

Reclaiming corporate tax revenues

Corporate income tax revenues are critical to the ability of state and local governments to provide basic services to their residents

Report • By [Josh Bivens](#) • April 14, 2022

Key takeaways

- Depending on how it is measured, the effective state and local tax rate on corporate profits shrunk by between a third and a half between 1989 and 2017.
- The resulting revenue shortfall is estimated to be at least \$43 billion and possibly as high as \$57 billion.
- The erosion of state corporate income tax revenue has nothing to do with corporations' ability to pay. Indeed, corporate profits have risen even as corporate tax revenues have declined.
- Information obtained from seven states reveals that more than 60% of corporations operating in these states pay no state corporate income tax. And depending on the state, between 11% and 27% of corporations with over \$1 billion in federal taxable income pay nothing or next to nothing in state corporate income taxes.
- The decline can be traced to a combination of state corporate income tax cuts, a rise in the share of corporate profits earned by S-corporations, which are exempt from most state corporate income taxes, and the ability of large, profitable corporations to exploit loopholes that allow them to minimize their tax bills.
- This has real consequences for state and local spending—constraining these governments' ability to provide basic services to their residents.

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Many of the most fundamental tasks we need performed by the public sector in our daily lives are carried out by state and local governments. These critical tasks include educating children; maintaining roads, bridges, and other transportation networks; ensuring public order and safety; monitoring public health; and providing clean water. The pandemic crisis of the past two years has shown the critical importance of the public services that state and local governments provide.

To provide these services, state and local governments need robust, sustainable sources of revenue. However, in recent decades state and local policymakers have consistently allowed corporations to reduce their share of taxes. The growing erosion of state corporate income taxes has been a prime source of revenue weakness over this time. Importantly, this erosion in corporate taxes does not stem from any reduced ability to pay from corporations—profits have been extremely strong for decades, and even during the pandemic.

Information obtained from a number of states reveals that a majority of corporations operating in those states are paying nothing in state corporate income taxes. Even among corporations with over \$1 billion in federal taxable income, significant shares pay nothing—or next to nothing—in state corporate income taxes. The data from these states are summarized in **Figure A** and explained in detail later in the paper.

This erosion of corporate income tax revenue threatens the delivery of valuable public goods and services. Going forward, state and local policymakers should ensure that profitable businesses pay their share for delivering these public goods by enacting the necessary fiscal reforms to ensure those changes.

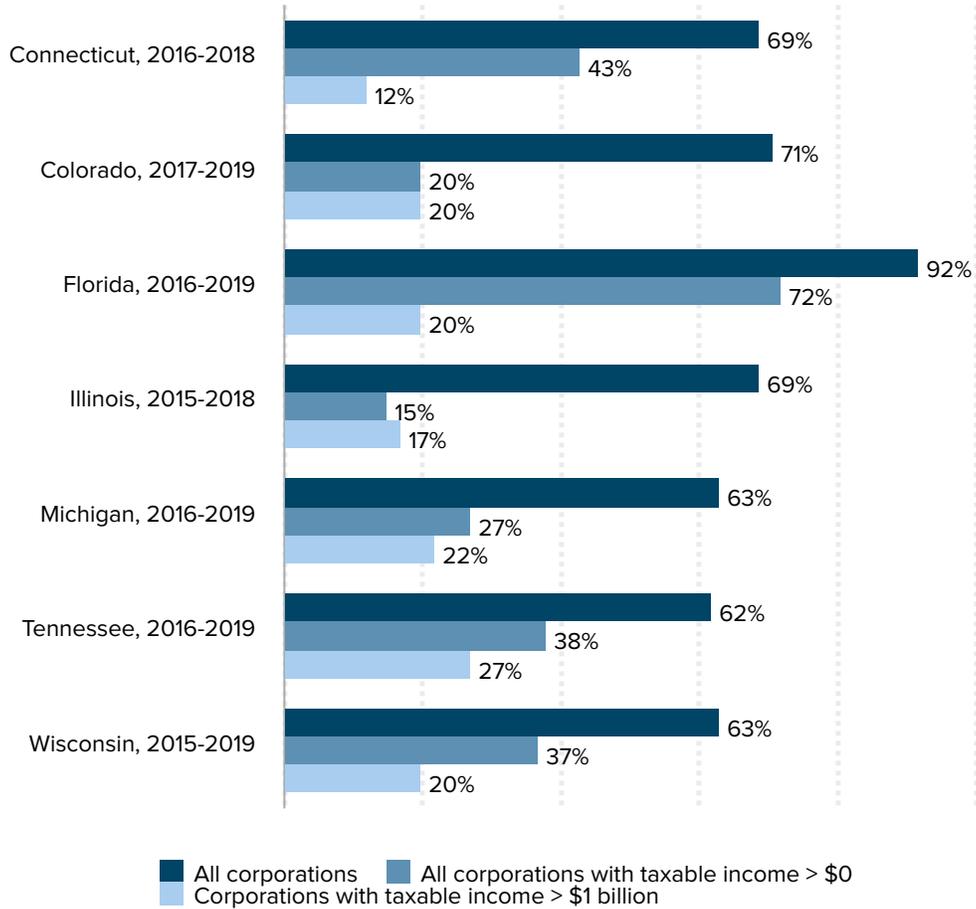
In this report we provide a brief overview of the importance of state and local governments in providing critical public services, the need for strong sources of revenue at the state and local level to meet public needs, the erosion of corporate tax revenue, and the impact on state budgets, communities, and economic inequality. In addition, we provide first-time state-level data on the extent to which highly profitable corporations have found ways to reduce their state corporate tax bill to nothing or next to nothing, just as they often have managed to accomplish at the federal level. We conclude with some potential reforms that could help to remedy the situation.

This need to restore profitable businesses' fair share of taxes is especially crucial because the state and local sector faces constraints—some legal and some economic—that force them to balance their operating budgets each year. Meeting the daily needs of their communities requires ensuring adequate revenue.

Figure A

A large share of corporations—even highly profitable ones—pay minimal income taxes

Share of corporations (%) paying zero corporate income taxes in surveyed states (multiyear averages)



Notes: We use “tax on corporate income” as a generic descriptor. Depending on the state, this tax may be called the corporate income tax, business tax, excise tax, or franchise tax. In Connecticut, all corporations pay a minimum tax of \$250, according to the Connecticut Department of Revenue. Based on the data we received, Connecticut corporations with over \$1 billion in federal taxable income paid more than this minimum—\$4,000 on average. We are still seeking clarification. Data received from Connecticut combined certain categories based on disclosure requirements for taxpayer counts of three or less. As such we calculated the percentage based on the highest and lowest potential count of corporations paying the minimum tax for each tax year.

