WebMemo

Published by The Heritage Foundation

No. 3146
February 11, 2011

Corporate Tax Reform Should Focus on Rate Reduction

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President Barack Obama called on Congress to reform the corporate tax system in his State of the Union address. There is much to fault with the current corporate tax code, but the high tax rate is the biggest threat facing the economy right now. Congress should focus on lowering the corporate tax rate first and work on other issues later.

Tax reform—whether of the individual tax code or the corporate tax code—requires early, sustained, and determined presidential leadership. If a lower rate is to become a reality in the near future, President Obama must follow up on his call to action with a clear plan to guide Congress and a willingness to spend political capital to turn the plan into reality.

Lower Rate Paramount. The corporate tax rate is such a large weight on the economy because the United States' rate is well above international norms. The U.S. has had the second-highest corporate tax rate among other developed nations represented in the Organization for Economic Cooperation and Development (OECD) since 2004. It trailed only Japan during that time—and by only a razor-thin margin. Japan recently announced that it will lower its corporate tax rate this year, meaning the U.S. will soon hold the ignominious distinction of having the highest corporate tax rate in the industrialized world.

The U.S. rate, when including the average of state corporate tax rates, is just over 39 percent (35 percent at the federal level). The average of all industrialized countries in the OECD is about 25 percent.

The corporate tax system influences economic growth because it is one of the key factors businesses consider when they decide where to invest. Many elements of the corporate tax system—such as the distortions built into it—affect this calculation, but the tax rate is the largest factor.

The high tax rate in the U.S. has for many years helped to drive business investment overseas. U.S. businesses struggle to compete when subject to such a high domestic tax rate; foreign businesses that are looking to expand are dissuaded from doing so by the high domestic tax rate.

As long as the U.S. rate remains well above its competitors, businesses will have an incentive to locate new facilities in foreign locations. The jobs that come with those new investments will continue to go to nations with more competitive tax rates.

The U.S. ended up higher than its international competitors largely by standing still. In the 1980s, the U.S. led the world in reducing its tax rates, first in 1981 as part of the Reagan tax cuts and then again in the 1986 tax reform. Other countries soon followed suit. Over the past 20 years, other developed countries continued to reduce their rates aggressively while the U.S. slept. It is past time for

