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## CUTTING STATE CORPORATE INCOME TAXES IS UNLIKELY TO CREATE MANY JOBS

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### Summary

Corporate income taxes are important sources of revenue that states use to fund public services, including services essential to long-term economic growth like education, infrastructure, health care, and public safety.

Nonetheless, a number of 2010 gubernatorial candidates have made corporate tax cuts key planks of their campaign platforms. This continues a trend of the past couple of years, during which policymakers in several states have proposed cutting corporate income tax rates — or even eliminating the tax completely — as a strategy for stimulating economic growth and creating jobs. These proposals, however, offer false hope. Corporate income tax cuts are unlikely to have a positive impact on a state's rate of economic growth or the pace at which it generates private-sector jobs. Such actions:

- **Would produce no net short-term stimulus, due to state balanced-budget requirements.** Since nearly every state is required to balance its budget, states must offset the revenue loss from corporate tax cuts by removing an equal amount of spending from the state economy through cuts in state spending on services and/or tax increases. Thus, there would be no net stimulus in the short run.
- **Could lead to a near-term *drop* in total in-state economic activity because corporations are unlikely to spend the full amount of the tax cut in-state.** Instead of spending the full amount of any tax cut they receive in-state, corporations likely will distribute some of their tax savings to out-of-state owners in the form of higher dividends. Another portion of the tax savings will go to multistate corporations headquartered out of state that, if they decide to spend the additional profit, likely will do so out of state. And another portion will pay for higher federal income taxes: a business can deduct its state corporate tax payments when calculating its federal corporate income taxes, so a cut in state taxes means fewer state taxes to deduct — and thus causes greater federal taxes. Meanwhile, the full amount of state revenue loss from the tax cut is translated into lower public-sector spending on goods and services, nearly all of which is in-state.

- **Would create little or no added incentive for corporate investment in the long run.**

Cutting state corporate income taxes might in theory encourage additional investment in a state by increasing the after-tax profitability of new investments. Numerous statistical studies suggest, however, that any such “supply-side” effect would be small and take several years to materialize. The consensus of these studies is that cutting *total* state and local taxes paid by businesses in a state by 10 percent — a very large reduction — is likely to boost economic output and jobs by only 2 percent to 3 percent. And because the corporate income tax accounts for less than 10 percent of total state and local business taxes in the vast majority of states, the complete repeal of the corporate tax would not even generate 2 percent to 3 percent long-term growth in such states.

Moreover, even these modest positive effects assume that a state will not cut public services or increase other business taxes to offset the lost revenue. Given states’ balanced-budget requirements, this is unlikely to be possible.

- **Do not “pay for themselves.”** The small economic impacts of state corporate tax cuts and the large loss of revenue mean that such cuts do not stimulate enough new taxable economic activity — and thus enough new revenues — to fully offset the revenues lost from the tax cut. Indeed, two state economic models concluded that additional economic activity would recoup only *16 percent* of the initial revenue loss. Thus, corporate tax cuts would require significant household tax increases or substantial cuts in state services to balance the state budget.
- **Could adversely affect long-term growth by leading to cuts in public services.** Businesses need and demand high-quality education systems to educate and train their workers and well-functioning infrastructure to get their employees and supplies to their plants and their products to customers. They need good police and fire protection for their facilities, which need to be located in areas that offer good schools and public recreation facilities in order to attract senior managers, engineers, and other highly paid personnel. If states help pay for corporate tax cuts through funding cuts that impair the quality of these services, even the tax cuts’ modest positive potential impacts are unlikely to materialize.
- **Are not rooted in real-world economic success stories.** There is only one recent example of a state eliminating its corporate income tax. Ohio phased out its corporate income tax from 2005 to 2009, and it also eliminated its taxation of business machinery, equipment, and inventory property. Although the state substituted a different type of general business tax, the new tax did not even fully replace the revenue from the business property tax; in other words, Ohio effectively repealed its corporate income tax without replacing any of the revenue. Nonetheless, despite a more than \$1 billion annual reduction in business taxes, Ohio’s shares of national income, employment, and investment have all *fallen* slightly since 2005.

Not all businesses are organized as corporations subject to the state corporate income tax, and for most corporations that *are* subject to it, it is a very small expense. Cutting it even substantially therefore does not have a major impact on most businesses’ “bottom lines” and their incentives to invest. Accordingly, it is not surprising that most objective research on the issue concludes that state corporate tax cuts are unlikely to have a significant positive impact on state economies.

While proposing corporate tax cuts is an easy and perhaps politically attractive thing to do at a time when citizens are looking to elected officials to jump-start the economy and create jobs, these

### **Corporate Income Taxes Are an Important Source of Revenue for States**

Corporate income taxes are the third-largest source of tax revenue for state governments after personal income taxes and general sales taxes. In fiscal year 2007, just before the current economic downturn began, they yielded \$53 billion. That amount represented 7.0 percent of all state tax collections and was greater than the revenue generated by alcohol, tobacco, and amusement taxes combined. Six states — Alaska, Delaware, Kentucky, Massachusetts, New Hampshire, and West Virginia — relied on corporate income taxes for at least 10 percent of their tax collections. Corporate tax collections dropped to \$40 billion in fiscal year 2009 due to the recession, but they will rebound quickly as the economy recovers.