Source: Information obtained from queries made by state legislators to their respective revenue departments. The specific information requests and responses can be found [here](https://sites.google.com/view/statecorporatetax/home). (hyperlink: <https://sites.google.com/view/statecorporatetax/home>)

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Key findings of this report

State and local revenue and spending

- **The state and local government sector accounts for the large majority of service provision and public investment in the U.S. fiscal system.**
 - In 2019, state and local governments combined to employ roughly 19.8 million workers, compared with 2.8 million in the federal government (not including the military). State and local public-sector workers include teachers, social workers, school nurses, child care and elder care providers, sanitation workers, and those who repair our roads, among a multitude of other jobs.
 - These jobs do not just provide needed public goods and services; they also disproportionately employ Black workers and women, groups that often face greater employment and occupational discrimination in the private sector.
 - In 2019, state and local governments combined to direct public investment equal to 2.0% of total gross domestic product (GDP). The federal government—even including defense spending—directed public investment less than 1% of GDP.
- **Any weakness in revenue raised directly by state and local governments translates directly into downward pressure on spending.**
 - This is true despite the rise in federal grants to state and local governments.
 - Across states, from 1979 to 2019 every \$1 in reduced revenue was correlated with an \$0.88 reduction in state spending.

The shortfall in state corporate income tax revenues

- **Over time, the share of total state and local government tax revenue accounted for by corporate income taxes has shrunk sharply.**
 - It has shrunk by 2.8 percentage points, more than any other major category of taxes.
- **This revenue shortfall in corporate income taxes has not been made up elsewhere in the tax system.**
 - Since 2000, reductions in per capita corporate income taxes are strongly associated with reductions in overall tax revenue across states.
 - The simple correlation between overall and corporate income taxes indicates that there is essentially a dollar-for-dollar reduction in overall revenues for each dollar cut in corporate income taxes.
- **Weakness in corporate tax revenue does not stem from weakness in corporate profitability.**
 - Pre- and post-tax profit margins have been extraordinarily strong since 2000 as corporate income tax revenue has declined as a share of overall revenue.

- The “effective” corporate income tax rate levied by state and local governments shrank from 5.2% in 1989 to 2.6% in 2017, a reduction of just under 50%.
- Even if one restricts attention to only the effective tax rate on the profits of C-corporations, which have been shrinking as a share of total corporate profits for decades, the effective rate declined from 5.9% in 1989 to 3.9% in 2019, a reduction of 33%.
- Recently obtained data from seven states reveal that a significant portion of highly profitable corporations operating in those states pay nothing or next to nothing in state corporate income taxes, including some with over \$1 billion in federal taxable income.
- **The shortfall is estimated to be at least \$43 billion and potentially as high as \$57 billion.**
 - The state and local government sector today would have more than \$43 billion in additional tax revenue if the effective tax rate of C-corporations had not declined post-1989.
 - That number rises to \$57 billion if the effective rate of taxation of corporate profits more generally had not been eroded due to the growing share of corporate profits reported by S-corporations.
 - The growing share of corporate profits reported by S-corporations (which largely escape state-level corporation taxation) is at least in part a strategy of tax evasion.¹

Implications

- **These scales of revenue loss are highly significant.**
 - For example, state and local governments could essentially fully fund universal high-quality pre-kindergarten for all 3- and 4-year-olds with \$57 billion.
 - Even the lower level of revenue gains (\$43 billion) realized simply by restoring the effective rate of taxation of C-corporations only is an amount equal to roughly 40% of all public investment undertaken by state and local governments in the education sector (both K–12 and higher education).
- **States’ steady reduction of statutory corporate income tax rates in recent decades has exacerbated inequality.**
 - Between 1989 and the onset of the Great Recession in 2007,² corporate income tax rate cuts were not meaningfully correlated with faster growth in the median wage growth.
 - But these cuts were *strongly* correlated with faster growth in the income share of the top 1%.

The state and local government sector provides valuable public goods and services

The U.S. system of taxation and public spending is characterized by *fiscal federalism*—a division of responsibilities between the federal, state, and local governments. The federal government raises more revenue than state and local governments combined, and it also spends more. This can make it easy to underestimate the economic importance of the state and local (S&L) sector, but that would be a mistake.

A very large share of federal government spending is on transfer payments. Transfers—like Social Security, Medicare, and the Supplemental Nutrition Assistance Program (SNAP—commonly referred to as food stamps)—provide income directly to recipient households. When the transfer income is spent by these households, it has economic effects on the wider economy, but there is no direct economic impact—as measured, say, by changes in gross domestic product (GDP)—of the transfer itself. Transfers broadly constitute well over half of all federal government spending. Besides transfer payments, the next biggest function of the federal government is defense spending, which accounts for roughly 15–20% of total federal government spending in recent years.³

In contrast, the S&L sector devotes the largest share of its resources directly to the provision of goods and services for residents. For example, the single largest function of S&L sector spending is education, both K–12 and higher education.⁴ To accomplish this function, S&L governments do not just transfer income to households. These governments have to hire workers and buy or build structures and equipment to deliver educational services. Other key functions of the S&L sector include the direct provision of social services (including publicly financed health care facilities) and public safety.

This focus on spending dedicated directly to the provision of goods and services means that the economic footprint of the S&L sector is actually larger in many important ways than the federal government. For example, **Figure B** shows that state and local governments employ significantly more workers than the federal government.

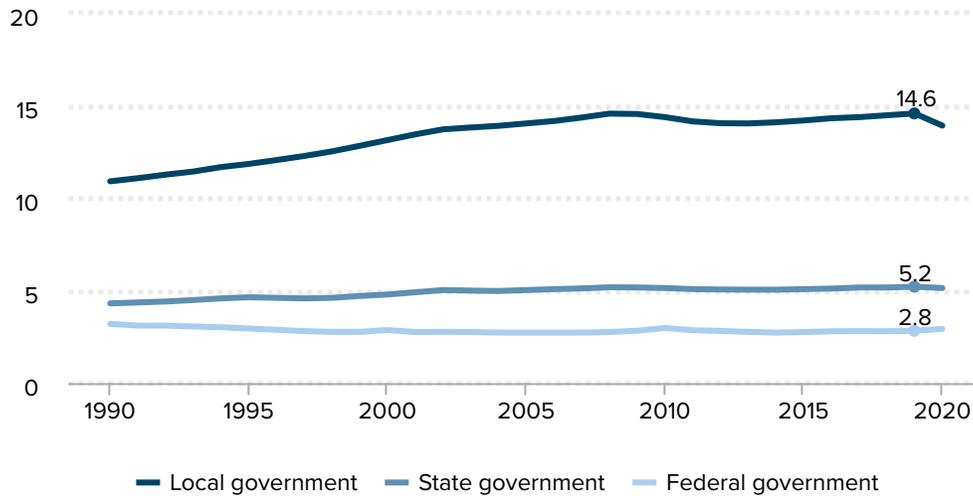
In 2019,⁵ the federal government employed 2.8 million workers (excluding the military), state governments employed 5.2 million, and local governments employed 14.6 million. (Essentially all K–12 public school employees in the United States are local government employees, accounting for much of this high employment level).

