Ten Benefits of Cutting the U.S. Corporate Tax Rate

Introduction
There is near unanimous bipartisan agreement in Washington that the U.S. corporate tax rate is out of step with rates levied by most industrialized nations and that America’s global competitiveness is suffering as a result. What seems to be lacking to fix the problem, however, is a sense of political urgency and a broader understanding of the substantial economic benefits that a lower corporate tax rate will generate.

President Obama’s two bipartisan “blue ribbon” panels – the Economic Recovery Advisory Board, chaired by Paul Volcker, and the National Commission on Fiscal Responsibility and Reform, chaired by Erskine Bowles and Alan Simpson – made strong cases for cutting the corporate tax rate and reforming the entire corporate tax system. The Economic Recovery Advisory Board, for example, found that:

The combination of a high statutory rate and numerous deductions and exclusions...

Ten Benefits of Cutting the U.S. Corporate Tax Rate

1. Cutting the corporate tax rate will promote higher long-term economic growth.

2. Cutting the corporate tax rate will improve U.S. competitiveness.

3. Cutting the corporate tax rate will lead to higher wages and living standards.

4. Cutting the corporate tax rate will boost entrepreneurship, investment, and productivity.

5. Cutting the corporate rate lowers the tax burden on low-income taxpayers and seniors.

6. Cutting the corporate tax rate will lower the overall dividend tax rate and taxes on capital.

7. Cutting the corporate tax rate can attract foreign direct investment (FDI).

8. Cutting the corporate rate would lead to lower corporate debt and reduce the incentives for income shifting.

9. Cutting the corporate tax rate can reduce compliance costs.

10. Cutting the federal corporate rate can help the states compete globally.
results in an inefficient tax system that distorts corporate behavior in multiple ways. The high statutory corporate tax rate reduces the return to investments and therefore discourages saving and reduces aggregate investment.\(^1\)

The so-called Bowles-Simpson report simply concluded that “America’s tax code is broke and must be reformed.” Moreover, the corporate income tax “hurts America’s ability to compete. On the one hand, statutory rates in the U.S. are significantly higher than the average for industrialized countries (even as revenue collection is low), and our method of taxing foreign source income is outside the norm... The current system puts U.S. corporations at a competitive disadvantage against their foreign competitors.”\(^2\)

While many lawmakers are understandably concerned about the budgetary consequences of cutting the corporate tax rate, they should give greater weight to the benefits that such a move would mean to the American economy. Growing the economy and making the U.S. more competitive are critical solutions to the long-term fiscal issues facing the nation.

While there are many benefits of cutting the U.S. corporate tax rate, we’ve compiled 10 that should help convince lawmakers that this is the right policy direction for the nation.

**Benefit #1: Cutting the corporate tax rate will promote higher long-term economic growth.**

Cutting the U.S. corporate tax rate will help put the country on a long-term growth path. An important 2008 report by economists at the Organization for Economic Cooperation and Development (OECD) measured the relationship between different types of taxes and economic growth. The evidence showed that the corporate income tax is the most harmful tax for long-term economic growth, followed by high personal income tax rates. Consumption taxes and property taxes were seen as less harmful.

Indeed, the report found that “Corporate income taxes appear to have a particularly negative impact on GDP per capita.”\(^3\) Lowering statutory corporate tax rates, they determined, “can lead to particularly large productivity gains in firms that are dynamic and profitable, i.e. those that can make

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the largest contribution to GDP growth.”

OECD economists speculate that this could be because these are the firms that rely most heavily on retained earnings to finance their growth. Higher taxes mean fewer retained earnings, which means less growth.

An earlier study by economists Young Lee and Roger H. Gordon looked at the relationship between corporate tax rates and economic growth for 70 countries over a 27-year period. They found that “statutory corporate tax rates are significantly negatively correlated with cross-sectional differences in average economic growth rates” and that “cutting the corporate tax rate by 10 percentage points can increase the annual growth rate by around 1.1%.”

Studies such as these should be a red flag to lawmakers because not only does the U.S. have a high corporate tax rate, it also has one of the most progressive personal income tax systems among industrialized nations, according to the OECD. This suggests that we are severely retarding the nation’s growth potential by maintaining such high tax rates.

