

Competitive Tax Rates for U.S. Companies: How Low to Go?

By Peter R. Merrill

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Both Democrats and Republicans have advanced proposals that would reduce the top federal corporate income tax rate from its current level of 35 percent. Looking ahead, a key question for policymakers is whether a reduction in the corporate tax rate to the 28 percent to 31 percent range advocated in recent proposals, discussed below, would be sufficient to match international benchmarks.

On October 25, 2007, House Ways and Means Committee Chair Charles B. Rangel, D-N.Y., introduced H.R. 3970, the Tax Reduction and Reform Act of 2007, which would reform the individual and corporate income tax systems in a manner estimated to be revenue neutral within each system over the fiscal 2008-2017 budget period. The bill would reduce the top corporate income tax rate to 30.5 percent.

On December 20, 2007, Treasury released a report that discussed various approaches for improving the competitiveness of the U.S. business tax system, including a revenue-neutral reduction in the top corporate income tax rate to 28 percent. As an alternative, Treasury presented a plan that would retain accelerated depreciation and reduce the top corporate income tax rate to 31 percent.¹

On June 19, 2008, Sen. George V. Voinovich, R-Ohio, introduced S. 3162, the Made in the USA Tax Act, which would reduce the top corporate income tax rate to 28 percent over the 2009-2013 period.

In a November 15, 2008, interview, Rangel announced his intention to introduce a revised version of his comprehensive income tax reform bill with a top corporate tax rate of 28 percent and additional measures "cutting

out the fat out of those industries that have taken an unfair advantage of the tax code."²

OECD Benchmark

One way to benchmark the U.S. corporate income tax rate is by reference to the OECD, a group of 30 countries with highly developed market economies that are home to companies that compete in global markets with U.S.-based companies. This benchmark is relevant for companies that operate in the United States and compete against companies with operations in other OECD countries.

The OECD annually updates a database on the top corporate income tax rate imposed by the central governments of member countries as well as the average top rate imposed by subcentral governments (typically states and provinces). The OECD includes surtaxes and, where applicable, accounts for the deductibility of subcentral corporate taxes against central government corporate tax liability. The OECD does not take account of targeted rate reductions that apply to specified qualifying income. As of 2008, the OECD reports that 17 countries, including the United States, have special regimes with reduced corporate tax rates on targeted categories of income.³

One benchmark for the United States is the average corporate tax rate of the other 29 OECD members. That benchmark treats all OECD member countries equally. From a competitiveness standpoint, however, it can be argued that the larger economies are more important and should be given greater weight. This article uses 2007 GDP measured in U.S. dollars from the IMF database to calculate weighted average corporate tax rates.⁴