State and local governments are an important source of employment for women and Black men, and wage penalties faced by women and Black men are smaller in these jobs than in the rest of the economy.⁶ In short, the S&L sector is not just a large employer in the U.S. economy, it is also a more equitable employer along many dimensions.

Figure B

State and local governments perform most of the basic functions of the public sector

Employment (millions) in federal, state, and local governments, 1990–2020



Source: Current Employment Statistics from the Bureau of Labor Statistics.

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Many of the most basic public investment functions we expect from the public sector—like maintaining roads and other transportation investments and ensuring the steady flow of electricity, heat, and clean water—are directed by the S&L sector. **Figure C** compares public investment undertaken by the federal government and the S&L sector, both expressed as shares of GDP.

For most years since 1979—and for all years since 1988—the S&L sector has directed more public investment than the federal government. By 2019 this gap was quite large, with public investment from the S&L sector equaling 2.0% of GDP while investment from the federal government totaled just 0.8% of GDP. In dollar terms, that’s a gap of roughly \$220 billion annually.

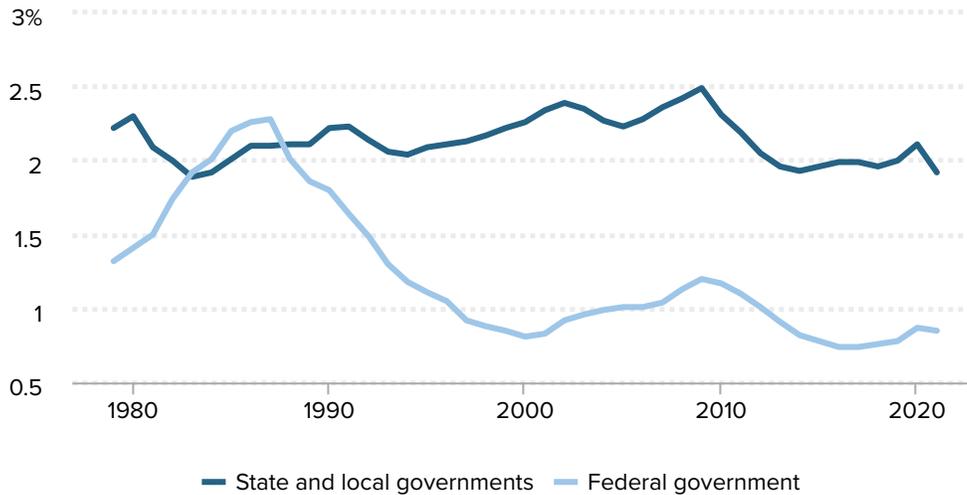
The federal government public investment data in Figure C include national defense spending, which not only explains the bump-up in the 1980s—when defense spending was accelerating—but also highlights that the gap in nondefense public investment directed by the S&L sector versus the federal government is even wider than the gap shown in Figure C.

All of this discussion highlights something very basic: A healthy S&L sector is hugely important to the day-to-day economic lives of Americans. The spending undertaken by the S&L sector is crucial not only for long-run economic growth but also for the daily quality of life U.S. families can expect.

Figure C

State and local governments take the lead on maintaining infrastructure such as roads and water systems

Public investment directed by state and local governments (combined) and the federal government, as % of GDP, 1979–2021



Note: Public investment refers to government spending on fixed assets and research and development that either benefit the public directly (highways and school buildings, for example) or aid government agencies in doing their jobs (information technology equipment for state-run health care facilities, for example).

Source: National Income and Products Account Tables 3.2, 3.3, and 1.1.5 from the Bureau of Economic Analysis.

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S&L governments need strong revenue sources going forward

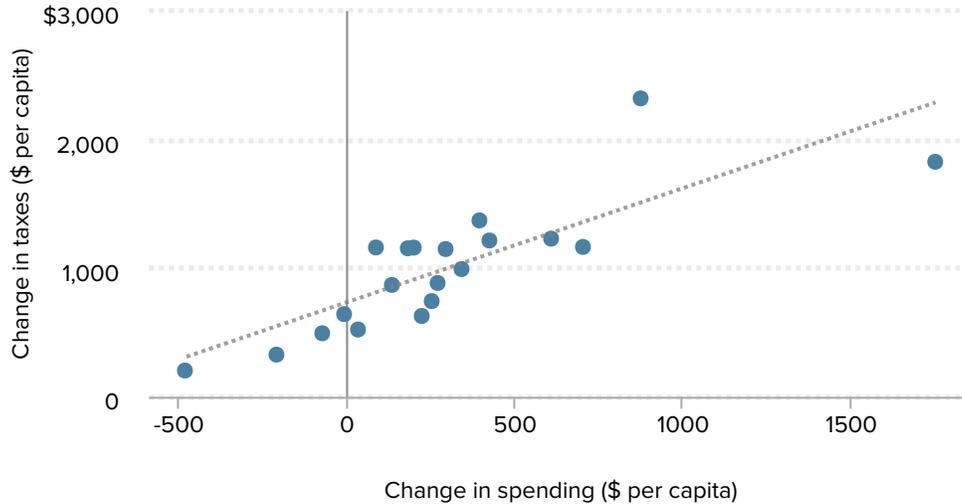
Besides the differences noted above in the character of spending by S&L governments relative to the federal government, there is one more glaring difference: Spending in the S&L sector is highly constrained by the revenue available to these governments. The federal government can undertake large amounts of borrowing to support current spending. S&L governments face much tighter constraints on borrowing.

Some of these constraints are legal—many states, for example, have balanced budget amendments in their state constitutions. But these constraints are also economic. Public entities that cannot issue currency are far more exposed to the danger of bond markets refusing to service their debt and causing a fiscal crisis. This lesson was demonstrated clearly, for example, in the Eurozone debt crises of the 2010s. Given that S&L governments cannot issue currency, they need to finance a large portion of their current spending with matching revenue—and the federal government has a strong obligation to use its own power to borrow during economic downturns to help S&L governments (see, for example,

Figure D

Reduced tax collections is strongly associated with reduced spending

Change (\$) in per capita state and local taxes and spending, 2000–2007 and 2007–2019



Notes: Figure is a binned scatterplot that ranks state changes in taxes between 2000 and 2007 and between 2007 and 2019, and then groups these state-specific changes into similarly sized “bins” of changes. States include D.C. If data allow for an exactly equal number of observations in each bin, then the number of observations in each bin is equal. If the data are unequal, bins are constructed using default settings on Stata binscatter command. Each bin’s average change in taxes and spending is then compared in the graph. Because it is an outlier on both taxes and spending, Alaska is omitted. Including it would strengthen the association.

Source: Underlying data are from the Census of State and Local Government Finance. Interactive tool from Urban Institute used to access data in March 2022.

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Bivens 2019 for a discussion of this).

