



# FACTS & OPINIONS

*On Public Interest Issues*

## Quotes

There is a certain enthusiasm in liberty, that makes human nature rise above itself, in acts of bravery and heroism.

—Alexander Hamilton

A healthy society is sustained by free individuals working at their chosen tasks and callings, not by those who reluctantly sign up for some government program of social do-goodism.

—William C. Dennis  
National Review

Do not consider collectivists as sincere but deluded idealists. The proposal to enslave some men for the sake of others is not an ideal; brutality is not idealistic, no matter what its purpose. Do not ever say that the desire to do good by force is a good motive. Neither power-lust nor stupidity are good motives

—Ayn Rand

## Repeal State Corporate Income Taxes

Chris Edwards

All taxes create economic distortions and impose compliance burdens on the private sector. However, some taxes are particularly inefficient because they create large burdens while raising little government revenue. State corporate income taxes are perhaps the most inefficient taxes in the nation. They generate only a small share of state revenues but “consume an inordinate amount of intellectual firepower and economic resources in terms of planning, compliance, and administration.” As such, states should consider repealing corporate income taxes as wasteful and unneeded parts of their fiscal systems.

### Declining Share of State Revenues

All states except Nevada, South Dakota, Washington, and Wyoming impose corporate income taxes. State corporate income taxes raised \$32 billion in 2001, accounting for just 5.7

percent of state tax revenues and 2.7 percent of total state revenues. These shares have declined since the late 1970s partly because corporate profits are more mobile than ever and companies have been effective at reducing their tax bills. In addition, government policies have reduced the corporate tax base. For example, rule changes have led to a rise in businesses organized as limited liability companies (LLCs), which are not generally required to pay corporate income taxes.

### High Compliance Costs

While states are receiving relatively less revenue from the corporate income tax, the tax continues to distort business decision making and impose large compliance costs on firms. One survey found that business compliance costs for the state corporate tax were about twice as high as for the federal

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## FACTS & OPINIONS

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**President**  
Dr. Don Racheter

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## Focus on Iowa Wesleyan College

Amy K. Frantz

On May 15, Iowa Wesleyan College graduates received their diplomas in an afternoon ceremony held on the campus lawn. The commencement address was given by Dr. Richard L. Ferguson, Chief Executive Officer of ACT, the college entrance testing company. Public Interest Institute congratulates our graduating Intern, Brian DePriest, and work study students Toussaint Williams and Chann Roberts. In addition, work study students Kyle Hare and Sinead Kelly completed their year overseas at IWC and have returned home to Ireland. We wish them all luck in their future endeavors!

Stanley and Helen Howe have offered a challenge grant of \$15 million to Iowa Wesleyan College. The Howe Foundation will match, dollar-for-dollar, any qualifying gifts to the college up to a maximum of \$3 million annually, for five calendar years beginning

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## What's New at Public Interest Institute?

Public Interest Institute welcomed new Research Analyst Laura Keith in July. She will be editing FACTS AND OPINIONS, helping to write the INSTITUTE BRIEF series, and working on other Institute research projects. She has particular interest in national security issues, international trade, and tying those issues to Iowa.

Laura is originally from Orange City, Iowa. She holds a B.A. in history and political science from Northwestern College, located in Orange City. From January to May 2004 she interned at the Heritage Foundation in Washington, D.C.

She will be replacing Research Analyst David Hogberg who has been with the Institute since May 2000. David is leaving to be an analyst at the Capital Research Center in Washington, D.C.

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## Repeal State Corporate Income Taxes

Chris Edwards

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corporate tax, relative to tax collected. The state corporate tax raises only about one-fifth as much as the federal tax, but has compliance costs that are more than two-fifths as high.

### **Carving Up the Tax Base**

Many corporations carry out production, distribution, and other activities in numerous states. What share of a firm's national profits should each state be entitled to tax? In the past, a three-factor formula of property, payroll, and sales occurring in each state was used to "apportion" a firm's profits between state governments. Today, varied and inconsistent formulas are used, and the definitions of the factors are subject to much debate and dispute.

With large differences in corporate tax rules between states, companies have incentives to restructure in order to minimize their tax burden. For example, firms can save money by moving labor-intensive production to states that de-emphasize payroll in their apportionment formulas. Tax-saving opportunities also arise because of differential taxation of intangible assets. For example, Delaware does not tax

the earnings from intangible assets, thus firms should move trademarks to subsidiaries in that state.

