Business Taxation and Sustainable Economic Development

Matt Gardner
Institute on Taxation and Economic Policy

11/14/2019

ITEP
INSTITUTE ON TAXATION AND ECONOMIC POLICY

Introduction to ITEP

The Institute on Taxation and Economic Policy (ITEP) is a non-profit, non-partisan research organization that works on federal, state, and local tax policy issues. ITEP's mission is to ensure that elected officials, the media, and the general public have access to accurate, timely, and straightforward information that allows them to understand the effects of current and proposed tax policies.

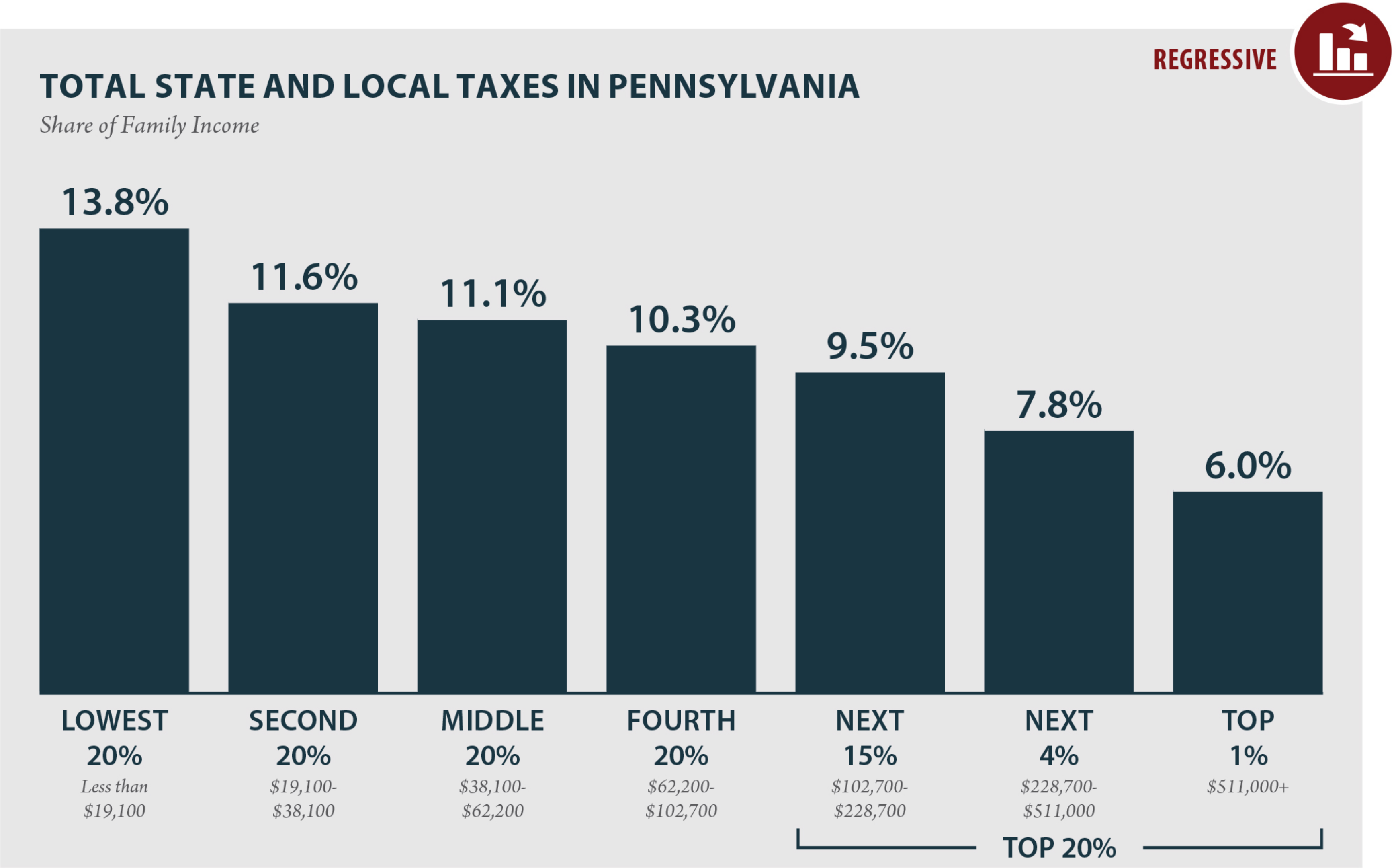
Tax Rates and Economic Development : Any Linkage?