Given these constraints, to maintain or even expand the crucially important public goods and service provisions they undertake, S&L governments will need more revenue going forward. In recent years, however, some key sources of revenue for these governments have been allowed to erode (or have even been affirmatively cut). Even with the rising importance of federal grants, weakness in S&L revenues has been strongly associated across states with austerity on the spending side.

Figure D shows the change in per capita S&L taxes and per capita spending between business cycle peaks (between 2000 and 2019) across states. It shows a strong correlation between the two, with each dollar of per capita tax changes associated with \$0.88 in per capita spending changes. In short, this relationship strongly suggests that to maintain or expand the public services provided by S&L governments, higher revenue is needed.

State corporate income taxes have eroded sharply in recent decades

In recent decades, a rise in federal grants provided to the S&L sector buffered some of the need to cut spending arising from revenue weakness (see Bivens 2019 for a discussion of these grants). But there are clear limits to how much the S&L sector can rely on federal transfers in the long run, and weakness in the S&L sector's own-revenue (revenue they raise apart from federal transfers) must eventually be strengthened.

Recent decades' weakness in the S&L sector's own-revenue is multifaceted, but the evidence that an erosion of corporate income tax revenue plays a large role is evident. Figure A in the introduction highlights the most extreme manifestation of this erosion, displaying the large share of corporations—and even highly profitable corporations—that pay essentially zero tax. Details on how these data were obtained and the substantial barriers existing that keep the public from knowing this information is provided in the text box below.

How much do companies actually pay?

Shedding light on corporate income taxes in the states

In the debate over what share of taxes should be paid by profitable businesses at the state and local level, the public could benefit from knowing just how much large corporations are really paying in corporate income taxes. For publicly traded corporations, some limited information is available at the federal level: The U.S. Securities and Exchange Commission (SEC) requires disclosure of federal corporate income tax payments as well as the actual tax rate paid compared with the statutory rate.

Unfortunately, similar information is not readily available at the state level. The SEC does not require information on specific state taxes, only the aggregate of total state taxes paid. Most state governments do not require corporations to release detailed information on their state corporate tax payments. Consequently, it is not possible to determine which corporations engage in state-level tax avoidance and do not pay their fair share in specific states.

The failure to require corporations to disclose their taxes allows them to unfairly avoid public scrutiny when they avoid paying billions in taxes. Without information on how much corporations actually pay at the state and local levels, there is no way to determine whether or not they are paying their fair share. If we could obtain transparent information at the state level, both government officials and the public could measure the actual costs and benefits of corporate

contributions and tax breaks.

In the spirit of pursuing such transparency, coalitions of labor and community organizations have been working closely with state legislators in eight states—Colorado, Connecticut, Florida, Illinois, Maine, Michigan, Tennessee, and Wisconsin—to collect data about corporate income taxes paid in those states.

The legislators requested information from their respective state departments of revenue on corporate taxes for the four most recent calendar years for which data were available. Specifically, they asked for the number and percentage of companies operating in the state that pay zero corporate income taxes in the state, the percentage of total state income taxes contributed by corporations, and other specific information pertaining to the largest for-profit corporations operating in the state. To ensure they were capturing total corporate profits before state modifications were applied, they requested data on both federal taxable income and state taxable income.

There has been no response to date from Maine. In the remaining states, legislators received answers to some—but not all—of the questions. The state departments of revenue cited privacy laws as the reason for not being able to provide answers to some questions. In some states, legislators had to follow up on their initial request or ask clarifying questions to complete their data collection. In short, under the status quo, even the most interested members of the public would have an extraordinarily difficult time collecting timely and useful information on this topic.

The ability of corporations to shed their tax responsibilities is not just anecdotal—it shows up clearly in macroeconomic data. **Figure E** shows the share of S&L taxes accounted for by several categories. Corporate income tax revenue as a share of overall tax revenues for S&L governments fell by 2.8 percentage points between 1979 and 2019, the largest fall of any category (though essentially tied with excise taxes).

This weakness in corporate tax revenues' share of overall taxes did not stem from weakness in corporate profitability over that time. **Figure F** shows estimates of pre- and post-tax profit margins in the corporate sector since 1979. These profit margins are defined as corporate profits divided by all other components of the cost of producing output. They can be thought of as a “markup” firms put on other costs of production.

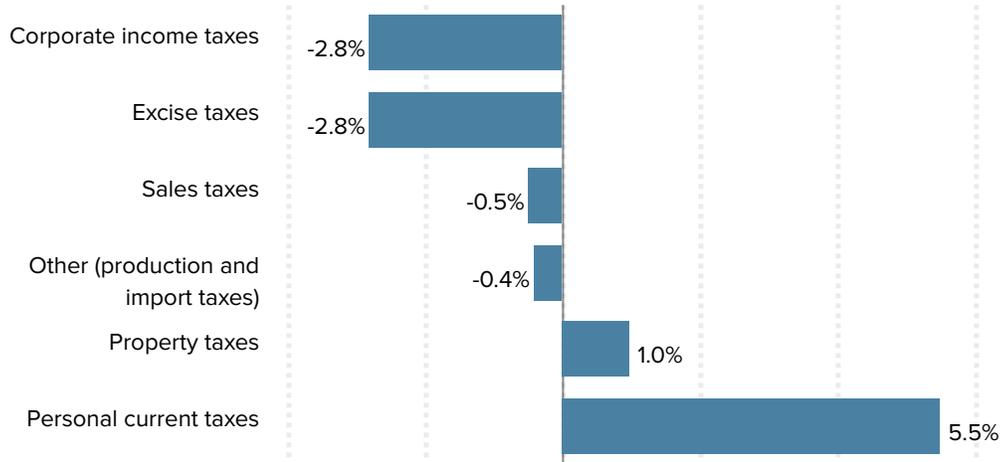
In the years since the Great Recession (2007–2019), pretax profit margins averaged 15.0%, while the share of corporate income tax revenues in total S&L taxes was just 3.6%.⁷ In the previous period between 1979 and 2007, pretax profit margins averaged less than 12%, but the share of corporate tax revenues in total S&L taxes averaged 4.7%. In short, there is no case to be made that the reduction in corporate income tax revenues stems simply from a declining ability to pay in the corporate sector.

Figure G shows two measures of the effective rate of state corporate income taxes. The

Figure E

Corporate income tax erosion is the biggest factor in declining state and local revenues

Percentage-point change in each tax category's share of state and local taxes between 1979 and 2019



Note: "Personal current taxes" include personal income taxes, personal property taxes, and payments for personal licenses.

Source: National Income and Product Accounts Table 3.3 from the Bureau of Economic Analysis.

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bottom line simply divides total corporate income taxes collected by S&L governments by total corporate profits. This measure falls from 5.2% to 2.6% between 1989 and 2017, a decline of just under 50%. If this rate had held steady at 5.2%, the corporate income tax would have boosted S&L revenues in 2019 by more than \$57 billion.⁸

The top line shows S&L corporate income tax revenues as a share of profits from only C-corporations. The implications of these data are discussed in the following section.

