CATO INSTITUTE
Tax & Budget BULLETIN

No. 62 • May 2010

U.S. Effective Corporate Tax Rate on New Investments: Highest in the OECD

by Duanjie Chen and Jack Mintz, School of Public Policy, University of Calgary

The U.S. corporate tax system has become unwieldy, inconsistent with world practice, and highly anti-competitive. The statutory corporate income tax rate is one of the highest in the world at about 40 percent, which harms the economy and encourages companies to shift investment and profits abroad to lower-tax jurisdictions.

Rather than following the international trend of reducing corporate tax rates and taking steps toward a more neutral tax base, the United States follows an antiquated approach with a high rate and narrow tax breaks that undermines economic growth and job creation.

This bulletin presents estimates of effective corporate tax rates on new capital investments in 80 nations for 2009. These effective rates take into account statutory rates plus tax base items that affect taxes paid on new investment, such as depreciation deductions, inventory allowances, and interest deductions. We also account for other taxes that impinge on investment, especially retail sales taxes on capital purchases. We find that the U.S. effective corporate rate is 35.0 percent, which is much higher than the 80-nation average of just 18.2 percent.

Falling Behind on Corporate Tax Reforms

In recent years, most major nations have reduced their statutory corporate income tax rates. Of the 30 nations in the Organization for Economic Cooperation and Development, 27 cut their general corporate income tax rates since 2000, with an average cut of more than 7 percentage points. Among the 50 other nations examined here, 28 reduced their corporate tax rates, with an average cut also of about 7 percentage points.

Along with these rate cuts, many nations have reformed their corporate tax bases to reduce the disparity of tax burdens across business activities. A recent OECD study found that these reforms have benefited both governments and economies—capital investment has grown and corporate tax revenues as a share of gross domestic product has risen in many countries as reported profits have increased.[1]

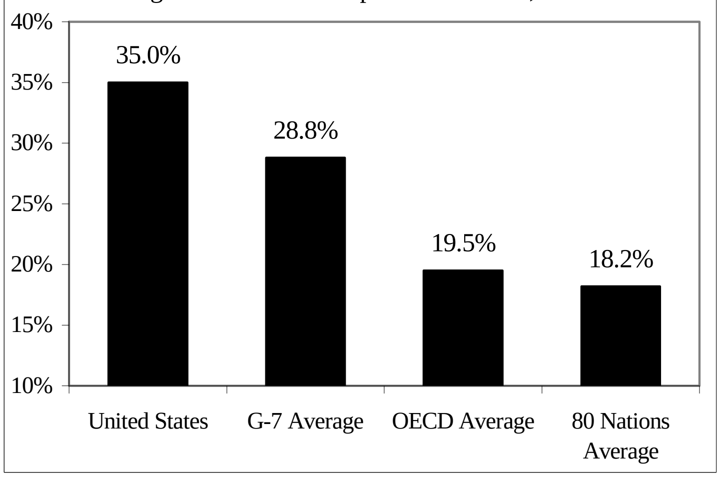
By contrast, the past decade is a lost one for U.S. business tax reform. Unlike most OECD countries that cut their corporate income tax rates or reduced other taxes on business investment, the United States enacted some targeted preferences while maintaining a very high federal corporate rate. The United States imposes additional tax burdens on investment as a result of state and local sales taxes on capital purchases and asset-based taxes on capital goods. These taxes increase the overall *effective* tax rate and create an additional disincentive for new investment.

U.S. Effective Corporate Rate Highest in the OECD

Figure 1 summarizes our calculations of corporate effective tax rates on new capital investment for 2009.[2] Table 1 on the next page shows the rates for 80 countries. These rates include both national and average subnational corporate taxes in each country.

The U.S. effective rate of 35 percent is the highest in the OECD, and is 15 percentage points higher than the

Figure 1. Effective Corporate Tax Rates, 2009



OECD average. The U.S. rate is also higher than the average rate in the G-7 nations, and is much higher than the average rate in our full sample of 80 countries.

The high U.S. effective tax rate is the result of a high federal statutory rate of 35 percent plus state-level corporate income tax rates. In addition, state and local sales and asset-based taxes on capital add to the tax burden on new investment. The latter taxes add about 7 percentage points to the U.S. effective rate, but only about 2 percentage points to the effective rate in other countries. As such, U.S. corporate tax reforms should include changes to both federal and state/local tax structures.