- Unsurprisingly, no academic consensus
- Some studies find significant, if small, negative relationships between marginal tax rates and economic growth at the state level
- Others find none, or even a positive relationship. But…
- Garbage in, garbage out
- Easy to quantify tax rates; harder to quantify the benefits of what taxes pay for
- The tragedy of the state fiscal policy academic: sample size
- Econ development means smart taxes, smart spending.

What Should We Ask From Our Tax System?

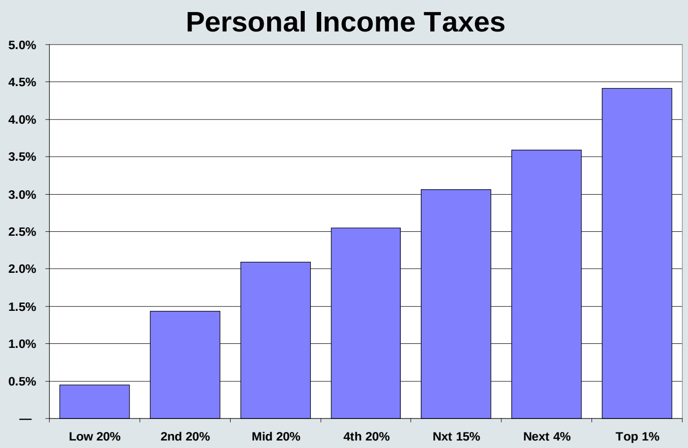
- Short-term adequacy: raise enough revenue to pay for services in FY20.
- Long-term sustainability: raise enough $ for 10, 20 yrs down the road.
- Fairness, part 1: tax system shouldn't hit low-income families hardest.
- Fairness, part 2: treat all forms of income, wealth and consumption the same. Don't pick winners.
- Fairness, part 3: think about intergenerational equity.
- Simplicity/transparency: avoids public antagonism
- Competitiveness: don't stick out.

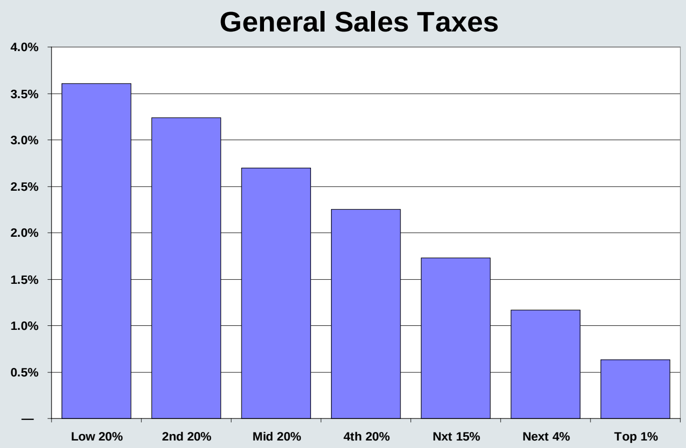
Pennsylvania state and local taxes are regressive.

