Scrap the corporate income tax ... and it will show up as another tax, economists say

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By Philip Newswanger

philip.newswanger@insidebiz.com

Eliminating the Virginia corporate income tax - an idea that would have saved Virginia companies $648 million in 2009 - gained traction within Gov. Bob McDonnell's transition team.

But the governor nixed the idea, saying he would not want to eliminate a source of revenue during Virginia's dire financial straits.

The governor's remarks imply he would not seek to replace the lost revenue with higher taxes elsewhere or by a reduction in spending even though he favors low taxes in Virginia.

Bob Marcellus, a Richmond hedge-fund manager who served on the transition team's economic development group, had suggested eliminating the tax. But McDonnell, a Republican, nixed the idea.

A corporate income tax is a partisan issue. Republicans prefer no tax on corporations while Democrats say everyone, including corporations, should pay taxes.

So the question is: If you eliminate the corporate income tax, where will state and local governments, hard hit by the recession, find other revenue?

With a corporate income tax of 6 percent, Virginia ranks 35th among states in corporate income taxes, according to the nonpartisan Tax Foundation.

But the state and local tax burden of 9.8 percent places Virginia 18th among 50 states.

Virginia also charges a bank franchise fee of 1 percent of net capital, according to the foundation.

Nevada and Wyoming don't charge a corporate income tax.

Nor does South Dakota, though banks are charged 6 percent on net income and a minimum tax of $200 for each location.

Most companies in Virginia are charged a flat 6 percent.

"Public-utility taxation used to consist of a tax on gross receipts, 2 percent or so, that was built into the regulated rates and passed on to the consumer," said Virginia Department of Taxation spokesman Joel Davidson.

"In response to competition from unregulated businesses, various utilities were switched to the regular corporate income tax. Common carriers (trucks and busses) have been subject to income tax since at least 1960," Davidson said.

"Railroads were switched in 1979, telephone companies in 1989, with a minimum tax on gross receipts that was phased down to its current level of 0.5 percent."

He said that gas and electric distribution companies were switched in 2001, and a minimum tax on electric suppliers was added in 2004 equal to 1.45 percent of gross receipts.

"All of these companies (except water) are now subject to regular income tax," Davidson said.

"Because there are still some regulatory functions related to the industries, they also continue to pay the regulatory revenue tax to the SCC.

"The tax is capped at 0.2 percent of gross receipts, but usually runs about half that rate," Davidson said. "The SCC sets the rate so that it will cover its costs to regulate these industries."

Corporate tax rates are based on three factors, according to Kail Padgitt, an economist with the foundation: natural resources (states such as Alaska and Louisiana have an abundance), the legislative process and historic precedent.

"The legislative process was meant to refer to binding agreements that prevent the legislature from changing the tax code," Padgitt said.

"Oregon has a strong referendum process that has made bad broad- based tax increases difficult. California has Prop 13. Other states have constitutional amendments.

"A corporate income tax is destructive," Padgitt said. "Individuals really pay taxes."

In a high corporate tax climate, consumers pay higher prices, workers see lower wages and dividends drop, Padgitt said.

If corporate income taxes are reduced or eliminated, consumer prices will drop and wages for workers will rise.

"The Tax Foundation advocates a broad-based rate that is low," he said. "We don't want to see a lot of exemptions."

But here's the catch.

"The downside of eliminating the corporate income tax is the loss in revenue," Padgitt said. "This must be made up in the form of other tax increases or spending cuts.

"The question that needs to be answered is whether the gains are greater than the loss of services and increased taxation elsewhere."

James Koch is an economist and the former president of Old Dominion University.

"The conclusion of economic research concerning the corporate income tax is that portions of it are passed on to consumers in the form of higher prices," Koch said.

"That is, some of the burden, probably less than 50 percent, of the corporate income tax is shifted to consumers, depending upon the supply/demand situation in a particular industry.

"Pragmatically, corporations that face relatively inelastic demands are going to be able to pass on more of the tax," Koch said. "Oil companies and gasoline provide a good example."

Inelastic demand means that consumers will pay any price for a good or service because there are few or no substitutes.

"Thus, some, but not all, of the attempts to 'tax corporations' are illusory, but constitute a politically more palatable way to take money away from consumers than, say, an outright increase in the sales tax," Koch said.

"If there were no corporate income tax, and nothing else changed in the tax world, this would increase the profits of the typical corporation," Koch said.

Income would shift away from consumers and toward stockholders and probably corporate employees, Koch said.

"At the same time, it probably would cause corporations to invest more in plants and equipment, expand employment, etc.," Koch said. "However, the evidence here suggests that these effects are not as large as some might believe.

"That is, the sensitivity of corporate business behavior to changes in corporate tax rates is positive and cannot be ignored, but is not huge in the short-run."

Koch said the corporate tax rates among states often do make a difference in location decisions by firms.

But he said it takes a while for such adjustments to become significant.

"Even so, over the space of a decade or more, one can see the results, e.g., firms leaving high tax states such as Michigan and California and going elsewhere," Koch said.

"Realistically, if there were no corporate income tax, then governmental units would be quite likely to attempt to collect an equivalent amount of money via other taxes: personal income taxes that would hit stockholders and employees, etc., as well as dividend taxes, sales taxes and capital gains taxes on increased stock values," he said.

"Hence, the question usually devolves to - would you rather tax the corporation, or the individuals who will benefit from corporate successes?

"Ultimately, then, the activities of corporations are likely to be taxed, one way or another," Koch said.

"Those who believe that the elimination of the corporate income tax would spur economic activity usually fail to take into account the likelihood that this would force marginal personal income tax rates upward and this would chill economic activity."

"There's no free lunch here. On the other hand, those who believe that they actually can tax corporations and none of this tax will be passed on to consumers also are wrong."

Koch said the issue of a corporate income tax is a political one.

"Government is going to collect revenue and if it does not do it via the corporate income tax, it will do so via alternate taxes," he said.

"The key to the whole thing is how much revenue government believes it must have.

"Voters send periodic signals on those issues but sometimes voters don't make the connection between the services they say they need and their cost." nib