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The Economic Impact of a 25 Percent Corporate Income Tax Rate

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One way to spur private sector investment in the U.S. and get it into the hands of entrepreneurs would be to reduce the federal statutory corporate income tax rate, which is currently 35 percent.

The Heritage Foundation's Center for Data Analysis (CDA) conducted a dynamic simulation of a reduction of the corporate income tax rate to 25 percent, comparing it to a baseline forecast of the economy with the current policy of a 35 percent corporate rate.¹ The results of this simulation show the U.S. economy growing faster than the baseline in the 2011–2020 forecast horizon.

Why the Corporate Tax Rate Matters. The federal corporate rate matters for U.S. economic growth because all corporations' investment decisions are influenced by the tax rate's effect on a project's rate of return. If the after-tax rate of return does not meet the required rate of return for investment, the project will be foregone. Additionally, it influences where multinational businesses decide to invest in new productive capital.

Greater investment in the U.S. increases the overall capital stock and the level of technology available to businesses. This increases the productivity of U.S. workers, which increases their real wages.² The higher income gives individuals the ability not only to consume more but also to put more into savings. These savings get channeled back into corporations and new ventures, continuing the positive growth cycle.

What a Reduction Would Do. The CDA analysis of a reduction in the corporate income tax rate to 25 percent shows impressive growth for the U.S. economy.³ For example:

- The number of jobs in the U.S. would grow on average by 581,000 annually from 2011 to 2020, with 531,000 on average being created in the private sector each year;
- U.S. real gross domestic product would rise on average by \$132 billion per year;
- A typical family of four's after-tax income would rise on average by \$2,484 per year;
- U.S. capital stock would grow by an average of \$240 billion more per year; and
- Gross private domestic investment would increase by \$57.2 billion per year.⁴

Reducing the corporate rate would make investing in the U.S.—by both domestic and international firms—more attractive. The lower rate provides an incentive for foreign corporations to make investments in the U.S.

In fact, the dynamic simulation shows that foreign assets in the U.S. would rise substantially by

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roughly 4 percent on average per year. The rate reduction would likely result in more entrepreneurial activity with investments in new, value-creating ventures as the hurdle created by the higher corporate tax is lowered.⁵ The CDA analysis shows total non-farm proprietors' income rising by an average of \$17.8 billion per year (nominally).⁶

Additionally, lowering the corporate tax rates helps minimize distortions in financial markets and bring about a more efficient mix of debt and equity. Companies finance investment by either selling ownership shares or stock (equity) or borrowing (issuing debt). The corporate tax skews corporate financing choices toward debt financing, because some of the cost of debt is offset by the benefit of deducting the interest expense, which lowers the corporation's tax liability.⁷

Allowing the split between debt and equity financing to be chosen according to the underlying economic fundamentals would send clearer investment price signals, which are transmitted throughout the real economy and are critical for all economic activity.

In the CDA analysis, reducing the corporate rate to 25 percent would cause the cost of debt to rise on average by 0.9 percentage point per year—as the benefit of the interest deduction is lower—and reduce the cost of equity financing on average by 0.1 percentage point annually. This reflects the

rebalancing adjustments between debt and equity and shows that a greater degree of equity financing would be increasingly economically desirable for many companies.

Lowering the rate to 25 percent would also increase the real after-tax profits of corporations by \$124 billion on average per year. Further, the increase in equity financing gives households (through savings accounts, pension funds, etc.) a share in those higher profits. Increased corporate profits are reflected in stock prices and dividend payouts. The value of the stock index is 8.3 percent higher, and total dividend income is on average \$90 billion (not adjusted for inflation) more per year. Economic growth, resulting in higher income and higher asset values, allows households to have, in total, an average \$1.4 trillion per year more of net wealth.

A Weight off the Economy's Shoulders. Because the economy is a complex system based on specialization and trade, those who incur a tax liability are not necessarily the ones who bear the burden of the tax. Theoretical and empirical studies show that the corporate income tax is particularly harmful to economic growth, because the burden falls on all of the economy's productive resources (workers, capital, and entrepreneurs).⁸ This is due to the fact that corporations do not pay taxes—individuals do. Corporations are merely an organizing

1. Heritage Analysts used the IHS/Global Insight July Short-term macroeconomic model. IHS/Global Insight, Inc., is a leading economic forecasting firm in the United States. The Global Insight model is used by private-sector and government economists to estimate how changes in the economy and public policy are likely to affect major economic indicators. The methodologies, assumptions, conclusions, and opinions presented here are entirely the work of analysts in the Center for Data Analysis at The Heritage Foundation. They have not been endorsed by, and do not necessarily reflect the views of, the owners of the Global Insight model.
2. See Congressional Budget Office, *Corporate Income Tax Rates: International Comparisons*, November 2005, at <http://www.cbo.gov/ftpdocs/69xx/doc6902/11-28-CorporateTax.pdf> (December 2, 2010).
3. The simulation made no assumptions regarding the average effective corporate tax rate (due to changes in depreciation allowances, etc.). Thus the average effective corporate tax rate is in the same proportion to the 25 percent statutory corporate rate as it is to the 35 percent corporate tax rate.
4. All dollar amounts are inflation-adjusted to the year 2010 unless otherwise noted.
5. See Simeon Djankov *et al.*, "The Effect of Corporate Taxes on Investment and Entrepreneurship," National Bureau of Economic Research *Working Paper* No. 13756, 2008.
6. Non-farm proprietors' income can be viewed as a crude proxy for entrepreneurial activity.
7. See Congressional Budget Office, *Corporate Income Tax Rates*, p. 3.

mechanism for productive resources. The CDA's simulation shows the powerful effects that lessening this burden can have on the U.S. economy.

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8. See, for example, Young Lee and Roger H. Gordon, "Tax Structure and Economic Growth," *Journal of Public Economics*, Vol. 89 (2005), pp. 1027–1043; Asa Johansson *et al.*, "Tax and Economic Growth," Organisation for Economic Co-operation and Development, July 11, 2008, at <http://www.oecd.org/officialdocuments/displaydocumentpdf/?cote=ECO/WKPpercent282008percent2928&doclanguage=en> (November 15, 2010).