Single-Sales Factor:
An Economic Development Tool That Isn't

By Michael J. Cassidy and Sara Okos

The Virginia General Assembly is studying whether to give Virginia's manufacturers the option of calculating their state corporate tax using a different formula than other businesses. The new formula, called the Single-Sales Factor (SSF), only considers in-state sales when calculating the corporate tax, whereas the old formula also factors in both a business' in-state payroll size and property holdings. SSF is often heralded as a useful tool for economic development because it is said to make expansion of property and payroll within a state more attractive. But there are significant drawbacks associated with this approach to corporate taxation. The loss of revenue to the state will be substantial if this change is adopted. In addition, evidence shows that adopting SSF does not help a state keep or grow manufacturing jobs. Before adopting SSF, it is crucial for lawmakers to fully consider the effects that the Single-Sales Factor is likely to have.

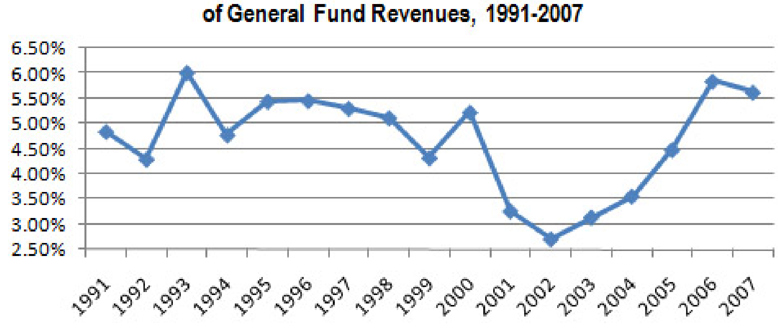
Background: Virginia's Corporate Income Tax

Virginia's corporate tax rate is currently six percent. It applies only to a company's profits — that is, its revenues minus expenses. Because corporations have fixed costs that generally do not change from year to year, it is not unusual to see a high degree of volatility in a corporation's profits over time. In years when corporate receipts are low enough to barely cover fixed costs, profits may be negative or very small. However, as soon as receipts clear costs, additional income is pure profit and, thus, taxable.

Because corporate income tax revenues are so erratic, it makes sense that in certain years they would account for a larger share of total general fund revenue than others. Figure 1 illustrates the shifting contribution of the corporate income tax to total general fund revenue in Virginia. Despite these wide fluctuations from year to year, this source of revenue is still important to the state budget, historically generating at least $200 million. To put this contribution into perspective, consider that this $200 million is just slightly less than the annual operating budget of the Department of Juvenile Justice. It represents over one third of the Department of Health's funding in 2007.

A Shifting Share of General Fund Revenue

Figure 1: Corporate Income Tax Revenues as a Percentage of General Fund Revenues, 1991-2007



Source: Annual financial reports, VA Department of Taxation

Reality Check: Missouri and the SSF

Missouri is the only state that currently allows manufacturers to choose between a Single-Sales Factor formula and the traditional three-factor formula, yet this option has failed to protect the state's manufacturing sector from plant closings and downsizing.

If the theory underlying the claimed economic development benefits of Single-Sales Factor were correct, a state like Missouri should perform especially well since no corporation pays more income tax when Single-Sales is an election rather than a requirement. But Missouri's manufacturing job performance has actually been below the median for the nation, with over 35,000 jobs lost since 2001.

Just this past June, Chrysler LLC announced that it would be closing its minivan assembly plant in Fenton and eliminating a production shift at its nearby pickup assembly plant.

Reality Check: Maryland and the SSF

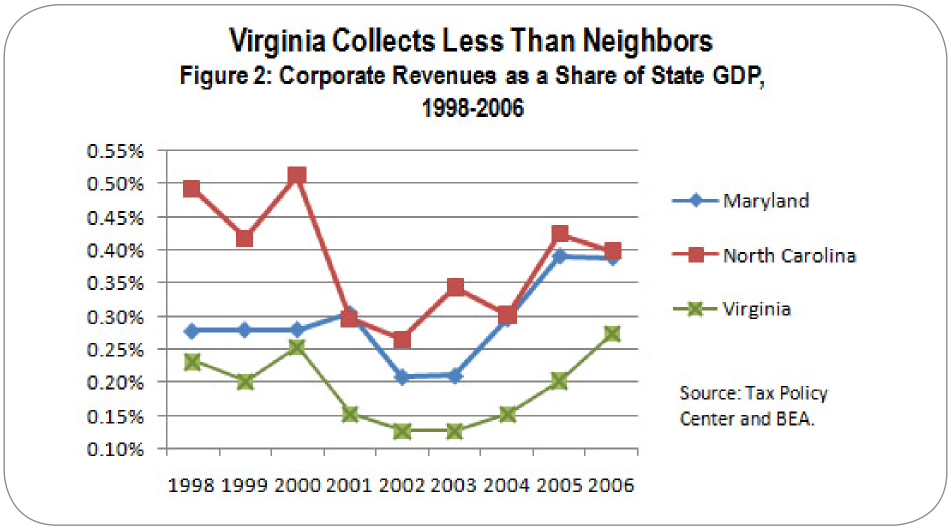
Since enacting the Single-Sales Factor in 2001, Maryland has witnessed a decline in manufacturing employment of nearly 18 percent, the seventh worst performance among the states with corporate income taxes.

