US Corporate Tax Rates Must Come Down

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Abstract

In a contribution to the Christian Science Monitor, Donald Marron discusses the U.S.'s controversial coporate income tax rates.

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April 1 is often a day for pranks. In the tax world, however, it will mark something more serious. Barring another Fukushima Daiichi-like catastrophe (which delayed its plans last year), Japan will cut its corporate tax rate by five percentage points. That move will leave the United States with the highest corporate tax rate in the developed world: 39.2 percent when you add state and local taxes to the 35 percent federal rate.

The corporate income tax is a particularly problematic way to collect tax revenues. Corporate taxes are often more harmful for economic growth than ones on personal income or consumption, as noted in a recent study by the Organization for Economic Cooperation and Development. Moreover, a high corporate rate is an invitation for US multina-tionals to play games with their accounting, locating profits overseas while reporting as many tax-deductible expenses as possible here at home.

That's why there's a growing bipartisan consensus that the federal rate needs to come down. President Obama recently proposed lowering it to 28 percent. His likely Republican challenger, Mitt Romney, wants to bring it down to 25 percent.

But corporate tax reform can't just be about lowering the statutory rate. America faces enormous budget challenges and cannot afford to simply cut future revenue. Moreover, the high statutory rate isn't the only problem with our system. The code is riddled with tax subsidies and loopholes. Those tax breaks, more generous than those in many nations, reduce corporate tax burdens significantly.

That leaves us with the worst possible system. It maximizes the degree to which corporate man-agers must worry about taxes when making business decisions but limits the revenue that the government actually collects.

One side effect is that the system plays favorites among different businesses. Retailers and construction companies, for example, pay an average tax rate of 31 percent, according to recent Treasury Department calculations, while utilities pay only 14 percent and mining companies (which include fossil fuel producers) pay only 18 percent.

I know of no reason why the tax system should favor utilities and mining while hitting construction and retailers so hard. Far better would be a system in which investors deployed their capital based on economic fundamentals, not the distortions of the tax system.

Another problem is that the system perversely favors debt financing over equity. Interest payments are tax-deductible, while dividends are not. Corporations thus have a strong incentive to finance their investments by borrowing. Given what our economy's been through, it is hard to believe that the tax system ought to subsidize more debt.

The solution to all this is to reduce the corporate tax rate while taking a hatchet to many corporate tax breaks. Done right, that would level the playing field across different businesses and between equity and debt and maintain revenues.

Mr. Obama and Mr. Romney have proposed reforms along these lines, albeit with much more clarity about the rate-cutting than the base-broadening. That isn't surprising. Leveling the playing field (while maintaining revenues) will require that some companies pay more so others can pay less. Politicians would rather focus on potential winners, not losers. But losers there will be.

The US Chamber of Commerce has said that it "will be forced to vigorously oppose pay-fors [tax increases] that pit one industry against another." But such pitting is exactly what will be necessary to enact comprehensive corporate tax reform.

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