REPLY

DOES THE STRUCTURE OF THE FRANCHISE TAX MATTER?

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IN Delaware’s Compensation, I analyzed the relationship between the structure of Delaware’s franchise tax and Delaware’s incentives for producing corporate law.¹

Conventional wisdom, supported by theory and evidence, has it that the franchise tax plays an important role in shaping Delaware corporate law. Under the widely held account, Delaware offers a product and charges a price, the franchise tax, which creates incentives for the state to attract incorporations. Some argue that this system results in a race to the bottom, while others argue that it results in a race to the top. But no one argues that the tax is unimportant to Delaware, and evidence demonstrates the tax’s significance. The literature, however, fails to address Delaware tax structure, and how such structure affects Delaware’s incentives. Delaware’s Compensation first submitted the view that if the tax matters, then the tax’s structure matters too.

My second goal in Delaware’s Compensation was to draw attention to the state’s current tax structure and to argue that this structure is suboptimal. Unlike some other taxes, the franchise tax is not a portion of income or revenues. Rather, approximately half of the tax is paid by firms who pay a lump sum tax, and for other firms, the tax is based primarily on the number of their authorized shares, and thus the tax is only remotely sensitive to firm performance. As a result, Delaware’s franchise

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tax revenue is overly dependent on the number of incorporated firms in the state, rather than on the aggregate value of incorporated firms.²

The third goal in Delaware’s Compensation was to offer potential reasons why Delaware’s tax is not better designed to reward Delaware for performance. A better design would require a change to the current structure of the franchise tax. Drawing on an earlier work, I suggested that risk aversion and lack of information make Delaware officials reluctant to change the structure of the franchise tax, which was set almost a century ago. In addition, the article suggested that since the current tax structure provides a commitment to managers that the state will not abandon their interests, Delaware officials might lack motivation to change it.

The fourth goal was to propose a change to Delaware’s tax. In particular, I suggested that a proportional component should be added on top of Delaware’s current tax so that Delaware franchise tax revenue could be positively influenced by decisions that maximize shareholder value. A proportional tax would have the advantage of aligning Delaware’s incentives with those of shareholders. A proportional tax’s benefits do not rely on competition or shareholder participation.

In his thoughtful and detailed commentary, Professor Henderson offers two challenges to the view that the structure of the tax matters and that a change to the structure could create value.³ First, he argues, I do not offer a coherent theory as to why tax structure should affect legislative incentives. More particularly, he argues that the tax structure may not be relevant since Delaware’s legislative utility does not simply or wholly correspond with increasing tax revenues. Rather, he argues, some legislators have other goals: for some, reducing taxes to citizens would not necessarily increase their reelection prospects, and others may prefer a large number of firms over tax revenues. Second, he argues, I do not take into account managers’ incentives to lobby Delaware’s legislature.

I anticipated most of Henderson’s criticisms and addressed them primarily in Sections V.A. and V.B. of the article. These parts of the article

² As I explain in the article, the problem could be less severe if Delaware was constantly changing the price that it charges to reflect changes to quality. Yet, Delaware makes adjustments to its franchise tax rates less than once a decade. Thus, as a price for services, the franchise tax is relatively rigid.

address the arguments that Delaware’s legislature and judges do not maximize revenues and also provide an account of how their incentives should be affected by the tax structure. Thus, my response here will draw on these parts of the article while adding some more specific responses to Henderson’s points.

First, as I explain in Section V.A., the article does not assume that the Delaware legislature’s purpose is to maximize revenues or that the marginal utility of the legislature increases with the tax. In contrast, the article assumes that Delaware legislators, although they do not maximize revenues, are also not completely oblivious to Delaware’s incorporation tax revenue. Delaware’s market power allows its tax revenue to far exceed marginal costs. As a result, Delaware makes approximately $500 million in revenues from incorporation taxes, an amount equivalent to $3000 per family of four in the state. Delaware’s budget is quite dependent on the franchise tax. Franchise tax revenue constitutes approximately twenty percent of Delaware’s tax revenue, and tax rate increases have been implemented to cover budget deficits. Thus, an extensive literature has assumed that franchise tax revenues are the main reason for Delaware running either to the bottom or to the top, not because Delaware law-makers maximize revenues, but rather because the tax is sufficiently important that legislators cannot ignore it completely.