In the vast majority of states, corporate income taxes are classified as a “General Fund” revenue source. As such, they fund state contributions to local school systems and higher education, health care, property tax relief, public safety, economic development, environmental protection, human services, and many other public services.

proposals represent a distraction rather than a solution. Policymakers should continue to focus on providing core public services like education and infrastructure in as cost-effective a manner as possible. These services play a critical role in underpinning private sector growth, and their quality is a key determinant of a state’s attractiveness for private investment. Supporting the market with appropriate public investments will be more likely to lead to long-term prosperity than will enacting small changes in economic incentives via risky corporate tax cuts.

### **At Best, Corporate Tax Cuts Would Have Neutral Impact on Short-Term Economic Growth**

In theory, cutting state corporate income tax rates could boost state economic growth and job creation in two related but conceptually distinct ways. This section discusses the first of those potential ways: the tax cuts would leave more profit in the hands of corporations that they could then spend within the state to hire additional employees, construct new facilities, buy raw materials and component parts, and so on. The recipients of these payments would in turn likely spend them on household goods and services and similar business purchases within the state, creating so-called positive “multiplier effects” on state economic output and employment. Any resulting economic boost would be considered a “macroeconomic” effect of the corporate tax cut.

In reality, however, states generally cannot provide significant macroeconomic stimulus to their economies by cutting either business or household taxes.<sup>1</sup> By law, every state except Vermont must balance its budget each year or biennium. This means that a state would have to offset the estimated loss of revenue from reducing or eliminating the state corporate income tax by a tax increase of the same size on other taxpayers or an equivalent cut in state spending on programs and services. Therefore, even if the corporation spent the entire tax cut in-state (which is very unlikely, as explained below), there would be no net stimulus.<sup>2</sup>

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<sup>1</sup> Iris J. Lav and Robert Tannenwald, “The Zero-Sum Game: States Cannot Stimulate Their Economies by Cutting Taxes,” Center on Budget and Policy Priorities, March 2, 2010, [www.cbpp.org/cms/index.cfm?fa=view&id=3100](http://www.cbpp.org/cms/index.cfm?fa=view&id=3100).

<sup>2</sup> One limited exception to this would occur if the state cut corporate taxes and replaced the revenue by drawing down reserves (such as “rainy day funds”) or financing more capital purchases with borrowing. If the corporate tax cut were

If a state offset the corporate tax cut with reductions in state spending, public-sector employees like teachers and corrections officers would have less money to spend when, for example, they were laid off or their overtime pay was cut. (A state could also reduce payments to private-sector vendors, like doctors that treat Medicaid patients, firms that repair highways, and nonprofits that provide social services, with similar effect.) Alternatively, if a state offset the corporate tax cut with higher taxes, the households and/or businesses paying those taxes would have less money to spend on their normal purchases. In either case, there would be *no net increase in total spending within the state*.

Moreover, corporate tax cuts might have a *net negative* macroeconomic impact in the short run. For the following reasons, tax cuts are unlikely to increase corporations' in-state spending by enough to offset the decline in spending by businesses and households that would result from the tax increases or budget cuts states would impose to pay for the corporate tax cuts:

- **Receiving additional cash, by itself, is unlikely to increase corporate spending.** Corporate spending on wages, salaries, and supplies for current production depends on current — or very near-term — demand for that production. Corporate spending on plant and equipment depends on anticipated demand for production when the facility can be ready. In the absence of increased demand for output now or in the future, corporations will simply pocket a tax cut as a windfall increase in their retained earnings rather than spend it.<sup>3</sup> That is a major reason why both the Congressional Budget Office and the Congressional Research Service have argued that cuts in *federal* corporate income taxes are unlikely to be an effective economic stimulus measure. (See the text box on the following page.)
- **A portion of state corporate tax cuts would in effect be diverted to the federal treasury in the form of increased federal tax payments.** Businesses can deduct their state corporate tax payments when calculating their federal corporate income tax (currently levied at a rate of 35 percent). This means that if a state reduces its revenues by \$100 million annually by cutting its corporate tax rate, the corporations receiving the tax cut actually pocket — and thus could potentially spend in-state — only \$65 million. Accordingly, state corporate tax rate cuts are likely to have a net negative impact on in-state spending when federal tax implications are factored in.<sup>4</sup>

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significant and permanent, however, these alternative sources of financing would probably be exhausted relatively quickly.

<sup>3</sup> It is possible for corporations both to have insufficient cash on hand to increase output to meet current demand and to be unable to access the credit markets. In such situations, the increased cash flow from a corporate tax cut could, by itself, encourage additional corporate spending. That is not the current situation confronting corporations, however. As the *Washington Post* recently reported: “Corporate America is hoarding a massive pile of cash. It just doesn’t want to spend it hiring anyone. Nonfinancial companies are sitting on \$1.8 trillion in cash, roughly one-quarter more than at the beginning of the recession.” Jia Lynn Yang, “Companies Pile Up Cash but Remain Hesitant to Add Jobs,” *Washington Post*, July 15, 2010.

<sup>4</sup> To be sure, if the state had spent the \$100 million on providing state services instead of corporate tax cuts, the recipients of that \$100 million would have had to pay federal taxes on that income as well — meaning that less than \$100 million would have been available for in-state spending. Nonetheless, most of the initial recipients of that income likely would have been low- and moderate-income individuals and small businesses that would have paid taxes at a significantly lower marginal rate than the corporations’ 35 percent rate, so they would have retained more income that could be spent in state.

