CATO INSTITUTE

Tax & Budget

BULLETIN

No. 3 • April 2002

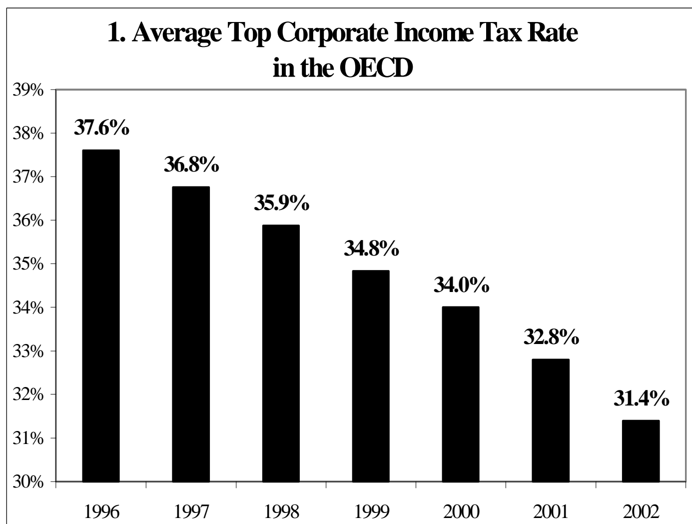
New Data Show U.S. Has Fourth Highest Corporate Tax Rate

by Chris Edwards, Director of Fiscal Policy, Cato Institute

Congress finally passed a stimulus package after stripping out most elements that would stimulate long-term economic growth. However, the plan includes an accelerated depreciation provision that will be beneficial if it is later made permanent. A new corporate tax survey by KPMG makes clear that this is only the first of many needed business tax reforms in the United States.

KPMG found that the United States has the fourth highest corporate income tax rate in the 30-nation Organization for Economic Co-operation and Development.[1] The combined U.S. federal and average state rate of 40 percent is almost 9 percentage points higher than the average OECD top corporate rate of 31.4 percent.[2] Only Belgium, Italy, and Japan have higher rates than that of the United States.

This is a dramatic reversal of the U.S. tax situation. After cutting the federal corporate rate from 46 percent to 34 percent in 1986, policymakers fell asleep at the switch, perhaps assuming that the U.S. had claimed a low-tax advantage permanently. But most industrial countries followed the U.S. lead and cut tax rates in the late 1980s. Another round of tax rate cuts began in the late 1990s, with the average OECD corporate rate falling from 37.6 percent in 1996 to just 31.4 percent by 2002 (see Figure 1). The average corporate rate in the European Union is now 32.5 percent, down from 38.2 percent in 1996.



Source: Cato calculations based on KPMG data. Unweighted averages.

We sometimes dismiss European countries as uncompetitive welfare states and ignore the fact that many have improved their business climates. In fact, a recent study by the Economist Intelligence Unit placed the United States second, behind the Netherlands, for the "best place in the world to conduct business."[3] And a study by GrowthPlus, a European think tank, compared 10 major countries to determine which had the best environment for entrepreneurial growth companies.[4] Again, the United States finished second, this time behind Britain.

In the last few years, the corporate tax rate was cut in Denmark, France, Ireland, Germany, Poland, and Portugal, as well as many countries outside of Europe (see Figure 2). Even socialistic Sweden has a top corporate tax rate of just 28 percent. It is certainly true that overall European taxes, when measured as a share of gross domestic product, are much higher than U.S. taxes. However, Europe has shifted about one-third of its overall tax burden to less distortionary consumption taxes.[5]

What the Europeans and others are realizing is that countries shoot themselves in the foot by imposing high tax rates on mobile capital income. Data from the International Monetary Fund data show that annual global portfolio investment rose six-fold during the past decade.[6] United Nations data show that global direct investment also rose six-fold during this period.[7] The United States attracts a big share of these flows because of its large economy, stable currency, and strong growth. But investment flows are increasingly sensitive to taxes, so it makes less and less sense to have a high corporate rate.

After all, last year's recession, the Enron collapse, and the high-tech bust show that the U.S. business sector is not as invincible as it seemed in the late 1990s.

