated for charitable purposes and left to somebody who is not a relative.

Wealth tax: A wealth tax is levied on the value of assets (capital itself), rather than on the income, they produce. In the United States no federal wealth tax exists, but Florida, Ohio, Mississippi, Pennsylvania, and West Virginia impose state taxes.

Finally, the table lists a few summary measures to facilitate comparisons across countries.

Forbes index: Forbes Global magazine publishes a Tax Misery Index as a way of comparing taxation across countries. The index compares the estimated taxes in 2003 paid by a hypothetical single executive earning a gross annual salary of 100,000 euros (€), which at the current exchange rate is about $120,000. The index as published in *Forbes Global* shows how much of the gross salary is left after paying personal income tax and the employee's share of payroll tax. However, to make the *Forbes* number easier to compare to others in Table 1, the table shows its counterpart, the percentage *taken* in taxes, rather than the percentage *left* after taxes. Note that the index omits sales taxes, property taxes, the employer's share of payroll taxes, and so forth, so it overstates the amount of gross salary left after *all* taxes.

Government/GDP: An estimate by the Organisation for Economic Co-Operation and Development (OECD) of combined government spending at all levels as a percentage of gross domestic product in each country in 2003. The OECD uses uniform methods in an attempt to make data truly comparable across countries.

Growth 00-03: Estimated average annual change in real gross domestic product per person from the end of 2000 to the end of 2003, using data from the OECD.