Competitive Position of U.S. Tax Rate

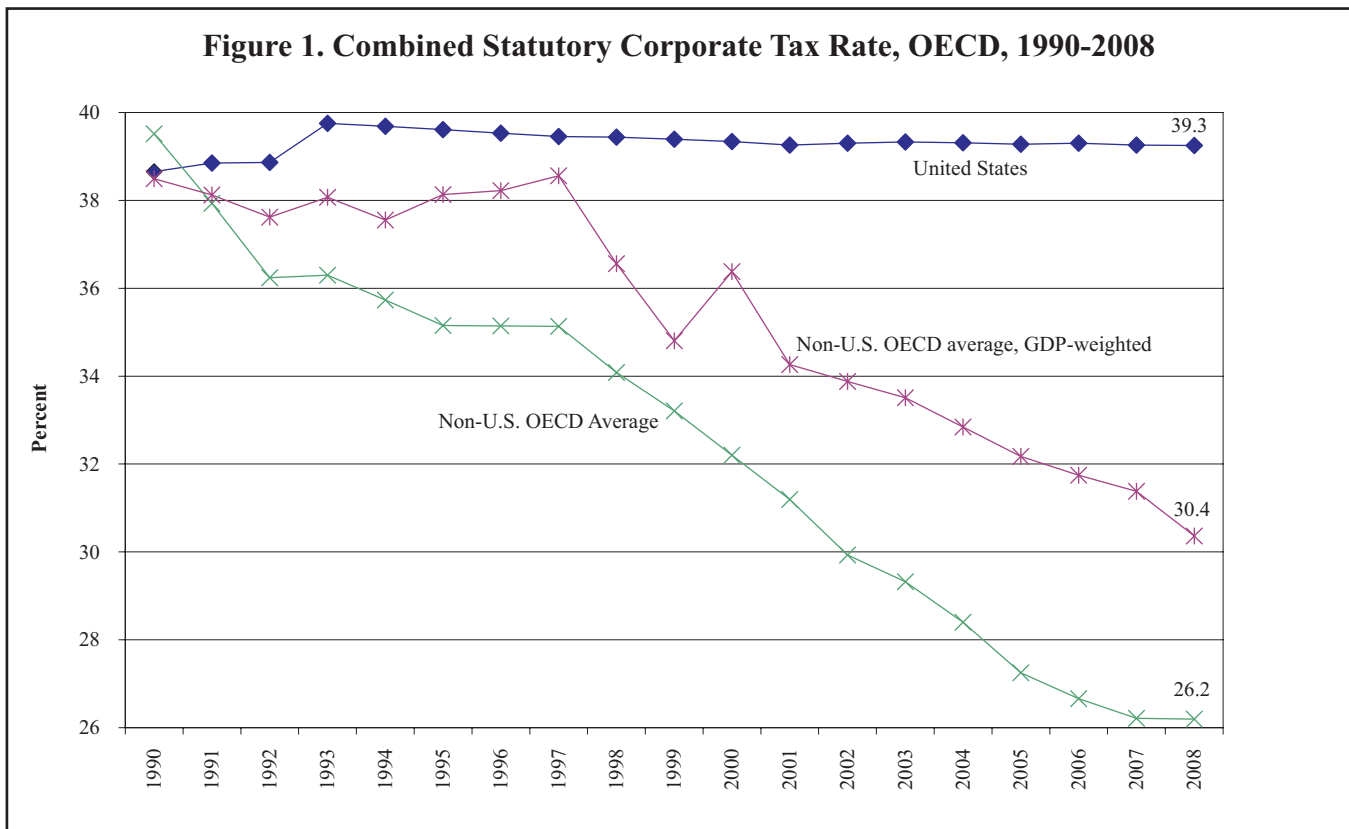
The top U.S. corporate income tax rate currently is 39.3 percent, a combination of the 35 percent federal rate and an average state rate of 6.5 percent (taking account of the deductibility of state against federal tax). By comparison, in 2008 the average top corporate income tax rate for the other 29 OECD member countries was 26.2 percent on an unweighted basis and 30.4 percent on a GDP-weighted basis (see Figure 1). Thus, using the OECD countries as a benchmark, the combined U.S. corporate tax rate is 9

²Ryan J. Donmoyer and Peter Cook, "Rangel Plans Push to Cut Top Corporate Tax Rate to 28 Percent," Bloomberg.com (Nov. 15, 2008), available at <http://www.bloomberg.com/apps/news?pid=20601087&sid=ag7ISuB.yyII&refer=home>.

³The U.S. domestic manufacturing deduction effectively reduces the federal corporate income tax rate by about 2 percentage points for some qualifying income.

⁴IMF, World Economic Outlook, Oct. 2008 database, available at <http://www.imf.org/external/pubs/ft/weo/2008/02/weodata/index.aspx> (last accessed Nov. 26, 2008).

¹U.S. Department of the Treasury, Office of Tax Policy, "Approaches to Improve the Competitiveness of the U.S. Business Tax System for the 21st Century" (Dec. 20, 2007), Doc 2007-27864, 2007 TNT 246-49.



percentage points to 13 percentage points above the OECD average, depending on whether the average is GDP-weighted.

The competitive position of the U.S. corporate tax rate has deteriorated markedly since 1990, when the U.S. and average OECD corporate tax rates were roughly in alignment. Since 1990, the U.S. corporate income tax rate has increased by 0.6 percentage points (from 38.7 percent to 39.3 percent), while the OECD average rate has declined by 13.3 percentage points (from 39.5 percent to 26.2 percent) on an unweighted basis and by 8.1 percentage points (from 38.5 percent to 30.4 percent) on a GDP-weighted basis.⁵ Thus, the competitive gap between U.S. and OECD corporate tax rates has opened up since 1990 primarily because of widespread and substantial rate reductions abroad, rather than any significant corporate tax increase in the United States.⁶

The United States and Japan are clear outliers, both with top corporate income tax rates about 5 percentage points higher than France, the OECD country with the next highest tax rate, at 34.4 percent in 2008 (see Figure 2). Ireland and Iceland are outliers at the low end of the distribution, with corporate income tax rates of 12.5

⁵As of 1993, there were 24 OECD member countries. Mexico joined the OECD in 1994; the Czech Republic joined in 1995; Hungary, Korea, and Poland joined in 1996; and the Slovak Republic joined in 2000.