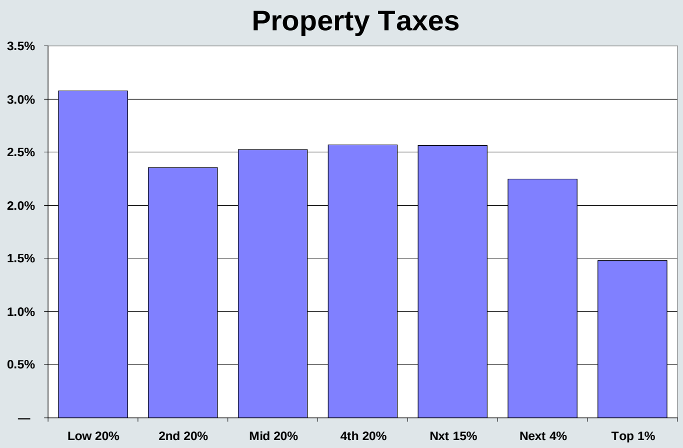


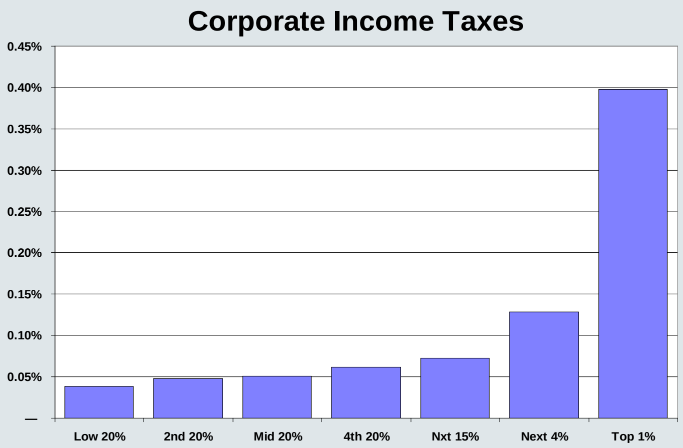
ITEP
INSTITUTE ON TAXATION AND ECONOMIC POLICY

Consumption and Property Taxes Drive Tax Regressivity









ITEP
INSTITUTE ON TAXATION AND ECONOMIC POLICY

Is Pennsylvania a High-Tax State? Depends Who You Ask

- PA taxes on PA residents, as share of PA income: 18th
- This matches well with aggregate Census data.
- But PA taxes on bottom quintile are 4th highest in the nation.
- Second quintile: also 4th highest
- Middle 20%: 7th highest
- Top 1%: 39th highest

PA Tax Fairness: Behind the Numbers

- Flat-rate income tax
- No refundable income tax credits
- Income tax exempts all retirement income
- Tax forgiveness credit
- Sales tax base excludes groceries

State Corporate Income Taxes in Decline

- Federal & state corp taxes falling as % of GSP, income, total taxes
- Decline is more rapid at state level
- Collections simply not keeping pace with the tax base (profits)
- Reason #1: income shifting
- Reason #2 : federal tax cuts and incentives
- Reason #3: state tax cut and incentives
- Reason #4: shift to pass-through entities
- The good news: state policymakers have the tools to combat each of these.

The State of State Corporate Income Taxes: 3 Percent and Dropping

- 2017 ITEP study assesses effective state corporate income tax rates nationwide, Fortune 500 firms only
- Weighted-avg statutory corporate rate was 6.2%; between 2008 and 2015, avg effective rate was 2.9%.
- This suggests profitable companies are avoiding tax on over half of their profits at the state level.
- 6 of 13 PA-based companies in the sample paid < 3%.
- Eight-year revenue loss from this gap: $126 billion

The Future of State Corporate Income Taxes Post-TCJA: ???

- New territorial tax system with international anti-avoidance measures. Effectiveness unclear.
- Federal collections plummeting (until they're not) post-TCJA
- Hard to know how much is temporary/permanent
- Similar problems at state level. Can observe collections, but hard to know what's driving.
- Candidates: income shifting from '17 to '18; repatriation tax; legit economic growth.

Why Bother Taxing Corporate Profits At All?

- 2/3 of corporate profit are never subject to personal income tax.
- Absent a corporate tax, retained profits wouldn't be taxed, creating an incentive for high-income individuals to incorporate.
- Corporations depend heavily on state infrastructure and derive benefits beyond those accruing to their employees.
- Repealing the CNIT would require an alternative– and most alternatives are just as unpopular.
- An important tax fairness tool.