## **Economists Concur That *Federal* Corporate Tax Cuts Are Not Cost-Effective Stimulus, Either**

Cuts in the federal corporate tax rate have also been proposed in recent years to stimulate investment and associated job creation on a national basis. The Congressional Budget Office and the Congressional Research Service — non-partisan policy analysis organizations serving Congress — have evaluated the likely efficacy of such cuts. Both agree that cutting the corporate income tax rate has significant shortcomings as a mechanism for stimulating economic growth.

CBO writes:

The most common form of a general cut in business taxes is a reduction in the corporate tax rate. This approach, however, is not a particularly cost-effective method of stimulating business spending: Increasing the after-tax income of businesses typically does not create an incentive for them to spend more on labor or to produce more, because production depends on the ability to sell output. . . .

[B]ecause taxes on business income essentially lower the return that firms earn from capital investment, reducing such taxes can increase firms' willingness to acquire more capital — that is, to invest. As a result, the principal influence of taxes on a firm's decision about investing depends on the prospective profits from its new investments, not on current profits made from old investments. However, a substantial effect of reducing current corporate tax rates is to increase the returns from past investments rather than increase the attractiveness of new investments. . . .

Consequently, a general cut in business tax rates will tend to generate significantly less investment demand for each dollar of [lost] revenue than a cut that applies only to new investment. A cut in corporate rates is also less effective because it does not apply to businesses that are not subject to the corporate tax.<sup>a</sup>

CRS concurs:

Most evidence does not suggest that business tax cuts would provide significant short-term stimulus. . . . This lack of effectiveness may occur because of planning lags [i.e., it takes time to execute major new investments even after the decision has been made] or because stimulus is generally provided during economic slowdowns when excess capacity may already exist. Of business tax provisions, investment subsidies are more effective than rate cuts, but there is little evidence to support much stimulus effect.<sup>b</sup>

As noted above, the federal government taxes corporate profits at a rate of 35 percent. The highest state corporate income tax rate currently in effect is 12 percent — only about one-third as high — and most states' top corporate tax rates are significantly lower. If, according to CBO and CRS, cuts in the federal corporate income tax rate are unlikely to be cost-effective means of stimulating corporate investment, cuts in state corporate tax rates are unlikely to be, either.

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<sup>a</sup> Congressional Budget Office, "Options for Responding to Short-Term Economic Weakness," January 2008, pp.13-14.

<sup>b</sup> Jane G. Gravelle, Thomas L. Hungerford, and Marc Labonte, "Economic Stimulus: Issues and Policies," Congressional Research Service, November 10, 2009, p. 12.

- **A large share of state corporate tax cuts would likely be spent out of state.** In most states, the large majority of corporate income tax payments are made by a small number of major multistate corporations that are headquartered out of state. And most of the stock in such corporations is likely to be owned by individuals or institutions located out of state. Both of these characteristics imply that a substantial portion of whatever corporate spending *is* stimulated by receiving an income tax cut is likely to occur out of state, where the employees, suppliers, or stockholders are located.<sup>5</sup> Only a small amount of the tax cut is likely to trickle back into the state in the form of increased spending.

### **“Supply-Side” Incentive Effects from Cuts in Business Taxes Are Small**

A second potential way in which cutting corporate tax rates theoretically could boost state economic growth and job creation is by increasing the after-tax profitability of new in-state investments, thereby encouraging corporations to expand investment or output in the state. For example, some corporations may have identified certain investment opportunities but concluded that they are not quite profitable enough after all applicable federal, state, and local taxes have been paid to be justified. Cutting the rate at which the state taxes profits from the investment could tip the balance in favor of the investment.

Nonetheless, there is considerable evidence that corporate tax cuts’ supply-side incentive effects are very small, and even this small effect depends on the unrealistic assumption that the tax cuts will not lead to any reductions in public services. Over the last 30 years, numerous statistical studies have examined the correlation between various measures of state economic growth and job creation and state business tax levels, business tax cuts, and the availability of specific business tax incentives. Perhaps the leading U.S. expert on these studies, economist Timothy Bartik of the Upjohn Institute for Employment Research, has summarized the consensus conclusions and implications of this research:

- “Reviews of the literature suggest that . . . a 10 percent reduction in effective state and local business tax rates (for example, a reduction of the state corporate income tax rate from 5.0 to 4.5 percent, *accompanied by similar reductions in other state and local business taxes*), *with state and local public services held constant*, will increase the *long-run* level of local business activity by 2 or 3 percent.”<sup>6</sup> Elsewhere he makes clear that “[I]f *all* state and local business taxes are lowered by 10 percent, the long-run increase in state business activity will be 2 percent.”<sup>7</sup> He also observes

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<sup>5</sup> Economist Timothy Bartik concurs that economic development subsidies that take the form of business tax cuts are likely to have a net negative impact on in-state aggregate demand because of these kinds of leakages to out-of-state business owners: “Alternatively, at the other extreme, the economic development subsidies could be delivered totally through tax subsidies to businesses. We would expect the net demand effects of this to be negative, as it is likely that most of the subsidies largely affect flow to business owners who live out of state.” Timothy J. Bartik, “Taking Preschool Education Seriously as an Economic Development Program: Effects on Jobs and Earnings of State Residents Compared to Traditional Economic Development Programs,” unpublished working paper, W.E. Upjohn Institute for Employment Research, March 30, 2006, p. 29. (Hereafter, “Bartik, Preschool.”)

