What “Tax Neutrality” Means and Why Businesses Don’t Care

The Tax Foundation’s major justification for much of the SBTCI is that it rewards tax neutrality – in other words, state tax systems that do not favor certain kinds of economic activity over others. Yet they present no evidence that businesses care about tax neutrality, and no logical argument why tax neutrality would make a state more competitive. In fact, business lobbyists work tirelessly to make taxes less neutral – trying to convince state legislatures to favor their company or their industry in the tax code – because they care most about paying less in taxes, not the economic principle of tax neutrality.

A neutral tax is one that does not create incentives for firms or individuals to change their behavior—to invest more or less, to work more or less, to locate in one place rather than another, to employ more or less labor or more or less capital.

While neutrality is an accepted standard for evaluating taxes among economists (unless changing behavior is one of the goals of tax policy, as it frequently and legitimately is), the Tax Foundation is not consistent in applying it. It states, for example: “States that levy neither a corporate income tax nor a gross receipts tax achieve a perfectly neutral system in regard to business income and so receive a perfect score…. States that do impose a corporate income tax generally will score well if they have a low rate. States with a high rate or a complex and multiple-rate system score poorly.”[1]

This argument has a number of flaws. While a zero corporate income tax is in one sense neutral by definition, in a broader sense it is anything but. A state with no corporate income tax must levy other taxes to finance government. As a result, these states may have a higher property tax, which penalizes businesses requiring large investments in plant and equipment. Nor must a tax be “low” to be “neutral.” A high tax that doesn’t create preferences for different conduct can still be neutral. In these ways, the Tax Foundation argument makes it clear what it really values: low taxes, not neutral taxes.

1. The coefficients were not statistically significant even at the 10 percent level.