A high statutory rate is not the only aspect of U.S. business taxation that needs reform. Aside from making the new depreciation rules permanent, the U.S. should switch to a "territorial" tax system from the current complex and uncompetitive system that taxes U.S. firms on their worldwide income. Glenn Hubbard, chairman of the Council of Economic Advisers, has noted that "from an income tax perspective, the United States has become one of the least attractive industrial countries in which to locate

2. Top Corporate Income Tax Rates in the OECD

Country	1996	1997	1998	1999	2000	2001	2002
Australia	36.0	36.0	36.0	36.0	36.0	34.0	30.0
Austria	34.0	34.0	34.0	34.0	34.0	34.0	34.0
Belgium	40.2	40.2	40.2	40.2	40.2	40.2	40.2
Canada	44.6	44.6	44.6	44.6	44.6	42.1	38.6
Czech Rep.	39.0	39.0	35.0	35.0	31.0	31.0	31.0
Denmark	34.0	34.0	34.0	32.0	32.0	30.0	30.0
Finland	28.0	28.0	28.0	28.0	29.0	29.0	29.0
France	36.7	36.7	41.7	40.0	36.7	35.3	34.3
Germany	57.4	57.4	56.7	52.3	51.6	38.4	38.4
Greece	40.0	40.0	40.0	40.0	40.0	37.5	35.0
Hungary	33.3	18.0	18.0	18.0	18.0	18.0	18.0
Iceland	33.0	33.0	30.0	30.0	30.0	30.0	18.0
Ireland	38.0	36.0	32.0	28.0	24.0	20.0	16.0
Italy	53.2	53.2	41.3	41.3	41.3	40.3	40.3
Japan	51.6	51.6	51.6	48.0	42.0	42.0	42.0
Korea	33.0	30.8	30.8	30.8	30.8	30.8	29.7
Luxembourg	40.3	39.3	37.5	37.5	37.5	37.5	30.4
Mexico	34.0	34.0	34.0	35.0	35.0	35.0	35.0
Netherlands	35.0	35.0	35.0	35.0	35.0	35.0	34.5
New Zealand	33.0	33.0	33.0	33.0	33.0	33.0	33.0
Norway	28.0	28.0	28.0	28.0	28.0	28.0	28.0
Poland	40.0	38.0	36.0	34.0	30.0	28.0	28.0
Portugal	39.6	39.6	37.4	37.4	35.2	35.2	33.0
Slovak Rep.	n/a	n/a	n/a	n/a	n/a	29.0	25.0
Spain	35.0	35.0	35.0	35.0	35.0	35.0	35.0
Sweden	28.0	28.0	28.0	28.0	28.0	28.0	28.0
Switzerland	28.5	28.5	27.8	25.1	25.1	24.7	24.5
Turkey	44.0	44.0	44.0	33.0	33.0	33.0	33.0
U.K.	33.0	31.0	31.0	31.0	30.0	30.0	30.0
U.S.	40.0	40.0	40.0	40.0	40.0	40.0	40.0
Average	37.6	36.8	35.9	34.8	34.0	32.8	31.4

Source: KPMG. Includes national and subnational taxes.

the headquarters of a multinational corporation."[8] As a consequence, there has been a "marked increase" in the number of U.S. firms reincorporating abroad, according to the U.S. Treasury Department.[9] Shouldn't the United States be trying to attract businesses, rather than drive them away?

The critics will say that big corporations and their shareholders should pay their "fair share" of taxes, and that the government needs to crack down on tax-avoiders such as Enron. Such views ignore big picture realities. First, the huge rise in global capital flows means that the corporate tax burden probably falls more on immobile workers and less on the mobile capital income that it is ostensibly intended for. Second, the high corporate tax rate is the reason why Enron and other firms go to such wasteful lengths to avoid taxes. If the United States were to cut its corporate rate to, say, 20 percent, not only would real capital investment increase, but firms would financially restructure in order to shift more of their global tax base into this country.

As the world economy changes, so must U.S. tax policy. Pressures to attract mobile capital through international "tax competition" will continue to increase. These trends dictate that the U.S. reform its tax system by moving away from a high-rate income tax to a low-rate consumption-based tax.

---

[1] KPMG, "Corporate Tax Rate Survey," January 2002, www.us.kpmg.com/microsite/Global_Tax/TaxFacts. Data include both national and average subnational (state or provincial) income taxes.
[2] The U.S. federal corporate income tax rate is 35 percent. KPMG found that the average state corporate tax would add 5 percentage points to the total corporate rate.
[3] Economist Intelligence Unit, "EIU Ranks Netherlands Best Place to Do Business," press release, August 14, 2001, http://www.eiu.com/.
[4] GrowthPlus and Andersen, "Not Just Peanuts," 2001, http://www.notjustpeanuts.com/.
[5] Organization for Economic Co-operation and Development, *OECD in Figures* (OECD: Paris, May 2001), p. 38.
[6] International Monetary Fund, *Balance of Payments Statistics Yearbook* (Washington: IMF, 2000).
[7] United Nations, *World Investment Report* (Washington: UNCTAD, 2001).
[8] Glenn Hubbard, "Comments on Sen. McCain's Tax Policy Toward U.S. Multinationals," *Tax Notes*, March 6, 2000, p. 1433.
[9] *Daily Report for Executives*, "Treasury Study to Look at Reincorporation of U.S. Multinationals in Foreign Countries," March 1, 2002, p. G-3.