<sup>6</sup> Timothy J. Bartik, “Solving the Problems of Economic Development Incentives,” *Growth and Change*, Spring 2005, p. 142. (Hereafter, “Bartik, Solving.”) Emphasis added.

that “If the state and local tax cuts are financed by cutting public services, the result may be lower business activity.”<sup>8</sup> As will be discussed below, significant cuts in business taxes are, in fact, likely to result in cuts in public services.

- “The . . . [2 percent] elasticity figure implies that . . . [t]he annual cost per job gained is equal to . . . \$19,445 in annual forgone business tax revenue. . . .”<sup>9</sup> This estimate was based on 2004 business tax levels; the cost today would be higher since business tax liabilities have increased since then.
- “[T]he economy only gradually adjusts to lower business taxes. . . . [A] business tax reduction will have about 61 percent of its long-run effects after 10 years.”<sup>10</sup>
- “[A]fter a year or two, between 50 and 80% of the new jobs go to increasing the employment rates of local residents, and the rest go to persons who otherwise would have lived elsewhere, such as in-migrants. The proportion going to in-migrants increases over time. . . after 17 years, perhaps 2 of 10 [of the initial] new jobs are still reflected in higher employment rates for local residents.”<sup>11</sup>

To summarize, the consensus of the relevant economic research is that, on average, it requires a permanent 10 percent cut in total business taxes in a state to increase output or employment by approximately 2 percent to 3 percent in the long run.<sup>12</sup> Less than two-thirds of that small employment growth is likely to occur in the first ten years after the tax cut. And over the long term, the large majority of the jobs created will be filled by in-migrants (for whom, as Bartik points out elsewhere, “new public expenditures will be required”).<sup>13</sup> As of 2004, states would have had to

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<sup>7</sup> Timothy J. Bartik and George Erickcek, “The Employment and Fiscal Effects of Michigan’s MEGA Tax Credit Program,” W.E. Upjohn Institute Working Paper No. 10-164, April 2010, p. 15, emphasis added. (Hereafter, “Bartik, MEGA.”) In this report, Bartik acknowledges that subsequent work by economist Michael Wasylenko leads to the conclusion that the low end of that range, i.e., 2 percent job growth, is “the most plausible estimate.”

<sup>8</sup> Bartik, Solving, p. 142.

<sup>9</sup> Bartik, Preschool, p. 17.

<sup>10</sup> Bartik, MEGA, p. 32.

<sup>11</sup> Bartik, Preschool, p. 21.

<sup>12</sup> In general, this result applies to general business tax cuts that are not strategically targeted to particular businesses or conditioned on specific in-state activities. Elsewhere, Bartik argues that some carefully designed business incentive programs can have a greater economic development “bang” for the forgone tax “buck.” See, Bartik, MEGA, for example.

<sup>13</sup> Bartik, Solving, p. 145. The in-migrants will both pay taxes and consume publicly funded services; the net effect of those is assumed to be approximately zero. The same is true with respect to newly attracted firms and their public service and infrastructure requirements: “Note that we do not count the revenue gained on the attracted firms [as an offset to the estimated cost per job created], as the fiscal effect of new firms will include any impacts on public service and infrastructure needs due to the new employment and the population it attracts, along with the tax impact of the new population.” Bartik, Preschool, p. 17.

permanently forgo approximately \$20,000 in annual business tax revenue to create one private-sector job. With average annual private sector earnings for full-time workers of \$37,715 in 2004, that is a very large subsidy in relation to the compensation of each newly created job.<sup>14</sup>

As Table 1 indicates, in only one-fifth of the states does the corporate income tax account for 10 percent or more of total state and local taxes paid by businesses, according to the Council on State Taxation. In light of Bartik’s literature summary, this means that in four-fifths of the states the *complete elimination* of the corporate income tax would not result in even a 2 percent boost in employment in the long run. Smaller reductions in the tax rate would, of course, have even smaller effects on in-state investment and job creation.

Moreover, even the small “supply-side” effects of business tax cuts just described are premised on there being no reduction in spending on public services (which would eliminate some jobs in the public and private sectors) and no offsetting increases in business taxes.<sup>15</sup> In other words, they effectively assume that *non-business* taxes will be increased in order to keep state budgets balanced.

In the real world, these conditions are unlikely to be met, at least with respect to significant cuts in state corporate tax rates, which are likely to be financed at least in part by cutting state spending. Indeed, a number of the corporate tax rate cuts proposed over the past two years undoubtedly would have resulted in spending reductions since no

State	Share (%)
New York	18.4
New Hampshire	18.1
California	15.9
Massachusetts	14.4
New Jersey	12.1
West Virginia	12.0
Alaska	11.7
Delaware	10.5
Illinois	10.4
Utah	9.8
Indiana	9.0
Arkansas	8.9
Maryland	8.7
Montana	8.7
Tennessee	8.6
Minnesota	7.8
Alabama	7.6
Pennsylvania	7.6
Idaho	7.5
Kentucky	7.5
North Carolina	7.5
Mississippi	7.4
Wisconsin	6.7
Kansas	6.6
New Mexico	6.6
Vermont	6.3
North Dakota	5.9
Oregon	5.9
Arizona	5.8
Connecticut	5.8
Louisiana	5.8
Oklahoma	5.6
Nebraska	5.4
Virginia	5.4
Florida	5.3
Maine	5.2
Georgia	5.0
Rhode Island	4.6
Iowa	4.3
Michigan	4.2
South Carolina	4.0
Colorado	3.8
Missouri	3.3
South Dakota	3.1
Hawaii	3.0
Nevada	No CIT
Ohio	No CIT
Texas	No CIT
Washington	No CIT
Wyoming	No CIT
United States	8.6

Source: Ernst & Young, “Total State and Local Business Taxes: State-by-State Estimates for Fiscal Year 2009,” Council on State Taxation, March 2010, Table A-3.

