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Tax Cannibalization and State Government Tax Incentive Programs
by David Gamage and Darien Shanske

A major distinguishing feature of the American system of fiscal federalism is the relative ease by which state governments can subsidize business activities through their tax codes. There is no formal rule to that effect. Indeed, the U.S. Supreme Court has struck down some tax incentive programs on the federal level. They also discuss ways the federal government could address the problem, while acknowledging that Congress is unlikely to act on the issue.

However, the Supreme Court has never ruled directly on a tax incentive structured to offer advantages to any business so long as it makes specified investments in state. Of course, it is hard to distinguish a tax break only for in-state businesses from a tax break meant to encourage out-of-state businesses to become in-state businesses. Thus, when the Supreme Court accepted a case — Cuno — 10 years ago about the constitutionality of tax breaks meant to encourage in-state economic activity, it seemed possible that the Court would significantly limit state economic development tax incentives. Yet the Court ruled that the plaintiffs in Cuno lacked standing to challenge the state tax incentives in question. Consequently, today, even for state development tax incentives that might in theory be vulnerable on the merits, the opponents of those incentives have little prospect of challenging them because of the problem of standing.

By contrast, the European Union has a much stricter regime governing state aid, at least formally. Congress could in theory change the U.S. rules governing state tax incentives, but there is little indication that it is contemplating doing so.

We explained in an earlier article how the current structure of the U.S. federal tax system distorts the choices of

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Footnote continued in next column.

1 See generally Alan O. Sykes, “The Questionable Case for Subsidies Regulation: A Comparative Perspective,” 2 J. Legal Analysis 473, 479 (2010) (“Pending new developments in the doctrine, therefore, the dormant commerce clause places little constraint on state subsidies unless they can be characterized as a tax that discriminates against interstate commerce”).

2 Walter Hellerstein and Dan T. Coenen, “Commerce Clause Restraints on State Business Development Incentives,” 81 Cornell L. Rev. 789, 794 (1996) (“The Court’s treatment of state tax incentives suggests that the constitutional suspicion surrounding such measures is well justified. Over the past two decades, the Court has considered four taxing schemes involving measures explicitly designed to encourage economic activity within the state. In each case, the Court invalidated the measure”). The four cases cited are New Energy Co. of Indiana v. Limbach, 486 U.S. 269 (1988); Bacchus Imports Ltd. v. Dias, 468 U.S. 263 (1984); Westinghouse Electric Corp. v. Tally, 466 U.S. 388 (1984); and Boston Stock Exchange v. State Tax Commission, 429 U.S. 318 (1977).

3 DaimlerChrysler Corp. v. Cuno, 547 U.S. 332 (2006). Note that the Sixth Circuit decision, which reached the merits, followed the reasoning of Hellerstein and Coenen, supra note 2. Cuno v. Daimler Chrysler Inc., 386 F.3d 738 (6th Cir. 2004).

4 For an example of a state intermediate appellate court striking down an incentive meant to encourage in-state investment, see Cutler v. Franchise Tax Board, 208 Cal. App. 4th 1247 (2012). It is hard to see how the reasoning of that decision would not doom many other state tax incentives, a point that has been noted by others. See, e.g., Kathleen K. Wright, “California Resurrects Retroactive Tax Remedies,” State Tax Notes, Jan. 28, 2013, p. 263 at 269.

5 Sykes, supra note 1 at 491 (“The EU system is by far the most restrictive on the surface, although it too allows considerable state aid). That the stricter EU system has at least some teeth is demonstrated by the recent controversy wherein the EU charged Apple $14.6 billion for taking advantage of illegal state aid from Ireland. See, e.g., Daniel N. Shaviro, “Friends Without Benefits? Treasury and EU State Aid,” Tax Notes, Sept. 19, 2016, p. 1681.
states as to tax bases — to the federal government’s disadvantage. In this article, we explain how current federal architecture also distorts the states’ choice of tax rates — again to the disadvantage of the federal fisc.

To review our earlier argument, the higher a state’s tax rate is on a shared base, say the corporate income tax base, the more revenue the federal government loses from the actions of taxpayers to avoid paying what is essentially a combined federal-state tax rate. Put more concretely, here is a very simple and simplified example. Suppose a corporation engages in additional profit shifting out of the United States because of the additional 8.84 percent corporate tax imposed by California. Say the corporation shields $1 million in additional profits and California thus loses $88,400 of tax revenue as a consequence. The federal fisc potentially loses $350,000, because the rate at the federal level is 35 percent.

