U.S. States Lead the World in High Corporate Taxes

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America's political leadership is finally waking up to the fact that the tax rates businesses face in the U.S. are way out of step with our major economic competitors. Last year, for example, Ways and Means Chairman Charles Rangel proposed cutting the federal corporate tax rate from 35 percent to 30.5 percent. While a 5 percentage point cut in the federal corporate tax rate may sound significant, it may not be sufficient to meaningfully improve the competitiveness of the United States.

Currently, the average combined federal and state corporate tax rate in the U.S. is 39.3 percent, second among OECD countries to Japan's combined rate of 39.5 percent.[1] Lowering the federal rate to 30.5 percent would only lower the U.S.'s ranking to fifth highest among industrialized countries.

More recently, other members of Congress—including Sen. John McCain and Congressman Eric Cantor—have released proposals to cut the corporate rate even deeper to 25 percent. While this lower rate would improve the U.S.'s international ranking and competitiveness, that improvement would be mitigated by the high corporate tax rates imposed by many states.

Many states impose state corporate income taxes at rates above the national average of 6.6 percent. Iowa, for example, imposes the highest corporate tax rate of 12 percent, followed by Pennsylvania's 9.99 percent rate and Minnesota's 9.8 percent rate. When added to the federal rate, these states tax their businesses at rates far in excess of all other OECD countries.

When compared to other OECD countries:

- 24 U.S. states have a combined corporate tax rate higher than top-ranked Japan.
- 32 states have a combined corporate tax rate higher than third-ranked Germany.
- 46 states have a combined corporate tax rate higher than fourth-ranked Canada.
- All 50 states have a combined corporate tax rate higher than fifth-ranked France.

Thus, if lawmakers are serious about making the U.S. corporate tax system more competitive internationally, corporate tax rates will have to be reduced both in Washington and in state capitals. State officials should be champions of substantial cuts in the federal corporate tax rate because there is only so much they can do to improve their own competitiveness. After all, even corporations that operate in the three states that do not impose a major state-level corporate tax—Nevada, South Dakota, and Wyoming—still shoulder a higher corporate tax rate than fifth-ranked France and 24 other OECD countries because of the 35 percent federal corporate rate.

The U.S. is among eight countries with extra corporate tax rates imposed by state or local levels of government. While the burden of these state-level taxes is somewhat lessened because they can be deducted from federal taxes, they do add a second layer of tax and also add considerable complexity for multi-state and multi-national businesses.

Some 44 states impose a traditional corporate income tax, with rates ranging from a low of 4.63 percent in Colorado to 12 percent in Iowa. Three states—Michigan, Texas, and Washington—impose a variant of a gross receipts tax in which businesses pay tax on their gross sales rather than their net profits.[2] Ohio is currently transitioning from a traditional CIT to a gross receipts-style tax but now it has both. And, as mentioned above, three states do not have a state-level corporate tax.

Table 1 shows that when the state rates are combined with the federal rate (and accounting for federal deductibility), states are effectively imposing a corporate tax rate which ranges from 35 percent to 41.6 percent. Indeed, 16 U.S. states impose a combined corporate tax rate of more than 40 percent, which is at least 12 percentage points higher than the OECD average of 27.6 percent.

Assuming that no state cuts its business taxes in the next year, the U.S. federal rate would have to be cut to 20 percent in order to bring the combined federal-state rate down to the middle of the OECD pack. But Washington does not bear the entire blame for America's eroding tax competitiveness, nor does it shoulder the entire responsibility for fixing it. State officials also have to be cognizant of the fact that they are not only competing against each other for investment and jobs, but against the rest of the world. The emerging low-tax countries in Europe and Asia benefit from the U.S. remaining a high-tax country.

In just the past two months, at least six countries have announced plans to cut their corporate tax rates: Canada, Hong Kong, Korea, South Africa, Spain and Taiwan. In an interview in the *Korea Times*, Choi Kyung-hwan, a member of the new Administration's Presidential Transition Committee, said, "The corporate income tax reduction is not a matter of choice, but a matter of life and death for Korea in an increasingly globalized business environment."

In a refrain that is equally applicable to the U.S., Choi went on to say, "Hong Kong and Singapore, which impose significantly lower corporate taxes than Korea, have further slashed taxes recently to draw more foreign investors. Also, France currently levies a 34.4 percent corporate income tax but plans to reduce the tax to as low as 20 percent. Unless Korea cuts corporate taxes, we will not be able to win over multinational firms."[3]

A growing body of academic research indicates that foreign direct investment (FDI) can be quite sensitive to the corporate tax rates imposed by a state or country. One recent study of the effects of corporate income taxes on the location of foreign direct investment (FDI) in the United States found a strong relationship between state corporate tax rates and FDI—for every 1 percent increase in a state's corporate tax rate FDI can be expected to fall by 1 percent.[4]

A new study of income tax rates in 85 countries by economists at the World Bank and Harvard University found a strong effect of both statutory and effective corporate tax rates on FDI as well as entrepreneurship. For example, the average rate of FDI as a share of GDP is 3.36 percent. But a 10 percentage point increase in the statutory corporate rate can be expected to reduce FDI by nearly 2 percentage points.[5]

In the end, the key to improving America's business tax competitiveness is a partnership between federal and state lawmakers to work toward the common goal of lowering the overall business tax burden in the U.S. Otherwise, the U.S. will continue to fall behind in the global tax race simply by standing still.