<sup>14</sup> U.S. Department of Labor, “National Compensation Survey: Occupational Wages in the United States, July 2004, Supplementary Tables,” August 2005, p. 73.

<sup>15</sup> See the first and third Bartik quotes in the bulleted paragraph beginning on the bottom of p. 6.

offsetting increases in other taxes were proposed.<sup>16</sup> Business taxes other than the corporate income tax are also likely to increase, even if the state does not do so explicitly. For example, cuts in state aid to school systems and other local governments can lead to increases in local property taxes, some of which will be paid by corporations and offset part of their corporate income tax savings.

In sum, dozens of economic studies conducted over three decades conclude that state business tax cuts have at most a very small “supply-side” impact on state economic growth and job creation. These impacts would likely shrink further if the tax cuts were actually enacted, because state and local public services would likely be reduced at least somewhat and corporate income tax reductions might be partially offset with increases in other business taxes.

### **Small Supply-Side Effect of Corporate Tax Cuts Makes Sense**

It should not be surprising that state business tax cuts generally — and corporate income tax cuts in particular — have only a small positive impact on long-term economic growth and job creation:

- **State and local taxes are a very minor expense for most corporations.** All state and local taxes paid by corporations represent between 2 percent and 3 percent of their total expenses on average, and the state corporate income tax represents on average less than 10 percent of that amount — or roughly *one-quarter of 1 percent* of total costs.<sup>17</sup> The potential influence of state corporate tax rates on corporate location decisions is simply overwhelmed in most cases by interstate differences in labor, energy, and transportation costs, which make up a much greater share of corporate costs than state corporate income taxes do and often vary more among the states than effective corporate tax rates do.<sup>18</sup>

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<sup>16</sup> For example, in his 2010 State of the State address, Minnesota Governor Tim Pawlenty proposed a 20 percent cut in the state corporate tax rate with no offsetting tax increases. (Elizabeth Carvlin, “Minnesota Governor Calls for Corporate Tax Cut,” *State Tax Today*, February 16, 2010.) Also in 2010, the Arizona House passed a bill to reduce the state corporate tax rate from 6.9 percent to 5.0 percent over five years with no offsetting tax increases. (William H. Carlile, “Arizona Legislature Adjourns without Action on Tax Cut Bill,” *BNA Daily Tax Report*, May 2, 2010.)

<sup>17</sup> These estimates derive from Internal Revenue Service data on the amount of taxes corporations deduct on their federal income tax returns. The Council on State Taxation, which represents major multistate corporations on state tax issues, disputes the use of these data for this purpose. However, COST’s preferred measure of the total tax burden on businesses — total state and local taxes as a share of gross state product produced in the private sector — is of the same order of magnitude (4.7 percent in Fiscal Year 2009) and reinforces the basic conclusion that state and local taxes are not major cost items for corporations. For a discussion of the measurement controversy and a defense of the use of the IRS data, see: Michael Mazerov, “Vast Majority of Large New Mexico Corporations Are Already Subject to ‘Combined Reporting’ in Other States,” Center on Budget and Policy Priorities, January 26, 2010; endnote 5; [www.cbpp.org/files/1-26-10sfp.pdf](http://www.cbpp.org/files/1-26-10sfp.pdf).

<sup>18</sup> Another way to demonstrate the relative insignificance of state corporate income taxes to corporations is to contrast them with corporate labor costs. In state fiscal year 2006, state corporate tax collections totaled \$47.5 billion. In that same year, corporations spent approximately \$4.6 trillion on employee compensation. (Bureau of Economic Analysis, National Income Accounts Table 1.13: National Income by Sector, Legal Form of Organization, and Type of Income; averaging values for calendar years 2005 and 2006, since most state fiscal years run from July 1 to June 30 of the following year.) Thus, eliminating state corporate income taxes in every state would have been the equivalent of saving a little over 1 percent of employee compensation, or roughly 30 cents per hour in that year. (Bureau of Labor Statistics, National Compensation Survey, results for private industry workers in establishments employing over 100 people.) Employee compensation routinely varies by much more than that each year; for example, between December 2004 and December 2009 it increased an average of 82 cents annually.

