On Yang's Proposed Federal Tax on Subnational Tax Incentives

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On Yang’s Proposed Federal Tax On Subnational Tax Incentives

by David Gamage and Darien Shanske

Democratic presidential candidate Andrew Yang recently announced a new proposal to — in his campaign’s words — “end bidding wars for corporate relocation.”

Even though Yang probably will not win the primary, we think that his proposal is still worth taking seriously, in part because we have heard similar proposals floated by other politicians over the last couple of years, including by current members of Congress. We thus expect to see similar proposals in the future, regardless of what happens with Yang’s candidacy.

To begin with, the text of Yang’s released proposal is short, so it is worth quoting in full:¹

The recent circus surrounding Amazon’s HQ2 project should highlight how damaging the practice of allowing localities to “bid” for investment from corporations can be to our country, and how important it is for us to find a solution to this problem.

You can’t blame the corporation for trying to save money, and you can’t blame the localities for trying to attract investment and new jobs. Because no one has an incentive to stop this practice, it continues unabated.

However, it amounts to up to $90 billion a year of tax breaks and cash grants. Since states and other localities can’t run a deficit or print money, these subsidies amount to money that could otherwise go to school, road repair, and other important functions. These incentives are meant to steal jobs and investment from other states, not from offshoring or to entice businesses to expand when they otherwise wouldn’t.

There’s also evidence that corporations start with an idea of where they want to move and then use a public bidding war to get tax breaks from those locations. Considering Amazon’s business, D.C. and N.Y. were likely locations for HQ2 even before they received 238 proposals from cities across the country.

¹ Friends of Andrew Yang, “End Bidding Wars for Corporate Relocation” (emphasis in original).
This form of corporate welfare needs to stop, and only the federal government has an incentive to do so. We must end it by considering any financial benefit provided to a company to entice local investment, or relocation, to be special income that is taxed at 100 percent. General investment by a locality to be more business-friendly is fine, but no more bribing companies to do something they were already planning to do. The only ones who win are the companies.

We agree with the underlying premise of this proposal, namely that the states and localities are trapped in a race to the bottom and that the federal government can and should intervene. We have even argued that doing so would not only be in the national interest generally, but in the federal government’s interest as a financial matter because this kind of harmful competition ultimately costs the federal government and states and localities because of the phenomenon we call tax cannibalization.

To review our earlier argument regarding tax cannibalization and tax incentives, 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 taxpayers’ actions to avoid paying what is essentially a combined federal-state tax rate. Put more concretely, here is a 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. If the corporation shields $1 million in additional profits, California loses $88,400 of tax revenues. The federal fisc potentially loses $210,000 because the rate at the federal level is 21 percent.

Now consider what happens when states provide tax incentives against tax bases that they share with the federal government. To meet their revenue targets, states must levy higher tax rates than they would otherwise need absent these special tax incentives. Thus, in order to provide tax incentives to some taxpayers, states are likely cannibalizing the federal base more as to most taxpayers. So there is a financial reason for the federal government to care about state tax incentives.

We applaud Yang’s proposal because it shows considerable sophistication about state and local finance. Specifically, the proposal observes that, as a general matter, tax policy at the state and local level is more of a zero-sum game because of balanced budget constraints. As for our analysis of the substance of Yang’s proposal, we think that his proposed federal tax rate of 100 percent is too high.

Consider that a 100 percent tax rate is effectively an outright prohibition, which raises constitutional concerns. The federal government forbids the states from taxing many specific activities, typically involving interstate commerce. We think — and think most scholars think — that these prohibitions are on solid ground. By contrast, we think — and again think that most other scholars also think — that were the federal government to legislate a broad prohibition against states using a specific tax base, especially one already in use, like the corporate income tax, this would go too far. Our reasons for these conclusions are elaborated in prior writing.

Applying this analysis to Yang’s proposal, a prohibition on targeted subsidies is clearly somewhere in the middle ground between these two extremes. That is, we think the constitutionality of Yang’s proposal for a 100 percent tax rate is uncertain. On this point, note that our reading of NFIB v. Sebelius suggests that an otherwise unobjectionable exercise of one of the federal government’s powers (in the case of Yang’s proposal, the taxing power) can go too far and thus can become unconstitutional if it would overly undermine the fiscal operations of states. We think a more modest tax rate as applied to

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2 Id.
4 Id.
5 Id. at 553.
targeted subnational financial incentives would be on reasonably sound constitutional footing but that a 100 percent tax rate arguably goes too far.

To elaborate, imagine that a city is desperate to keep its local sports franchise and wants to offer financial incentives to do so. The Yang proposal would effectively forbid this at any price. Yet even agreeing that it is typically bad policy for cities to bribe sports teams in this manner, it is not clear whether the federal government either has — or should have — the power to completely ban subnational governments from engaging in this sort of behavior.

Under the federal constitutional framework, state and local governments are supposed to compete through policy experiments, to further their operating as laboratories of democracy. Industrial policy experiments should arguably be part of this. Moreover, it can be difficult to distinguish between subnational financial incentives that would be subject to Yang’s tax and the provision of public goods by subnational governments that are especially valued by some potentially mobile actors that the subnational governments wish to attract or retain. The higher the tax rate, the greater the pressure on this distinction and the more potential the tax will have to undermine subnational governments that seek to offer desirable public goods that just happen to be especially attractive to certain mobile actors.

If a 100 percent tax rate or a complete ban were the federal government’s only options to deter bad behavior by state and local governments of the sort that Yang is concerned with, then we would perhaps be less worried about these constitutional concerns. But a lower tax rate (say, perhaps, 50 percent) would serve policy goals far better than an outright ban created by a 100 percent tax rate.

To elaborate, from a national perspective, the primary concern underlying Yang’s proposal is that state and local tax incentives can generate a race to the bottom because each incentive imposes an externality on competing state and local governments that may then lose desired business and other activities unless they match the offered incentive. In this light, a sensible goal for federal government policy would be to correct this externality. As has long been understood, the best way to correct an externality is through a tax rate set to price the externality, not through a ban.

Pricing these externalities correctly through a federal-level tax on subnational tax incentives potentially achieves two goals. First, the federal-level tax should deter state and local governments from providing tax incentives unless the subnational government has a strong interest in doing so. Second, regarding subnational tax incentives that are provided anyway, the fact that the parties are willing to pay the federal-level tax is a strong indicator that the project is worthwhile from a national perspective. And should there be such projects, the federal-level tax will generate a pot of money that can be used to mitigate the harm being done. For instance, these federal revenues could be dedicated to helping disadvantaged communities that cannot enter the competition to begin with.

We have commented on Yang’s proposal because it is a refreshing and smart engagement with state and local tax issues and one that we wish to encourage. The Yang proposal reflects the important fact that many — arguably most — core government services are provided at the state and local levels. Therefore, the fiscal health of these governments is of national importance and should be a matter for debate at the national level. There are numerous other ways that the federal government can improve state and local finance. We will conclude with a few ideas that we hope will also make it into the national political conversation:

• restore a reformed SALT deduction;
• provide support so that states can improve their sales taxes and impose a VAT;

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6 We discuss this difficulty and possible ways of addressing it in a prior writing: Gamage and Shanske, supra note 2.


• revive the estate tax credit;¹⁰
• repeal Public Law 86-272;¹¹
• support state rainy day funds;¹² and
• resurrect the Advisory Committee on Intergovernmental Relations so that there is a mechanism by which the federal government can learn what is really happening at the state and local levels.¹³