The Single Sales Factor Formula

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Joint Subcommittee Studying the Benefits of Adopting a Single Sales Factor to Apportion the Income of Multistate Corporations for Purposes of the Corporation Income Tax

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Problem 1: A Formula that Doesn't Reflect Economic Reality

- SSFF does not reflect where corporate income is actually earned

- "[S]tates may attempt to minimize the [corporate] tax burden [by enacting SSFF] but to do so they must abandon logic. Would it be logical to apportion corporate income tax looking only at the relationship of payroll within the state. . .? Obviously, it would be illogical because for a company to earn income it must combine property, labor, and marketing. For these reasons the Uniform [Division of Income for Tax Purposes] Act struck a balance and considered all factors as they relate to corporate earnings."

Problem 1: A Formula that Doesn't Reflect Economic Reality

- SSFF does not reflect where corporations receive the benefits of state services
- "A business' in-state property and payroll are a significant indicator of the measure of the benefits that the business derives from the state, as well as the social costs it imposes on the state. By contrast, the geographic distribution of a corporation's sales alone is a dubious measure of the protections and benefits provided by the state."
- Source of both quotes: Testimony and "White Paper" (respectively) submitted by Philip Morris Corp. <u>in opposition</u> to the enactment of SSFF in Maryland (2001)

Problem 2: SSFF Is Costly — Especially When It's an Election

- When SSFF is elective, no higher liability for "out-of-state" corporations to offset tax cuts given to "in-state" corporations
- VA D of Taxation estimates elective SSFF would cost

  $122.7m if given to all corporations (=14% cut in annual CIT revenue)

  $64.7m if just given to manufacturers (= 7.4% cut in annual CIT revenue)

- VA already faces almost $1Billion FY09 budget gap

Problem 3: Mandatory SSFF Is Inherently a Double-Edged Sword for Economic Development

- If you want to claim that SSFF will encourage companies to create jobs in VA, you have to acknowledge that mandatory SSFF can encourage the “losers” (companies that pay more) to:
  - Remove existing jobs/investment from the state to “break nexus”
  - Shun the state for future job-creating investment if the company already has substantial sales in the state but has not yet created “nexus”
- Can’t predict what the net effect on jobs/investment will be when some jobs are attracted and some repulsed

Problem 3: Mandatory SSFF Is Inherently a Double-Edged Sword for Economic Development

- "[I]f changing the apportionment formula can affect a business's locational decision making, then a single sales factor could actually be counterproductive, by encouraging certain corporations to move their operations out of state. For example, consider a corporation that sells a substantial amount of its products into a state in which it has a small operation. If that state moves from an evenly weighted three-factor formula to a single factor of sales, the corporation has a greater incentive than previously to move its operational activities out of the state. This will eliminate its "nexus" with the state, terminating the state's ability to levy a corporate income tax on the firm."

- Source of quotes: "White Paper" submitted by Philip Morris Corp. <u>in opposition</u> to the enactment of SSFF in Maryland (2001)

Problem 4: SSFF Is a Windfall: No Job Creation Required

- SSFF provides automatic tax cut for any corporation with a greater % of out-of-state sales than % of out-of-state property/payroll — a pure windfall
- No quid pro quo for job creation
- Indeed, businesses can cut jobs and still receive tax benefits as long as % of out-of-state sales remains larger than % of out-of-state property/payroll

Problem 5: SSFF Doesn't Work — Some Anecdotes

- Black & Decker was leading advocate of SSFF in MD, then closed all its MD manufacturing plants. Yet still benefiting from SSFF because still headquartered in MD.

- Bayer is currently a leading advocate of SSFF in PA. But Bayer moved it US HQ and R&D facility from CT (a SSFF state) to NJ (a non-SSFF state).

- Just last week, Freightliner (a major backer of SSFF in OR) announced it will close its Portland truck manufacturing plant and move jobs to Mexico and its existing plants in NC/SC. (NC not a SSFF state.) But because its HQ will remain in OR, it will still benefit from SSFF.

- SSFF tax savings paid for the moving vans

Problem 5: SSFF Doesn't Work — Barr Laboratories

- In 1996, there were already 4 states with SSFF in effect. Barr chose to invest in Forest, VA instead.
- In 2003, Barr moved its administrative offices from NY to NJ. NJ is not a SSFF state. Neighboring CT was a SSFF state at the time.
- Last year, Barr expanded its Forest, VA facility rather than its NY manufacturing plant. SSFF had already been enacted in NY and was almost completely phased in there.
- Barr has no facilities in any SSFF states, even though SSFF has been in effect in 3 states for nearly 20 years.

Moral of the Story (1)

- Corporations will invest/disinvest and increase/decrease jobs where the fundamentals of their businesses dictate.

- Trying to influence these decisions with corporate tax breaks is not a prudent use of limited state financial resources.

- It is especially imprudent to provide a tax break like SSFF, where there is no quid pro quo, no inherent guarantee of new job creation/investment

Moral of the Story (2)

- *I never made an investment decision based on the tax code. . . If you are giving money away I will take it. If you want to give me inducements for something I am going to do anyway, I will take it. But good business people do not do things because of inducements, they do it because they can see that they are going to be able to earn the cost of capital out of their own intelligence and organization of resources.*

  — Former Alcoa CEO Paul O'Neill at his confirmation hearing to be President George W. Bush's first Secretary of the Treasury, January 17, 2001

Moral of the Story (3)

- Corporations are only too happy to accept SSFF if you are “giving it away”

- It is an extremely valuable windfall:

- Because VA does not have a “throwback rule” in effect, profit on all sales of products shipped from a VA manufacturing plant into states where the corporation isn’t taxable will not be taxed by <u>any</u> state — it will be pure “nowhere income”

Track Record of SSFF States: Investment

- Data presented by Commonwealth Institute at 9/30 meeting showed little apparent correlation between adoption of SSFF and manufacturing jobs.
- Question was asked: what about investment?
- Answer appears to be much the same.