This paper, in its entirety, can be found at:
http://report.heritage.org/wm3146

Produced by the Thomas A. Roe Institute for Economic Policy Studies

Published by The Heritage Foundation
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Washington, DC 20002–4999
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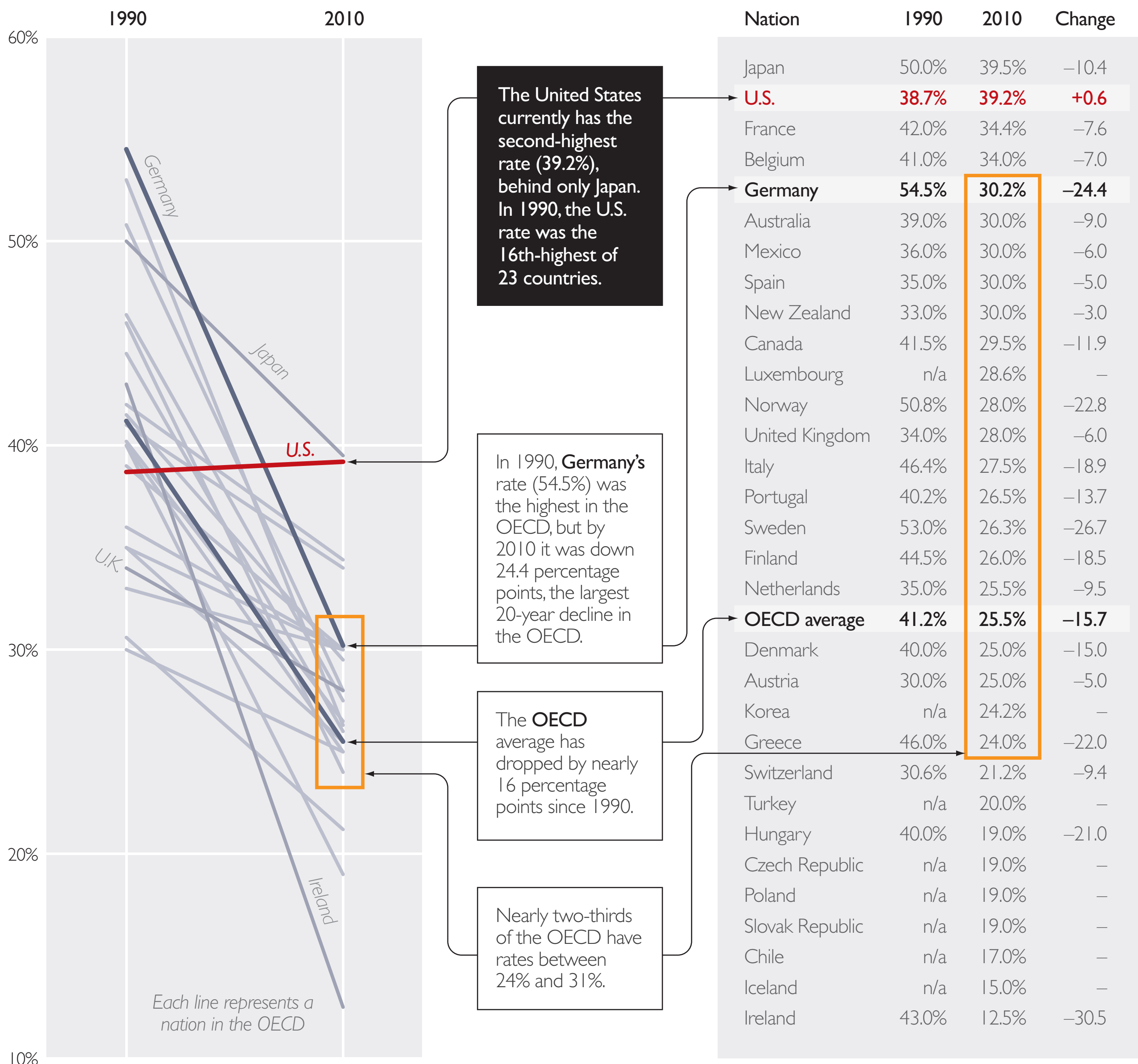
Making the United States Less Competitive

To attract business and investment in a fiercely competitive global marketplace, every industrialized country except the United States has lowered its corporate income tax over the past 20 years. The United States has bucked that trend and *increased* its rate, creating a less-hospitable environment for corporations.



Nation	1990	2010	Change
Japan	50.0%	39.5%	–10.4
U.S.	38.7%	39.2%	+0.6
France	42.0%	34.4%	–7.6
Belgium	41.0%	34.0%	–7.0
Germany	54.5%	30.2%	–24.4
Australia	39.0%	30.0%	–9.0
Mexico	36.0%	30.0%	–6.0
Spain	35.0%	30.0%	–5.0
New Zealand	33.0%	30.0%	–3.0
Canada	41.5%	29.5%	–11.9
Luxembourg	n/a	28.6%	–
Norway	50.8%	28.0%	–22.8
United Kingdom	34.0%	28.0%	–6.0
Italy	46.4%	27.5%	–18.9
Portugal	40.2%	26.5%	–13.7
Sweden	53.0%	26.3%	–26.7
Finland	44.5%	26.0%	–18.5
Netherlands	35.0%	25.5%	–9.5
OECD average	41.2%	25.5%	–15.7
Denmark	40.0%	25.0%	–15.0
Austria	30.0%	25.0%	–5.0
Korea	n/a	24.2%	–
Greece	46.0%	24.0%	–22.0
Switzerland	30.6%	21.2%	–9.4
Turkey	n/a	20.0%	–
Hungary	40.0%	19.0%	–21.0
Czech Republic	n/a	19.0%	–
Poland	n/a	19.0%	–
Slovak Republic	n/a	19.0%	–
Chile	n/a	17.0%	–
Iceland	n/a	15.0%	–
Ireland	43.0%	12.5%	–30.5

Source: OECD, "Taxation of Corporate and Capital Income (2010)," Table II.1. "Corporate Income Tax Rate," at *http://www.oecd.org/dataoecd/26/56/33717459.xls* (December 9, 2010).