⁶The top federal corporate tax rate was last changed in 1993, when it was increased from 34 percent to 35 percent.

percent and 15 percent, respectively. In general, countries with smaller economies tend to have lower corporate income tax rates. The two countries with the largest GDP — the United States and Japan — are the same countries with the highest corporate tax rates. By contrast, the country with the smallest economy — Iceland — has the second lowest corporate tax rate.

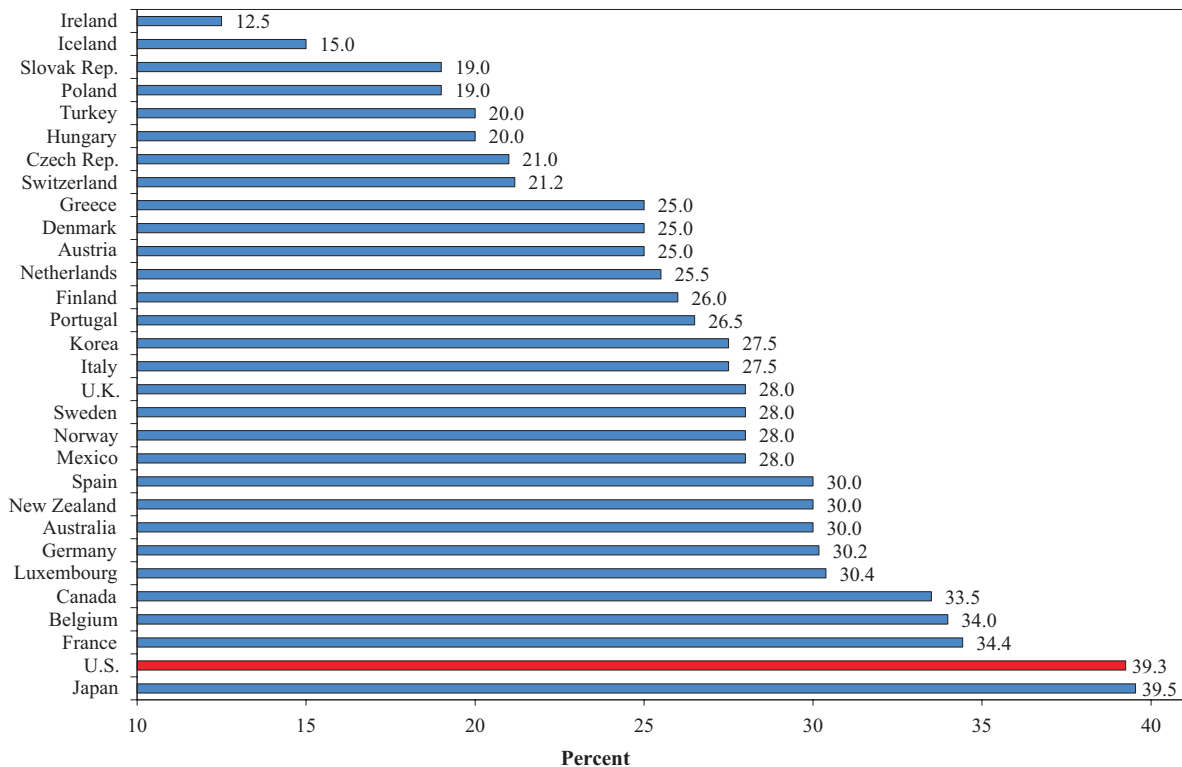
As the forces driving globalization reduce the importance of geographic distance between markets, large countries increasingly face competitive pressures similar to those of smaller countries. Increasing competition from new members of the European Union explains in part Germany's decision to reduce its top central government corporate tax rate by more than 25 percentage points since 2000.