Similarly, the article argues that the current tax creates pressure on Delaware’s legislature and judiciary not to lose firms, not because they maximize revenues, but rather because these actors cannot completely ignore the tax. Under the current tax regime, if Delaware’s legislature makes a decision that increases total firm value by three percent but results in ten percent of firms leaving the state, the decision hurts the state’s income significantly. For example, in 2003 the Delaware legislature increased the tax to raise approximately $100 million to cover a

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4 See Barzuza, supra note 4, at 561–62.
5 Henderson questions the oft-cited benefit that tax revenues can reduce taxes paid by Delaware residents, arguing that for this argument to be valid, one needs to explain why taxing corporations is more efficient for the state than taxing individuals. See Henderson, supra note 3, at 52. But this is not the point. The point is that by charging a tax on out-of-state corporations, Delaware can reduce the tax burden on its own residents. These corporations do not vote in Delaware. Thus, all other things being equal, the legislature should be interested in a higher franchise tax.
budget deficit. A change that would cause ten percent of the companies to leave would erase more than half of this tax increase. If we view the franchise tax as an important source of incentives, it is difficult to justify a structure that is so focused on quantity.

My article also argued that Delaware case law reflects this pressure to maximize the number of firms incorporated in the state. While Delaware case law is richer than that of other states, it falls short of being optimal. Furthermore, on more than one occasion, Delaware judges have made decisions that were later overturned because their pro-shareholder decisions pressured firms to leave the state.

Moreover, my suggestion to change to the design of the tax also does not assume that the Delaware legislature seeks to maximize revenues. Rather, the goal of such a change would be to offer some release for Delaware legislators from the pressure to maximize the quantity of incorporations. A small change could achieve a significant improvement. If the aggregate value of firms incorporated in Delaware is around $9 trillion, a change in corporate law that would increase firm value by just one percent would result in an increase in value of $900 billion. If Delaware captured just 0.1% of this increase, this amount would be more than its current tax collections. Thus, even if a change to the law may cause some companies to leave Delaware, the increase in revenue collected from the firms that remain should make this less of a problem.

Henderson is correct in noting that even if a proportional tax were implemented, Delaware players would still be interested in attracting a high number of companies and would sometimes be willing to achieve this result at the price of lower tax revenues. Delaware judges, Delaware attorneys, and others all care to some extent about the number of incorporations regardless of tax revenues. As I discuss in my article, for this reason, a change to the tax would not achieve a first-best solution. Yet, a proportional tax would still represent an improvement relative to the current tax: in the trade-off between shareholder value and quantity of corporations, the former will have more weight with a proportional tax. To be sure, a proportional tax may not have any influence if a legal change in favor of shareholders—though increasing shareholder value—

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7 Barzuza, supra note 1, at 526 n.12.

8 Id. at 557–58.
may cause a mass migration of corporations outside Delaware. But massive migration is unlikely to happen simply due to managers’ dissatisfaction. Reincorporation requires shareholder approval, which should serve as a constraint to movement in some corporations. Furthermore, some managers have stronger preferences for protection than others. Thus, if Delaware passes a law that favors shareholders, only some firms may leave. Moreover, the marginal companies that are more likely to leave will be those with managers that extract high private benefits and those with a weak shareholder base, which Delaware is less interested in attracting.

How does my analysis apply more particularly to the different constituencies that make Delaware law? The article discussed the incentives of Delaware judges, the major actors in making Delaware law. Unquestionably, Delaware judges are influenced by factors other than state taxes. Yet, it is far from clear that Delaware judges, who are nominated by the state governor, completely ignore the state budget. Moreover, if judges deviate significantly from the state’s needs, they face the risk of having their decisions overturned by the Delaware legislature. Lastly and most importantly, the article made the assessment that Delaware judges currently face pressure not to lose companies incorporated in Delaware, which sometimes stands in tension with other judicial goals and with their own preference to balance managers’ and shareholders’ interests. Additionally, a law that is more protective to shareholders is likely to result in attracting better firms with lower agency costs. Accordingly, as I detailed in my article, Delaware judges have made several decisions—which have been overturned—that protected shareholder interests but created a risk of firms leaving the state.9