**Benefit #2: Cutting the corporate tax rate will improve U.S. competitiveness.**

At more than 39 percent, the overall U.S. corporate tax rate is the second-highest in the world, 15 percentage points higher than the OECD average of 25 percent and China’s 25 percent tax rate. Over the past four years, 75 countries have cut their corporate tax rates to be more attractive to business investment.

In contrast to many of our major trading partners, the U.S. has no official policy regarding our tax competitiveness. The Canadian government has set an explicit goal of having “an overall tax rate on new business investment that is the lowest in the Group of Seven (G7) countries,” and “the lowest statutory corporate income tax rate in the G7” by 2012. On January 1st, Canada lowered its federal corporate tax rate from 18 percent to 16.5 percent. The rate will eventually fall to 15 percent.

**At more than 39 percent, the overall U.S. corporate tax rate is the second-highest in the world, 15 percentage points higher than the OECD average of 25 percent and China’s 25 percent tax rate.**

The British government has also set out a detailed plan to “create the most competitive corporate tax regime in the G20.” A key element of that plan is lowering the British corporate tax rate from 28 percent to 23 percent by 2014. The rate was lowered to 26 percent this year as a first step toward that goal.

Finally, the Japanese government approved a plan last December to cut their effective corporate tax rate by 5 percent “in order to promote domestic investment and job creation through enhancing Japanese companies’ international competitiveness as well as improving the environment for business establishment.” That plan was scheduled to go into effect on April 1, 2011.

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4 Ibid. p. 9.
but was put on hold after the recent earthquake derailed the government’s legislative agenda.¹⁰

The high “sticker price” of the U.S. corporate tax rate not only makes the American economy less competitive globally, it makes American businesses less competitive. Cutting the corporate tax rate will make the U.S. a more attractive place to do business in, and do business from. The White House and the Congress should set out an explicit goal of making the U.S. corporate tax system more competitive before the nation falls too much further behind our major trading partners.

Benefit #3: Cutting the corporate tax rate will lead to higher wages and living standards.

Economists have long debated who bears the true economic burden of corporate income taxes. The general consensus has been that at least some portion of the tax is born by consumers through higher prices, workers through lower wages, and shareholders through lower returns. But the question has always been, Which party bears the greater burden?

In recent years, however, economic research is indicating that in a world where capital is extremely mobile but workers are not, the true economic burden of corporate taxes tends to fall most heavily on labor. Indeed, studies show that workers bear between 45 percent and 75 percent of the economic burden of corporate taxes with the rest falling on capital.¹¹

In one such study, economists at the Oxford University Centre for Business Taxation used data on over 55,000 companies located in nine European countries. They found that a $1 increase in the corporate tax would reduce real wages at the median by 75 percent.¹²

The overwhelming body of economic evidence suggests that cutting the U.S. corporate tax rate will benefit U.S. workers through higher wages, which translate into higher living standards.

Alison Felix, an economist at the Federal Reserve Bank of Kansas City, also used cross-country data to study corporate taxes’ effect on the gross wages of workers. She found that “labor’s burden is more than four times the magnitude of the corporate tax revenue collected in the U.S.”¹³ According to her model, a one percentage point increase in the average corporate tax rate decreases annual gross wages by 0.9 percent. Translated to U.S. corporate tax collections and wages, this means that a $10.4 billion increase in corporate tax collections would lower overall wages by $43.5 billion.¹⁴

In a separate study, Felix and James Hines found that workers in firms that were largely unionized bore a large share of the corporate tax burden. Their estimates “imply that if a firm’s workforce is entirely unionized, then roughly 54 percent of the cost of higher tax rates is borne by union members in the form of lower wages.”¹⁵

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¹⁰ The recent earthquake may have delayed the implementation of this policy.
¹⁴ Ibid. p. 20.
¹⁵ Felix and Hines, p. 2.
The overwhelming body of economic evidence suggests that cutting the U.S. corporate tax rate will benefit U.S. workers through higher wages, which translate into higher living standards.

**Benefit #4: Cutting the corporate tax rate will boost entrepreneurship, investment, and productivity.**

Studies show that the corporate income tax hinders entrepreneurship, risk, and investment. Indeed, a study by Jens Arnold and Cyrille Schwellnus supports the notion that corporate taxes are “success taxes” which “fall disproportionately on firms that are contributing positively to aggregate productivity growth.”

