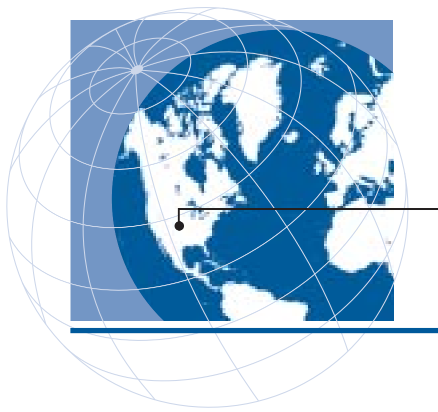


# U.S. states: Corporate taxes wane

**Recent declines have many questioning the effectiveness of the corporate tax system.**

BY *WILLIAM F. FOX*

In the United States, a corporate income tax is imposed not only by the federal government but also by almost all state governments. In 2002, Iowa levied a record 12 per cent corporate income tax and the rates for Minnesota and Massachusetts were greater than nine per cent. Yet, because they compete for investment capital, states generally choose to lower rather than increase corporate income taxes. The federal corporate income tax rate has also been declining, from a top rate of 46 per cent in 1985 to a rate of 35 per cent in 2001.

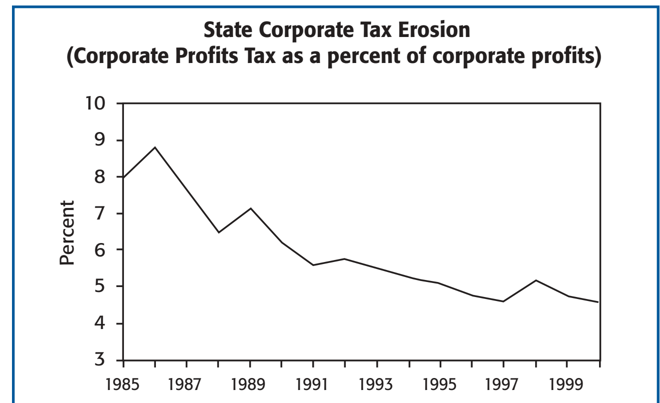
The use of corporate income taxes by states as a revenue source is under increasing pressure in the United States. Many analysts are asking what can be done to raise more revenues, while others are questioning the tax's long-term viability. The hefty 20.1 per cent decline in state corporate tax revenues during the fiscal year ending in June 2002 has brought these concerns into sharper focus. Some of the revenue decline can be attributed to the recent drop in corporate profits, but the slowdown in corporate income taxes began much earlier.

## *Long history*

U.S. state governments have relied on corporate income taxes for approximately a century, with the first corporate income tax being levied by Wisconsin in 1911. Hawaii first imposed a corporate income tax in 1901, but it was not a state at that time. Over the years more jurisdictions followed suit and today 44 states (together with the District of Columbia) impose a corporate income tax, of which 31 levy progressive rates. The 12 per cent rate imposed by Iowa is the highest in the country and the 4 per cent rate imposed by Kansas is the lowest. In addition, a number of states charge a tax on the value of corporate capital, and two states, Michigan and New Hampshire, levy variants of an origination-based value-added tax as part of their business tax structure.

Despite their seemingly broad use by states, corporate income and franchise taxes generated only 7.2 per cent of state tax revenues in 2000, down from 10.7 per cent in 1979. Decline in the relative importance of corporate tax revenues has been consistent over this 20-year time period. The effective corporate tax rate has also been falling, down from 7.1 per cent of corporate profits in 1989 to 4.6 per cent in 2000 (see Figure). This rate is calculated as total state corporate tax revenues divided by total corporate profits.

There are a number of reasons for this decline. National policy changes and administrative practices have lowered state tax bases. Most state corporate taxes begin with the federal definition of corporate profits, which states then adjust for




their own purposes. Policy decisions by the president and the Congress change the federal tax base and these choices are often made with little regard for the effects on state tax revenues.

In some cases, states simply accept the revenue consequences of federal decisions. In other cases, states do not incorporate federal changes. For example, at least half of the states did not mirror the accelerated depreciation provisions enacted by Congress as part of the 2002 economic stimulus package. Tax-planning decisions by businesses – such as the timing of profit repatriations by subsidiaries of U.S. corporations – also influence the federal tax base and, in turn, state tax bases. Policy decisions in Washington and tax planning both appear to have reduced states' corporate tax bases.

## *Lower rates and tax breaks*

As well, states have directly legislated changes in their tax bases and rates. From the 1960s through the mid-1980s states gradually *increased* their average tax rates. But growing tax competition in subsequent years has dramatically altered this pattern. Only 13 states raised rates and 14 decreased rates between 1986 and 2001. On top of that, many states have narrowed their tax *base* with generous tax incentives to business.