For corporations, the complexity of state tax planning is magnified because of uncertainty in the rules for "nexus." That is, there is no clear standard for how much presence a company must have in a state before it is required to pay tax. Indeed, there is increasing litigation over nexus issues, which wastes resources and creates a roadblock to interstate commerce because businesses fear triggering new state taxes when they expand.

### **More Complexities**

State corporate income taxes have all the complexities of the federal corporate tax, plus further problems:

***Different state and federal tax rules.*** Businesses need to keep track of different income tax rules for every state they operate in. In addition, state rules can differ from federal tax rules. For example, about 20 states did not follow the recent federal depreciation changes that allowed partial capital expensing.

***Business vs. nonbusiness income.*** State corporate taxes require that firms separate "business income" from "nonbusiness income." Business income is apportioned between the states while nonbusiness income (such as interest) is assigned to the state of commercial domicile. This distinction is surprisingly complex

and is subject to many legal disputes with different rules in each state. Once again, businesses have many opportunities to pursue tax-cutting ideas such as converting business income to nonbusiness income and then moving it to a low-tax state.

***Separate vs. combined reporting.*** Some states allow separate reporting for each company in a corporate group. Other states require combined reporting with the whole corporate group filing together. This creates many tax-planning issues for companies, such as whether to operate facilities in the various states as internal divisions or separate subsidiaries. A related tax-planning issue for companies involves how each state treats firms' foreign affiliates.

***Other complexities.*** Businesses can shift profits from high-tax to low-tax states in many ways. One way is transfer pricing, which can move profits between states by altering the prices of goods shipped between related corporate entities. Holding companies are another planning tool. They can be established to carry out certain activities in states where they are not subject to tax, such as Nevada and Delaware.

In sum, state corporate tax systems are all different, complex, and require extensive business tax planning. As corporate profits have become more mobile, states have increased their enforcement and added complex new rules to stop supposed abuses of often ambiguous laws. As an editor of

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## **Repeal State Corporate Income Taxes**

**Chris Edwards**

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*State Tax Notes* observes: “The only people who really make money from the state corporate income tax system are the major law firms and big accounting firms.” Rather than continuing the costly battle between corporate tax lawyers and state tax administrators, states should throw in the towel on the corporate income tax.

### **Swiss Cheese**

One might have sympathy for state governments in their losing battle to grab a share of the mobile corporate tax base if they had not turned the tax into a Swiss cheese of narrow loopholes. “Incentive packages” for favored companies and fancy credits for job creation, job training, and other activities have proliferated. Such narrow breaks are unfair to businesses that pay the full tax load, and they open up government officials to corruption as firms lobby for special deals. Also, narrow breaks add to complexity in administration. For example, there are calls for states to spend more time and money monitoring firms that receive job credits to see if they actually create jobs. The reality is that

even if corporate taxes were a good idea in theory, state politicians have shown that they are incapable of enacting simple and efficient corporate taxes in practice.

### **Hidden Burden on Individuals**

State tax systems should be efficient, but they should also be transparent so that citizens can understand how much the government costs them. The corporate tax is not transparent and hence causes much confusion. For example, Virginia’s governor Mark Warner says that he wants to increase corporate taxes because “individual taxpayers carry too much of the tax burden.” But Warner should know that individuals carry the burden of all the state’s taxes, including corporate taxes. One view is that the state corporate tax burden falls on individuals based on the apportionment factors of property, payroll, and sales. Thus, as states have moved to emphasize the sales factor in their apportionment formulas in recent years, the state corporate tax burden falls increasingly on consumers.

### **Conclusion**

State politicians have created a costly and complex mess with corporate income taxes. As the mobility of corporate profits continues to rise, the corporate tax will become more inefficient and tougher for states to enforce. The solution is to repeal them, with the modest revenue losses to state governments made up with cuts to

state business subsidies. The result would be more efficient state fiscal systems that did not favor any particular industry but promoted higher growth in all industries.

*Chris Edwards is the Director of Fiscal Policy for the Cato Institute. Reprinted with permission from the Cato Institute. For more information, contact Cato at 1000 Massachusetts Ave., NW, Washington, DC 20001, call (202) 842-0200, or visit its Website at [www.cato.org](http://www.cato.org).*

**Check out our feature — Question of the Quarter — on page 6. We want to know your thoughts about the issues!**

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Individuals like you who believe in individual liberty and free-market solutions envelope to make your tax-deductible contribution to this effort today.

## Congressional Mandates Contribute to Higher Gas Prices

Charli E. Coon, J.D.

During the early part of summer, gas prices shot up. Although they have tapered off some, U.S. Energy Information Administration (EIA) expects gasoline prices to remain high and volatile throughout the summer months. While government policies are not the sole reason for these high prices, they do contribute to regional and seasonal price fluctuations that increase costs and reduce flexibility to meet consumer demand.