- **Cutting the state corporate income tax does nothing to enhance the profitability of the many businesses that are *not* subject to this tax.** These businesses include sole proprietorships, “Subchapter S” corporations, partnerships, and limited liability companies, and they account for roughly one-third of total business profits.<sup>19</sup> Because they usually are not subject to state corporate income taxes in the first place, cutting or eliminating the tax provides no direct incentive for them to expand employment or investment.<sup>20</sup>
- **Corporate tax cuts are unlikely to have significant incentive effects in many states because they would merely duplicate the effects of other incentives that have already been enacted.** See the text box on the following page for a prime example.
- **Corporate tax cuts are poorly targeted.** Cuts in corporate tax rates are neither conditioned on the business undertaking new in-state economic activity (for example, investment, job creation, or research and development), nor targeted to businesses that would not engage in the activity without the incentive. A substantial share of the forgone revenue will flow to corporations that will simply pocket the windfall but not increase investment or output because the underlying economics do not justify it. Another large share will flow to corporations that would have made additional investments anyway because the investments were profitable even without the rate reductions. In short, a cut in the state corporate income tax rate is inherently such a scattershot “incentive” that much of the forgone revenue will be wasted.
- **Cuts in public services resulting from corporate tax cuts are likely to have a *negative* impact on long-run economic growth.** As discussed in the next section, because the positive “supply-side” impacts of corporate tax cuts are so small, the cuts will result in a substantial net loss of revenue. If states respond by reducing public services that businesses need, their attractiveness as a location for business investment is likely to suffer. As economist Robert Lynch has observed:

Businesses need to know that they can rely on high-quality, well-administered public services to facilitate the conduct of their enterprises. Snow removal and flood control must be reliable and timely; roads, bridges, and highways must be maintained in good repair; fire protection and police services must be there when needed; the justice system must be professional, impartial, and quick to resolve contract disputes; and the schools and colleges must help to generate a skilled and well-trained workforce.<sup>21</sup>

In sum, corporate tax cuts could be substantially self-defeating when it comes to stimulating long-run economic growth.<sup>22</sup>

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<sup>19</sup> Internal Revenue Service “Integrated Business Data” series; [www.irs.gov/taxstats/bustaxstats/article/0,,id=152029,00.html](http://www.irs.gov/taxstats/bustaxstats/article/0,,id=152029,00.html).

<sup>20</sup> A few states apply their corporate income taxes to such businesses. In addition, some partnerships and limited liability companies are owned in whole or in part by corporations, and some or all of the profits of such businesses *are* “passed through” to their corporate owners and thereby subject to corporate income taxation.

<sup>21</sup> Robert G. Lynch, *Do State and Local Tax Incentives Work?*, Economic Policy Institute, Washington, DC, 1996, p. 6.

<sup>22</sup> Footnote 18 above explained that, on average, the positive impact on corporate profitability of eliminating state corporate income taxes would be equivalent to that of cutting employee compensation by roughly 1 percent. But the benefit of the latter would evaporate if employee output per hour also fell by 1 percent. It is not difficult to envision that eliminating the corporate income tax completely could necessitate such large cuts in state spending on education,

## **Corporate Tax Cuts in “Single Sales Factor States” Create Even Smaller “Supply-Side” Incentives**

This report explains why cuts in state corporate tax rates are likely to create, at most, only very small incentives for corporations to expand their investment, output, and employment. But these already-small effects are likely to be rendered almost minuscule in the numerous states that have already enacted another corporate tax-based investment incentive, known as the single sales factor apportionment formula.

In most states, the share of a multistate corporation’s nationwide profit that the state taxes is the average of the shares of the corporation’s nationwide property, payroll, and sales that are located in the state. Under this formula, if a corporation increases its employment and physical investment in a state, its income tax liability there will increase as well.

Some have argued that this creates a disincentive for new in-state investment and job creation, and some 20 states have modified their formulas to eliminate the property and payroll measures and to base their taxes entirely on the state’s share of the corporation’s nationwide sales. Under such a “single sales factor formula,” if a corporation places a new plant and additional employees in a state but all of the output of that plant will be sold to customers in other states, the siting of the plant in the state has no impact on the corporation’s tax liability to that state.

There is scant evidence that the single sales factor formula provides a significant incentive for in-state investment, for many of the same reasons set forth in this report with respect to state corporate income tax cuts themselves.<sup>a</sup> But in any event, if a corporation incurs no additional tax liability from new in-state investment because of the formula, cutting its corporate tax rate can have no additional effect.

Ironically, the majority of proposals for significant corporate income tax rate cuts in recent years have been made by elected officials in states that have adopted single sales factor formulas (or formulas that have substantially the same impact). Georgia is already a single sales factor state, Arizona gives an 80 percent weight to sales in its formula, and South Carolina and Minnesota are phasing in single sales factor formulas. There is no evidence from any of these states that proponents of these cuts understood that most of the purported economic development benefits had already been realized through the adoption of these formulas.

Twenty states have implemented or are phasing in single sales factor formulas for all corporations or manufacturers; two other states have adopted formulas that base taxes almost but not entirely on sales.<sup>b</sup> In these 22 states, claims that corporate income tax cuts are likely to stimulate significant economic development are worthy of especially great skepticism.

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<sup>a</sup> Michael Mazerov, “The Single Sales Factor Formula for State Corporate Taxes: A Boon to Economic Development or a Costly Giveaway?” Center on Budget and Policy Priorities, September 2005.

<sup>b</sup> The first group consists of California, Colorado, Connecticut, Georgia, Illinois, Indiana, Iowa, Louisiana, Maine, Maryland, Massachusetts, Michigan, Minnesota, Missouri, Nebraska, New York, Oregon, South Carolina, Virginia, and Wisconsin; the second group consists of Arizona and Pennsylvania.

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child care, health care, or other services that enhance labor productivity that the reduction in output per hour could easily exceed that amount — eliminating the small positive “supply-side” impact of the tax reduction.

