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Darien Shanske  
University of California, Davis, dshanske@ucdavis.edu

David Gamage  
Indiana University Maurer School of Law, dgamage@indiana.edu

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Tax Cannibalization by State Corporate Taxes: Policy Implications

by Darien Shanske and David Gamage

Darien Shanske is a professor at the University of California, Davis, School of Law (King Hall), and David Gamage is a professor of law at Indiana University Maurer School of Law.

In this installment of Academic Perspectives on SALT, the authors clarify a point of possible confusion about tax cannibalization issues and discuss policy implications.

In a recent article,1 we reported revised estimates for the magnitude of the “tax cannibalization” problem caused by state corporate income taxes in 2020. To repeat just two striking take-aways from this analysis, we estimated that California’s corporate income tax rate is currently destroying somewhere in the range of 51 cents to $1.06 of net revenues from other jurisdictions, including the federal government, per marginal tax dollar raised by California,2 and that Pennsylvania’s corporate income tax rate is likely destroying somewhere in the range of 55 cents to $1.24 of net revenues from other governments per marginal tax dollar raised by Pennsylvania.3

Tax cannibalization operates through (for example) a state corporate income tax rate inducing taxpayers to engage in additional tax-reduction behaviors such as profit-shifting transactions to move reported income to tax-haven jurisdictions that deprive both the state and federal government of revenue. Because state tax policymakers generally do not consider the fiscal externalities of how state tax policy choices affect federal revenues, the tax cannibalization problem can negatively bias state tax policy choices from the perspective of national welfare. In prior research, we have argued that our estimates for tax cannibalization have profound implications for numerous debates about fiscal federalism in the United States — including the design of federal- and state-level taxes,4 questions about constitutional doctrines,5 and controversies regarding economic development tax incentives.6

The tax cannibalization problem is especially large for state corporate income taxes because state governments piggyback on a deeply flawed federal corporate tax base. In this article, we clarify a point of possible confusion about these issues and then discuss some policy implications.

2 Id. at 491.
3 Id. at 491.
A Clarification: Effective Versus Statutory Corporate Tax Rates

Before we discuss policy implications, we think it’s important to clarify a question that we have been asked about our revised estimates for 2020. Why is it that we base our analysis on statutory federal- and state-level corporate income tax rates, rather than on estimates for effective corporate tax rates?

Consider the following explanation from a 2017 Congressional Budget Office report:

The effective corporate tax rate, which is a measure of the tax on a marginal investment, is more informative for decisions about whether to expand ongoing projects in those countries in which a company already operates. In contrast, businesses focus on the narrower statutory corporate tax rate when they develop legal and accounting strategies to shift income earned in high-tax countries to low-tax jurisdictions — especially low-tax jurisdictions in which those businesses do not plan to invest and from which they thus expect no benefits from tax preferences for business investments.

In our view, the tax cannibalization problem is primarily caused by tax-gaming transactions, what the CBO report calls “legal and accounting strategies.” We think this is especially true on the margin.

One way to contemplate this question is to ask: Why do corporate income taxpayers with positive tax liabilities not engage in even more tax gaming than they currently do? For instance, a corporate taxpayer reporting income in a foreign low-tax jurisdiction could become even more aggressive with transfer pricing valuations to shift further reported profits to that low-tax jurisdiction. Why does it not do so?

Ultimately, we think that corporate taxpayers must engage in some form of cost-benefit analysis when contemplating incremental tax-gaming transactions. The benefit of shifting an additional dollar of reported profits abroad can be measured by the combined state and local domestic statutory corporate income tax rates minus the relevant foreign jurisdiction tax rate. The costs include increased risks of audit and legal sanctions, increased risks of negative publicity, any real costs associated with effectuating the tax-gaming transaction, and any complexity or other accounting or management type costs associated with effectuating the transaction. The key takeaway here is that marginal benefit from incremental tax gaming is a function of the combined U.S. state and federal statutory tax rates.