Sensible Corporate Income Tax Reform Options Available to Pennsylvania

- Don't give up. Repeal has not worked well for states taking this path.
- Focus first on base-broadening reforms
- Avoid "race to the bottom."
- Decouple from harmful federal base-narrowing measures
- "**Combined Reporting**" (preferably with worldwide reach on tax havens)
- **Disclosure/Clawbacks.**
- **Three-factor apportionment factor**
- **Economic nexus**
- **Minimum tax**

Combined Reporting: The Basics

- Combined reporting is one way of tackling a basic problem: what is the "company" to which we apply apportionment rules?
- Example: General Electric has 50 U.S.-based subsidiaries.
- <u>Separate accounting</u> says you apply apportionment rules separately to each of GE's subsidiaries, one at a time.
- <u>Combined reporting</u> says you throw GE and all its subsidiaries in the same big pot, and apply the apportionment rule to the whole pot, just once.
- Subsidiaries must be part of a "unitary business" to be thrown in the pot.

Combined Reporting: Why?

- Takes away the incentive for cross-state income shifting. Less hanky-panky= more productive activity.
- Puts in-state, mom & pop businesses on a level playing field with big, multistate corporations.
- Makes sure that a company's tax bill doesn't depend on its legal form. It should matter what you earn, not how many subsidiaries you hide the earnings in.

Combined Reporting: Why Not?

- "Manufacturing companies will flee to other states." (Empirically, there's no evidence this has happened.)
- "It's an administrative burden."

  (CBPP report: of 120 biggest MD companies, most are already subject to combined reporting in at least 10 other states already.)
- "A better approach is to just close specific loopholes as they emerge."

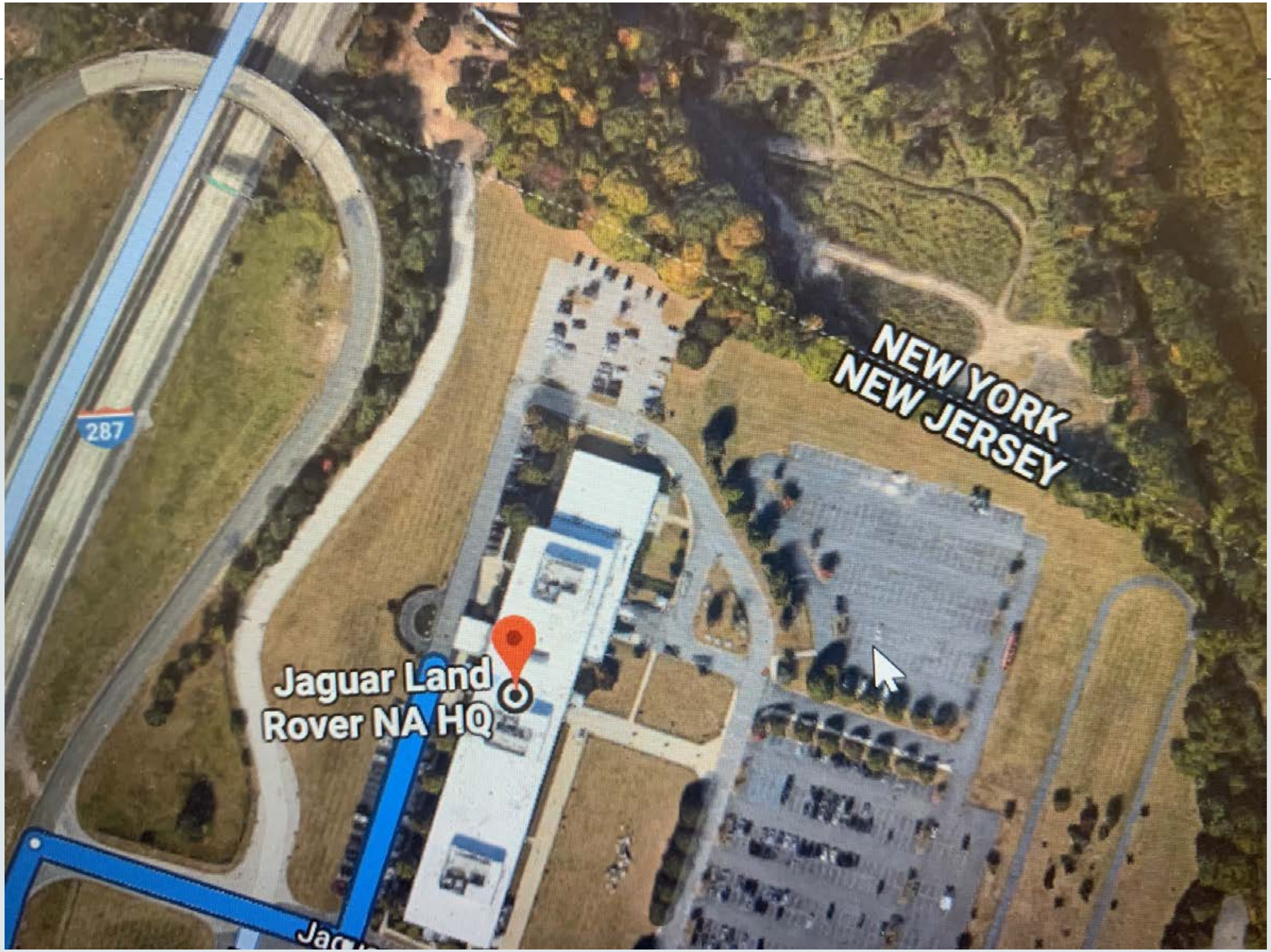
  (Amounts to playing "whack-a-mole.")

