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Congress Finally Considers Lower Corporate Tax Rate but Underestimates International Tax Competition

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by **Chris Atkins** and **Scott A. Hodge**

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Introduction

Chairman Rangel has proposed to cut the U.S. corporate tax rate from 35% to 30.5%,[1] which would make the U.S. rate fourth highest internationally, instead of second highest where it stands right now (see Table 1). The average OECD corporate tax rate, U.S. excluded, is 28.1%.

Although this proposed cut may seem inadequate after what our international trading partners have done, nevertheless Congress is finally trying to catch the wave of corporate income tax reduction that has been sweeping the developed world for more than a decade. Five countries in the Organization for Economic Cooperation and Development (OECD) cut their corporate income tax rates in 2006, and eight more, including Germany, will have cut their rates by January 1, 2008.

In the OECD, only Japan's 39.5% rate is higher than the U.S. rate right now. The U.S. would leapfrog only Italy and Canada under Rangel's proposal.[2] Germany is one of several countries that had higher tax rates than the U.S. in 2000 but will have a lower rate than the U.S. in 2008 even if the Rangel cut is enacted. Ireland has the OECD's lowest rate at 12.5 percent.

As OECD countries have lowered their corporate income tax rates, they have reaped more foreign direct investment from the U.S. A recent study by Devereux and Lockwood found that when an EU member state cuts its corporate rate by 10 percent, from 30 to 27 percent for example, it can expect to reap a 60-percent, short-run increase in investment by U.S. multinational corporations.[3]

As foreign governments have enticed U.S. investors with these lower tax rates, the U.S. has kept the same basic rate structure for 20 years, merely enacting a one-point rate hike from 34% to 35% in 1994. That has left the U.S. as one of only two countries in the OECD not to reduce its corporate tax rate between 1994 and 2006, and one of only six OECD countries without a rate cut between 2000 and 2006. Not one OECD country raised its corporate tax rate between 2000 and 2006, and the average reduction was from 33.7 percent to 28.5 percent. France, Japan, and the United Kingdom may also reduce their rates in the next year.[4]

Part of the U.S. disadvantage comes from its sizable state-level corporate income taxes. Many international comparisons ignore these substantial sub-national tax rates because most countries don't have them. The average U.S. state-level corporate income tax rate between 2000 and 2006 was 6.6%. Because those payments are deductible on the federal return, the additional tax boiled down to an extra 4.3% in 2006. That's why the U.S. combined federal-state rate is listed at 39.3% in 2006 and 35.1% in 2008 if the Rangel plan is enacted.

Table 1
Proposed U.S. Corporate Tax Rate Cut Would Drop US from Second-Highest to Fourth-Highest in OECD

Country	Corporate Tax Rate in 2000 (a)	Rank in 2000	Corporate Tax Rate in 2006 (a)	Rank in 2006	Cuts Enacted Since 2006	New Combined Federal-State Rate (2008)	New Rank (2008)
Japan	40.9%	4	39.5%	1		39.5%	1
Italy (c)	41.3%	3	37.3%	4		37.3%	2
Canada	44.6%	2	36.1%	5		36.1%	3
United States (b)	39.3%	7	39.3%	2	- 4.5 points (Rangel plan)	35.1%*	4
France	37.8%	8	34.4%	7		34.4%	5
Belgium	40.2%	5	34.0%	8		34.0%	6
New Zealand	33.0%	16	33.0%	9		33.0%	7
Spain	35.0%	11	35.0%	6	-2.5 points	32.5%	8
Luxembourg	37.5%	9	30.4%	10		30.4%	9
Germany	52.0%	1	38.9%	3	- 8.9 points	30.0%	10
Australia	34.0%	14	30.0%	11		30.0%	11
United Kingdom	30.0%	21	30.0%	11		30.0%	12

Mexico	35.0%	11	29.0%	15	- 1 point	28.0%	13
Denmark	32.0%	18	28.0%	17		28.0%	14
Norway	28.0%	26	28.0%	17		28.0%	15
Sweden	28.0%	26	28.0%	17		28.0%	16
Korea	30.8%	20	27.5%	20	- .1 point	27.4%	17
Finland	29.0%	24	26.0%	22		26.0%	18
Netherlands	35.0%	11	29.6%	14	- 4.1 points	25.5%	19
Greece	40.0%	6	29.0%	15	- 4 points	25.0%	20
Portugal	35.2%	10	27.5%	20	- 2.5 points	25.0%	21
Austria	34.0%	14	25.0%	23		25.0%	22
Czech Republic	31.0%	19	24.0%	24		24.0%	23
Switzerland	24.9%	28	21.3%	25		21.3%	24
Turkey	33.0%	16	30.0%	11	- 10 points	20.0%	25
Poland	30.0%	21	19.0%	26		19.0%	26
Slovak Republic	29.0%	24	19.0%	26		19.0%	27
Iceland	30.0%	21	18.0%	28		18.0%	28
Hungary	18.0%	30	16.0%	29		16.0%	29
Ireland	24.0%	29	12.5%	30		12.5%	30
Unweighted OECD Average excluding U.S.	33.7%		28.1%				
(a) Rates for 2000 and 2006 are combined central and sub-central tax rates. Where sub-							

central income tax is deductible against central government tax, this is reflected in the net rate of the central government.
(b) The sub-central tax rate for the U.S. is calculated as a weighted average of states' top corporate income tax rates in 2000 and 2006, deductible in both years from federal taxable income.
(c) Includes regional business tax which is levied at a rate of 4.25 percent.