In a study for the OECD, Djankov et al. found that “the effects of taxes on entrepreneurship are large and statistically significant, and show up with both the statutory and the effective tax rates. A 10 percentage point increase in the 1st year effective corporate tax rate reduces business density by 1.9 firms per 100 people (average is 5), and the average entry rate by 1.4 percentage points (average is 8).”

Arnold and Schwellnus focused on the impact of the corporate tax on productivity through what is known as the “user cost of capital” and its impact on investment. Higher corporate taxes increase the user cost...
of capital, which leads to less investment and lower productivity. The consequences of this, they found, are quite significant.

Perhaps a worrisome sign for the U.S., they found that firms in relatively profitable industries “have disproportionately lower productivity growth rates in countries with high statutory corporate tax rates.” The corporate tax has the biggest impact on firms that are on the way up as opposed to those that have plateaued or are on the way down. In other words, companies that are “in the process of catching up with the technological frontier are particularly affected by corporate taxes.”

A key factor for the health of the overall economy is the extent to which investment leads to new technology which, in turn, improves productivity. However, “high corporate taxes may reduce incentives for productivity-enhancing innovations by reducing their post-tax returns.” Thus, if U.S. lawmakers want to increase the amount of innovation in the country, a good first step would be to cut the corporate tax rate.

Benefit #5: Cutting the corporate rate lowers the tax burden on low-income taxpayers and seniors.

As Figure 1 shows, most low-income people not only pay nothing in personal income taxes, they actually have a negative average tax rate, which means they receive generous refundable tax credits that supplement their income. Obviously, additional income tax cuts cannot help these taxpayers. However, low-income taxpayers do pay corporate income taxes through higher prices, lower wages, or lower dividends in their retirement funds. As Figure 1 indicates, while corporate taxes are certainly not the burden that payroll taxes are for low-income taxpayers, a corporate rate cut would still benefit them.

These estimates, of course, depend greatly on the assumptions of who bears the burden of corporate taxes — labor or the owners of capital. We do know, however, that dividends are an important source of income for seniors and retirees. Presuming that lower corporate income taxes will translate into higher dividend payouts, IRS data indicates that seniors will benefit substantially.

| Table 2 |
| Overall Statutory Tax Rates on Dividend Income (Corporate & Individual Rate) |

<table>
<thead>
<tr>
<th>Country</th>
<th>2010 Rate</th>
<th>2010 Rank</th>
<th>2000 Rate</th>
<th>2000 Rank</th>
<th>Change in Rate 2000 to 2010</th>
<th>Change in Rank 2000 to 2010</th>
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*2008 Data

18 Arnold and Schwellnus, p. 4.
19 Ibid. p. 10.
20 Ibid. p. 9.
For example, IRS data for 2008 indicates that while 19 percent of all returns reported dividend income, 42 percent of taxpayers over 65 reported dividend income. The age group with the next highest share of dividend earners is those aged 55 to 65 (see Table 1).

Overall, taxpayers over age 55 account for 71 percent of all dividend income earned. The lion’s share of dividend income – 48 percent – is earned by those over 65, and dividend income accounts for 6 percent of all the income earned by these taxpayers.

**Benefit #6: Cutting the corporate rate will lower the overall dividend tax rate and taxes on capital.**

In order to compare the tax rate on dividend income across countries on an equivalent basis, OECD economists combine the corporate tax rate with the personal tax rate to produce an overall dividend tax index. As Table 2 indicates, the U.S. has the fourth-highest overall tax rate on dividends among OECD nations at 49.5 percent. Interestingly, the overall rate on dividend income in the U.S. has dropped 10 percentage points since 2000 – in large measure due to the Bush tax rate cuts – yet our ranking among OECD nations went up from eighth-highest to fourth-highest. This is a testament to how much other nations have cut their corporate tax rates during the same period.

Were the U.S. corporate tax rate cut from 35 percent to, say, 25 percent, our overall tax rate on dividends would fall to roughly 40 percent. This would lower the U.S. ranking from the fourth-highest overall tax rate on dividends to 20th among the 31 OECD nations ranked on Table 2. More importantly, this would lower the overall cost of capital for U.S. firms, making it cheaper for them to acquire the resources to grow and expand.

