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Comparing International Corporate Tax Rates: U.S. Corporate Tax Rate Increasingly Out of Line by Various Measures

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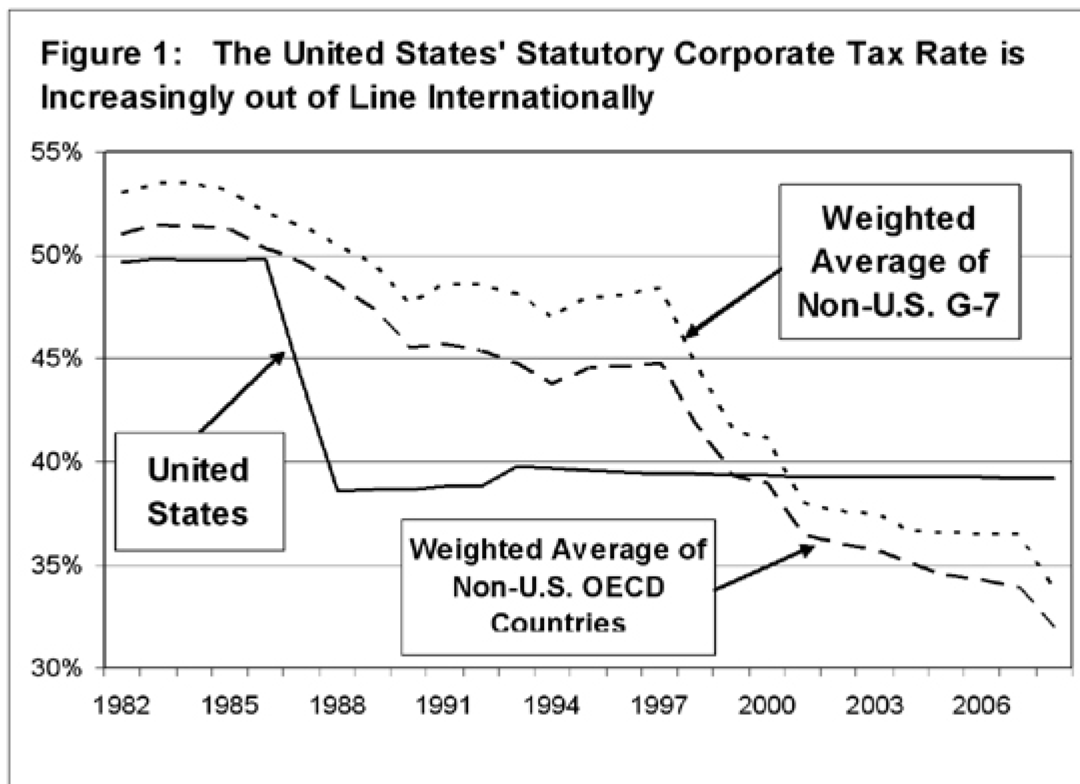
The U.S. has left the major features of its business tax system unchanged over the past fifteen years. Meanwhile, other countries have been changing theirs, potentially hurting the competitiveness of the United States. Perhaps most emblematic of the trend abroad is lower corporate tax rates in virtually all developed nations. As a result, the United States now has the second-highest statutory tax rate among OECD member nations.

Figure 1 below tells this story: The U.S. became a low-tax rate country with enactment of the Tax Reform Act of 1986, dropping its federal corporate tax rate from 46 to 34 percent. But since then the reduction in corporate tax rates by most other developed nations has left the United States in the unenviable position of a high-tax rate country.[1]