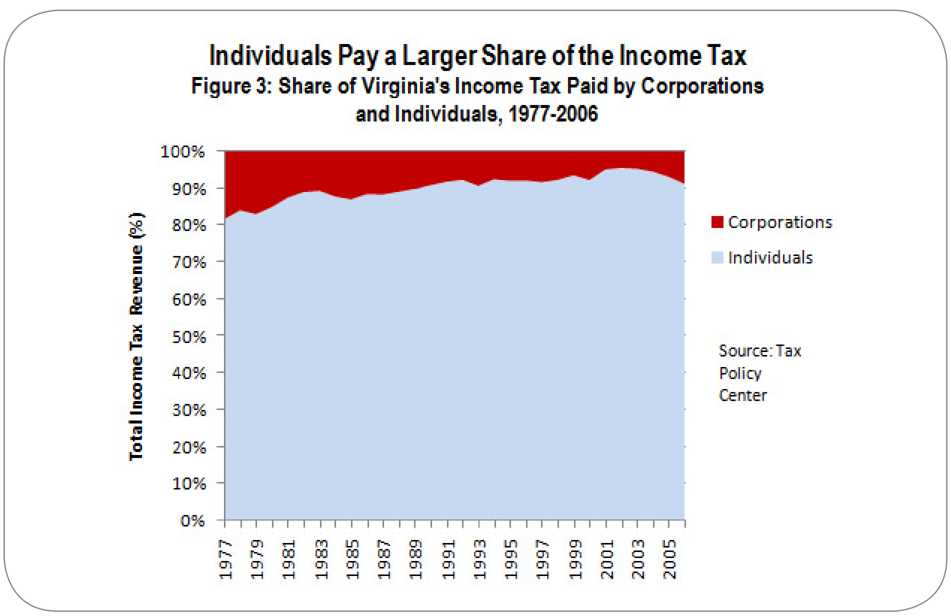
Since enactment of the SSF formula, Maryland has seen the closing of Black & Decker, Eastalco, GM, and Volvo plants. Tyson also closed a plant in Maryland, while leaving its Virginia plant open.

In 2005, both Maryland and Virginia competed for a $140 million PepsiCo Gatorade Thirst Quencher production facility that would create 250 jobs. Despite its SSF formula, Maryland lost the fight to Wytheville, Va.

In evaluating the robustness of Virginia's corporate income tax, it is useful to compare revenues to changes in state gross domestic product (GDP). This comparison helps in determining whether the state's tax collections are in line with expectations or whether they demand deeper investigation. It also helps in comparing corporate income taxes across states. As shown in Figure 2, Virginia's revenues, as a share of state GDP, are consistently below those of neighboring states. In 2006, for example, Virginia's corporate income tax revenues (as a share of state GDP) were a third lower than revenues in Maryland and North Carolina.

In addition, even though the corporate tax is important, individuals in Virginia still pay the vast majority of income tax revenue coming into state coffers, and the individual share has grown over time. As shown in Figure 3, in 1977, corporations paid 18 percent and individuals paid 82 percent. But in 2006, 91 percent came from individuals, whereas only nine percent came from corporations.





The Single-Sales Factor: A Failed Promise

Part of the decline in state corporate income tax revenues is due to increasing competition among states for business investment. This intense competition has resulted in a "race to the bottom" that has spurred many state legislatures to offer significant incentives to keep existing jobs and to lure new jobs into the state. Among these incentives is the SSF. As outlined below, despite promises of job growth in manufacturing as a result of this lucrative tax break, few benefits actually accrue to the state in return.

1. The Single-Sales Factor does not boast a positive record as an effective economic development incentive.

Eight states have had a Single-Sales Factor formula in effect for at least six years. Of these states, five have experienced above-average losses in manufacturing jobs, while only three have experienced below-average losses. Of the four states that had net gains in manufacturing jobs between 2001 and 2007, not one was a Single-Sales Factor state. (See table, p.4.)

A large body of research shows that state and local taxes have, at most, a small effect on economic development.[1] This same body of research has indicated that factors such as a highly skilled workforce, high-quality infrastructure, and good public schools and universities play at least as big a role as taxes in enhancing the attractiveness of a state's business environment.

2. The SSF is unfair tax policy for Virginia businesses with minimal or no out-of-state sales.

Because a Single-Sales Factor apportionment formula disregards a company's in-state property holdings and payroll size in calculating its tax liability, it disproportionately benefits corporations with a very high quantity of out-of-state sales. The larger the percentage of a business' sales that occur out of state, the larger the tax savings under an SSF formula. This means that smaller Virginia firms, which are not as likely to be taxable in other states, are not able to profit from this approach, while their significantly larger, multistate competitors are.