## State Corporate Income Tax Cuts Do Not Pay for Themselves

Proponents of various kinds of state tax incentives for investment and job creation — including cuts in state corporate tax rates — sometimes suggest that they will stimulate so much additional economic activity that the incentives will completely or substantially pay for themselves. That is, they argue that there will be little if any *net* revenue loss from the tax cut because the earnings of new employees will be subject to income taxation, their purchases will be subject to sales taxes, additional corporate activity will generate additional corporate income tax and sales tax revenue, and similar revenues will flow from employment and business activity generated through multiplier effects of the initial increase in corporate spending. These new tax revenues, it is claimed, will substantially or completely offset the initial revenue loss from the corporate tax cut.

Such claims are not based on either the empirical research or the common-sense analysis described above. To be sure, it is not difficult to find state economic models driven by ideologically desired outcomes that assume tax changes have such profound impacts on corporate activity that individual and corporate tax cuts do indeed pay for themselves when run through the models. But mainstream analysis relying on objective empirical research on this issue concludes that business tax cuts generally — and state corporate income tax cuts specifically — have significant net costs in forgone revenue:

- According to economist Timothy Bartik: “The elasticities [found in the economic literature as described above] are not large enough to produce a Laffer Curve, in which cuts in tax rates would raise the tax base enough to increase revenue. . . . The higher business tax base would offset only about a quarter of . . . [the initial] revenue loss . . . ”<sup>23</sup>
- The Oregon Tax Incidence Model predicted that a 30 percent (\$100 million) cut in state corporate income taxes would result after five years in a 0.06 percent increase in employment, a 0.2 percent increase in personal income, and a 0.5 percent increase in investment. The new taxable economic activity would recoup only \$16 million of the original \$100 million tax cut.<sup>24</sup>
- Similarly, the California Dynamic Revenue Analysis Model predicted that a permanent 20 percent cut in the Bank and Corporation Tax rate, initially costing \$1 billion annually in lost revenue, would lead to a 0.1 percent increase in employment after five years (all of these 12,000 jobs would be filled by in-migration from other states) and a 0.2 percent increase in aggregate state personal income. Here, too, the increased economic activity would recoup only 16 percent of the original revenue loss.<sup>25</sup> (Moreover, neither the Oregon nor the California model takes into account the added cost of providing core public services to new businesses creating the jobs and the new state residents filling them.)

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<sup>23</sup> Bartik, Solving, p. 142.

<sup>24</sup> Oregon Legislative Revenue Office, “The Oregon Tax Incidence Model,” March 16, 2001, p. 71.

<sup>25</sup> P. Berck, E. Golan, and B. Smith, “Dynamic Revenue Analysis for California,” California Department of Finance, summer 1996, [www.dof.ca.gov/HTML/FS\\_DATA/DYNA-REV/DYNREV.HTM](http://www.dof.ca.gov/HTML/FS_DATA/DYNA-REV/DYNREV.HTM). The 12,000 new jobs created represent the net effect of 17,000 jobs gained in the private sector and 5,000 jobs lost in the public sector due to the net loss of state revenue.

- A recent analysis of proposed Arizona legislation that would have cut the corporate tax rate — as well as other taxes — acknowledged that there would be dynamic revenue impacts but said that they would likely be modest: “The bill will potentially have other impacts that are difficult to quantify, including dynamic revenue feedback effects resulting from an overall change in economic activity related to the tax reductions. REMI, a regional policy simulation model used by many state agencies in the country, . . . typically generates feedback effects that range between 5% and 18%. In other words, for each \$1 tax reduction, REMI predicts that the state economy will generate a tax revenue offset of between 5¢ and 18¢.”<sup>26</sup>

If corporate income tax cuts result in a net revenue loss of 75 percent to 85 percent of the initial revenue loss after the “dynamic” or feedback effects of small increases in economic activity are taken into account, significant reductions in public services are likely to occur. As discussed above, such cuts in state and local services are themselves likely to have an adverse long-term impact on private sector growth and thus tax revenues, a feedback effect that these models do not take into account.<sup>27</sup>

### **Eliminating Corporate Income Tax Is Unlikely to Be a “Game Changer”**

In recent years, some elected officials have gone so far as to call for the complete repeal of their state’s corporate income tax. They often argue that such a dramatic step would send a powerful signal that their state is “pro-business” and thereby attract substantial new corporate investments and jobs.

Ohio represents a recent real-world test of this argument, and the results cast cold water on the “game-changer” hypothesis. In 2005, Ohio enacted legislation phasing out its corporate income tax by 2010 and simultaneously phasing in a Commercial Activity Tax (CAT) on businesses’ gross sales. The same legislation also phased out local taxes on “tangible personal property” (business machinery, equipment, and inventories), and used revenue from the CAT to hold schools and local governments harmless.

According to the Ohio Department of Revenue, the elimination of the corporate income tax costs the state approximately \$1.6 billion annually beginning in 2010, and the phase-out of local taxes on business tangible property costs the state approximately \$1.6 billion in additional tax savings annually.<sup>28</sup> The CAT, however, generates only about \$1.4 billion in additional revenue, less than the property tax savings alone. In other words, Ohio in effect repealed its corporate income tax without replacing *any* of the lost revenue.

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<sup>26</sup> Hans Olofsson, Arizona Joint Legislative Budget Committee, Fiscal Analysis of House Bill 2250, February 12, 2010, p. 2.

<sup>27</sup> “[The California Dynamic Revenue Analysis Model] DRAM does not link the productivity effects of reduced education expenditure on private businesses. To the extent that it would, some of the expansive effects of such a tax reduction may be lost.” See the source cited in Note 25, p. XI-4.