**In addition to the distorted treatment of debt and equity financing, studies have shown that companies have a greater incentive to take on debt in countries with high corporate tax rates – such as the U.S. – than in low-rate countries because debt payments lower their effective tax burdens.**

Cutting the corporate tax rate will also likely increase the incentive for companies to pay dividends, which would subsequently improve the value of stocks overall. In 2003, the top tax rate on dividend income was cut from 39.6 percent to 15 percent. Studies show that the rate cut had a number of positive effects on corporate policies.21 First, after a two-decade decline, the number of publicly traded companies paying dividends increased immediately after the rate cut. Second, firms that were already paying dividends increased their dividend payouts measurably after the rate cut.22

**Benefit #7: Cutting the corporate tax rate can attract foreign direct investment (FDI).**

Studies show that high corporate income taxes can deter foreign investment. While taxes may not be the largest determinant of FDI – others include the size of consumer markets, profit opportunities, and the regulatory environment – they are becoming more

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important as other barriers to capital mobility are being eliminated.

The biggest cost of the corporate tax system is the deadweight cost to the economy that results from the distortions, inefficiencies, and misallocation of resources caused by the code’s complexity and incentives.

One study by economists at the World Bank and Harvard University found a statistically significant effect of both the statutory and effective corporate tax rates on FDI. For example, they found that “raising the 1st year effective tax rate by 10 percentage points reduces the investment rate by 2.2 percentage points (average investment rate is 21.5%) and FDI rate by 2.3 percentage points (average FDI rate is 3.36%).”

The OECD reports that “studies examining cross-border flows suggest that on average, FDI decreases by 3.7% following a 1 percentage point increase in the tax rate on FDI.” Moreover, OECD economists have determined that “lower corporate tax and labour rates may also encourage inbound foreign direct investment, which has been found to increase productivity of resident firms.”

Foreign investment is increasingly important for the U.S. economy, American workers, and government coffers. According to the Bureau of Economic Analysis, foreigners invested more than $1.7 trillion in the U.S. between 2001 and 2010. The U.S. subsidiaries of foreign multinationals employ more than 5.6 million Americans and have payrolls of $408.5 billion. According to IRS statistics, foreign-owned subsidiaries paid more than $52.5 billion in federal corporate income taxes in 2007, the most recent data available.

Cutting the U.S. corporate tax rate will make the country more attractive to investment from abroad which will be a net positive for the economy, workers, and tax revenues.

Benefit #8: Cutting the corporate rate would lead to lower corporate debt and reduce the incentives for income shifting.

It is well understood that corporate taxes distort business financing decisions by favoring debt over equity financing because interest payments can be deducted from taxable profits while dividend payments cannot. U.S. companies do appear to be highly leveraged. According to Federal Reserve data, nonfinancial corporate debt in the U.S. totaled nearly $7.4 trillion in 2010, an increase of 24 percent since 2006. Remarkably, in 2008, corporate debt exceeded the federal government’s publicly held debt by $600 billion.

In addition to the distorted treatment of debt and equity financing, studies have shown that companies have a greater incentive to take on debt in countries with high corporate tax rates – such as the U.S. – than in low-rate countries because debt payments lower their effective tax burdens. Djankov et al. found that a “10 percentage point increase

25 Johansson et al., p. 9.
28 Johansson et al., p. 34.
in the 1st year effective corporate tax rate raises the debt to equity ratio by highly statistically significant 40 percentage points (the mean is 111%). In our data, countries with higher effective (as well as statutory) tax rates use sharply more debt.29

Multinational firms can manipulate the debt structure between the parent and foreign subsidiaries to lower the firm’s overall tax burden. For example, a company can have a subsidiary in a low-tax country lend cash to a subsidiary in a high-tax country. The debt payments, thus, lower the tax bill for the subsidiary in the high-tax country and increase the income for the subsidiary in a low-tax country, producing a lower overall effective tax rate for the company. One study observes that as a result of this sort of tax planning, high-tax countries reap proportionately lower tax revenues from multinational firms than do countries with low tax rates.30

In addition to debt-motivated tax planning and income shifting, companies can use a variety of other planning techniques to shift income to low-tax countries. The most common technique is through the pricing of intercompany transactions, known as transfer pricing. Naturally, companies want to shift as many of their costs into high-tax countries as possible in order to reduce their taxable income. At the same time, they want to shift as much income as possible into low-tax countries in order to increase their after-tax profits.