The rise of S-corporations played a key role in eroding corporate income tax revenue

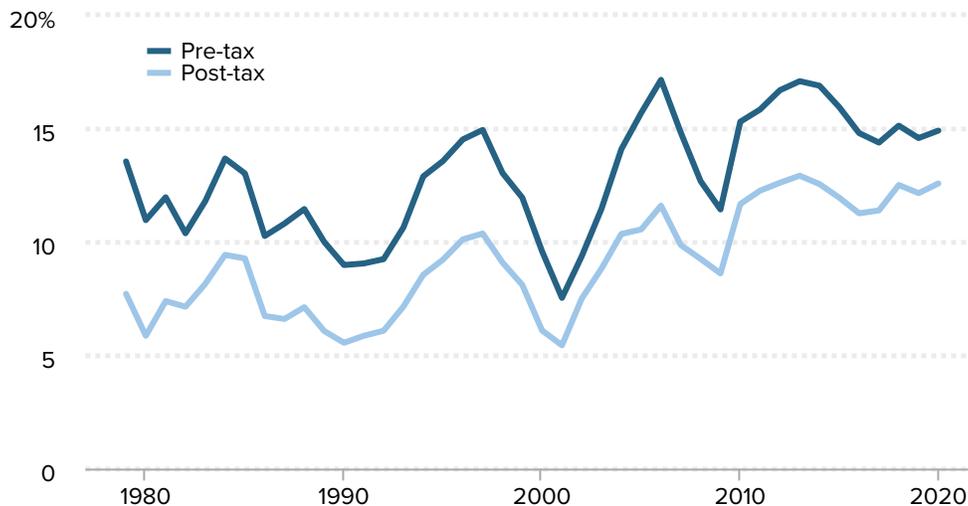
One issue often raised in discussions of eroding corporate income tax revenues is the large decrease in the share of corporate profits in recent decades that can be accounted for by traditional C-corporations.⁹

C-corporations are likely what most people think of when they think of corporations. They are incorporated companies whose owners are not personally liable for debts incurred by the business entity. C-corporations are allowed to raise financial capital from as many individual owners (or shareholders) as they wish, and many large C-corporations have thousands or even millions of individual shareholders. C-corporations may retain earnings within the corporation rather than paying them out as dividends to shareholders. C-

Figure F

The decline in corporate income tax revenue has nothing to do with corporations' ability to pay

Pre- and post-tax profit margins in the nonfinancial corporate sector, 1979–2020



Note: Profit margins are defined here as unit profits (profits per dollar of output) divided by all other unit costs.

Source: National Income and Product Accounts Table 1.14 from the Bureau of Economic Analysis.

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corporations are responsible for paying corporate income taxes before either retaining post-tax profits or distributing them to shareholders (at which point shareholders must pay individual income taxes on the distributed dividends).

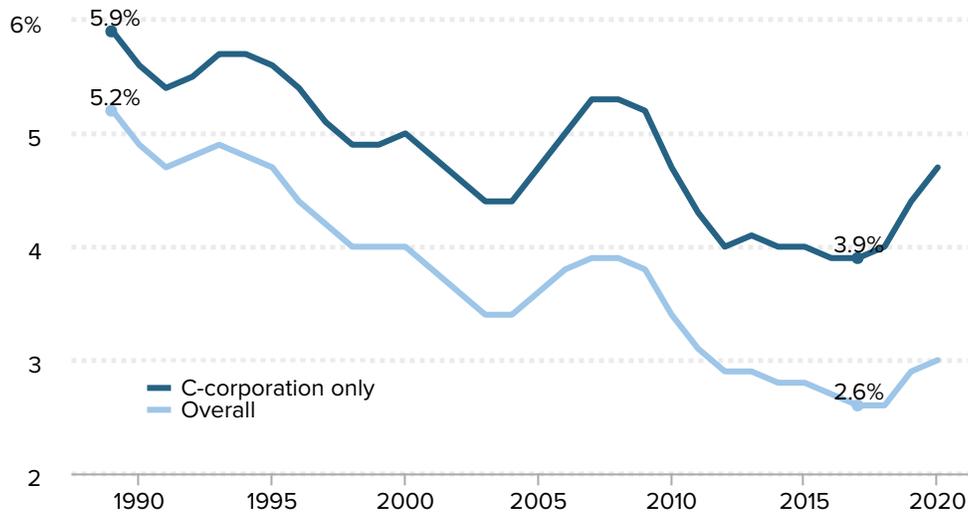
The decline in the share of corporate profits accounted for by traditional C-corporations has been driven by the rise in profits accounted for by S-corporations. S-corporations differ from C-corporations in a number of ways. For one, the maximum number of shareholders in S-corporations is legally capped. S-corporations are also not allowed to retain earnings—all profits of S-corporations are passed through immediately to individual shareholders, and the shareholders pay taxes on these profits (or dividends) through the individual income tax. S-corporations are exempt from federal corporate income taxes, and are exempt from most (but not all) state corporate income taxes as well.¹⁰ In 1979, S-corporations accounted for 5% or less of total corporate profits, but by 2019 this share had risen to roughly 35%.¹¹ This rise means that all else equal, corporate income tax revenues should have been expected to fall (as they in fact did).

Figure G includes a line showing the effective rate of corporate income taxation faced by C-corporations only. In constructing this figure, we allow the share of profits accounted for by C-corporations to fall smoothly from 95% in 1979 to 65% in 2019. The actual fall in the share of profits accounted for by C-corporations has been quite smooth over time,¹² so this is a logical way to reflect this. This implied effective C-corporation tax rate falls from 5.9% in 1989 to 3.9% in 2017, a decline of about 33%. In dollar terms, if the effective rate of

Figure G

Corporate tax revenue has been reduced by both base erosion and rate cuts

State and local corporate income tax revenue as a % of corporate profits, total and expressed as share of profits from only C-corporations, 1989–2020



Notes: Data from Nelson 2016 and Krakower et al. 2021 show that the share of corporate profits accounted for by C-corporations fell from roughly 95% to 65% between 1980 and 2021, with a corresponding rise in profits accounted for by S-corporations. (S-corporations largely escape state-level corporate taxation, and the growth of S-corporations is at least in part attributable to tax evasion strategies aided by policy.) To estimate profits of C-corporations only for this figure, we use the data from Nelson 2016 and Krakower et al. 2021 and linearly interpolate this declining share smoothly over the entire period.

Sources: National Income and Product Accounts Tables 3.3 and 1.14 from the Bureau of Economic Analysis; Nelson 2016.

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taxation on C-corporation profits had remained constant post-1989, S&L governments would have collected roughly \$43 billion more in revenue in 2019.