As the example illustrates, because the federal government levies much higher taxes on the shared bases of corporate and individual income than do any state governments, the federal government suffers most of the harm when state-level tax rates induce taxpayers to engage in additional distorting behaviors that shrink the shared tax base. Of course, the higher federal tax rate induces far more profit shifting and other distorting behaviors than does the lower state tax rate. Nevertheless, the additional distorting behaviors induced by the state tax rate can result in large federal revenue losses by comparison to state revenue raised. We estimate in our full article that, on the margin, the federal government loses more than a dollar for every dollar some state governments raise from their highest tax rates on corporate income and on capital gains.

There has not been much federal government interest in the problem of state tax incentive programs, or in state tax systems more generally, for quite a long time, with the exception of the ongoing Quill saga and occasional bursts of attention such as when the Supreme Court was pondering Cuno. Abstract considerations of optimal fiscal federalism simply do not seem to motivate Congress. By contrast, our recent research on the tax cannibalization problem indicates that the federal government is losing large amounts of revenue because of choices made by the state governments about their revenue systems, including the overuse of tax incentives. We hope that this insight into the loss of federal revenue provides Congress with more direct motivation to reconsider state government tax incentive programs.

**Tax Cannibalization and State Tax Incentives**

The first step in understanding this article’s argument is to step back to a simple case of horizontal competition. Imagine that State A is competing with State B for a new manufacturing plant to be built by Corporation X. Suppose as well that the only revenue instrument available is the corporate income tax and that the only tool the two states have for luring mobile business activity is to reduce the corporate income tax rate. And so, in that restricted hypothetical world, at some point Corporation X will likely play the two states off against each other, until the overall corporate tax rate could potentially become rather low, at least in the winning state. Indeed, in that simple world, the resulting tax rate might be so low that the winning state, say State A, might have a hard time providing basic services.

Further imagine that a few years later, States A and B compete again for a new manufacturing plant, this time to be built by Corporation Y. Needless to say, Corporation Y will likely play the two states off against each other, hoping to do at least as well as Corporation X. This time, however, imagine that State A has a new plan. State A will not reduce its overall corporate tax rate to attract Corporation Y; instead, State A will award Corporation Y special tax incentives that will, in effect, give the target corporation, but only it, the same low rate as Corporation X. That way State A will continue to raise revenue at a higher rate from other corporations — corporations that are less mobile.

This hypothetical explains the prevalence of tax incentives in a relatively favorable light to illustrate how tax incentives can in theory play a legitimate role in responding to horizontal tax competition through differentiating between more and less mobile capital. Nevertheless, because states must raise revenue to fund spending, states must at some point choose between awarding more special tax incentives and keeping their regular tax rate higher, or awarding fewer special tax incentives while keeping the overall tax rate lower.

In deciding between those two approaches for responding to tax competition, one might think in the abstract that states should err toward having an overall lower rate and broader base — that is, minimizing the use of special tax preferences. The policy rationale for that approach is that lower tax rates distort overall economic activity less, whereas the empirical literature on tax incentives generally questions their effectiveness.

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7We go through much more detail in the complete article, *id.*

8Id.

9There is much more to be said about this including about there being many different kinds of economic inputs (labor as well as capital) and their relative mobility changes over time. See generally David E. Wildasin, “Fiscal Competition for Imperfectly-Mobile Labor and Capital: A Comparative Dynamic Analysis,” *J. Pub. Econ.* 1312 (2011).

However, as is well known, states award an enormous amount of special tax incentives, often against tax bases that they share with the federal government — especially the corporate income tax. In order to meet their revenue targets, states must therefore levy higher tax rates than they would otherwise need in the absence of those special tax incentives, meaning that the federal government suffers more revenue loss from tax cannibalization than it would otherwise.

Why are the states so blasé about the cost of higher tax rates, and especially regarding state corporate income taxes? To be sure, a large part of the reason may be the political economy of state legislatures. Yet there is also a dollars-and-cents reason regarding tax cannibalization. That is because it is the federal government that suffers most of the loss from a general corporate income tax rate higher than what is optimal for national welfare.\(^\text{12}\)

So far, it may seem as though the driving force behind the problem here is merely that the federal government has a corporate income tax and that the states do also. But there is more to the issue. Remember that one of the characteristics of the American federal system — in contrast to other systems — is the relative freedom that states have to use tax incentives. That did not happen as a result of forethought. Rather, the Supreme Court made challenging tax incentives very difficult and Congress has not used its power to restrict state tax incentives. Whether Congress should do so is much debated. On the one side are those who argue, quite plausibly, that state tax incentives for the most part are ineffective at best and generally harmful.\(^\text{13}\) On the other side are those who maintain, also plausibly, that there can be positive roles for state tax incentives and further that crafting a rule that sensibly distinguishes good incentives from bad incentives is impossible.\(^\text{14}\)