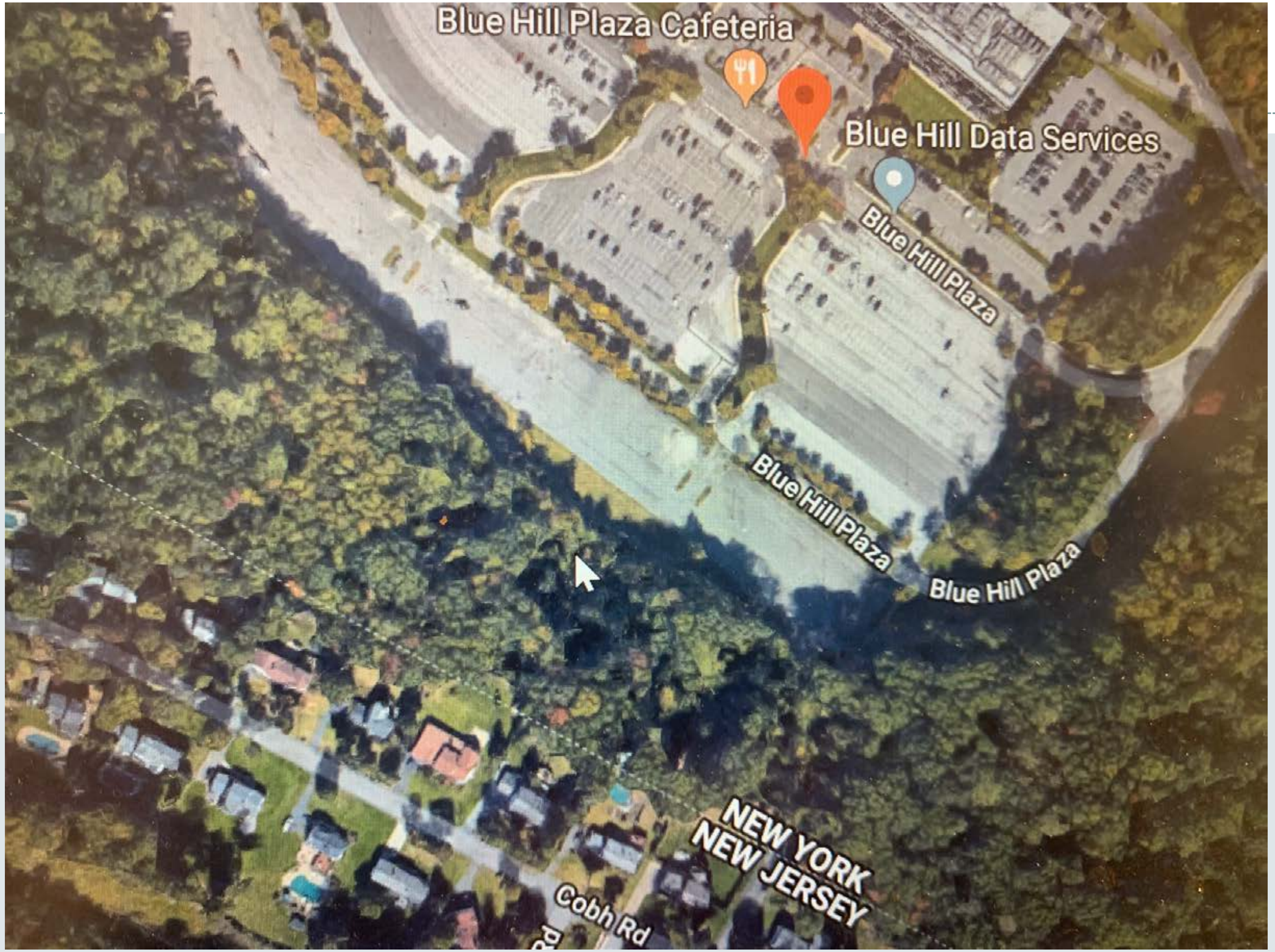
Disclosure: What Should It Look Like?