We should be clear, however, that calculating the effective tax rate faced by C-corporations is not a simple “correction” that solves a politics-free measurement problem in assessing trends in corporate income taxation. The rise of S-corporations was not an inevitability. Instead, this rise was fostered by policy choices and its rise was often the result of strategic policy efforts to aid the evasion of corporate taxes.

This can be seen in the evolution of the law governing S-corporations over time. The key advantage of S-corporations relative to C-corporations is (obviously) the exemption from taxation at the business entity level. However, a key disadvantage is the legal cap on the maximum number of shareholders. The tax law allowing the creation of S-corporations became effective in 1958, and the maximum number of shareholders was capped at 10. The law was aimed at allowing genuinely small businesses to avoid having to pay corporate income taxes while still having some key benefits of incorporation (mostly limited liability).

The key benefit of C-corporations' uncapped number of potential shareholders is this provides them the ability to raise enormous amounts of financial capital to invest—investment on a scale not likely needed by the small businesses meant to be helped by the creation of S-corporations.

Over time, however, the maximum number of S-corporation shareholders has been steadily increased. The last increase was during the Bush administration in 2004 when the limit hit its current level of 100. This 10-fold increase in the maximum number of shareholders (along with other changes in tax law and financialization and a huge increase in overall inequality that has given rich individuals vastly more wealth to invest) has made the shareholder limits on S-corporations far less binding over time, and hence has reduced the cost to claiming S-corporation status.¹³ Today, there are hundreds of enormously profitable and large companies claiming S-corporation status. For example, Smith et al. (2019) note that “over 69% of the top 1% [of households ranked by income] and 84% of the top 0.1% earn some pass-through business income.” One can imagine that the ultrarich of the top 1% and top 0.1% are not relying on ownership of mom and pop stores to generate that income.

Some states currently *do* levy some income taxes on S-corporations directly. There is no iron rule that says this is impossible. Incorporation is a legal benefit conferred by governments, and there is no particular reason why government cannot ask for a payment in return for it. If current S-corporation owners did not like a new regime in which they had to pay entity-level taxes, they would always be free to give up the benefits of incorporation.

In short, the rise of S-corporations and the resulting erosion of taxes collected from corporate profits has been aided and abetted by policy over decades. This erosion of revenue is not an immutable natural occurrence, and it is a simple fact that the effective rate of business-level taxation faced by corporate profits fell by roughly 50% (from 5.2% to 2.6%) between 1989 and 2017, as noted above. The rise of S-corporations is indeed one reason why this effective rate fell. But many other strategies of tax evasion also contributed. This does not mean that it did not happen or that it cannot be restored.

The erosion of corporate income taxes was a tax cut, not a tax shift

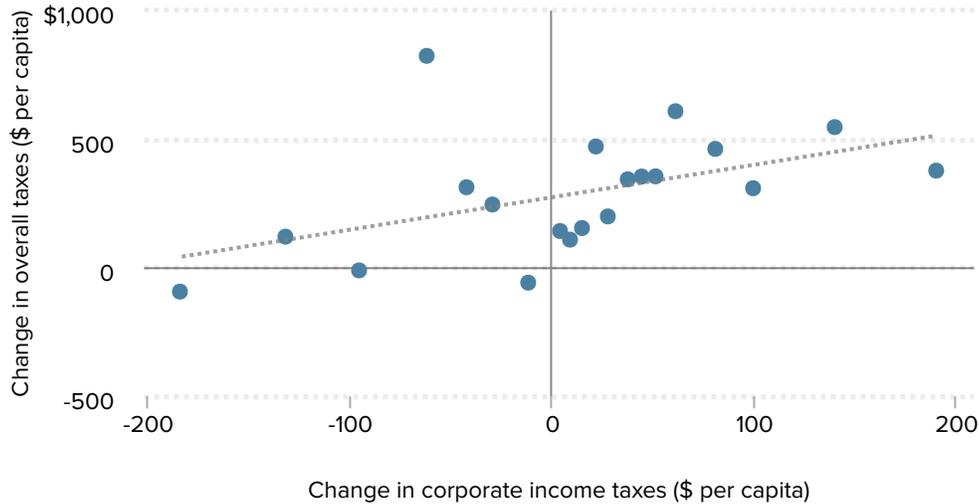
In theory, S&L governments could have reacted to the fall of revenue from corporate income taxes by raising revenue from other sources to preserve continuity of funding for vital public services.

There are many reasons why even this type of tax shift could have been undesirable policy. For example, corporate income taxes are highly progressive. Economists generally estimate that the large majority of the effect of corporate income tax changes falls on owners of corporations (not workers or consumers). Ownership of corporations is highly concentrated. In 2019, for example, roughly 88% of all corporate equities were held by the wealthiest 10% of households (with the top 1% owning roughly 51%).¹⁴

Figure H

Reduced corporate income tax collections were not offset by increased collections from other state and local tax sources

Change (\$) in per capita state and local overall taxes and corporate income taxes, 2000–2007 and 2007–2019



Notes: Figure is a binned scatterplot that ranks state changes in corporate income taxes between 2000 and 2007 and between 2007 and 2019 and then groups the state-specific changes for each time period into similarly sized “bins” of observations. States include D.C. If data allow for an exactly equal number of observations in each bin, then the number of observations in each bin is equal. If data are unequal, bins are constructed using default settings on Stata bincscatter command. Each bin’s average change in corporate income taxes and overall taxes is then compared in the graph. Because it is an outlier on both measures, Alaska is omitted. Including it would strengthen the association.

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Given all of this, even a tax shift that saw taxes raised from revenues besides corporate income taxes would have likely led to a more regressive S&L tax system overall, but at least revenues for providing vital public services would have been preserved in this scenario.

Unfortunately, the data show instead that falling corporate tax revenues were far more likely to lead simply to less revenue being collected overall. **Figure H** shows the relationship between overall tax revenues collected by state governments and revenues collected through the corporate income tax.¹⁵ There is a strong positive relationship between the two series, with each \$1 collected in corporate income taxes being associated with more than \$1 in overall tax revenue. The logic would work in reverse for cuts—each \$1 reduction in corporate income tax revenues would be associated with more than a \$1 reduction in overall taxes (although the correlation is statistically indistinguishable from a \$1 for \$1 shift).

Of course this kind of simple correlation does not imply strict one-way causation. But what

it does prove is that the decline in corporate income taxes is not prima facie irrelevant to the fiscal position of states. Those states that cut corporate income taxes more also raised less overall revenue than other states.