Yet heretofore absent from this debate has been the point we have just made about tax cannibalization. Apart from the debate over whether state tax incentives are beneficial or harmful to state governments, because of tax cannibalization, when state governments opt for higher general tax rates accompanied by targeted tax incentives rather than a strategy of a broader base and lower rates for all — it is the federal government that bears much of the costs. Consequently, the issue of state tax incentives is not just a conflict between “saving the states from themselves”\(^\text{15}\) versus preserving state autonomy. On top of those considerations, in deciding the kind of rule that the federal government should adopt, the federal government should also take into account that state tax incentives are enabling further cannibalization of the federal government’s revenue.\(^\text{16}\)

**What Could the Federal Government Do?**

What would Congress do if it were to act to limit the use of state tax incentives?\(^\text{17}\) One approach would be to add the value of state tax incentives back into the federal corporate income tax base.\(^\text{18}\) That was the approach of the Distorting Subsidies Limitation Act of 1999 (DSL).\(^\text{19}\) Suppose Corporation X was awarded targeted subsidies worth $1 million; that $1 million would now be considered income to the corporation. Assuming a 35 percent federal corporate tax rate, Corporation X would now need to pay the federal government $350,000 of its $1 million subsidy, a significant drag on the value of the state subsidies. Of course, the rate on such incentives could be much higher, say a special rate of 50 percent, because that is a form of income that the federal government has decided is particularly disfavored. But even just assessing the 35 percent federal corporate tax rate on the value of awarded tax incentives would greatly alleviate the tax cannibalization problem. Again, the rationale for such a reform is that, as we have discussed above, targeted tax incentives are added back, but not all. For recent analysis of this issue, see Alan L. Feld, “Federal Taxation of State Tax Credits,” *Tax Notes*, May 30, 2016, p. 1243 at 1247 (“State income tax credits ordinarily affect the federal income tax of the recipient by reducing the state tax liability and any corresponding federal deduction. They enter directly into the federal income tax calculation only when the taxpayer receives something more, in the form of a right to a refund from the state or the proceeds of a sale of the credit”).


\(^{13}\)At least one prominent commentator has indicated that she sees a connection between the greater limits placed on the use of targeted tax incentives in the EU and the fact that some EU jurisdictions choose to compete on the basis of their general corporate tax rate. Deborah H. Schenk, “The Cuno Case: A Comparison of U.S. Subsidies and European State Aid,” 2006 Eur. St. Aid L.Q. 3, 7 (2006). If U.S. states responded to a restriction on tax incentives similarly, then they would reduce rates and mitigate the tax cannibalization problem.

\(^{14}\)In an earlier column we explained why we think Congress would have the power to enact limitations on the states’ use of tax incentives. See Gamage and Shanske, *supra* note 6. In short, there could be (at least) two compelling sources of power. First, Congress could use its power over interstate commerce because state incentives manifestly distort the economic decisions made by interstate commercial actors. Second, Congress has the power to define its own tax bases and so the taxing power (and 16th Amendment) could ground treating state tax incentives as income.

\(^{15}\)It should be noted that in some cases state subsidies are already added back, but not all. For recent analysis of this issue, see Alan L. Feld, “Federal Taxation of State Tax Credits,” *Tax Notes*, May 30, 2016, p. 1243 at 1247 (“State income tax credits ordinarily affect the federal income tax of the recipient by reducing the state tax liability and any corresponding federal deduction. They enter directly into the federal income tax calculation only when the taxpayer receives something more, in the form of a right to a refund from the state or the proceeds of a sale of the credit”).
incentives allow states simultaneously to cannibalize the federal base while not suffering consequences in terms of horizontal competition.

One could argue that crafting such a restriction might create a difficult line-drawing problem, as there is not necessarily universal agreement as to what constitutes a tax incentive as opposed to a tax-base definition rule. For instance, a generous depreciation or depletion rule could be devised as an industry-specific benefit, but could alternatively be conceived as embodying a necessary tax judgment as to how best to measure net income over a specific time frame.

Further complicating matters, tax incentives could also be ground in rationales not regarding mitigating the cost of horizontal externalities on account of having high tax rates. For example, most states exempt food purchases from their sales taxes, which functions as a benefit to the food industry, but the motivation for those exemptions is to mitigate the regressiveness of the sales taxes.