### Primary Costs to Produce Gasoline

Four major components drive the retail price of gasoline: the cost of crude oil, refinery processing costs (including environmental regulations), distribution and marketing costs, and taxes.

### Crude Oil

Crude oil is the largest cost component. EIA data show that crude oil accounted for 46 percent of gasoline costs in March. Increasing world demand, unrest in energy-rich countries such as Venezuela, and the March decision by OPEC to cut crude oil output by 1 million barrels per day have kept world supplies tight

and have driven up crude oil prices.

The EIA's "Summer 2004 Motor Gasoline Outlook" notes that the price for West Texas Intermediate crude oil surpassed \$38 per barrel in late March — the highest level since early 1991. The EIA projects that crude oil prices will average \$33.40 per barrel (79.6 cents per gallon) during the summer. It expects retail regular gasoline prices to average \$1.76 per gallon from April through September — up 20 cents from summer 2003. While Congress can do little to drive down the cost of crude oil during the summer driving season, it can and should authorize access to more domestic oil supplies for the future.

### Taxes

Federal, state, and local taxes account for 24 percent (the second largest component) of the retail price of gasoline. The federal gas tax is 18.4 cents per gallon. State gasoline tax rates vary: They amount to 8 cents per gallon in Alaska, 33 cents per gallon in New York, 32.4 cents per gallon in California, and 36.3 cents per gallon in Hawaii. These taxes add to the price of motor fuel and — in part — drive the regional price differences. On average, local taxes add approximately another 2 cents per gallon to the price.

### Distribution and Marketing

The EIA also reports that distribution and marketing costs in

March accounted for 11 percent of the retail price of gasoline. The wide variety of specialized regional gasoline formulas required by federal and state regulators make storage and distribution more difficult and increase the potential for supply disruptions and short-term price spikes. Moreover, specialized blends required for one area of the nation may not be suitable for another area.

Furthermore, not every refinery can produce every grade of gasoline and pipelines have limited flexibility to move different grades of gasoline to different places. The American Petroleum Institute states that these circumstances make it difficult for refiners to get the right grade of gasoline to the right market in the right quantity.

### Regulations

According to the EIA, refining costs represented almost 20 percent of the retail cost of gasoline in March. Congress could significantly reduce these costs by scaling back the excessive and cumbersome federal regulations on refiners.

For example, the 1990 Clean Air Act amendments mandate the sale of cleaner-burning reformulated gasoline (RFG) in order to reduce summer smog in nine major metropolitan areas. The law also requires that RFG contain at least 2 percent oxygen by weight. To comply with these regulations, refiners must switch

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**Congressional Mandates  
Contribute to Higher  
Gas Prices**

**Charli E. Coon, J.D.**

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from winter-grade fuel to costlier summer-blend gasoline. According to the Federal Trade Commission (FTC), this adds 4 cents to 8 cents per gallon to the price of gasoline.

Moreover, a common oxygenate, MTBE (methyl tertiary butyl ether, which is used in about 70 percent of the reformulated gasoline) has been banned in California, New York, and Connecticut. This means that refineries must use a different additive, such as ethanol — which requires more crude oil in the production process. Reducing or phasing out MTBE use — but leaving the 2 percent oxygenate requirement in effect—would increase ethanol use. This would further contribute to price volatility and unnecessarily high gasoline prices.

Likewise, complying with a new national low-sulfur gasoline regulation for passenger cars not only presents scientific challenges for refiners, but also could adversely affect gasoline supply and availability. The industry will need to invest more than \$8 billion over the next three years to meet this requirement—which will result in higher prices at the pump.

In addition to these federal regulations, some state and local

governments require specialized fuel blends — “boutique fuels” — to satisfy local air quality needs. This hodgepodge of customized fuel requirements increases production costs, which are ultimately reflected in the price of gasoline. These varied gasoline specifications also restrict the ability of refiners and distributors to move supplies around the country in response to local and regional shortages. Further proliferation of boutique fuel requirements would only contribute to the overall problem and drive up costs during disruptions.

**Reducing the Price of Gasoline**

Instead of calling upon the FTC to investigate recent price spikes for alleged market manipulation, Congress should take note of past FTC findings that “unusual movements in gasoline prices typically have a natural cause” and act to reduce the high cost of producing gasoline. Specifically, Congress should:

- (1) Repeal the federal oxygen mandate;
- (2) Provide protections against additional specialized fuels that complicate production and distribution;
- (3) Open exploration in areas currently off-limits to domestic production—such as the Arctic National Wildlife Refuge and offshore moratoria areas; and
- (4) Remove burdensome restrictions on domestic production.