The erosion of corporate income taxes was economically significant

The scale of revenue losses to the S&L sector documented above are large. The \$57 billion loss relative to a baseline where all corporate profits saw their 1989 effective tax rate held steady over time, for example, could essentially finance universal, high-quality pre-kindergarten programs for all 3- and 4-year-old children in the country. This would be a major investment in the nation's children.¹⁶

The smaller revenue loss of \$43 billion that accounts only for the falling effective tax rate faced by C-corporations is still highly significant. For example, in 2019 this amount of revenue would be equal to nearly 40% of all public investment made by state and local governments in education (both K–12 and higher education). Give that education is the single most expensive function in S&L budgets, a revenue gain that would allow investment to expand by up to 40% is large indeed.¹⁷

State corporate income tax cuts benefit the wealthy, not typical workers

As noted above, the most obvious beneficiaries of corporate income tax cuts are the owners of corporations. Every dollar that does not need to be paid in entity-level taxes by the owners of corporations is another dollar they can pocket directly. Because owners of corporations are a privileged group, proponents of cutting corporate income taxes (at either the federal or S&L level) rarely say outright that this is who they are hoping to benefit.

Instead, vague appeals are often made to boosting state or national “competitiveness” through corporate income tax cuts. These claims are almost never fleshed out and usually are completely merit-free (see Bivens and Blair 2017 for the baselessness of competitiveness arguments for corporate tax cuts).

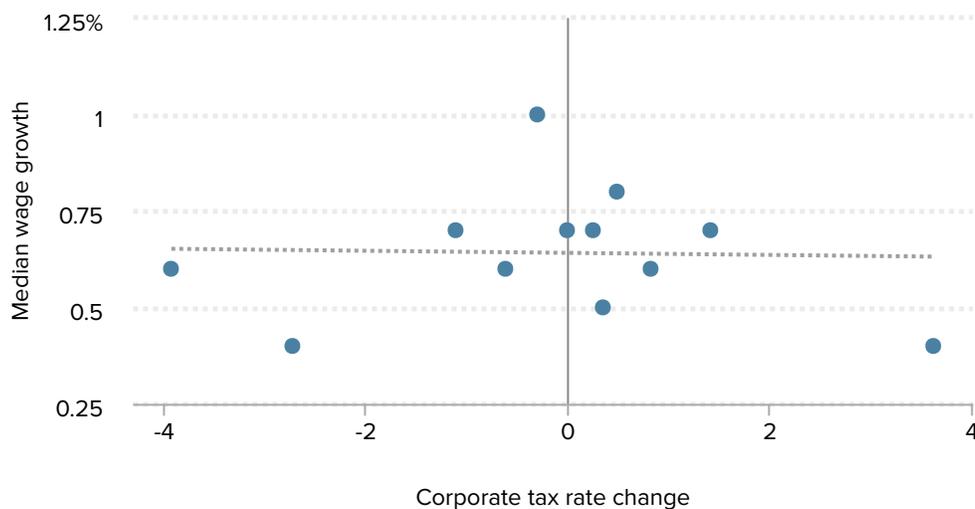
In the debate over the Tax Cuts and Jobs Act (TCJA) in 2017, proponents of corporate rate cuts made large claims that cutting corporate tax rates would actually benefit typical workers in the long run by boosting economywide productivity and wages. These claims had very slim evidentiary backing (see Bivens 2017 for a roundup of reasons to doubt them).

At the state level in particular, previous work (Serrato and Zidar 2016) has shown that the

Figure I

State corporate tax cuts do not strongly correlate with faster wage growth for typical workers

Change in state corporate tax rate (percentage points) and average annual change (%) in median wages, 1989–2007



Notes: Figure is a binned scatterplot that ranks state changes in corporate income taxes between 1989 and 2007 by state, and then groups them into similarly sized “bins” of observations. If data allow for an exactly equal number of observations in each bin, then bins are equally sized. If data are unequal, the number of observations in each bin is constructed using default settings on Stata binscatter command. Each bin’s average change in corporate income tax rates and median wages is then compared in the graph. Alaska and D.C. are excluded.

Sources: Data on state corporate tax rates taken from the replication file to Serrato and Zidar 2016. Median wage data from EPI analysis of Community Population Survey microdata.

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large majority of the effects of corporate income tax changes at the state level fall on owners of capital (including land), and a much smaller minority fall on workers’ wages. **Figure I** uses Serrato and Zidar’s (2016) data on state corporate income tax rates and shows the correlation between rate changes and average annual growth in state median wages between 1989 and 2007. It finds a very weak and statistically insignificant effect, indicating that as a strategy to boost living standards broadly, cutting corporate income taxes is extraordinarily weak. Conversely, efforts to raise revenue by increasing corporate income taxes will do no measurable harm to median wage growth.

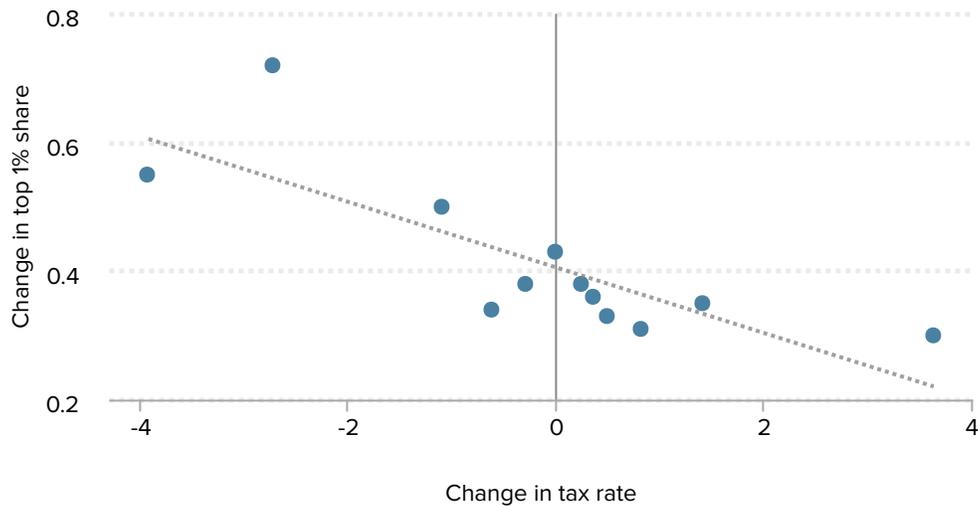
Figure J replicates this investigation but replaces median wage growth with the average annual change (in percentage points) in the share of total income claimed by the top 1% in a state. Here the correlation is strong, with reductions in corporate income tax rates significantly (both economically and statistically) associated with a higher share of income claimed by the top 1%.

Of course, this correlation does not prove a purely one-way causal relationship running from corporate income tax cuts to top 1% income shares. But positing that the causal relationship runs the other way is hardly a great argument for why corporate tax rates

Figure J

State corporate tax cuts go hand in hand with rising inequality

Change in state corporate tax rate (percentage points) and change in share (percentage points) of total state income claimed by top 1% of households, 1989–2007



Notes: Figure is a binned scatterplot that ranks state changes in corporate income taxes between 1989 and 2007 by state, and then groups them into similarly sized “bins” of observations. States include D.C. If data allow for an exactly equal number of observations in each bin, then bins are equally sized. If data are unequal, the number of observations in each bin is constructed using default settings on Stata `binscatter` command. Each bin’s average change in corporate income tax rates and change in top 1% share of total income is then compared in the graph. Because it is an outlier on both measures, Alaska is omitted. Including it would strengthen the association.