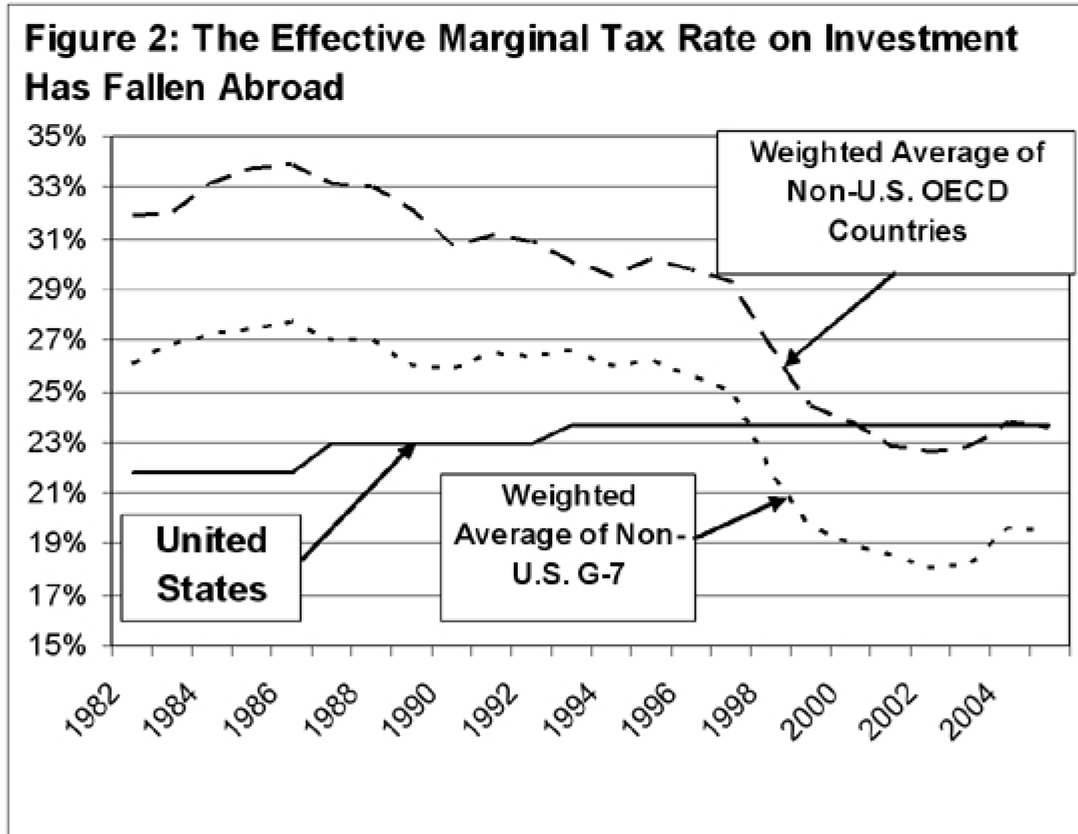
As shown in Figure 1, the U.S.'s combined federal-state statutory corporate tax rate (39.3%) is now well above the weighted average for both the member nations of the OECD[2] (31.9%) and the larger G-7 countries (33.8%). Moreover, both groups of countries continue to lower their tax rates. The weighted average corporate tax rate has fallen by 38 percent for OECD nations and 37 percent for the G-7 from the early 1980s.

While the statutory corporate tax rate may be emblematic of the changes occurring abroad, there are other metrics for comparing business tax systems internationally. Other important factors are a country's depreciation system—how quickly businesses are allowed to write off investment in equipment and buildings; a country's tax treatment of debt; and a country's investor-level taxes on capital gains, dividends and interest. All of these affect the cost of capital and a country's ability to attract investment. For example, the benefit of lower corporate tax rates could well be offset if less generous tax depreciation were offered as a means to finance the rate cut, depending on the net effect of these two policies on the cost of capital. Thus, it is important to consider a broader measure of countries' corporate tax systems when making such comparisons.[3]

Economists often use the "effective marginal tax rate," a measure that accounts for the major features of a country's business tax system—corporate tax rate, depreciation, investor-level taxes, and other considerations—to gauge how well a country's overall business tax system stacks up.[4] This measure is often relevant to a firm's decision whether to invest another dollar or where to locate that dollar of investment.

Figure 2 compares the effective marginal tax rate for equity-financed investment in equipment for the United States to the G-7 and select OECD countries from 1982 through 2005, the latest year for which these calculations are available.[5] What is striking about this chart is that it tells a story

very similar to the one described above depicting statutory tax rates. Effective marginal tax rates abroad have also fallen relative to the United States. That is, when we take a more comprehensive look at the business tax systems and account for changes in the business tax base, we find that the effective marginal tax rates of other nations have fallen while the United States has stood still.[6] Indeed, the effective marginal tax rate abroad has fallen by about 30 percent since the mid-1980s while remaining largely unchanged in the United States. Also, while the U.S. is now about at the same level as the average among other OECD nations (both at 23.6% in 2005), the weighted average effective marginal tax rate for the G-7 countries (excluding the U.S.) has fallen to a level well below the United States (19.5% in 2005).[7]



The average corporate tax rate, sometimes expressed as corporate tax revenues divided by a proxy for corporate profits/income or gross domestic product, is another measure occasionally used for international comparisons. The average corporate rate in the United States is below the average for the OECD member nations and the G-7. For example, corporate revenues as a percentage of GDP averaged 3.5 percent for the OECD, but was only 2.2 percent for the United States.