Another technique is to shift highly profitable assets into low-tax countries to maximize the return on those investments. These assets could include corporate headquarters, R&D facilities, trademarks, and patents. Treasury economist Harry Grubert estimated that the income generated from R&D spin-offs—such as trademarks, licensing, and patents—accounts for “about 50 percent of the income shifted from high-tax to low-tax countries.”31 Indeed, he found that R&D intensive companies engage in more intercompany transactions than other industries because of the high value of those intangible products.

Married with a simplification of the system, a rate cut would surely help reduce the corporate tax system’s drag on the U.S. economy.

It is difficult to estimate how much of the U.S. corporate tax base is lost due to income shifting. One study of income shifting among European nations found a large amount of redistribution of tax revenues in Europe and that Germany—which had the highest corporate tax rate in Europe when the study was performed—suffered the biggest losses from income shifting to other countries.32 Germany’s losses equaled 8.1 percent of their tax base, which would equate into $108 billion for the U.S. corporate tax base. By contrast, Hungary—which had the lowest corporate rate at the time—enjoyed a 3.5 percent increase in their tax base due to inbound profit shifting.33

These findings suggest that cutting the corporate tax rate would reduce the tax distortion for debt over equity financing, but...
perhaps increase the amount of profits kept in the U.S. by reducing the incentive for tax-motivated planning and income shifting. The OECD reports that reduced income shifting can lower the revenue losses associated with a cut in the tax rate.\textsuperscript{34}

**Benefit #9: Cutting the corporate tax rate can reduce compliance costs.**

The corporate tax system is incredibly complex and costly to comply with. While estimates vary greatly, a 2002 University of Michigan Business School survey of corporate taxpayers estimated that the largest firms spent more than $1.3 million on average to comply with their federal income tax forms.\textsuperscript{35} President Obama’s Economic Recovery Advisory Board, the so-called Volker commission, estimated the total compliance costs for U.S. companies at $40 billion annually, or more than 12 percent of the revenues collected.\textsuperscript{36}

These figures likely underestimate the total costs of the corporate tax system. The Large and Mid-size Business Division within the IRS employs thousands of people to audit and enforce the corporate tax code. In fact, every Fortune 500 firm has IRS agents housed on-site to audit their tax returns on a constant basis. Moreover, a considerable amount of resources is spent each year litigating disputes between taxpayers and the IRS.

But the biggest cost of the corporate tax system is the deadweight cost to the economy that results from the distortions, inefficiencies, and misallocation of resources caused by the code’s complexity and incentives. As the President’s Advisory Board noted, “All of these factors act to reduce the productivity of American businesses and American workers, increase the likelihood and cost of financial distress, and drain resources away from more valuable uses. Most of these distortions also affect businesses beyond the corporate sector.”

**A rate cut could reduce the incentives for corporate debt while saving U.S. companies hundreds of millions in compliance costs.**

By itself, cutting the corporate rate will not necessarily reduce corporate compliance costs. But married with a simplification of the system, a rate cut would surely help reduce the corporate tax system’s drag on the U.S. economy.

**Benefit #10: Cutting the federal corporate rate can help the states compete globally.**

States go to great lengths to compete against each other to attract business investment. Some have cut their business taxes while others have modified their apportionment formulas to minimize the tax burden on large exporting firms. Most states have generous incentive programs that offer tax breaks or other inducements to lure companies to locate jobs or facilities within the state.

But while states work hard to compete against each other, there is a limit to what actions they can take on their own to compete globally against scores of nations that not only offer lower taxes, but offer more generous treatment for research and devel-


opment expenses, tax holidays, and other investment incentives.

The states are competing at a disadvantage because the federal corporate income tax, at 35 percent, is the highest federally imposed corporate income tax among all industrialized nations. When the average state rate of 6.56 percent is added to the federal rate, some 24 states have a higher overall corporate tax rate than Japan, and all 50 states – even those such as Nevada that don’t impose a state-level corporate income tax – effectively levy a higher overall corporate tax rate than France, which has the third-highest tax rate in the OECD.