Matching the OECD Benchmark

Based on 2008 data, by how much would Congress need to lower the corporate tax rate to match the OECD benchmark? Taking into account state income tax rates, the federal statutory corporate tax rate would need to be reduced by 9.5 percentage points or 14 percentage points (to 25.5 percent or 21 percent) to match the OECD average on a GDP-weighted or unweighted basis, respectively (see Figure 3). Thus, a 7 percentage point reduction in the federal corporate tax rate to 28 percent would not be enough to match the OECD benchmark, let alone to gain an advantage for U.S. companies.

Effective Tax Rates

Several authors have questioned whether focusing on statutory tax rates exaggerates the anticompetitive impact of the high U.S. corporate tax rate on the grounds

Figure 2. Combined Corporate Income Tax Rate, OECD Countries, 2008

that the “effective” tax rate is less than the statutory rate.⁷ For example, 2005 data from Schedule M-3 of the corporate income tax return suggest that the “book” effective tax rate was 25.3 percent, determined by dividing U.S. corporate income tax liability before foreign tax credits by pretax book income of the tax consolidated group.⁸

From an international competitiveness standpoint, however, the issue is not whether the effective tax rate is less than the statutory rate, but how the U.S. effective tax rate compares with the effective tax rates in other countries. There are a variety of ways in which an “apples-to-apples” comparison can be made. One is to consider a representative company in a typical year of operation and compute the taxes it would pay if located in different countries as a percent of its financial income using standardized financial accounting (a “book” measure of

effective tax rate). This is the approach used by the World Bank in its annual *Doing Business* report.⁹

According to the World Bank *Doing Business* 2009 report, the U.S. book effective tax rate in 2008 was quite high by global standards, ranking 50th highest out of 181 countries (top 28th percentile), and was also quite high by comparison to OECD member countries, ranking 7th highest out of 30 (top 23rd percentile).¹⁰

Another approach for calculating effective tax rates, developed by economists, is to calculate the “tax wedge” between the pretax and posttax internal rate of return on a new investment that either just breaks even or earns a higher rate of return due to some element of market power. Dividing the tax wedge into the pretax internal rate of return yields an effective tax rate — termed the marginal effective tax rate when calculated for a break-even investment, and the average effective tax rate when calculated for an investment that earns an above break-even return.

