John Hood's Daily Journal

Cut The Corporate Tax Rate

By John Hood

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RALEIGH – Gov. Bev Perdue does some good and important things in her 2011-13 budget proposal, such as downsizing the state’s workforce, cleaning up the state’s organizational chart, and eliminating hundreds of millions of dollars worth of wasteful, duplicative, or low-priority programs.

Perhaps the most important is her proposed reduction in North Carolina’s tax rate on corporate income. Given increased competition for investment, labor, and customers, we can’t afford to continue to price North Carolina out of the market.

Remember, the competition isn’t just among North Carolina and other American states. Increasingly, North Carolina firms are competing with those of Europe, Asia, and Latin America. When they do business in North Carolina, the marginal tax rate is higher than in most of these other areas.

Last month, the Cato Institute updated their analysis (it’s the first pdf on the list) of effective corporate-tax rates across 83 different countries. The authors took the statutory national and subnational (e.g. state) tax rates in each country and then adjusted for differences in the tax base, such as depreciation allowances, interest deductions, and special exemptions.

They found that the effective corporate tax rate on new investment in the United States averaged 34.6 percent in 2010. That’s the highest corporate-tax rate in the developed world – defined as members of the Organization for Economic Cooperation and Development (OECD) – and the fifth-highest rate overall.

The average corporate-tax rate in OECD countries was 18.6 percent. For the entire sample of 83 countries, it was 17.7 percent. Countries with lower rates of corporate taxation than the U.S. included Japan (29.5 percent), Korea (29.5 percent), Britain (27.9 percent), Germany (23.8 percent), Canada (20.5 percent), and Mexico (17.5 percent).

To say that a country ranks lower than the U.S. in effective tax rates on corporate income is not necessarily to say that the country ranks lower than the U.S. in overall tax burden. Many of these countries do not.

Corporate income taxes are not the only taxes that impose significant costs on households and businesses or affect economic competitiveness. But they are among the most damaging taxes, in that they constitute extra layers of taxation on certain business forms – income from taxable corporations is taxed again when received by shareholders – and thus encourage debt over equity as a means of financing those businesses.

In other words, America’s relatively high tax rate on corporate income is one reason why American corporations are more highly leveraged than are many of their competitors. As we have recently been reminded, excessive debt poses severe risks to the economy.

Furthermore, as JLF’s Roy Cordato recently observed, taxing income at the corporate level rather than the individual level creates problems of transparency and accountability. Taxpayers are unlikely to get the best possible government services at the lowest possible cost if we don’t know much tax we actually pay. At least with personal income and property taxes, we get a bill. With corporate (and sales) taxes, no one sends us an annual tally of how much government costs us, giving us little basis for comparing the costs and benefits.

While most of America’s corporate tax burden is federal, the state component is also important. That’s why Gov. Perdue’s proposal to cut North Carolina’s rate to 4.9 percent from the current 6.9 percent rate is welcome. In the JLF alternative budget, we proposed a larger cut, down to 4 percent. Eventually, North Carolina should move to a simpler, fairer, and more efficient tax code that levies a single marginal rate on all consumed income.

At the federal level, Congress and the administration should at least adopt the corporate-tax reform proposal from the Bowles-Simpson commission to broaden the base and lower the rate, which would yield an effective tax rate of 28.7 percent, down from 34.6 percent. Better still would be comprehensive reform that eliminates the double-taxation of corporate income entirely.

First things first, however. Let’s cut North Carolina’s corporate tax. Need an incentive? Sweden, of all places, has a combined corporate tax rate that is nearly 50 percent lower than ours.