<sup>28</sup> Ohio Department of Taxation, “Fact Sheet: Tax Reform in Ohio,” 2010; [tax.ohio.gov/divisions/communications/news\\_releases/documents/Tax\\_reform\\_fact\\_sheet.pdf](http://tax.ohio.gov/divisions/communications/news_releases/documents/Tax_reform_fact_sheet.pdf).

While the 2005 tax overhaul has undoubtedly boosted after-tax corporate profits, there is no evidence thus far that it has benefited Ohio families or dramatically changed the state's economic prospects:

- Between the second quarter of 2005, when the overhaul was enacted, and the first quarter of 2010 (the most recent for which data are available), Ohio's share of total national personal income fell from 3.6 percent to 3.4 percent.<sup>29</sup> This is roughly the same rate of decline as in the four years prior to the corporate income tax cut.
- Between June 2005 and June 2010 (again, the most recent month available), Ohio's share of national private-sector employment fell from 4.2 percent to 4.0 percent (representing a loss of almost 400,000 jobs) and its share of national manufacturing employment fell from 5.7 percent to 5.4 percent (representing a loss of almost 200,000 jobs).<sup>30</sup>
- Between 2005 and 2008, Ohio's share of new investment in manufacturing plant and equipment was flat, at 4.9 percent.<sup>31</sup>
- A January 2009 report by Policy Matters Ohio provides a much more detailed look at the early impact of the 2005 tax changes and finds that on several economic measures Ohio did not even perform as well as most of its neighboring states in the early years after enactment.<sup>32</sup>

Admittedly, only a few years have elapsed since the enactment of the tax overhaul, and it could always be argued that Ohio's economy would have performed even worse without it. Nonetheless, the fact that the Ohio corporate income tax has been completely eliminated — saving corporations more than \$1 billion annually — with *no* discernable positive impact on the state's economy is strong evidence that any “supply-side” incentives from state corporate tax cuts are exceedingly weak.

## **Alternative Ways to Strengthen State Economies**

Given the seriousness of the current downturn, state policymakers are understandably anxious to boost their states' economies and put people back to work. Unfortunately, cutting or eliminating corporate income taxes is unlikely to be an effective approach. State balanced-budget requirements prevent corporate tax cuts from providing any meaningful short-term stimulus to total in-state spending. Even in the long run, numerous studies conclude that corporate tax cuts alone can have only a small impact on private-sector job creation and are likely to come at the cost of substantial cuts in state and local services. Such cuts are likely to create personal hardships for the families and individuals who receive the services and, if they occur in areas that businesses demand, will have a negative impact on the state's attractiveness for future business investments.

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<sup>29</sup> U.S. Department of Commerce, Bureau of Economic Analysis.

<sup>30</sup> U.S. Department of Labor, Bureau of Labor Statistics.

<sup>31</sup> U.S. Census Bureau, Annual Survey of Manufactures.

<sup>32</sup> Jon Honeck, “The 2005 Tax Overhaul and Ohio's Economy,” Policy Matters Ohio, January 2009; [www.policymattersohio.org/pdf/TaxOverhaul2009\\_0115.pdf](http://www.policymattersohio.org/pdf/TaxOverhaul2009_0115.pdf).

The better course of action is for elected officials to focus on the principles of good tax policy and sound management of core public responsibilities. States should close corporate tax loopholes and examine existing economic development tax incentives for effectiveness — and cost-effectiveness— at regular intervals. Small businesses often are overlooked when states distribute business tax breaks, and scaling back tax breaks that disproportionately help larger firms can help state economies grow by leveling the competitive playing field between small entrepreneurial firms and large multistate corporations. States should continue to make investing in education and infrastructure a priority; surveys of site-selection consultants and CEOs continue to identify both as key drivers of corporate location decisions.<sup>33</sup> Investing in child care, health care, and worker retraining can increase both the size and productivity of the state’s labor pool.<sup>34</sup>

Cutting corporate tax rates may be politically appealing, but neither logic nor evidence suggests that doing so will stimulate significant economic growth. The fact that no state has enacted such cuts in the past two or three years suggests that many policymakers already doubt the proponents’ claims.

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<sup>33</sup> A recent report by economist Jeffrey Thompson thoroughly summarizes the literature on the positive impact on state economic growth of investments in education and infrastructure. See: “Prioritizing Approaches to Economic Development in New England: Skills, Infrastructure, and Tax Incentives,” University of Massachusetts Political Economy Research Institute, August 2010; [www.peri.umass.edu/fileadmin/pdf/published\\_study/priorities\\_August9\\_PERI.pdf](http://www.peri.umass.edu/fileadmin/pdf/published_study/priorities_August9_PERI.pdf).

<sup>34</sup> Bartik has evaluated the relative cost-effectiveness of a number of economic development programs focused on investments in human capital, including customized job training, consulting assistance to entrepreneurs in manufacturing industries, universal pre-K education, mandatory summer school for elementary school students, and setting up “career academies” for non-college-bound high school students. See: Timothy J. Bartik, “What Should Michigan Be Doing to Promote Long-Run Economic Development?” Upjohn Institute Working Paper No. 09-160, November 2009; [www.upjohninst.org/publications/wp/09-160.pdf](http://www.upjohninst.org/publications/wp/09-160.pdf).