Table 1
Comparing U.S. State Corporate Taxes to the OECD

OECD Overall Rank	Country/State	Federal Rate Adjusted	Top State Corporate Tax Rate	Combined Federal and State Rate (Adjusted) (a)
	Iowa	35	12	41.6
	Pennsylvania	35	9.99	41.5
	Minnesota	35	9.8	41.4
	Massachusetts	35	9.5	41.2
	Alaska	35	9.4	41.1
	New Jersey	35	9.36	41.1
	Rhode Island	35	9	40.9
	West Virginia	35	9	40.9
	Maine	35	8.93	40.8
	Vermont	35	8.9	40.8
	California	35	8.84	40.7
	Delaware	35	8.7	40.7
	Indiana	35	8.5	40.5
	New Hampshire	35	8.5	40.5
	Wisconsin	35	7.9	40.1
	Nebraska	35	7.81	40.1
	Idaho	35	7.6	39.9
	New Mexico	35	7.6	39.9
	Connecticut	35	7.5	39.9
	New York	35	7.5	39.9
	Kansas	35	7.35	39.8
	Illinois	35	7.3	39.7
	Maryland	35	7	39.6
	North Dakota	35	7	39.6
1	**Japan**	**30**	**11.56**	**39.54**

	Arizona	35	6.968	39.5
	North Carolina	35	6.9	39.5
	Montana	35	6.75	39.4
	Oregon	35	6.6	39.3
2	**United States**	**35**	**6.57**	**39.27**
	Arkansas	35	6.5	39.2
	Tennessee	35	6.5	39.2
	*Washington	35	6.4	39.2
	Hawaii	35	6.4	39.2
3	**Germany**	**26.38**	**17.0**	**38.9**
	*Michigan	35	6	38.9
	Georgia	35	6	38.9
	Kentucky	35	6	38.9
	Oklahoma	35	6	38.9
	Virginia	35	6	38.9
	Florida	35	5.5	38.6
	Louisiana	35	8	38.5
	Missouri	35	6.25	38.4
	Ohio	35	5.1	38.3
	Mississippi	35	5	38.3
	South Carolina	35	5	38.3
	Utah	35	5	38.3
	Colorado	35	4.63	38.0
	Alabama	35	6.5	37.8
4	**Canada**	**22.1**	**14**	**36.1**
	*Texas	35	1.6	36.0
	Nevada	35	0	35.0
	South Dakota	35	0	35.0
	Wyoming	35	0	35.0
5	**France**	**34.43**	**0**	**34.4**
6	**Belgium**	**33.99**	**0**	**33.99**
7	**Italy**	**33**	**0**	**33**
8	**New Zealand**	**33**	**0**	**33**
9	**Spain**	**32.5**	**0**	**32.5**
10	**Luxembourg**	**22.88**	**7.5**	**30.38**
11	**Australia**	**30**	**0**	**30**
12	**United Kingdom**	**30**	**0**	**30**
13	**Mexico**	**28**	**0**	**28**
14	**Norway**	**28**	**0**	**28**
15	**Sweden**	**28**	**0**	**28**
16	**Korea**	**25**	**2.5**	**27.5**
17	**Portugal**	**25**	**1.5**	**26.5**
18	**Finland**	**26**	**0**	**26**

19	**Netherlands**	**25.5**	**0**	**25.5**
20	**Austria**	**25**	**0**	**25**
21	**Denmark**	**25**	**0**	**25**
22	**Greece**	**25**	**0**	**25**
23	**Czech Republic**	**24**	**0**	**24**
24	**Switzerland**	**8.50**	**14.64**	**21.32**
25	**Hungary**	**20**	**0**	**20**
26	**Turkey**	**20**	**0**	**20**
27	**Poland**	**19**	**0**	**19**
28	**Slovak Republic**	**19**	**0**	**19**
29	**Iceland**	**18**	**0**	**18**
30	**Ireland**	**12.5**	**0**	**12.5**
*Michigan, Texas and Washington have gross receipts taxes rather than traditional corporate income taxes. For comparison purposes, we converted the gross receipts taxes into an effective CIT rate. See footnote 2 for methodology.				
(a) Combined rate adjusted for federal deduction of state taxes paid				

Source: OECD, http://www.oecd.org/dataoecd/26/56/33717459.xls

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Notes

1. Because of the federal deductibility of state and local taxes, the effective "tax cost" of the average state rate is 35 percent less than 6.6 percent, or 4.3 percent. This rate is then added to the 35 percent federal rate to give an overall rate of 39.3 percent. In the appendix table, each state's rate is reduced by 35 percent before being added to the federal rate.

2. In 2007, Michigan's Single Business Tax rate was 1.9 percent, Texas's Franchise Tax rate was 1 percent, and Washington's B&O Tax rate was 0.484 percent. For the sake of comparison, these gross receipts rates have been converted into an effective corporate income tax rate. We did this by using federal corporate income tax collection data to determine the tax base in the state. Based upon Michigan Department of Revenue statistics, 65 percent of gross receipts taxes are paid by corporations; the remainder is paid by non-corporate businesses. Therefore, to determine the amount of replacement revenue needed to be raised by a corporate income tax, we multiplied the current amount of gross receipts tax collected by each state by 65 percent. This replacement amount was then divided by the base to create an effective CIT rate. These effective CIT rates have not been included in the state average. If they were to be averaged in, the overall state average rate would rise to 7.4 percent, which would give the U.S. an overall rate of 39.8 percent and, thus, higher than Japan.

3. Lee Hyo-sik, "Corporate Tax Cut Key to Economic Recovery," *Korea Times*, February 11, 2008.

4. Claudio A. Agostini, "The Impact of State Corporate Taxes on FDI Location," *Public Finance Review 2007*; 35; 335. http://pfr.sagepub.com/content/abstract/35/3/335

5. Sineon Djankov, Tim Ganser, Caralee McLiesh, Rita Ramalho, and Andrei Shleifer, "The Effect of Corporate Taxes on Investment and Entrepreneurship," National Bureau of Economic Research, *Working Paper 13756*, January 2008. http://www.nber.org/papers/w13756

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