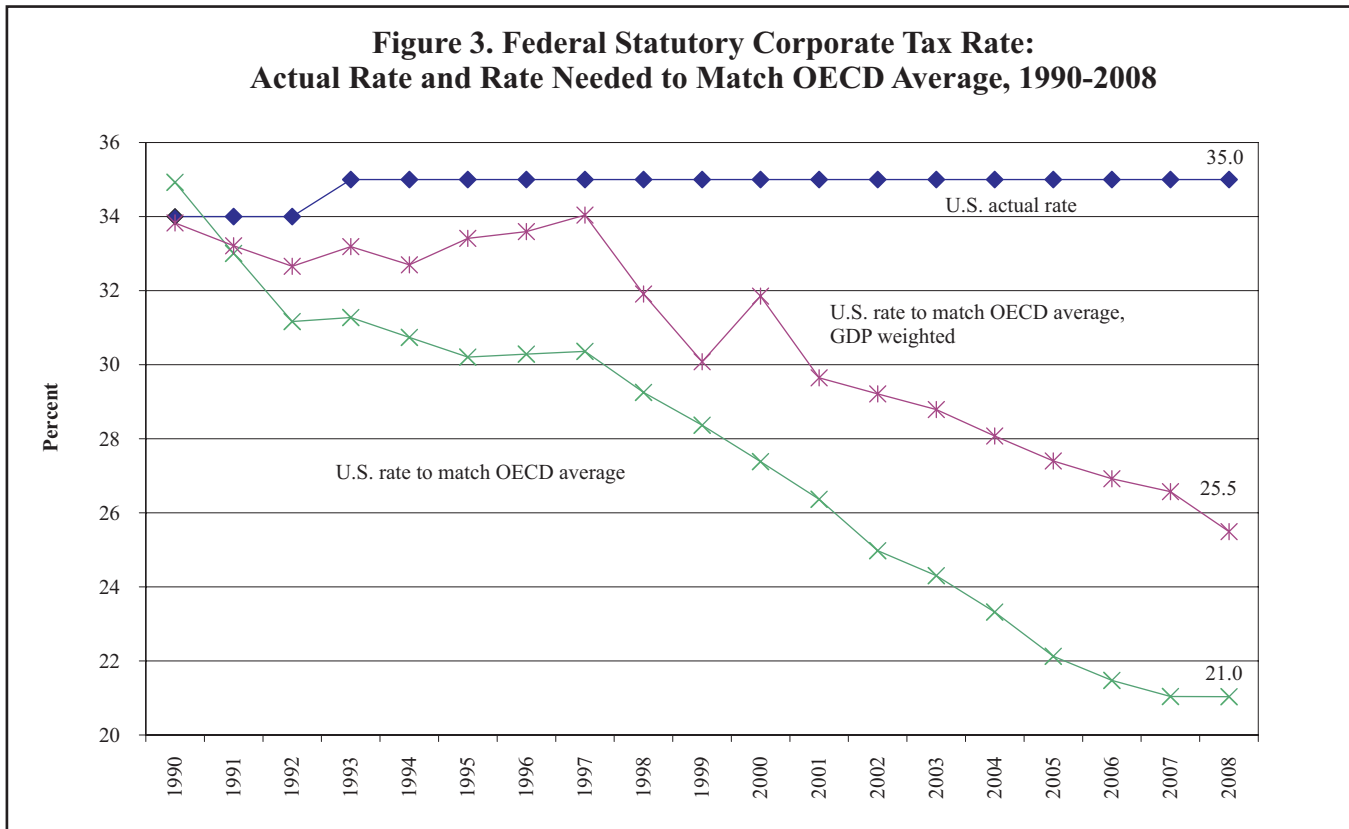
⁷See Jane G. Gravelle and Thomas L. Hungerford, “Corporate Tax Reform: Should We Really Believe the Research?” *Tax Notes*, Oct. 27, 2008, p. 419, *Doc 2008-18748*, or *2008 TNT 209-18*; and Aviva Aron-Dine, “Fiscally Responsible Corp. Tax Reform Could Benefit the Economy,” *Tax Notes*, Aug. 18, 2008, p. 691.

⁸See Charles Boynton, Portia DeFilippes, and Ellen Legel, “A First Look at 2005 Schedule M-3 Corporate Reporting,” *Tax Notes*, Nov. 3, 2008, p. 563, *Doc 2008-22309*, or *2008 TNT 214-23*. For tax year 2005, U.S. corporate tax liability was \$263 billion, foreign tax credits were \$77 billion, and pretax book income for the includable group was \$1.345 trillion.

⁹For a discussion of the World Bank method, see Simeon Djankov, Tim Ganser, Caralee McLiesh, Rita Ramalho, and Andrei Shleifer, “The Effect of Corporate Taxes on Investment and Entrepreneurship,” NBER Working Papers 13756, National Bureau of Economic Research Inc., Jan. 2008.

¹⁰The World Bank and PricewaterhouseCoopers, *Paying Taxes 2009: The Global Pictures*, Nov. 2008, available at <http://www.doingbusiness.org>.

Figure 3. Federal Statutory Corporate Tax Rate: Actual Rate and Rate Needed to Match OECD Average, 1990-2008



The Institute for Fiscal Studies has calculated marginal and average effective corporate tax rates for equity-financed investment in plant and machinery for 19 OECD countries.¹¹ For 2005, the most recent year available, the United States had the 5th highest marginal effective tax rate out of 19 countries (top 26th percentile) and 3rd highest average effective tax rate (top 16th percentile).

In a research paper prepared for the World Bank, Prof. Jack Mintz has calculated marginal effective tax rates on corporate capital for 80 countries. The study includes national and state government taxes on corporate income as well as other taxes on capital, including irrecoverable sales tax on capital purchases, property taxes, gross receipts taxes, and financial transaction taxes.¹² The overall effective tax rate is determined as a weighted average of investments in plant, equipment, land, and inventory and takes into account debt financing. For 2008, excluding temporary bonus depreciation, Mintz finds that the United States had the 8th highest effective tax rate on corporate capital (top 10th percentile).