In order to avoid those line-drawing problems, a first cut at a federal approach for reform could be to ban all state tax incentives that, on their face, trade lower taxes for economic investment in the state. If it were to turn out that such a law was ineffective, then it could be revisited, but we suspect that the political economy reasons that encourage states to use narrow, targeted tax incentives will make a federal statute focused on facial state locational incentives reasonably effective.

If Congress did want to pass a broader measure, we think the definition used in the DSLA would be a good start. The DSLA defined a targeted subsidy as a subsidy “designed to encourage any trade or business operation of such person to locate in a particular governmental jurisdiction or to remain in a particular governmental jurisdiction.” That general definition would not seem to sweep up state tax policies such as the exemption of sales of food from the sales tax.

A narrower rule here could forbid or limit state tax incentives offered only against the corporate income tax, a shared base, rather than against the property tax or the sales tax. That would be a direct response to the problem of tax incentives as a mechanism for states to keep tax rates high on tax bases that they share with the federal government. Such a rule would allow states to use tax incentives, which preserves state autonomy and perhaps even enhances horizontal competition. All that such a rule would in effect say to the states is that if they want to offer tax breaks then they should pay the full cost of that decision through reduction to a non-shared tax base.

Conclusion

Despite living in ivory towers, we do get enough oxygen to know that congressional action on state tax incentives is about as likely as Congress passing the Unicon Habitat Restoration Act of 2016 (or maybe less likely). So we will end with a more limited aspiration: We hope that we have begun to make the case that there are interesting fiscal facts about our federal system that Congress does not know, but could know and in so knowing could save the federal government a lot of money.

It has been 20 years since Congress dissolved the American Council on Intergovernmental Relations (ACIR). Formed in 1959, ACIR issued dozens of important reports and policy proposals, many of which substantially influenced law reform. Even 20 years later, ACIR’s reports on features of American federalism are still cited as invaluable.

21For instance, the California Research and Development Credit is only available for “research conducted in California.” Cal. Rev. & Tax. Code section 23609(c)(2). The R&D credit was the largest California corporate tax expenditure for 2012. The cost of single-sales-factor apportionment might have been larger but a calculation was apparently not possible. Franchise Tax Board, “California Income Tax Expenditures” (2012), available at http://bit.ly/2ct73ks.
23Another part of the DSLA seems promising as it would have prohibited the use of the federal tax exemption on the interest of bonds issued by state and local government in connection with projects regarding locational incentives. Thus, if a state offered to issue bonds to rebuild the roads near a manufacturing plant that also received locational tax incentives, then the interest on those bonds would not be exempt from the federal income tax.
24A related reform might forbid single-sales-factor apportionment, which has generally been adopted as an economic development tool. See Enrigh, supra note 15, at 462 (“As sales factor adjustments become a standard tool in the interstate competition for business, there seems to be little reason why they should escape Commerce Clause scrutiny of their distorting impact on the location of economic activity.” Indeed, they fall into the particularly suspect category of measures that target their benefits on mobile businesses, because only taxpayers engaging in significant interstate activity can reap the benefits or incur the costs of sales factor adjustments”); and Shanske, “A New Theory of the State Corporate Income Tax: The State Corporate Income Tax as Retail Sales Tax Complement,” 66 Tax Law Rev. 305, 312-17 (2013).
25To be sure, money is fungible. A state could therefore dole out property tax incentives while keeping its corporate income tax high. That critique relies on the assumption that tax bases are politically fungible. We think not. For the property tax for instance, property taxes are generally reserved for local governments and so such a shift of incentives would be complicated. Not that there could not be some shifting, but we think some tamping down of the use of incentives is the best one can reasonably hope for. After all, the Coenen and Hellestein argument, supra note 2, followed by the Sixth Circuit decision in Cuno, essentially proscribes corporate income tax incentives while permitting property tax incentives, though on different (and we think less persuasive) grounds. Embracing that distinction as a form of rough justice meant to reduce tax cannibalization seems more appealing. Indeed, as explained by Sykes, supra note 1, the impact of the greater restrictions on state aid in the EU has not eliminated tax incentives so much as reduced them through creating additional legal and administrative hurdles.
resources — resources that have not been updated for 20 years.26 It has of course been more than 50 years since the Willis Committee Report specifically considered interstate taxation.27 Maybe the next time that a crisis forces Congress to consider state fiscal affairs there might also be some thought given to building knowledge infrastructure.