Source: OECD data as of July 17, 2007, located at http://www.oecd.org/dataoecd/26/56/33717459.xls, and KPMG's 2007 Corporate Tax Rate Survey

Cutting Corporate Tax Rates Doesn't Always Translate Into Lower Revenue
Many would expect that the higher the rate, the higher the revenue, but corporate tax rates in the OECD are not a reliable predictor of corporate tax collections. In 2004 (most recent collection data), the countries with high corporate tax rates but low collections included the U.S., Germany, Italy and France. In 2004 only 18 of the 30 OECD countries matched high corporate rates with high corporate revenue or low corporate rates with low corporate collections.

OECD corporate tax collections averaged 3.1 percent of Gross Domestic Product (GDP) in 2004 (most recent year). The U.S. combined rate (39.3 percent that year) brought in only 2.2 percent of GDP. Luxembourg and Australia levied rates near the OECD average, 30.4 and 30.0 percent respectively, but they collected the most revenue as a percentage of their GDPs.

A few years ago Germany was talking about forcing tax harmonization in the EU to stop corporate tax competition (mainly from their smaller neighbors in Central and Eastern Europe). That bullying strategy of forcing other nations' tax rates up hasn't worked, so Germany has joined in the competition, lowering its rates. Naturally, the lower Germany's rate-still the highest in Europe-the less resentful other European nations will be about the idea of harmonization.[5]

Conclusion: The U.S. Needs a New Corporate Tax Policy
Despite its high corporate tax rate, the U.S. collects less revenue as a percentage of GDP than other OECD countries with lower rates, and that will persist if Congress is so timid about trying keep pace with our international trading partners. Congress should aim to put the U.S. in the middle of the OECD pack. Allowing for a 6.6% deductible state rate, the federal rate that would put the U.S. right at the OECD average would be 23 percent. This policy would have the following four benefits:

- It would enhance the competitiveness of our corporate tax system by reducing the effective tax rate borne by new investment in the U.S.
- U.S. multinationals would feel less pressure to engage in corporate inversions and other forms of profit-shifting.[6]
- U.S. companies would be more likely to reinvest foreign earnings in U.S. companies.
- State governments would feel less pressure to offer special tax preferences and credits in their efforts to attract new international business investment.

To be sure, the biggest obstacle to cutting the top corporate rate is its perceived cost to the U.S. Treasury. Calculated on a static basis, almost any cut in the corporate tax rate would certainly be scored as a revenue loss. However, as the data from OECD show, a lower rate is not a guarantee of lower revenues.[7]

Notes

1. Many US firms will experience a much smaller tax cut than this statutory change suggests because the Rangel plan includes the repeal of a popular "manufacturers' deduction" that already reduces the tax rate of those firms to 32%.

2. Rates levied by multiple layers of government are combined, taking deductibility into account. The highest rate in the U.S. is found in Iowa where the state rate is 12 percent and the combined federal-state rate is 42.8 percent. Iowa corporations would pay a total tax rate of 38.8% if Chairman Rangel's proposal is adopted. States have continued raising corporate income tax rates, and several sources now cite the average as 6.9%, which would make the combined federal-state rate 39.5% under current law and 35.3% under Chairman Rangel's proposal.

3. Michael Devereux and Ben Lockwood, *Taxes and the Size of the Foreign-Owned Capital Stock: Which Tax Rates Matter?*, located at http://www.ifs.org.uk/conferences/etpf_lockwood.pdf.

4. Henry M. Paulson, Jr., "Our Broken Corporate Tax Code," *Wall Street Journal* (7/19/2007).

5. Carter Dougherty, "Germany to Lower Corporate Tax Rate," *International Herald Tribune-Business* (November 2, 2006), located at http://www.iht.com/articles/2006/11/02/business/tax.php. In this article, Roland Koch, a negotiator for the Christian Democrat party, says that "There is no disagreement between the coalition parties that we have to tax companies differently than in past decades...(t)oday, we're exposed to international and European tax competition."

6. See, for example, Martin A. Sullivan, "Economic Analysis: A New Era in Corporate Taxation," 41 *International Tax Notes* 415 (Feb. 6, 2006) ("...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.").

7. The federal corporate capital gains rate, currently levied at the same rate as ordinary federal corporate income (35 percent), is also ripe for reduction. A stand-alone reduction in the corporate capital gains rate would almost certainly lead to a short-term increase in revenues as companies sell assets that have been "locked-in" by the high capital gains tax rate.

Tax Foundation
2001 L Street NW, Suite 1050
Washington, DC 20036
Ph: (202) 464-6200
Fax: (202) 464-6201
www.taxfoundation.org