In short, the marginal, average, and book effective tax rate comparisons published by the World Bank and the

Institute for Fiscal Studies show that the United States is in or near the top quartile of OECD countries in terms of high effective corporate tax rates. These analyses show that U.S. tax base differences are not sufficient, from an international competitiveness standpoint, to offset the very high statutory U.S. corporate tax rate.

Benchmark for Foreign-Source Income

The United States taxes corporate income on a worldwide basis, including dividends repatriated by foreign subsidiaries, and allows a limited credit for foreign taxes paid regarding those dividends. By contrast, most OECD countries (21 out of 30) have dividend exemption systems under which dividends from foreign subsidiaries are exempt and foreign taxes associated with these dividends are not creditable. As a result, U.S. companies that invest abroad may not view merely matching the OECD average corporate tax rate as sufficient in all cases to compete with multinationals based in countries with territorial tax systems.

For example, consider a Hungarian subsidiary that earns \$100 million in profits and pays \$20 million in income tax at Hungary’s combined corporate and solidarity tax rate of 20 percent. If the subsidiary is owned by a Dutch parent, it can repatriate the \$80 million in after-tax profits free of Dutch tax because the Netherlands has a territorial tax system (like most other OECD countries) and inter-EU dividends are free of withholding tax. By contrast, if the Hungarian subsidiary is owned by a U.S. parent, the repatriation of \$80 million of after-tax profits, net of \$4 million of withholding tax levied at a 5 percent rate, would trigger U.S. tax of \$11

¹¹Institute for Fiscal Studies, Corporate Tax Rate Data, available at http://www.ifs.org.uk/publications.php?publication_id=3210

¹²See Duanjie Chen and Jack Mintz, “Taxing Business Investments: A New Ranking of Effective Tax Rates on Capital,” World Bank, July, 2008. This research is summarized in Jack M. Mintz, “Cutting the Effective Corporate Tax Rate,” *Tax Notes*, Dec. 8, 2008, p. 1197, Doc 2008-23917, or 2008 TNT 237-29.

million after \$24 million in credits for Hungarian tax, resulting in a combined U.S. and Hungarian tax of \$35 million.¹³ Other things being equal, for the U.S. multinational to be competitive in Hungary vis-à-vis a Dutch multinational, it is not sufficient for the U.S. tax rate to match the Dutch tax rate (25.5 percent). Instead, the United States would need either to adopt a territorial tax system or to reduce the corporate rate to 20 percent, that is, the tax rate in the *host* country rather than in the *competitor's* country of residence.

For U.S. multinationals, a relevant competitive benchmark for the taxation of foreign-source income is the average corporate tax rate in the countries in which their foreign affiliates have operations. According to 2004 IRS data, the average foreign tax rate on income earned by large foreign subsidiaries of U.S. parents was 15.7 percent (19.1 percent if subsidiaries with losses are excluded) and the average withholding tax rate on dividends paid by foreign corporations to U.S. companies claiming a foreign tax credit was 4 percent. Thus, for foreign affiliates with profits, the average foreign income tax rate plus the

withholding tax equals 19.1 percent.¹⁴ This benchmark for U.S. taxation of foreign-source income is much lower than the average OECD corporate tax rate (26.2 percent or 30.4 percent depending on weighting), which is the competitive benchmark most relevant for taxation of domestic-source income.

Conclusion

To match the average top statutory corporate tax rate in the other 29 OECD member countries, the U.S. federal corporate tax rate (taking into account state income taxes) would need to be reduced from 35 percent to between 21 percent and 25.5 percent, where the lower benchmark is a simple average and the higher benchmark is GDP-weighted. Effective tax rate calculations, which take into account both the tax base and tax rate, also show that the U.S. corporate tax burden is quite high by international standards. The benchmark tax rate relevant for U.S. taxation of foreign-source income is much lower than the average OECD tax rate.

¹³The residual U.S. tax on Hungarian dividends might be reduced if the U.S. parent has excess foreign tax credits from other sources.

¹⁴Per \$100 of net profits, \$15.70 of foreign income tax is paid, leaving \$84.30 to be paid as dividend net of \$3.37 withholding tax at a 4 percent rate. The combined foreign income and withholding tax per \$100 of net profit is \$19.07.