The only way states can adequately compete against other nations is if Washington cuts the federal corporate tax rate substantially enough to bring the combined federal and state average rate in line with our major trading partners.

How Low Must the Rate Go?
Lawmakers will need to decide how competitive they want to make the U.S. rate. Do they simply want to match the weighted average of OECD nations at 30 percent, match the simple average of OECD nations at 25 percent (this would match China’s rate too), or go even lower and make the U.S. rate one of the lowest in the OECD?

Table 3 illustrates the various plans that have been introduced in recent years and where those plans would move the U.S. corporate tax rate relative to certain benchmarks. We can see that the federal rate will have to be lowered substantially to make the combined rate reasonably competitive with our major trading partners.

The plan put forward by former Ways and Means Chairman Charlie Rangel (D-NY) in 2007, which can be credited with launching the current discussion over corporate tax rate cuts, would have lowered the federal rate to 30.5 percent. Including the average state rate, the Rangel plan would not have changed the relative ranking of the U.S. to our major competitors.

The 25 percent federal rate contained in the 2012 plan introduced by Budget Committee Chairman Paul Ryan and passed in the House would bring the combined U.S. rate down to 30 percent, which would match the weighted average of the major OECD nations. The U.S. rank would fall from second to seventh. By contrast, the 24 percent rate contained in the Wyden/Coats plan would be a slight improvement, lowering the U.S. rank to 11th among OECD nations.

To put the U.S. corporate tax rate on par with the OECD average of roughly 25 percent would require heavier lifting. To move the U.S. toward the middle, and equal to China, requires a federal corporate rate of 20 percent. Such a rate would lower the U.S. ranking to 19th among industrialized nations.

Table 3
How Different Plans Affect the Overall U.S. Rate and OECD Rankings
(Adjusted for federal deductibility of state taxes)

<table>
<thead>
<tr>
<th>Plan</th>
<th>Federal Rate</th>
<th>Average State Rate</th>
<th>Combined Rate</th>
<th>Resulting OECD Rank</th>
</tr>
</thead>
<tbody>
<tr>
<td>Current Law</td>
<td>35%</td>
<td>6.56%</td>
<td>39%</td>
<td>2</td>
</tr>
<tr>
<td>Rangel Plan (2007)</td>
<td>30.5%</td>
<td>6.56%</td>
<td>35%</td>
<td>2</td>
</tr>
<tr>
<td>Bowles/Simpson (2010)</td>
<td>28%</td>
<td>6.56%</td>
<td>33%</td>
<td>5</td>
</tr>
<tr>
<td>House/Ryan 2012 Budget Plan</td>
<td>25%</td>
<td>6.56%</td>
<td>30%</td>
<td>7</td>
</tr>
<tr>
<td>Wyden/Coats (2011)</td>
<td>24%</td>
<td>6.56%</td>
<td>29%</td>
<td>11</td>
</tr>
<tr>
<td>Match China/OECD Simple Avg.</td>
<td>20%</td>
<td>6.56%</td>
<td>25%</td>
<td>19</td>
</tr>
<tr>
<td>Match 2012 Canadian Federal Rate</td>
<td>15%</td>
<td>6.56%</td>
<td>20%</td>
<td>24</td>
</tr>
</tbody>
</table>
Should lawmakers want to be very bold and match Canada’s scheduled 15 percent federal corporate rate in 2012, that would require lowering the federal U.S. rate to 15 percent. This would lower the U.S. ranking to 24th.

Conclusion
The economic evidence points to substantial benefits to the U.S. economy, workers, and companies from cutting the corporate income tax rate. A corporate rate that is competitive with other industrialized nations would improve the nation’s long-term economic growth while boosting the wages and productivity of American workers.

The nation would also see greater entrepreneurship and more investment from both domestic and foreign sources. Moreover, a rate cut could reduce the incentives for corporate debt while saving U.S. companies hundreds of millions in compliance costs. Finally, because it would curb income-shifting, a lower corporate rate would result in more corporate profits being kept in the U.S. which could lead to more tax revenues for the federal government.

These benefits should overwhelm any anxieties lawmakers have over the short-term fiscal impact of cutting the U.S. corporate tax rate.