- Current state income tax, and state pretax profits. Needed to calculate effective tax rate in your state.
- Value of each tax break claimed, above a certain threshold, so we can understand WHY companies aren't paying taxes.
- For each tax break, need a record of what the company promised to do in exchange for that tax break– and whether they did it.
- Also need "clawback" rules to take back tax breaks when promises aren't fulfilled.
- Not just for the biggest companies. All publicly traded companies, and larger privately owned companies.

Why Cutting Corporate Income Taxes Won't Help State Economies

- Short-term budget constraints mean spending must be cut to pay for it.
- Benefits of tax cut accrue to shareholders, wherever they live. Iowa? China?
- "Federal offset" dampens difference in corporate tax rates between states.
- These taxes are a small part of the cost of doing business to begin with.
- Growing evidence that big Fortune 500 companies are paying less than the statutory tax rate to begin with.


NEW YORK
NEW JERSEY
287
Jaguar Land
Rover NA HQ


Blue Hill Plaza Cafeteria
Blue Hill Data Services
Blue Hill Plaza
Blue Hill Plaza
Blue Hill Plaza
NEW YORK
NEW JERSEY
Cobh Rd

Business Tax Incentives: Do They Have An Impact?

- **Incontestably, yes: they cost money.**
- **And they shift the cost of funding govt to everyone else.**
- More contestable is whether they change business investments decisions, or simply reward them for what they would have done anyway.
- And even if they do affect behavior, that likely means channeling investment from its most efficient use to a less optimal use. Encouraging investment in inefficient industries is many things, but NOT a development strategy.

Business Tax Incentives: Maximizing "Bang for the Buck"

- **Case study: Arizona "Alternative Fuel Credit"**
- Arizona legislature enacts income tax credit for businesses or individuals' purchase of cars that can run on alternative fuel– or conversion of existing vehicle fleets to do so. No requirement to actually use alt fuels.
- Initial revenue estimate: a $5 million tax credit.
- Cost quickly ballooned to $680 million as people discovered how to game the system.
- Lesson: sometimes even when an incentive "works," the outcome isn't what you wanted.