Another important actor in the legislative process is the Delaware bar.10 The bar has an interest in having a large volume of incorporations, but this is not its only interest.11 The Delaware bar has market power in charging Delaware firms. With this market power, the Delaware bar can charge and collect some of the surplus that is created by Delaware law. As a result, Delaware attorneys may be interested in a law that maximizes this surplus and thus could benefit from a law that balances managers’ and shareholders’ interests rather than a law designed primarily to attract

9 Id. at 546–49, 562–64.
11 See Barzuza, supra note 6, at 175–77.
companies. The bar may have an interest in protecting shareholders for another reason—to decrease the likelihood of federal intervention.\textsuperscript{12}

Lastly, the bar also has an interest in attracting better corporations, which would be achieved by better law.\textsuperscript{13} As with Delaware judges, however, the Delaware bar may currently feel pressure to maximize the quantity of incorporations, which could be alleviated by a change to the franchise tax.

What about other possible constituencies who, as Henderson argues, may have other goals? Most other goals of legislative bodies do not conflict with the goal of maintaining high tax revenues. Thus, other things equal, on average, the legislature should prefer higher tax revenues to lower ones. Second, even if there are considerations that are in tension with maximizing shareholder value, these same tensions also exist under the current tax. A proportional tax, thus, would change some of the trade-offs that the Delaware legislature currently faces in favor of increasing shareholder value.

Henderson further argues that a change to the tax would not be effective because if managers were displeased with a change to the law, they could lobby the Delaware legislature, whose members could very well prefer lobbyist money filling their campaign funds to tax money filling the state coffers. Managers have achieved success in other states in lobbying for anti-takeover rules, but did not achieve the same success in Delaware. Lobbying is typically initiated by companies with political clout that reside in the state, and there are very few companies like that in Delaware.\textsuperscript{14} Second, in Delaware, the bar typically reviews and approves corporate law changes.\textsuperscript{15} Thus, the conventional wisdom has typically been that in Delaware managers vote primarily with their feet—by leaving Delaware. As I explain above, although managers’ ability to leave may constrain the influence of a proportional tax, it should not eliminate it. Finally, this ability of managers to lobby does not seem to be an argument that the tax does not matter. Even if managers have lob-


\textsuperscript{13} See Roe, supra note 12, at 601–07.

\textsuperscript{14} See Roberta Romano, Competition for Corporate Charters and the Lesson of Takeover Statutes, 61 Fordham L. Rev. 843, 856 (1993).

buying power in Delaware, they could lobby with the current tax as well. Making the franchise tax more sensitive to shareholder value would give more weight to shareholders than managers relative to the current regime.

Henderson’s last point relates to the old debate regarding the desirability of regulation. He seems to assume that my article supports regulation of the relationship between managers and shareholders. My article, however, does not take a position in this debate. All the article offers is an argument to change the franchise tax in order to improve Delaware’s incentives. Thus, if an enabling corporate law is better for shareholders than a mandatory one, a proportional tax would encourage the state to offer enabling law. Moreover, my proposal may result in less need for mandatory corporate law in the form of federal intervention, as Delaware’s incentives would be more geared in favor of shareholders.

To summarize, I enjoyed reading Henderson’s illuminating comments. Although I do not agree with him that the article “omits any analysis of the legislative process that a proportional tax is designed to influence,” I do agree with him that the debate on the market for corporate law could benefit from more research on Delaware’s political economy and a richer picture of the different legislative bodies. Meanwhile, the article suggests that the current structure and rigidity of Delaware’s franchise tax is suboptimal. Regardless of whether the different governmental bodies in Delaware maximize revenues, whether there is a race to the bottom or the top, and whether managers’ and shareholders’ interests are aligned, as the tax is not sensitive to firm performance and as the tax rates change only once a decade, they provide only limited incentives to maximize shareholder value.

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16 To be sure, the article identifies reasons to regulate the franchise tax. In particular, it suggests that states face a collective action problem with regard to setting their taxes in general and that the tax in Delaware has not been efficient due to lack of information and risk aversion. The regulation of the tax, however, is very focused and limited and could avoid the issue of regulating the relationship between managers and shareholders.

17 Henderson, supra note 3, at 51.