Some Policy Implications

A thorough discussion of the policy implications of these estimates is beyond the scope of this short article. The policy implications we discussed in our three prior articles generally remain applicable in 2020, but with the magnitude of some aspects of the tax cannibalization problem somewhat reduced. Nevertheless, a few points seem worth emphasizing here.

First, Congress reduced the federal corporate income tax rate in 2017 in part as a response to the growing problem of corporate taxpayers engaging in tax planning to shift profits to foreign low-tax and tax-haven jurisdictions. Yet our analysis implies that a better approach to dealing with this problem would be for the federal government to encourage state governments to move away from using the corporate income tax base.

To understand why, consider that, at the margin, state corporate income tax rates generate incentives for taxpayers to engage in profit shifting that are similar to those generated by the federal tax rate. But state tax rates then create additional economic waste through horizontal distortions, making state corporate income tax rates much worse in terms of efficiency than the federal tax rate. Moreover, multijurisdictional issues created by state corporate income taxes are notoriously complex, producing large administrative and compliance costs.

Several different readers have asked us versions of this question. But we especially owe thanks to Karen Burke for explaining to us the importance of clarifying this point.


Gamage and Shanske, supra note 4, at 335.

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We think it likely that, at some point in the coming decades, Congress will contemplate increasing the federal corporate income tax rate above its current 21 percent rate. As an alternative or an accompaniment to this, our analysis implies that Congress should consider encouraging state governments to reduce or abandon their corporate income taxes. There are a number of ways Congress might attempt to do so, some of which we explained in our 2017 article. Perhaps our top recommendation would be for Congress to work with state governments to devise a new state business entity tax base that, in contrast to today’s state corporate income taxes, would not exacerbate the problem of profit shifting by corporate taxpayers. Congress could then offer subsidies or other incentives for state governments to swap their existing corporate income taxes for this new tax base. Promising ideas for such a new tax base include (a) state-level value added taxes that would be designed around a federal-level registry for cross-border transactions, (b) variations on New Hampshire’s business enterprise tax, or (c) other approaches for entity-level consumption taxes.

Second, the problem of state and local economic development tax incentives has received increased attention of late, in part because of Amazon.com’s well-publicized competition for its secondary headquarters. We have been approached by congressional staffers to advise on proposals for federal legislation that would regulate these economic development tax incentives. As we argued in an earlier article, the tax cannibalization problem makes it so that the federal government has a large and direct stake in state and local governments’ offering of economic development tax incentives and thus offers the federal government a promising hook for regulating these practices. In another article we published earlier this year, we discussed the implications of presidential candidate Andrew Yang’s proposed federal tax on subnational tax incentives.

Third, from the perspective of the states, there remains little reason to move away from the corporate income tax. Indeed, the recent changes made by the Tax Cuts and Jobs Act reduces the incentives for states to make such a change. This is because, first, states can credibly claim that their corporate income taxes are now less distorting than they were. And, second, considering the capping of the state and local tax deduction, some states can claim that cannibalizing the federal base is a sort of rough justice given that the federal government has made it harder to tax progressively at the state level.

Most interestingly, the TCJA contains base broadening provisions that states can conform to, such as global intangible low-taxed income and the base erosion and antiabuse tax. To the extent that there is a credible argument that the federal government set its tax rate on this income too low, states supplementing the federal rate as to shifted income are not cannibalizing the federal base but protecting it. Further, to the extent that state conformity is not perfect and, in effect, is taxing a taxpayer along a different margin, then that too reduces cannibalization. It is thus arguable that the way that some states are conforming to GILTI — and could — are efficient in this way.

We hope to further discuss these and other policy implications of the tax cannibalization problem in future writings. We continue to view the tax cannibalization problem as playing a central — and mostly negative — role in the dynamics of U.S. fiscal federalism. By shedding light on this problem, we hope to reveal more promising opportunities for fiscal cooperation between the federal and state governments.