Chart 1 • WM 3146 heritage.org

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the U.S. to catch up. To regain standing compared to competing nations, Congress must lower the rate so it is on par with the current OECD average.

Congress and the states should keep in mind that state corporate taxes raise the average rate by about 5 percentage points above the federal rate. To combat this complication, Congress would ideally lower the rate below the current OECD average and encourage states to lower their rates as well.

Equalize Treatment of All Businesses. If Congress lowers the corporate tax rate, many businesses would continue to pay a high rate. Pass-through entities like S-corporations, limited liability corporations, partnerships, and sole proprietorships pay taxes on their owners' individual returns. As a result, the pass-through businesses that employ the most workers would still pay a rate of 35 percent—plus the additional state tax rates.

A substantially lower rate available to corporations would provide a powerful incentive for pass-through businesses to change their organization for purely tax purposes. To prevent businesses from switching for non-economic purposes and enhance the competitiveness of all business types, Congress should alter the tax treatment of pass-through entities so they pay tax at the entity level when it lowers the corporate rate. It should then lower the pass-through rate so that it is equal to the corporate tax rate.[1]

Make Expensing Permanent. The inability of U.S. businesses to immediately deduct the cost of capital purchases (known as expensing) is another major detractor to economic growth in the corporate tax code. The cost of capital is lower in countries that allow expensing. This makes expansion to these countries more attractive to growing businesses.

The 2010 tax deal that extended the 2001/2003 tax cuts for two more years also gave businesses the chance to expense 100 percent of new capital purchases through the end of 2011. Congress should then set about making this crucial policy permanent. Once the economy begins to strengthen, expensing will become even more effective as businesses look to expand and take advantage of developing opportunities.

Territorial System Secondary. The U.S. is the lone remaining country that taxes its businesses on the income they earn in foreign countries. Changing from this worldwide system of taxation to one that taxes businesses only on the income they earn in the U.S. (a territorial system) is necessary to fully repair America's global competitiveness.

Changing to a territorial system is complicated and would require much time and thought. It would be best for Congress to take the necessary time to study how to transition to a territorial system and make the change only once it has had the time to fully consider the issue.

In the interim, the economic pain caused by the worldwide system would lessen if Congress lowered the tax rate. As long as the foreign tax credit remains unchanged, businesses would continue paying additional tax on income they earned in countries with rates lower than the U.S.

Currently, because the U.S. has the highest rate in the world, businesses pay U.S. tax on all their foreign-source income. But if the rate were greatly reduced, they would owe tax domestically only on income they earn in a handful of countries that would still have a lower rate.

Deficit Concerns Complicate Reform. Lower tax rates on businesses would no doubt boost the ailing economy, but the growth would not be enough to offset the tax revenue lost from lower rates in the short term. With a deficit projected to be $1.5 trillion this year, adding to the deficit is unacceptable.

Closing "loopholes" in the tax system is a popular answer for replacing the revenue foregone to lower rates. However, many of the provisions that are commonly referred to as loopholes move the system closer to expensing of capital acquisitions and away from the cumbersome depreciation system.

1. For a detailed explanation of how to accomplish this change, see Curtis Dubay, "How to Fix the Tax Code: Five Pro-Growth Policies for Congress," Heritage Foundation *Backgrounder* No. 2502, December 14, 2010, at *http://www.heritage.org/Research/Reports/2010/12/How-to-Fix-the-Tax-Code-Five-Pro-Growth-Policies-for-Congress*.

Eliminating these policies would make the tax system less competitive—even with a lower corporate rate. Eliminating the few remaining provisions that all sides can agree should be eliminated would not come close to gaining the revenue needed to replace that lost to lower rates.

To achieve a lower rate and not add to the deficit, Congress will need to do more than just close loopholes. It will also have to lower spending, including eliminating corporate welfare programs, such as subsidies to big agribusiness.

Obama's Move. Tax reform, like all major reform initiatives, succeeds only when the President puts the energy and bully pulpit of the office behind the effort. President Obama needs to present Congress with a detailed plan to keep the momentum going on this vital issue. His forthcoming budget for fiscal year 2012 is the perfect opportunity to lay out this vision.

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