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spotlight

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The Corporate Income Tax

Repeal, Not Reform

KEY FACTS: **• The corporate income tax imposes a second and even a third layer of taxation on people's incomes and is hidden, dishonest, and inconsistent with informed decision making in a free and democratic society.**

• North Carolina has had a corporate income tax since 1921. Between 1921 and 1991 the rate increased from 3 percent to 7.75 percent. It was then lowered every year between 1997 and 2000 to its current rate of 6.9 percent.

• The corporate income tax is riddled with special exemptions meant to facilitate government manipulation of the economy.

• The corporate income tax is based on the myth that corporations actually pay taxes. In fact ,corporations not only do not pay taxes, they cannot pay taxes.

• All taxes "paid" by a corporation must come out of real people's wallets or bank accounts. These real people are shareholders, employees, and customers.

• In order to make intelligent voting decisions, citizens need to be aware of how much their government is costing them. The corporate income tax is a deceptive tax because it is invisible to those who are paying it.

A good deal of discussion of late has centered on reforming North Carolina's tax code, and that is a good thing. There is no aspect of North Carolina's tax system not in need of significant change. The current code penalizes worker productivity while placing multiple layers of taxation on saving, investment, and entrepreneurship. Members of both political parties are acknowledging these arguments, and there seems to be a real possibility that in the coming few years we could see significant changes made to North Carolina's tax code.[1]

Nevertheless, there is one aspect of North Carolina's system of taxation that needs more than reform, and that is the state's 6.9 percent tax levied on the income of corporations. The corporate tax should be repealed, not reformed.

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It violates all basic principles of sound economic policy and open government. It not only imposes a second and even a third layer taxation on many people's incomes, but it is hidden, dishonest, and inconsistent with informed decision making in a free and democratic society.

Why Not Reform? Corporate Income Taxes As a Tool of Central Planning

Leaving the corporate income tax in place and lowering the rate (i.e., reforming the tax) would not solve the problems introduced by the tax. As will be discussed, the problems brought by the tax are part and parcel of its fundamental nature, and while lowering the rates could ameliorate its negative impacts on the state's economy and political process, its corrupting features will remain as long as it remains in place and continues to be collected. Furthermore, if history is any gauge, rate reductions will only be temporary.

North Carolina has had a corporate income tax since 1921, and its history shows clearly that there is no such thing as a permanent rate change. Between 1921 and 1991 the rate increased steadily from 3 percent to 7.75 percent. It was then lowered every year between 1997 and 2000 to its current rate of 6.9 percent.

Politicians have viewed the tax since its inception as one they can and should manipulate. While theoretically the tax is levied on all for-profit corporations doing business in the state, in reality it is riddled with special exemptions meant to facilitate government manipulation of investment and business activity, usually in the name of "economic development" or, more recently, "energy efficiency" or environmental protection.

Most of the major economic incentive schemes launched by North Carolina state government have centered around granting exemptions from the corporate income tax in the form of tax credits. They have included everything from building recycling facilities and installing solar power plants to using the state's ports (see more complete list). The political mode of operation is to tax corporations generally at a relatively high rate and then use exemptions from the tax as a way of subsidizing favored or politically correct businesses. Politicians have come to see the tax as a way to gain power over market outcomes through the process of granting exemptions.

In light of all that, the corporate income tax is best viewed as a type of "negative slush fund." Instead of using a stash of already

North Carolina's Corporate Income Tax Credits[2]

Business and Energy Tax Credits

- Investing in Business Property
- Renewable Energy Property
- Constructing Renewable Fuel Facilities
- Small Business Employee Health Insurance
- Biodiesel Producers
- Work Opportunity
- Donations to Nonprofit Organization or Unit of State or Local Government for Acquisition of Renewable Energy Property

Tax Incentives for Recycling Facilities

Historic Rehabilitation Tax Credits

Low-Income House Tax Credits

Research and Development Tax Credit

Tax Incentives for Major Computer Manufacturing Facilities

Tax Credits for Growing Businesses

Mill Rehabilitation Tax Credit

Tax Incentive for Railroad Intermodal Facility

General Tax Credits

- Dwelling Units for Handicapped Persons
- Construction of Cogenerating Power Plant
- Real Property Donated for Conservation Purposes
- Conservation Tillage Equipment
- Gleaned Crop
- Certain Telephone Subscriber Line Charges
- Supervisory Fees Paid by Savings and Loan Associations
- Use of North Carolina Ports
- Poultry Compositing Facility
- Manufacturing Cigarettes for Exportation
- Manufacturing Cigarettes for Exportation While Increasing Employment and Utilizing State Ports

