Why Reform Our Corporate Tax Code?

Sep 14, 2012

Corporate taxation is likely to be a major issue for the 113th Congress. Many Republicans and Democrats are concerned with our relatively high corporate tax rates and have already advanced proposals for reforming our corporate tax system. Why are policy makers concerned about our current system for taxing corporate income?

KEY POINTS

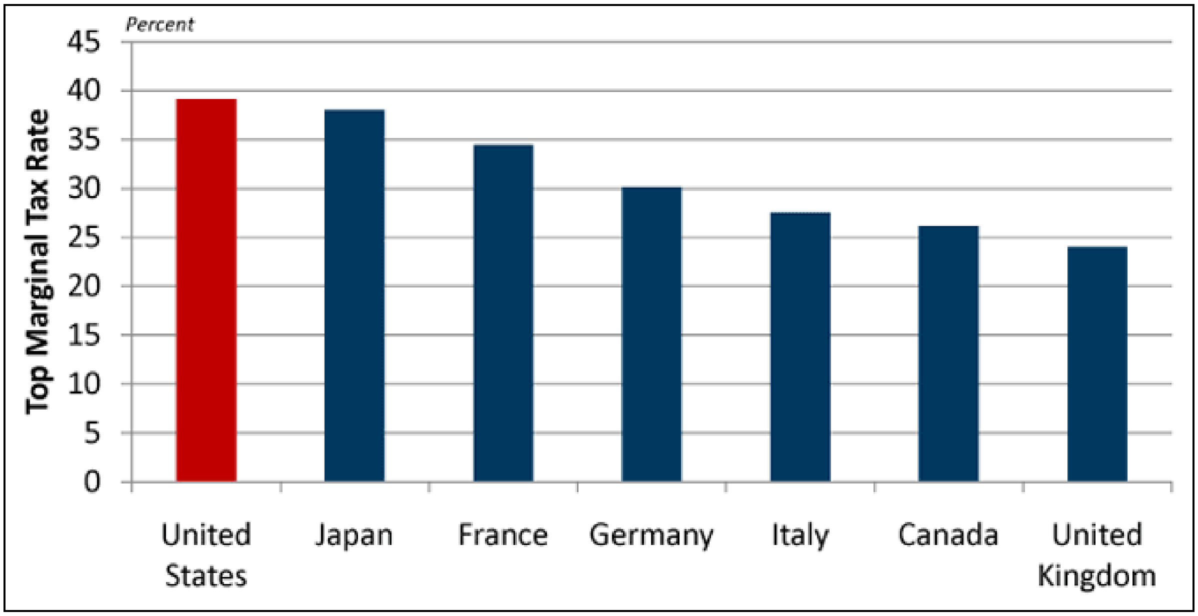
- The U.S. has the highest corporate income tax among advanced economies, making it less desirable for companies to do business, invest and create jobs in the U.S.
- Despite our high tax rates, U.S. corporate tax revenues are slightly below average compared to other advanced economies.
- Our corporate revenues aren't high because our corporate tax code is littered with tax expenditures — special deductions, exemptions and credits — that lower tax payments for corporations engaged in favored activities.
- The U.S. lost $181 billion to special corporate tax provisions last year, which was the same as the amount of revenue the federal government actually collected from corporations.
- Many of those corporate tax expenditures provide implicit subsidies that distort economic activity and reduce the efficiency of our economy.

STATUTUORY CORPORATE TAX RATES

Among the most economically advanced countries in the world, the United States has the highest total statutory corporate tax rate, which currently stands at 39.1 percent. That tax rate includes the federal tax on corporate income — 35 percent in the United States — as well as taxes imposed at the state and local levels. By contrast, corporate tax rates were only 26.1 percent in Canada, 24 percent in the United Kingdom, and 25.4 percent on average among the 34 advanced countries in the Organisation for Economic Co-operation and Development (OECD).

Many economists and business leaders have raised concerns about these high tax rates because they make the U.S. a less attractive place to conduct business and thus affect multinational corporations' decisions about locating facilitates and jobs here.

