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Issues Associated with Corporate Income Taxation

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Members of the Committee:

My name is Elizabeth Malm and I am an Economist at the Tax Foundation, a non-partisan, non-profit organization founded in 1937. We analyze tax issues at all levels of government and raise economic awareness among taxpayers, lawmakers, and the general public. I am also a Montgomery County resident.

I am pleased to have the opportunity to speak with you today regarding House Bill 261, a bill that would reduce Maryland's state corporate income tax rate from its current level of 8.25 percent to 6 percent. The Tax Foundation takes no position on this bill, but I am eager to offer analysis based on our examination of corporate income taxation in general. Maryland and other states considering tax reform should be fully informed about the benefits and costs associated with various tax instruments. We find two compelling reasons that corporate taxes are a poor instrument for collecting tax revenue. First, corporate taxes are detrimental to economic growth; and second, they provide unstable and inadequate revenue over the business cycle.

As of 2012, Maryland's corporate income tax rate was the 15th highest nationally and the third highest in the region. The most problematic rate differential, however, is the significant difference between Maryland and neighboring Virginia. Virginia's corporate rate is only 6 percent—more than two percentage points lower than Maryland's. Businesses choosing to locate in the Washington, D.C. metropolitan area have the choice between three jurisdictions—Virginia, Maryland, and D.C. Potential tax burden is most certainly one of the costs a business considers in choosing where to locate. Reducing the corporate rate would make Maryland even more competitive in relation to its neighbors.

Issue #1: Corporate tax rates are harmful to economic growth.

Though the fiscal note for this legislation indicates an initial revenue loss, it is important to consider how reductions in corporate income tax rates benefit states in the long run. Tax structure and economic growth are inextricably linked. The Tax Foundation recently published a comprehensive academic literature review on the empirical relationship between taxes and economic growth over the last three decades. The review found overwhelming evidence that taxes negatively affect growth. Of the 26 studies surveyed, all but three found a negative relationship between the two. What's more interesting is that of the studies that distinguished between tax types, corporate income taxes were found to be the most detrimental to economic growth. I would be happy to provide copies of this study to the Committee.

Issue #2: Corporate tax revenues provide unstable and inadequate revenue over the business cycle.

A state's total tax revenue is derived from a variety of sources. If a state's revenue mix is heavily dependent on sources of revenue that do not grow at the same rate as the overall economy and fluctuate considerably as the overall economy changes, the state will have to make up revenue losses elsewhere to meet spending demands. Corporate income tax revenues have been empirically shown to grow at a significantly slower rate than the overall economy. If tax revenues are unable keep pace with spending demands, states must raise rates, move to other sources of revenue, or reduce spending.

Another important feature of a sound tax system is revenue stability. Corporate income tax revenue has been shown to be the most volatile of all tax revenue sources. Though corporate tax revenues are cyclical (that is, they grow when the economy grows and shrink when the economy shrinks), they undergo more pronounced changes when the overall economy changes. Though corporate income tax revenues will be plentiful in economic booms, they will contract severely when the economy dips, leading to revenue shortfalls and the need to make up revenues elsewhere. By focusing on tax revenue sources that provide a stable source of funding, states will circumvent the need to raise rates or cut spending to keep up with spending demands.

Conclusion

Since all states are different, an important consideration in any tax reform measure is the overall tax revenue portfolio of the state. Lowering rates for tax revenue sources that make up a significant portion of a state's budget can lead to revenue shortfalls. Corporate income tax revenues, however, make up a very small portion of Maryland's overall tax revenues (approximately 3.2 percent in 2010). They made up an even smaller portion of overall general revenues in 2010 (1.8 percent). Because of this feature of Maryland's tax system, reducing corporate rates would have minimal revenue effects in the grand scheme of total revenue collection.

In conclusion, corporate income taxes have many negative implications. Namely, they harm economic growth and fail to provide stable revenue. Reduction in corporate income taxation is associated with economic growth and increased revenue stability during the business cycle. Further, as one of the smallest sources of income for Maryland, revenue implications would be nominal.

I appreciate the opportunity to speak with you today. The Tax Foundation would be happy to provide further information on this subject at the Committee's request. Thank you, and I am able to answer any questions you may have.

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About the Tax Foundation

One of the oldest think tanks in the United States, the Tax Foundation is a non-profit, non-partisan organization that provides research and analysis on tax policy issues and the size of the tax burden at all levels of government. Based in Washington, D.C., our work advances the principles of simplicity, neutrality, transparency, and stability.

About the Center for State Fiscal Policy at the Tax Foundation

The Tax Foundation's Center for State Fiscal Policy produces timely, high-quality, and user-friendly research and analysis for policymakers and the public, shaping the state policy debate toward economically principled tax policies.