NATIONAL CENTER FOR POLICY ANALYSIS

The Case for Corporate Tax Reform: The Marginal Tax Rate on Capital

Issue Brief No. 189 by Pamela Villarreal March 2016

Globalization and capital mobility are increasing tax competition among countries. Lower tax rates increase after-tax returns to capital, raising economic growth rates. They can also make economies more attractive for foreign investment. Furthermore, lower taxes on capital are generally associated with increased government tax revenues.

Despite this, the United States has the highest corporate tax rate in the developed world at a top rate of 35 percent.

Why Is There a Corporate Tax? Economist Jack Mintz cites three reasons for the corporate income tax:[1]

- The corporate tax pays for public goods, such as infrastructure, and services used by corporations to help their profitability.
- It acts as a backstop to personal income taxes; otherwise, wealthy individuals could use "shell" corporations to reclassify their personal income as corporate earnings.[2]
- And, it captures profits from fixed factors of production, such as land and buildings.

However, the corporate tax is not the largest revenue producer for governments by any means. On average, it produces about 8.5 percent of revenue for the G-7, the group of seven wealthiest countries, and about 10.5 percent for the United States.

Investment is very sensitive to corporate tax rates. Globalization makes it increasingly easier to move capital across national borders, and investors generally seek lower tax jurisdictions. Some developing nations have cut corporate tax rates to attract foreign investment from developed countries.

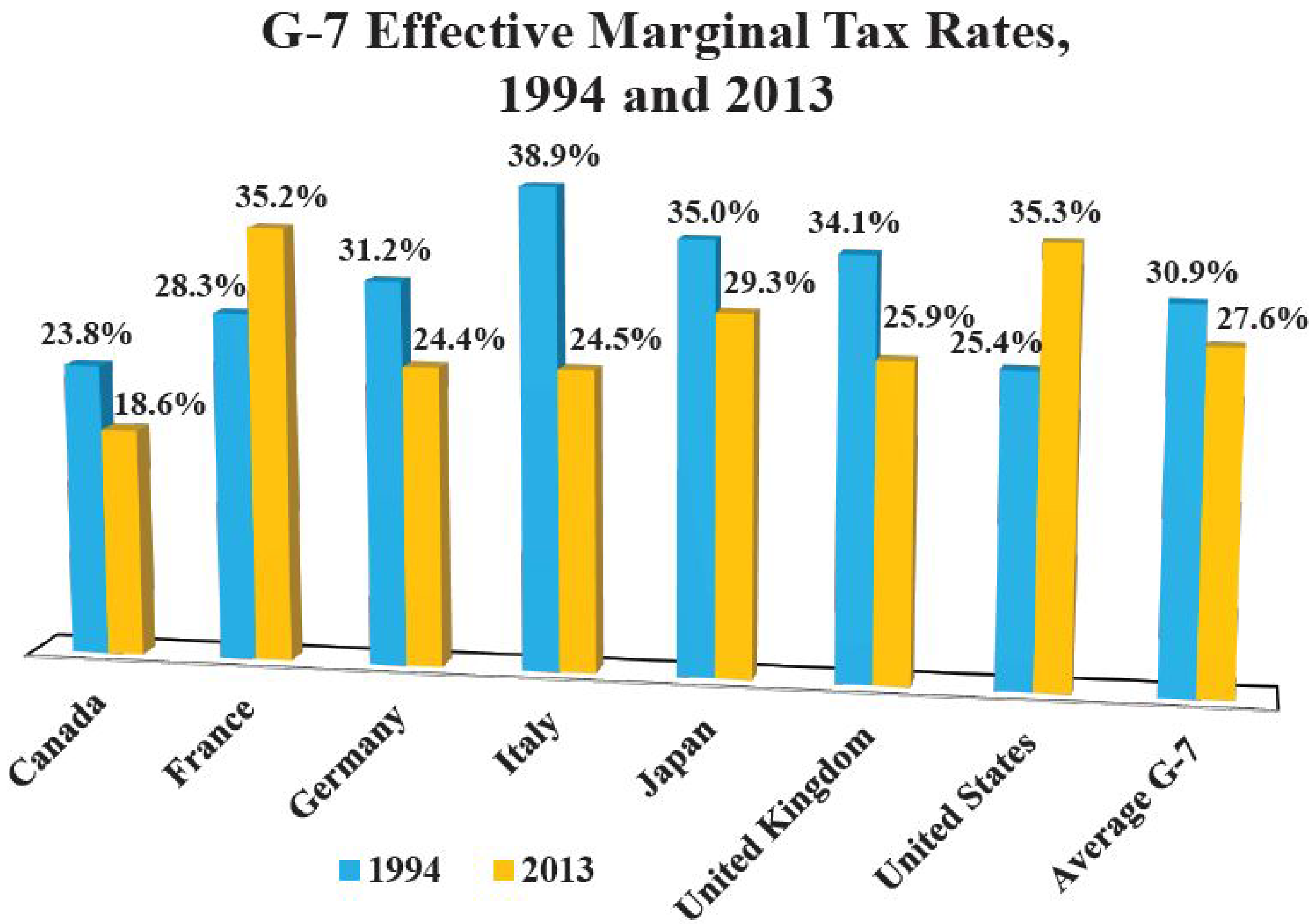
Measuring Marginal Tax Rates on Capital. According to Mintz, it has become more popular among academics to measure the *effective marginal corporate tax rate on capital*, which is the amount of tax paid as a percentage of the rate of return on the last dollar of capital invested. Mathematically, the rate of return after taxes is subtracted from the rate of return before taxes, then divided by the rate of return before taxes. Thus, if the return to capital is 10 percent and the after-