Comparison of statutory corporate tax rates across the G7

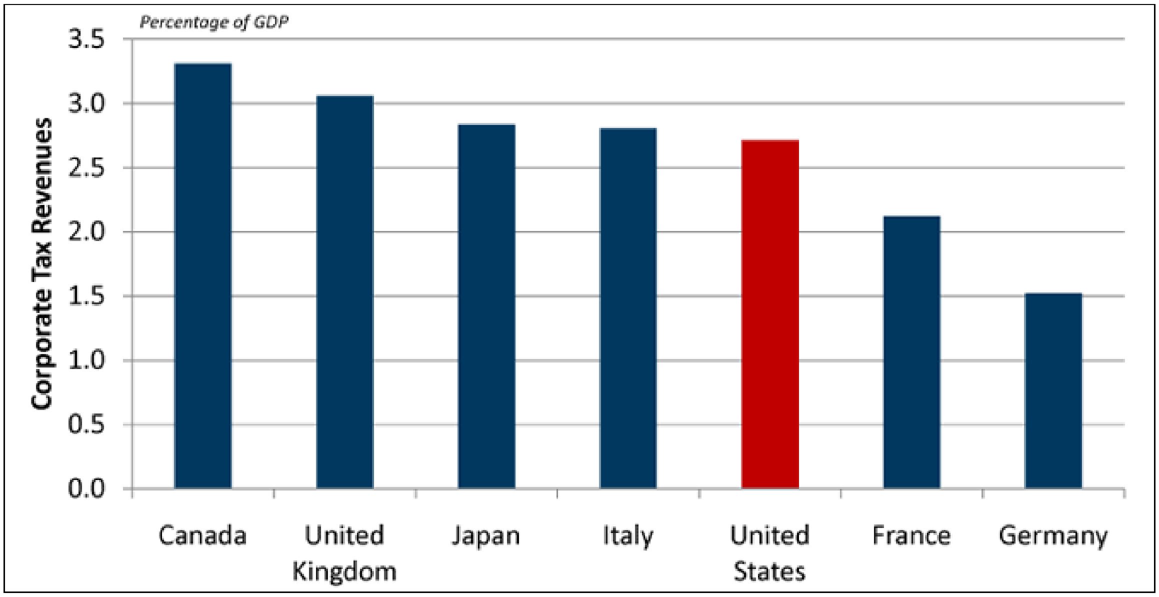


SOURCE: Data from OECD Tax Database, 2012; Japan's Ministry of Economy, Trade and Industry, Points of FY 2012 METI Related Tax Reform. Compiled by PGPF.
NOTE: Data are from 2012 and reflect the basic combined national and subnational statutory corporate income tax rate. Japan cut its statutory corporate tax rate on April 1, 2012 to 38.01 percent, which includes a temporary 10 percent surtax that will expire after 2014. At that point, corporate income tax rates in Japan are scheduled to fall to 35.6 percent.

CORPORATE TAX REVENUE

Despite our high statutory rates, the United States collects less revenues from corporations than many other advanced countries do. In 2010, the latest year for which data is available for international comparison, the United States corporate tax revenues accounted for only about 2.7 percent of gross domestic product (GDP). By contrast, corporate tax revenues in Canada were 3.3 percent of GDP, even though their corporate tax rate is significantly lower than the U.S. rate. Among the countries in the OECD, corporate revenues were 2.9 percent of GDP on average.