Source: Data on state corporate tax rates taken from the replication file to Serrato and Zidar 2016. State top 1% shares taken from data compiled by Frank (2022).

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were cut. If the rising income shares (and presumably political influence) of the top 1% led to cuts in corporate income taxes at the state level, this should be taken as strong independent evidence of just who expects to benefit from these cuts.¹⁸

Conclusion

Corporate income taxes—both at the federal and S&L level—are highly progressive parts of the U.S. fiscal system. The erosion of revenues collected from corporate income taxes has made the overall tax system less progressive, and at the state level it has been a key driver of overall revenue weakness, which in turn has fueled too-austere spending.

The S&L sector is vitally important to the economic health and quality of life of U.S. families. It plays a leading role in the direct provision of valuable public goods and services. But the sector’s ability to provide these services well is highly constrained by how much revenue can be raised. Corporate income tax cuts in recent decades have

compromised this revenue collection.

A number of obvious reforms could help stem these losses. Statutory corporate income tax rates could be raised. (Given the enormous cut in corporate income taxes at the federal level in 2018, even very large increases in state corporate income tax rates would leave capital-owners far better off than they were just a few years ago.)

Besides changing statutory tax rates, reforms should also focus on the tax base. Corporations undertake a range of tax evasion techniques to minimize the scale of taxable profits they report to governments. While federal government changes have failed to rein in these tax evasion efforts, there are a range of reforms states could undertake on their own to force a more honest accounting of taxable profits.¹⁹ Most fundamentally, new legislation forcing transparency in regard to which profitable corporations pay taxes in a state and which do not could help educate the public about this issue.

Finally, of course, other bases of income—like business income earned by entities besides C-corporations—could also be tapped for more revenue. The rise of S-corporations highlights how business forms have been manipulated for tax evasion. There is no reason legislators must let that stand—the new business forms (or their owners) could certainly pay more in taxes.

Notes

1. The differences between C-corporations and S-corporations, and the implications of the rise of S-corporations, is discussed in detail later in this report.
2. Outside of this timespan, changing federal corporate income tax rates introduce too much statistical noise and it is therefore not possible to establish correlations one way or the other.
3. For shares of federal spending, one could consult Tables 1.1 and 3.2 of the National Income and Product Accounts (NIPA) of the Bureau of Economic Analysis. The rough characterization of shares of transfer payments and defense spending do not include the extraordinary relief measures undertaken in the wake of the COVID-19 pandemic.
4. For data on state and local government spending by function, see the Census Bureau's Annual Survey of State and Local Government Finance (2019).
5. Most charts in this report include the latest data available (through 2020 or 2021). However, in our analysis we focus on pre-pandemic years to minimize distortions caused by pandemic-related economic conditions.
6. On the demographic composition of state and local government employees, see Cooper and Wolfe 2020. On the wage penalty faced by women and Black men in state and local governments, see Wilson and Darity 2022.
7. The share of corporate income taxes in overall S&L taxes that we report in this paragraph is from the same underlying data that we used to construct Figure E.
8. We choose 1989 as our starting point in Figure G because the effective corporate income tax rates rose a bit from 1979 to 1989, largely as an artifact of the 1986 federal tax reform. We choose

2017 as our endpoint for assessments of how much corporate income taxes have eroded because 2018–2020 were atypical years. As discussed in the text, the 2020 data are distorted by the pandemic economy. The years 2018 and 2019 saw temporary surges of revenue due to federal tax changes in corporate taxation. The so-called Tax Cuts and Jobs Act (TCJA) that took effect in 2018 saw corporations trying to move as much taxable income as possible from early periods to the post-TCJA enactment to take advantage of the more favorable rates. As the years go on from TCJA implementation, this temporary distortion will fade.

9. The “C” in C-corporations refers to the subchapter of the Internal Revenue Code that defines this business form. The same is true for the “S” in S-corporations, also discussed in this section.
10. For a list of states that tax S-corporation profits at the entity level, see Friedman LLP 2014.
11. See Nelson 2016 and Krakower et al. 2021 for the evolution of S-corporations’ share of total corporate profits over time.
12. See Nelson 2016, for example.
13. In terms of tax law, the federal reform of 1986 likely spurred a switch from C-corporation to S-corporation status by lowering the effective rate of individual taxation relative to corporate taxation. Besides increasing the maximum number of S-corporation shareholders, law and regulation has changed to allow S-corporations to own up to 80% of a C-corporation. This allows for a tiering of corporate ownership that can be very useful for tax evasion. At some point in economic history, 100 shareholders may have seemed like too small a number to allow investment at large scale, but the huge rise of inequality in recent decades means that 100 shareholders—if they’re the right shareholders—can mobilize enormous amounts of financial capital.
14. These numbers come from the interactive tool provided by the Federal Reserve’s Distributional Financial Accounts. I chose numbers from 2019 so they are not distorted by the effects of the pandemic.
15. Because it is overwhelmingly state governments, not local, who collect corporate income taxes, for this state-by-state comparison we restrict attention to only state governments.
16. See Lynch and Vaghul 2015 for the costs (and benefits) of implementing universal, high-quality pre-K programs. In 2017 dollars, they find that the gross costs of such a program would be roughly \$41 billion annually. By 2022, these costs are certainly closer to \$50 billion. However, they note that current commitments to pre-K made by federal, state, and local governments totaled over \$10 billion in 2017, and that spending would no longer be needed in the context of a universal program. So, in short, the \$57 billion would certainly be enough to finance a universal, high-quality pre-K program in the United States, and there would also be nontrivial money left over for other investments.
17. The numbers on total public investment made by the S&L sector on education come from the Census Bureau’s Annual Survey of State and Local Government Finance.
18. As a technical note, we restrict our investigation to business cycle peaks to avoid relationships between the variables being driven solely by cyclical effects. We also focus only on years when the *federal* corporate income tax rate has been stable. Because state corporate income taxes can be deducted by businesses from their federal taxes, the effective state tax rate is actually $(1 - \text{federal rate}) * \text{state tax rate}$. But between 1980 and 1989, and between 2007 and 2019, the federal corporate tax rate was lowered dramatically. Between the early 1980s and 1989 it fell from over 45% to 35%, and in 2018 it was lowered from 35% to 21%. All else equal, this would have on average *increased* state effective corporate tax rates significantly. This effect of federal tax

changes on effective state corporate tax rates adds substantial noise to any statistical investigation of changes in state statutory rates and economic variables, hence the restriction of our analysis in Figures I and J to the 1989–2007 period.

19. See Phillips and Proctor 2019 for one particularly important potential fix that states could undertake to stop the erosion of corporate income taxes stemming from the abuse of tax havens.

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