3. The SSF is a no-strings-attached tax giveaway.

If the SSF option is adopted, multistate corporations will experience substantial tax savings without necessarily creating any new jobs or making any new investments in Virginia. Virginia firms can actually cut jobs and still get a savings from SSF as long as their proportion of sales in the state is lower than their proportions of property and payroll.

4. Virginia already ranks at the top as a business-friendly state.

Forbes recently (July 2008) bestowed upon the Commonwealth, for the third consecutive year, the honorable number one ranking for "Best State for Business." In addition, Virginia's current apportionment formula already double-weights the sales factor. According to a 2008 study by Ernst & Young, Virginia is tied with Indiana and Connecticut as having the fifth lowest overall business taxes in the nation.

5. If Virginia's manufacturers are paying less, Virginia's residents will end up paying more.

Virginia's corporations and individuals share in the cost of state services. Because corporations, like individual citizens, benefit from publicly provided services — such as the state's transportation, public safety, legal, and education systems — it makes sense that corporations should contribute to their funding. By reducing corporate income taxes, Virginia's individuals will be left to make up the difference if the state is to continue to provide current service levels.

6. The true cost of SSF is not clear.

By giving manufacturers the opportunity to choose between apportionment formulas, it is only logical that they will select the formula under which they owe the state fewer income taxes. The fiscal impact statement prepared for last session's HB1514 suggests a loss of $36 million in revenues. However, this number comes from data from just one year, tax year 2003, and the statement acknowledges that this figure may not be representative of future effects. The Department of Taxation is updating this cost estimate with a thorough review of relevant corporate income tax returns and the cost estimate will likely be significantly higher.

Reality Check: Massachusetts and the SSF

Massachusetts phased in a single sales factor apportionment formula between 1995 and 2000 after significant pressure from the defense contractor, Raytheon. Since enactment of the SSF, Raytheon not only closed several of its Massachusetts plants, but also reduced its workforce in the state by 3,000. These actions led one legislator to label the SSF formula as "payoffs for layoffs." During the 1995-1999 period, that commonwealth lost nearly 12,000 manufacturing jobs — a percentage decline more than five times that of the national average. More recently, between 2001 and 2007, Massachusetts had the third highest manufacturing job loss of any state with a corporate income tax. Roughly one in five manufacturing jobs were lost during this period.

Footnotes

[1] See Lynch, Robert. 2004. "Rethinking Growth Strategies: How State and Local Taxes and Services Affect Economic Development." Economic Policy Institute. See also Wasylenko, Michael. 1997. "Taxation and Economic Development: The State of the Economic Literature." New England Economic Review, March/April.

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Single-Sales Factor States Do No Better Than Other States

Percentage Change in Manufacturing Employment: Dec. 2001-Dec. 2007

Utah*	11.26%
North Dakota	8.86%
Alaska	6.67%
Montana	0.96%
[Iowa]	-0.13%
Oregon	-1.03%
Kansas	-1.83%
Arizona	-2.55%
Idaho	-3.50%
[Texas]	-5.68%
Alabama	-5.82%
[Nebraska]	-6.18%
Indiana	-6.30%
Louisiana	-6.35%
Hawaii	-6.88%
New Mexico	-7.67%
Minnesota	-8.01%
Wisconsin	-8.09%
Oklahoma	-8.33%
Florida	-8.53%
Kentucky	-10.04%
Mississippi	-10.38%
Georgia (median)	-10.60%
Tennessee	-11.37%
[Missouri]	-11.79%
California	-12.23%
[Connecticut]	-12.95%
Virginia	-13.47%
[Illinois]	-13.49%
Arkansas	-14.44%
Ohio	-15.16%
Colorado	-15.95%
New Hampshire	-15.96%
Pennsylvania	-16.53%
Maine	-16.76%
West Virginia	-16.76%
Delaware	-16.93%
New Jersey	-17.25%
[Maryland]	-17.97%
Vermont	-18.45%
North Carolina	-19.05%
New York	-20.00%
[Massachusetts]	-20.04%
South Carolina	-20.05%
Rhode Island	-22.21%

*NOTE: Utah was an equally-weighted 3 factor formula state until 1/1/06.

Key:
Single-Sales Factor States in Brackets
Equally-Weighted 3 Factor States are in Italics

Major Finding:
Single-Sales factor states are scattered throughout the ranking of manufacturing employment growth rates. States' use of this apportionment formula is not related to state job growth in the sector.

Why This Comparison Matters:
This comparison of the growth rates in manufacturing jobs and states' corporate income tax policy is the only comparison that addresses the effectiveness of the SSF in attracting and retaining jobs. To compare the raw number of manufacturing jobs in a state to its apportionment formula has little meaning. A state's manufacturing employment is largely dependent upon the size of the state- and not on any tax policy enacted by the state.