Track Record of SSFF States: Growth in Manufacturing Capital Expenditures, 2001-06

<u>DE</u>	<u>104.9%</u>	LA	16.7%			<u>AL</u>	<u>-2.4%</u>	NY	-19.8%
WV	61.6%	GA	14.5%			SC	-3.1%	KY	-22.4%
<u>KS</u>	<u>61.4%</u>	**TX**	**13.5%**			TN	-3.8%	NH	-28.2%
NM	55.0%	MN	10.5%			VA	-5.8%	CA	-28.4%
<u>MT</u>	<u>53.2%</u>	WI	10.5%			NJ	-6.6%	**CT**	**-29.3%**
MS	44.9%	<u>HI</u>	<u>10.4%</u>	<u>0K</u>	<u>-2.2%</u>	<u>ND</u>	<u>-7.3%</u>	AZ	-30.9%
<u>AK</u>	<u>40.5%</u>	AR	9.2%			PA	-7.3%	**MA**	**-31.1%**
RI	35.7%	OH	3.7%			**MO**	**-11.6%**	ME	-36.7%
FL	23.9%	**MD**	**1.4%**			ID	-14.7%	OR	-38.4%
NE	**23.2%**	**IL**	**0.4%**			NC	-15.2%	CO	-39.6%
IA	**17.0%**	IN	0.4%			UT	-17.5%	VT	-6-.7%
SSFF states in bold; equally-weighted 3-factor formula states underlined									

Track Record of SSFF States: Capture of “Trophy” Plants

- 2005 Mazerov study looked at 71 facilities valued at more than $700m that were sited between ’95 & ’04
- 3 of 5 states with SSFF in place throughout period captured none
- 4 additional states that enacted SSFF toward end of period captured none after enacting it
- 2 states captured major plant investment roughly proportional to size of their economies
- Only 1 state, TX, did slightly better than that, and much of investment was oil-related
- Between 1990 and 2004, Intel Corp. placed more than 8 ½ times as much investment in non-SSFF states as in SSFF states

Why These Counterintuitive Results?

- Vast majority of corporations are not taxable in other states and therefore get no tax savings from SSFF; if there's no tax savings, there's no new investment incentive
- According to VA Dept. of Taxation, 2/3 of all corporations taxable only in VA
- As pointed out by Rob McClintock in his 9/30 testimony, all state/local taxes paid by businesses only about 2% of their total expenses
- State corporate income taxes represent less than 10% of that 2%
- Reducing such a minor expense through enactment of SSFF doesn't have major effect on avg. corporation's profitability, and therefore won't have major impact on its location decisions.

The “Tipping Point” Issue

- Q: Might not the absence of SSFF be a “tipping point” turning a particular corporation against an investment in VA?

- A: It’s possible. But that doesn’t make SSFF a good idea. Virginia has limited resources. SSFF is a windfall; no investment quid pro quo. For every 1 corporation that might be induced by SSFF to invest in VA, you’ve given a tax break to many more that will either simply pocket it, or that planned to make VA investments anyway.

“Dynamic” Revenue Impact of SSFF

- If SSFF did, in fact, induce new VA investment, then there would be some positive “feedback” effect on revenue from taxing personal incomes and purchases of new workers.

- But most mainstream economists would assume that dynamic revenue effects would be only (very) partially offsetting.

- CA’s dynamic revenue model estimates that a $1b cut in CIT revenue recoups $180m in dynamic revenue gains after 5 years; OR’s estimates $160m recoupment (OR has no sales tax)

The Goolsbee/Maydew Studies of the Job-Creation Impacts of SSFF (1)

- These studies were <u>predictions</u>, not descriptions of what actually occurred.

- Goolsbee/Maydew conducted studies for chambers of commerce in 4 states; every successive study resulted in <u>smaller</u> predictions.

- A 2nd, more conservative study of Illinois predicted increase of 75,000 new manufacturing jobs there. Illinois had lost 218,000 manufacturing jobs since SSFF went into effect (as of 12/07) — worse performance than the average state

The Goolsbee/Maydew Studies of the Job-Creation Impacts of SSFF (2)

- Goolsbee/Maydew studies predict that there is significant positive impact of SSFF on manufacturing employment in the very first year it goes into effect, and entire impact is felt within 3 years — not very realistic in light of how much time it takes to make location decisions and build manufacturing plants.
- 2005 Mazerov study shows that for Goolsbee/Maydew's manufacturing job increase predictions for WI to pan out, one would have to believe that average WI "winner" from SSFF would be willing to shift 46 jobs into the state to reap an annual tax savings averaging $12,000; again, not very realistic

Is SSFF the Best Use of Virginia's Limited Economic Development Resources?

- Rob McClintock, Virginia Economic Development Partnership, 9/30 testimony:

  "Funding Priorities for Economic Development
  - Invest in workforce development
  - Increase the funding of discretionary incentives
  - Strengthen our innovation capacity
  - Maintain our competitive business environment"

- Revenue forgone due to SSFF is revenue unavailable to fund the top 3 priorities

Conclusion

- SSFF is unlikely to be an effective or cost-effective means of stimulating job creation and investment in VA

- Its enactment seems especially ill-advised at a time when Virginia is confronting a major fiscal crisis

- Notwithstanding the fiscal crisis, if VA can afford to put an additional $65m-$123m into economic development, there are probably much better ways to spend it.