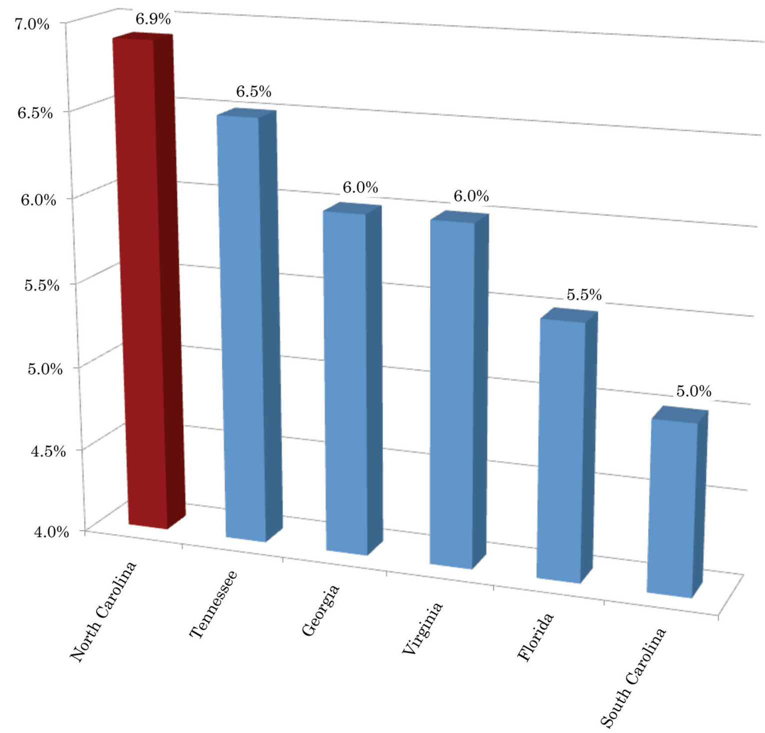
collected tax money to subsidize favored businesses and political allies directly, the politicians allow favored business interests to keep more of their own money than the tax would otherwise indicate. Ultimately, the corporate income tax is not a tool of taxation but a lever for centrally planning the state's economy.

The Myth: Corporations Pay Taxes

The corporate income tax is based on the myth that corporations actually pay taxes. In fact, corporations not only do not pay taxes, they cannot pay taxes. The argument isn't that corporations shift the tax burden onto consumers or workers or shareholders, but that it is conceptually impossible for corporations to pay taxes.

A corporation is a legal and accounting entity. They can't pay taxes; only people can. It's the flip side of the fact that all revenues that flow to a corporation ultimately ends up in some real persons' wallets or bank accounts: all taxes "paid" by a corporation must come out of some real persons' wallets or bank accounts.

Comparison of Corporate Income Tax Rates



Source: Tax Foundation

Here are the people who pay corporate income taxes:

- **Shareholders.** They pay through reduced dividends and capital gains. For those who are investing outside the context of a tax-free Individual Retirement Account (IRA) or 401(K) retirement plan, the corporate tax imposes a third layer of taxation on their investments. When their principle investment is taxed as regular income, it also reduces any investment returns that investment can generate. That is the first layer. The tax on dividends and capital gains is a second layer. The corporate tax, by reducing the revenues available for dividends and by reducing the overall value of the corporation, imposes a third layer of taxation on that income stream.

  For those investing within the context of an IRA (either a regular or Roth) or a 401(K), where either the principle or the returns to the investment are tax-exempt, the corporate tax imposes a second layer of taxation.[3]

- **Corporate employees.** They pay in the form of lower wages. Since their wages are already reduced by the standard income tax, the corporate tax imposes a second layer of taxation on wages of corporate employees. (Also, it has the negative effect of reducing employment opportunities for workers in general.)

- **Customers.** They pay in the form of higher prices. That payment comes as an additional layer of taxation, of course, to the sales tax rate paid in North Carolina, depending on the county, of approximately 7 percent.

The bottom line is that those who argue for increasing corporate income tax rates, claiming that corporations are "not paying their fair share" of taxes, are really charging that shareholders, employess, and consumers are all being undertaxed.

The Reality: The Corporate Tax Is Fiscal Slight-of-Hand

The corporate income tax is a hidden tax. While a few of the of the individuals making up the groups mentioned above may understand conceptually that they are bearing the burden of the corporate tax, none of them know or even can know what that burden is. The corporate tax adds a real but unquantifiable layer of taxation on the citizens of North Carolina. As such, it is a dishonest tax that is antithetical to the functioning of a transparent democratic process.

In order to make intelligent voting decisions, citizens need to be aware of how much their government is costing them. Unfortunately, those who are paying the corporate tax are being deceived.

On the other hand, the hidden nature of corporate taxes make them easy to demagogue. It allows certain politicians and ideologues, whose desire is simply to raise taxes in order to support favored programs or interest groups or to gain additional leverage in the process of private investment, to invoke a fiscal slight-of-hand. It lets them make promises to constituents while misleading them into believing that someone else — greedy corporations — are paying the bill.

It is interesting to note that very often the supporters of corporate taxes are progressives who know full well the tax is not paid by corporations, but rather in large part by the people they claim to represent — workers and consumers.

The fact that many of North Carolina's political leaders are calling for a reduction in the corporate tax rate is laudable, but that step would only ameliorate the injustices and distortions of the political and economic processes created by the tax. It wouldn't make the tax any less dishonest or more transparent. As long as the corporate income tax is in place, North Carolina's citizens will continue to be misled.

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End Notes

1. For a comprehensive discussion of both the economics and ethics of tax reform for North Carolina and how such reform should proceed, see Roy Cordato, "Tax Reform in North Carolina," Nathaniel Macon Research Series No. 4, John Locke Foundation, March 2009, *johnlocke.org/policy_reports/display_story.html?id=196*.
2. North Carolina Department of Revenu, *www.dornc.com/taxes/corporate*.
3. Op. cit., note 1.