While other nations have cut their general statutory corporate rates in recent years, the United States has enacted narrow tax breaks. In 2005, a federal tax break was added for "domestic production activities" to aid manufacturing and some other specified industries. In 2009, this narrow break had the effect of shaving about two percentage points from the U.S. effective tax rate, which is included in our calculations.[3]

Congress has also enacted a few rounds of "bonus" depreciation for certain capital investments. We did not include the effect of this tax break in our results as this break is temporary. However, if this added capital allowance is factored into our data, it would reduce the U.S. effective rate for 2009 from 35 percent to 27 percent.

Narrow and temporary tax breaks are less effective at generating new investment per dollar of lost revenues than permanent cuts to the statutory corporate rate. One reason is that firms that produce ideas and services invest heavily in intellectual property and human capital rather than tangible assets. These firms add to the economy's productivity through innovation, but they benefit little from tax breaks such as bonus depreciation. Statutory tax rate cuts also have the advantage of discouraging businesses from shifting reported profits abroad.

Recent U.S. corporate tax breaks were small and narrow, while other countries have pursued larger and broader tax reductions. For example, while the "domestic production" tax break reduces the U.S. rate by 3.15 percentage points when fully phased-in, the average statutory corporate income tax rate in the European Union has plunged 9.6 percentage points just since 2000.[4]

Consider recent reforms in America's largest trading partner, Canada. Since 2000, the Canadian government has reduced the federal corporate tax rate from 43 percent to 31 percent. At the same time, federal and provincial governments have reduced other tax burdens on capital investment. When current reforms are fully phased in

Table 1. Effective Corporate Tax Rates, 2009

United States	35.0%		
Argentina	41.7%	Switzerland	16.8%
Chad	40.8%	Botswana	16.6%
Brazil	36.5%	Ecuador	16.4%
India	35.7%	Netherlands	16.3%
Uzbekistan	35.5%	China	16.0%
France	34.4%	Uganda	15.9%
Japan	33.5%	Mexico	15.8%
Korea	32.6%	Peru	15.2%
Spain	30.9%	Israel	15.1%
Canada	28.0%	Jamaica	15.0%
UK	27.5%	Morocco	14.9%
Italy	27.2%	Bangladesh	14.6%
Russia	26.7%	Madagasear	14.3%
Australia	25.9%	South Africia	14.2%
Austria	25.2%	Hungary	13.6%
Pakistan	25.0%	Poland	13.6%
Germany	24.4%	Czech Rep.	13.4%
Lesotho	24.2%	Chile	13.3%
Costa Rica	23.9%	Trinidad	13.3%
Norway	23.8%	Nigeria	12.8%
Bolivia	23.6%	Ghana	12.4%
Indonesia	22.3%	Ireland	12.3%
Tunisia	22.0%	Slovak Rep.	12.2%
Sierra Leone	21.1%	Vietnam	12.2%
Fiji	20.8%	Greece	12.0%
Tanzania	20.4%	Croatia	9.8%
Zambia	20.3%	Iceland	9.6%
Iran	19.9%	Egypt	9.2%
Finland	19.6%	Kenya	9.1%
Sweden	19.5%	Romania	8.9%
Malaysia	18.6%	Singapore	8.8%
Portugal	18.6%	Ethiopia	8.0%
Luxembourg	18.4%	Mauritius	7.0%
Thailand	18.4%	Turkey	4.1%
Jordan	18.4%	Bulgaria	4.1%
Denmark	18.2%	Latvia	3.8%
New Zealand	17.7%	Ukraine	3.7%
Georgia	17.6%	Serbia	-5.4%
Rwanda	17.4%	Belgium	-6.5%
Kazakhstan	17.2%	Average of 80 nations	18.2%

Note: The U.S. rate excludes bonus depreciation.

by 2012, the average statutory corporate tax rate in Canada will be 26.4 percent, while the average effective tax rate will be 19.5 percent, per our calculations.