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*Facts & Opinions*  
**Question of the Quarter:**

Should Iowa eliminate its corporate income tax?

Send your thoughts on this issue to us at [public.interest.institute@limitedgovernment.org](mailto:public.interest.institute@limitedgovernment.org).

We will publish some of your ideas in the next issue of *Facts & Opinions* in November 2004 and on our Website at [www.limitedgovernment.org](http://www.limitedgovernment.org).

## Michigan's Poor: Do Numbers Tell Us Much?

Robert P. Murphy

Last Sept. 26, the U.S. Census Bureau released its annual report on poverty in the United States. The report indicated that the number of people below the official poverty line had risen from 32.9 million in 2001 to 34.6 million in 2002.

Here in Michigan, the Census figures show a similar pattern. The number of Michiganders in poverty was up from 927,000 in 2001 to 1,152,000 in 2002, while Michigan's poverty rate jumped from 9.4 percent to 11.6 percent.

Although disturbing, such statistics are liable to give a false impression of the condition of the poor. Policy changes based on emotion and faulty visions may make the situation worse.

The first problem is that the Census collects its data on income by asking a sample of Americans to fill out a survey, rather than relying on a more objective measure.

Even if the self-reported incomes are accurate, such statistics still aren't a true measure of poverty by any commonsense definition. According to a Heritage Foundation report, many of the officially poor in America enjoy expensive, durable consumer goods. For example, a 1995 Department of Commerce survey showed that 41 percent of

poor households owned their own homes, 69.7 percent owned a car or truck, 99.3 percent owned a refrigerator, and 66.3 percent had air conditioning.

Another flaw is that the Census statistics measure only pre-tax income, and exclude non-cash government entitlements (such as public housing, Medicaid, and food stamps). To hear that someone only makes \$5,000 a year conjures up images of the barest survival, until we realize that the taxpayers are paying for his or her room and board.

Moreover, calculating the number of people in poverty in a given year, and then comparing the figure with previous years, gives the impression that we are referring to the same group of poor people. To quote an article in *The Detroit News* Dec. 28, "Hard economic times left another 225,000 people in Michigan in poverty last year..."

But imagine we are measuring the number of people in a public swimming pool. Suppose that at noon on June 15, we count 50 people in the pool. If we return at noon on Aug. 15 and count 250 people in the pool, is it accurate to report, "Hot summer times left another 200 people in the swimming pool"?

The official poverty rate merely gives us a snapshot of how many people were earning less than the official income threshold at the time of the survey. The Census report itself notes that in a longitudinal study (which tracked the same people over time), over half of the measured poverty

spells lasted four months or less, and 79.6 percent were over within a year.

Poverty is indeed a vexing social problem, and the government can definitely take steps to ameliorate the situation. Governments at all levels could cut taxes, which would allow the poor man's dollar to go that much farther. They could also reduce the contradictory and pointless regulations that stifle entrepreneurship and thus retard economic development in depressed areas. In Michigan, elimination of the steel tariffs would spur steel-using industries to begin hiring once again.

Another source of poverty is a poor education system. Government school monopolies that typically spend more on failure than most private schools spend on success are, in our inner cities especially, veritable poverty mills. If kids graduate unable to read or write at levels that make them valuable in the marketplace, they will find it exceedingly difficult to avoid a life of poverty. But when a Detroit philanthropist offered \$200 million to start 15 innovative charter schools in Detroit last year, the unions and the political administrations in Detroit and Lansing killed the idea. To them, the system was more important than the kids.

Finally, perhaps the biggest reduction in the official poverty rate would occur if only our government would stop spending billions of dollars subsidizing it. Cynical as it sounds, there are many able-bodied people who

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### **Michigan's Poor: Do the Numbers Tell Us Much?**

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prefer to remain officially “poor” and live off of the taxpayers indefinitely. Private charities and churches are far better able to distinguish such frauds from the truly needy than are government agencies.

In any event, we should be wary each time the poverty stats come out. At best, they tell us a very small part of the story.

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### **Focus on Iowa Wesleyan College**

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in 2005. IWC President William N. Johnston said the Howe’s challenge grant “will enable us to strengthen our financial stability, grow enrollment, enhance the quality of the students’ experience inside and outside the classroom, renovate and construct facilities, improve faculty and staff compensation, and expand our academic programs.” Stanley Howe has served on the Iowa Wesleyan College Board of Trustees for almost 30 years. Helen Howe is a graduate of Iowa Wesleyan College.