Comparison of corporate income tax revenue across G7 countries



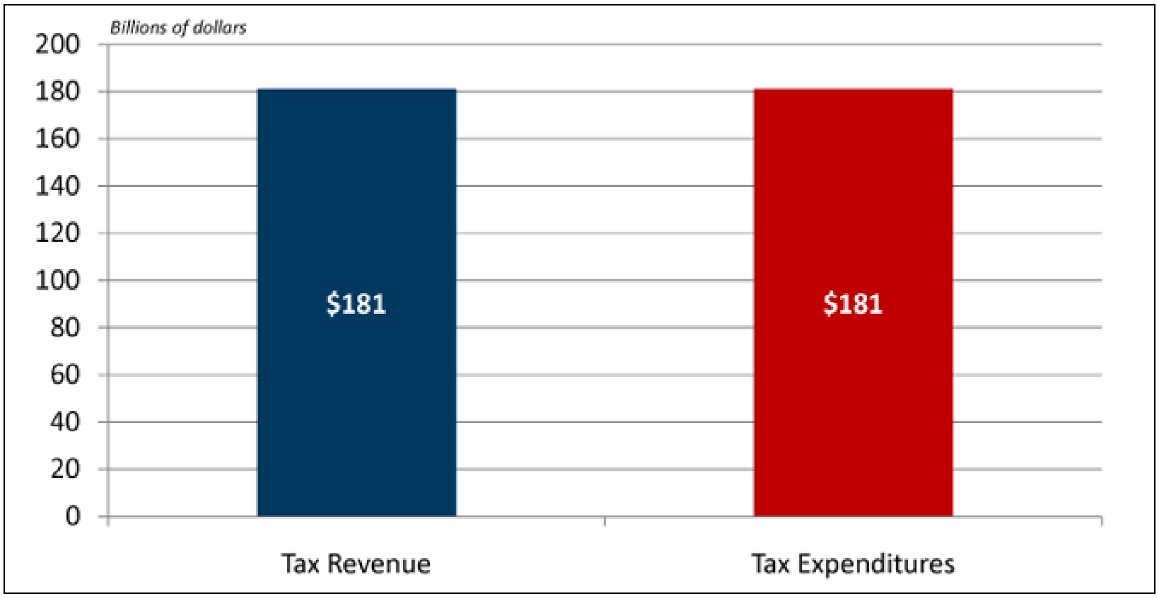
SOURCE: OECD, *Revenue Statistics: Comparative tables*, 2011. Compiled by PGPF.
NOTE: Data are from 2010 and include revenue from national and subnational level corporate income taxes.

CORPORATE TAX EXPENDITURES

Why aren't U.S. corporate tax revenues higher when we have the highest tax rate? The reason is tax expenditures. Although nearly all corporations are nominally subject to the statutory tax rate, the rate that companies actually pay is significantly lower because of numerous exclusions, deductions, exemptions, and credits available to corporations to reduce their taxable income. These tax preferences contribute to an*effective* tax rate, the portion of income a corporation will actually pay in taxes, that is for many companies much lower than the rate written into the tax code.

Corporate tax expenditures are big — their cost adds up to a substantial sum relative to the revenue collected from the corporate tax system. In fact, corporate tax expenditures at the federal level were $181 billion in 2011 — the same amount that the federal government collected in corporate income tax revenues.

Corporate tax revenue vs. corporate tax expenditures, United States, 2011



SOURCE: Congressional Budget Office, *An Update to the Budget and Economic Outlook: Fiscal Years 2012 to 2022*, August 2012; Tax Policy Center, *How Large are Tax Expenditures? A 2012 Update*, April 2012.
NOTE: Data do not include corporate tax revenue and expenditures at the state or local level.

These tax preferences are referred to as "tax expenditures" because many of them provide financial assistance and are functionally the same as spending programs, except that they are carried out through the tax code. However, tax expenditures are politically protected in an important way — most are not subject to the annual congressional review that spending programs funded through annual appropriations are. Once enacted, tax expenditures can be very difficult to remove from the tax code.

Some of the largest corporate tax expenditures include: the depreciation of machinery and equipment, the deferral of income from U.S.-controlled foreign corporations, deductions for U.S. production activities, exclusions for state and local bonds, and credits for increasing research activities.

DOMESTIC DISTORTIONS

Corporate tax expenditures can distort businesses' economic decision-making because they create disparities in the tax treatment of different types of business investments. For example, the tax code includes generous tax breaks for certain types of depreciation, but the value of these breaks varies widely depending on which type of investment is being depreciated[i]. The tax code also includes a host of industry-specific tax preferences that create further disparities in the taxes paid by different companies. And last, by making interest payments on borrowings deductible, the corporate tax system also encourages businesses to use debt, rather than equity, to finance investments.

The wide variation in effective tax rates for various types of corporate activity creates a system of implicit subsidies that skew the allocation of resources in our economy and reduce its efficiency. They also cause companies to pay too much attention to taxes when making investment decisions—and create incentives for business to spend more resources lobbying Congress to maintain and expand their existing tax preferences.

CONCLUSION

In the minds of many experts, our corporate tax system is ill-equipped to address the economic and budgetary challenges our country is facing today. First, high statutory rates encourage corporations to look overseas at a time when we badly need investment at home. Second, billions of dollars of revenue are lost every year on corporate tax expenditures in the face of unsustainable projected budget deficits and debt. Finally, these expenditures create subsidies that distort the allocation of resources in the economy and reduce its productivity.

[i] Depreciation rules affect how fast a company can write off the cost of an investment over time for tax purposes.