Disadvantages of High Corporate Tax Rates

U.S. policymakers seem to think that America can get by with imposing a heavy tax burden on corporations because the country has many non-tax advantages, such as a large consumer market and an excellent university system. However, many studies have shown that high corporate taxes substantially reduce incentives to invest in a country, even though taxes are just one of several factors that influence investment decisions.[5]

Under pressure from globalization, both developed and developing nations are moving away from narrow tax incentives to tax systems with lower statutory rates and more neutral tax bases. This positive trend provides lessons for the United States. China, for example, enacted dramatic tax reforms recently. The government had imposed a nonrefundable value-added tax on machinery investments, but that was eliminated this past year. China once had one of the highest effective tax rates on new investment, but it is now below the world average making it even more attractive for investment.

By contrast, the lack of reform in the United States is likely reducing both tax compliance and inward foreign investment. During the 1980s, the United States enjoyed larger direct investment inflows than outflows, but during the 1990s and 2000s, the situation reversed and outflows became larger than inflows.[6] Both tax and non-tax factors probably caused this reversal, but it does not help that the United States is near the top of the 80 nations in Table 1. The nations with the highest effective tax rates, such as Argentina, Brazil, Chad, India, and Uzbekistan, generally have high statutory rates and taxes on capital or gross revenue that add to the burden on investment.

The excessively high U.S. corporate tax rate reduces economic growth by discouraging both domestic capital formation and inward foreign direct investment. Less investment means slower wage growth and reduced living standards over the long run.

A further problem is that the high U.S. corporate tax rate is applied to worldwide profits, which places the overseas operations of U.S. multinational corporations at a tax disadvantage compared to businesses based in countries that have both a lower corporate tax rate and a tax exemption for repatriated foreign profits.[7]

Finally, the high U.S. corporate tax rate reduces government revenues because it increases tax avoidance. Empirical studies have found that the revenue-maximizing corporate income tax rate is about 25 percent today and has declined over time.[8] The U.S statutory and effective corporate rates are much higher than the revenue-maximizing rate, thus both the government and the economy would gain from a major rate cut.

Conclusions

The U.S. corporate tax system needs major reforms. The combined federal-state corporate income tax rate should be cut to 25 percent or less to increase capital investment and attract more reported profits to the United States. The government would lose little if any revenue from such a cut over the long run.

In addition, the tax base should be reformed to reduce the disparity of tax burdens across industries. Reducing the corporate tax rate helps in this regard, but special incentives, such as the “domestic production” tax break, are distortionary and should be repealed.

State and local governments can also make reforms. They should reduce their corporate tax rates and reform their sales and other capital-related taxes to ensure that these levies do not impose a burden on capital investment. U.S. policymakers have much work to do because investment and profits are increasingly mobile and other nations are moving ahead with further tax reforms.

---

[1] Asa Johansson et al., “Tax and Economic Growth,” Economics Department Working Paper no. 620, Organization for Economic Cooperation and Development, July 11, 2008.

[2] The effective tax rate on capital is measured as the annualized value of capital-related taxes paid as a share of the gross-of-tax return on capital for a “marginal” project that earns sufficient after-tax income to attract investor financing from international markets. See Duanjie Chen and Jack Mintz, “Taxing Business Investments: A New Ranking of Effective Tax Rates on Capital,” World Bank, July 2008.

[3] When fully phased-in in 2010, the tax break provides a reduction of 3.15 percentage points in the effective tax rate.

[4] KPMG, “Corporate and Indirect Tax Rate Survey,” 2009.

[5] For a summary of the literature, see Ruud de Mooij and Sjef Ederveen, “Taxation and Foreign Direct Investment: A Synthesis of Empirical Research,” *International Tax and Public Finance* 10, no. 6 (November 2003): 673–93.

[6] Chris Edwards and Daniel J. Mitchell, *Global Tax Revolution* (Washington: Cato Institute, 2008), Figure 2.4.

[7] Robert Carroll, “The Importance of Tax Deferral and A Lower Corporate Tax Rate,” Tax Foundation, February 19, 2010.

[8] See Alex Brill, “Corporate Tax Rates: Receipts and Distortions,” *Tax Notes*, December 22, 2008. And see Jack Mintz, “2007 Tax Competitiveness Report,” C. D. Howe Institute, September 2007.