Automobile plants have been one important target for tax breaks. Some southern states have granted sweeping concessions to vehicle manufacturers. Alabama has provided tax breaks valued at more than US$250 million to attract a Mercedes-Benz plant, and South Carolina and Georgia have granted automakers concessions worth around US$300 million.

The fact is that many states have pursued a deliberate policy of *sacrificing* tax revenues in an attempt to ignite economic growth and impress their voters. Savvy corporations are using sophisticated tax-planning techniques to lighten their overall burden. One of these methods consists of creating complex

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corporate structures – often involving limited-liability subsidiaries – that facilitate the transfer of potentially taxable profits to low-tax or no-tax states. The combined effects of state policy changes and more aggressive tax planning have been to reduce the tax burden on profits earned by *multi-state* corporations but not on those earned by *single-state* firms. The result is a tax levied unevenly across businesses and increasingly paid by firms that are relatively small and located in a single state.

### Time to abolish the tax?

Many analysts have questioned whether the taxation of corporate income is a good policy. Arguments exist both pro and contra. Two primary arguments can be marshaled in favour of the tax. First, some mechanism for taxing corporations may be necessary to achieve equity. According to this view, a corporate income tax should operate hand-in-hand with individual income taxes to ensure that taxpayers are taxed evenly on all parts of their income. In the absence of the corporate income tax, many individuals would house income within a corporation and defer taxation of that income until they withdraw profits from the corporation. The amount of income earned in corporations could grow if states were to eliminate the corporate income tax because of the greater incentive to shift income to the corporate form.

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If this were to happen, the incentives for housing income within corporations would be mitigated by the imposition of a federal corporate income tax. Such an approach would result in the application of a corporate rate to all profits generated within the corporation and of an individual rate to any distributions to the shareholders.

A strong case can be made for businesses helping to finance public services. Levying taxes on businesses according to the benefits they receive helps to ensure that the costs of delivering public services are borne in proportion to the use of those services.

The "benefit" argument would tend to support the concept of a corporate income tax. Yet corporate taxes are usually ineffective mechanisms for taxing benefits because they are only levied on corporations (not on all businesses) and only on profitable corporations (not on all corporations). Since all businesses benefit from public services, one can argue that all should pay if a benefit tax were to be imposed. However, a tax on corporate profits would not be an effective means to this end. Several researchers have argued that an origin-based value-added tax is a preferable means of taxing benefits. This would be levied at the source rather than at the destination (as are the value-added taxes used in Europe and Canada) and can operate as a tax on the value of production rather than on the value of consumption.

There are also two primary arguments against state imposition of a corporate income tax. First, economists have generally concluded that sub-national governments should restrict themselves to the taxation of relatively immobile activities and resources and should leave the taxation of mobile activities and resources to the national government. Among productive resources, capital is relatively mobile. This suggests that a corporate income tax is likely to influence the location of business capital in ways that distort the functioning of the market, thus making this approach a poor choice for state governments.

Second, the compliance and administrative burdens of the corporate income tax are costly, especially for multi-state firms. Firms must make many decisions, including the determination of the states in which they must file, the types of income that are taxable in each state, the expenses that are attributable to taxable and tax-exempt activities, the set of affiliated companies that is taxable in each state, and so forth.

In principle, the attribution of income between jurisdictions can be done either by requiring companies to engage in separate accounting for each jurisdiction in which they operate or by using "formulary apportionment". The latter, which is used by U.S. states, is a system of formulas applied to the income of multi-state corporations with a view to ensuring that each sub-national government receives its fair share of revenues from those corporations.

Historically, states have made some attempts to harmonize corporate taxes in order to reduce the compliance burdens, but recently inter-state tax competition has resulted in decreases in uniformity.

### What to do?

Ultimately, any judgment on the wisdom of corporate taxes must strike an appropriate balance between equity and efficiency. States in the U.S. may have to make fundamental reforms to their tax structures in order to address the causes of the decline in effective tax rates. Such reforms would ensure that taxes are collected evenly and that corporate and individual income taxes operate as a seamless package. But tax competition makes such changes politically difficult and potentially undesirable for individual states. It follows that a good tax policy may involve the replacement of the corporate income tax with a more effective instrument.

An alternative is for the federal government to take one of two courses of action. Congress could pass legislation that would prevent states from imposing corporate income taxes. This approach would be undesirable from the perspective of maintaining the independence of state governments within the federal system.

The second avenue would be for the federal government to impose a single corporate income tax at the national level with the revenues (or some share thereof) distributed to state governments. This would substantially mitigate the perverse effects attributed to the corporate income tax.

Both the compliance burdens and the incentives for corporations to go "location shopping" would be smaller because the tax structure would be consistent across the country. But such a policy would effectively eliminate an independent source of state revenues and would add another level of complexity to the intergovernmental transfer program. And under such a scenario the states could be expected to object vigorously to their loss of autonomy.