Dallas Headquarters:
14180 Dallas Parkway, Suite 350
Dallas, TX 75254
972.386.6272

www.ncpa.org

Washington Office:
202.830.0177
governmentrelations@ncpa.org

National Center for Policy Analysis



Source: Jack Mintz, "Corporation Tax: A Survey," *Fiscal Studies*, Vol. 16, No. 4, 1996, and Jack Mintz and Duanjie Chen, "The U.S. Corporate Effective Tax Rate: Myth and the Fact," Tax Foundation, 2014. Available at http://taxfoundation.org/article/us-corporate-effective-tax-rate-myth-and-fact.

tax return is 7 percent, the effective tax rate on capital is 30 percent.

In 1994, Mintz found that effective marginal tax rates on capital in the United States were the second lowest among the G-7 countries. By 2013, however, Mintz and Chen found that effective marginal tax rates in the United States were the highest. Both of these estimates include national and state corporate taxes, estate taxes, sales taxes and any other taxes on capital income or investments [see the figure]:[3]

- In 1994, the U.S. rate was 25.4 percent, second lowest to Canada's 23.8 percent. Italy's rate was the highest, at 38.9 percent.
- In 2013, the U.S. rate was 35.3 percent, while Canada's is now the lowest, at 18.6 percent.

In addition to the differences in the corporate tax code among countries, U.S. industries face different marginal tax rates due to the complexity of the tax code, special taxes levied on some industries, and the extent to which land, machinery and buildings are taxed through sales and property taxes under current law. Additionally, capital is often taxed twice — first in the form of the federal corporate tax (or applicable state corporate taxes) and again through the personal income tax when dividends paid out of profits are distributed to shareholders.

Tax Burden on Capital by Industry. Using the NCPA's DCGE model, NPCA Senior Fellow David Tuerck, executive director of the Beacon Hill Institute, calculated the effective marginal tax rate on capital by industry. The taxes include federal and state corporate income taxes, and any personal income taxes that bear on capital, such as capital gains and dividends.

The first column of the table provides current-law estimates of the *EMTR* based on this approach for 27 industrial sectors:

- Under current law, the effective marginal tax rate across all industries is 48.03 percent, on average.

Effective Marginal Tax Rates by Industry Under Current Law and a Hypothetical 25 Percent Corporate Tax Reduction

SECTOR	CURRENT-LAW EMTR	TAX-CHANGE EMTR
Agriculture Forestry and Fishing	49.88%	44.53%
Mining	45.43%	40.08%
Construction	50.11%	44.19%
Food and Tobacco Products	45.89%	40.35%
Textiles and Apparel	45.31%	39.83%
Building Materials	46.85%	41.18%
Paper and Publishing	51.31%	45.73%
Chemicals Petroleum Rubber Plastics	48.53%	42.83%
Business Machinery and Instruments	47.17%	41.23%
Electronics and Electronic Equipment	54.48%	48.08%
Motor Vehicles and Other Transportation	54.13%	48.11%
Primary and Fabricated Metal	44.82%	39.46%
Industrial Machinery and Equipment	47.15%	41.41%
Other Manufacturing	49.17%	43.19%
Transportation	44.57%	39.35%
Communications	47.70%	41.89%
Electricity Gas Sanitary	42.25%	37.50%
Wholesale Trade	46.97%	40.97%
Retail Trade	43.80%	38.48%
Banking	56.06%	50.74%
Insurance	56.60%	50.91%
Real Estate	37.39%	32.76%
Personal and Repair Services	54.50%	48.29%
Business Services	49.36%	43.45%
Health Services	45.83%	40.56%
Hotels Amusements Motion Pictures	42.85%	37.57%
Eating Drinking Miscellaneous Services	43.36%	38.37%
AVERAGE	**48.03%**	**42.36%**

Source: David G. Tuerck and James P. Angelini, "The Economic Burden of Corporate Taxation," National Center for Policy Analysis, Policy Report No. 376, November 24, 2015.

- The highest effective marginal tax rates are in insurance and banking, with rates of 56.60 percent and 56.06 percent, respectively, and the lowest rate is in real estate, at 37.39 percent.

The second column shows a tax-change scenario that assumes the U.S. corporate income tax rate is reduced to 25 percent for the top seven brackets and remains at 15 percent for the lowest bracket. The model found:

- The rates in insurance and banking would fall to 50.91 percent and 50.74 percent, respectively, and the effective tax rate on real estate would fall to 32.76 percent.
- The average rate across all industries would fall to 42.36 percent, reducing the effective marginal tax on capital by about 12 percent.

Conclusion. Policymakers bemoan the fact that U.S. companies are locating factories and headquarters across borders, but their responses fall more along the lines of restrictions or punitive measures to prevent capital flight rather than substantive tax reform. While cutting the corporate tax rate is only one aspect of spurring economic growth, it is an essential step.

Pamela Villarreal is a senior fellow with the National Center for Policy Analysis.

Notes

1. Jack Mintz, "Corporation Tax: A Survey," *Fiscal Studies*, Vol. 16, No. 4, 1996.

2. Shell corporations are legal corporations that do not necessarily possess actual assets or conduct business operations.

3. Jack Mintz and Duanjie Chen, "The U.S. Corporate Effective Tax Rate: Myth and the Fact," Tax Foundation, 2014.