There are two primary reasons: the U.S. has a narrower corporate tax base and a larger non-corporate sector. In the United States, the corporate tax base tends to be narrower than in other OECD countries because the U.S. provides accelerated depreciation and a variety of tax provisions, from the research and experimentation credit to the new markets tax credit, that are targeted to specific types of activities or projects. While these provisions lower the average corporate tax rate, they only do so only for firms engaged in these particular activities and require

tax rates to be higher on other taxpayers. Indeed, some of the corporate rate reduction occurring abroad has been financed by broadening corporate tax bases.

Making an international comparison with only corporate taxes—excluding the business taxes paid in the non-corporate sector—probably understates the U.S.'s average tax rate because the non-corporate sector tends to be considerably larger in the U.S. than in most other countries. About 30 percent of U.S. business taxes are paid by the owners of non-corporate business entities (e.g., S corporations, partnerships, sole proprietorships, etc) when they file their individual income tax returns. Including these tax payments with corporate income tax payments paid would increase business taxes as a percentage of GDP in the U.S. to 3.3 percent.

In some respects, the trends described in Figures 1 and 2 only tell part of the story. Wage rates, education levels, the regulatory environment, among other factors, also affect a nation's competitiveness. Nevertheless, these charts indicate quite clearly that the business tax environment abroad has changed considerably over the past two decades.

Moreover, other countries continue to reform their business tax systems in ways that have likely pushed the weighted average effective marginal tax rates down further since 2005, the last year covered by Figure 2. For example, nine of the 30 OECD member nations—including Canada, Germany, the United Kingdom, Italy, Switzerland, Spain, New Zealand and the Czech Republic—lowered their corporate tax rates between 2007 and 2008.

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1. Note that the chart below, similar to a chart in a *Tax Foundation Fiscal Fact* released earlier this year and the December 2007 Treasury Study, compares the U.S. corporate tax rate to the OECD average weighted by each countries gross domestic product (GDP).

2. The calculations are for the 22 OECD nations for which data are consistently available for the full 1982 through 2008 period. The average weighted tax rates are weighted using gross fixed capital formation. The weights for 2007 and 2008 were based on 2006 figures.

3. For example, the recent reports issued by the U.S. Department of the Treasury on business tax reform and competitiveness, *Background Paper for the Treasury Conference on Business Taxation and Global Competitiveness*, July 26, 2007, and *Approaches to Improve the Competitiveness of the U.S. Business Tax System for the 21st Century*, December 20, 2007, consider statutory rates, effective marginal tax rates and average tax rates.

4. The effective marginal tax rate, derived from an estimate of the cost of capital, shows the share of an investment's economic income needed to cover taxes over its lifetime to compare the investment climate across countries.

5. Gross fixed capital formation (in constant U.S. dollars) was used to construct the weighted average for both select OECD member nations and the non-U.S. G-7. Data on effective marginal tax rates were only available for 19 of the 30 OECD member countries.

6. It is important to note that if the business tax reforms abroad have been financed with increases in value-added taxes, they would generally reduce further the effective marginal tax rate on investment. One virtue of consumption-based taxes, such as a value-added tax (VAT), is that they impose no tax on the return to saving and investment at the margin. European-style VATs remove the tax on the return to investment by, in effect, allowing all investment to be written off immediately (i.e., 100% expensing). Thus, a lower corporate tax rate financed with a higher VAT rate would lower the effective marginal tax rate on investment.

7. The U.S. tends to fare less well in comparisons of the effective marginal tax rate on investment in structures because, while the U.S. tax depreciation system generally provides accelerated depreciation for investment in equipment, it provides less favorable treatment for investment in structures.

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