Gone With the Wind

Massachusetts' Vanishing Corporate Income Tax

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EXECUTIVE SUMMARY

Massachusetts is expected to face a budget shortfall ranging from $1.4 billion to $2.2 billion in FY 2004. This deficit is not merely a cyclical one, the natural result of a weak economy. Rather, it is largely a structural deficit, the consequence of changes in tax and budget policy over the past decade. Indeed, even if the Massachusetts economy were to stage a fairly robust recovery in the year ahead, there would still be a substantial gap between available tax revenue and existing budgetary commitments.

One of the principal causes of Massachusetts' structural deficit – that is, the Commonwealth's inability to maintain existing service levels with current revenue streams – is the state's rapidly vanishing corporate income tax. Simply ensuring that profitable corporations pay their taxes in accordance with the laws that policymakers have adopted would bring down the curtain on that vanishing act and reduce the state's deficit significantly. Accordingly, this paper reviews the declining contribution that the corporate income tax makes to state revenues, describes the major factors behind that trend, suggests several options for restoring the integrity of the corporate income tax, and addresses concerns that changes in the corporate income tax would harm the state's "business climate."

Among the principal findings of the paper are the following:

- **Over the past several decades, the corporate income tax in Massachusetts has fallen relative to other state taxes, relative to personal income, and relative to gross state product.**

    - The Massachusetts corporate income tax (or corporate "excise" tax, as it is formally known) has fallen from over 16 percent of total state tax revenue in 1968 to just four percent in 2002.

    - Over the same period, the corporate excise tax has dropped, as a share of personal income, from $7.43 per $1,000 of personal income to $2.36 per $1,000 of personal income, a decline of over two-thirds.

- Massachusetts' gross state product grew by nearly 80 percent, after adjusting for inflation, between 1990 and 2000, but corporate excise tax payments grew by only about 20 percent.

- **The vanishing corporate income tax has had profound consequences for state finances and for individual taxpayers.**

  - After adjusting for inflation, the amount of revenue generated by the corporate income tax dropped $227 million between 1991 and 2002. Between 1982 and 2002, it fell $356 million.

  - If corporate income tax revenue had remained constant as a share of personal income between 1991 and 2002, Massachusetts would have collected an additional $490 million this past fiscal year. If it had remained constant as a share of personal income between 1982 and 2002, that figure grows to an astounding $1.1 *billion*.

  - As a result, more and more of the state tax burden has been thrust upon working families. In 1968, sales and corporate income taxes were nearly equal; the sales tax generated $760 million (in inflation adjusted dollars) while the corporate income tax produced $815 million. The personal income tax totaled $1.6 billion or roughly twice the amount yielded by each of these taxes. Today, the sales tax amounts to 6 times the size of the corporate income tax, while the personal income tax is 13 times as large. This, in turn, may help to explain voters' apparent frustration with the personal income tax in Massachusetts.

- **The vanishing corporate income tax in Massachusetts is part of a national trend.**

  - According to one study, the effective corporate income tax rate, for all states that levy such a tax, fell from a peak of 8.1 percent in 1986 to 3.8 percent in 1998, the lowest level in 30 years.

  - From 1995 to 2000, federal corporate tax revenue grew by an average of six percent per year, while state corporate tax revenue, in the aggregate, grew by just three percent per year on average. In other words, a great deal of economic activity that is taxed at the federal level is escaping taxation at the state level.

- **Massachusetts' vanishing corporate income tax is, in part, the result of active corporate tax policy changes. It is also the result of the passive acceptance of aggressive tax avoidance strategies – that is, the failure by elected officials to prevent corporations from manipulating existing tax law to their advantage.**

  - Between 1991 and 2001, eight changes in corporate tax law were enacted in Massachusetts; the Department of Revenue estimated last February that such changes will reduce state tax revenue by $382 million in FY 2004. Among those who benefited from these changes were manufacturers, mutual fund companies, banks, and insurance companies.

  - Far more damaging to Massachusetts' fiscal health are the actions that elected officials failed to take in recent years. In increasing numbers and with increasing vigor, corporations are employing complex strategies to shift profits out of Massachusetts and into states where they either will not be taxed or be taxed at a significantly lower rate. To date, they have met with little resistance from either the Legislature or the Governor.

- **There is no shortage of strategies available to combat the erosion of Massachusetts' corporate income tax and to ensure that profitable businesses pay their fair share of state taxes.**

  - The most comprehensive response to aggressive corporate tax avoidance is to institute combined tax reporting. All the interlocking and subsidiary businesses in a corporate "family" would be treated as a single unit, without regard to where profits were deemed by corporate accountants to occur, thus negating such profit-shifting schemes as passive investment corporations and transfer pricing. Currently, 16 states use combined reporting.

  - Massachusetts could also address the many problems related to the apportionment of corporate profits. For instance, it could adopt a "throwback" rule to ensure that profits earned by corporations based in Massachusetts, but not presently taxed in any other state, are subject to the Commonwealth's corporate income tax. In addition, it could change the treatment of one-time or "non-business" income, so that profits arising from irregular transactions occurring solely in Massachusetts are not subject to apportionment.

- Lastly, the state could end its failed attempt to use tax policy to overcome the fundamental economic forces that determine changes in employment patterns and repeal the single sale factor apportionment formula now used by manufacturers and mutual fund companies.

- **Existing research and thoughtful economic analysis offer little support for claims that efforts to halt the erosion of the corporate income tax would damage the "business climate" in Massachusetts.**

  - In a study released in 2001, Joseph Stiglitz, a recipient of the Nobel Prize for Economics, and Peter Orszag, a Senior Fellow at the Brookings Institution in Washington, DC, found that, during times of recession, states with balanced-budget requirements were better off pursuing targeted tax increases instead of spending cuts, since tax increases – particularly on the affluent – inflict less damage on the economy than cuts in either direct spending or transfer payments to low-income individuals.

  - Corporate tax policy changes will not harm businesses struggling to recover from the current recession. Corporations that suffer a loss in a given year are not subject to the corporate income tax. What's more, the Massachusetts tax code allows corporations to use losses incurred in one year to reduce their tax liabilities in future years. Consequently, businesses hard hit since the recession began in March 2001 likely will not experience the full effect of any corporate tax law changes for several years to come.

  - A number of studies have shown corporate tax policy has little impact on economic development. For instance, a 1996 study by Robert Tannenwald, Assistant Vice President and Economist at the Federal Reserve Bank of Boston, examined business tax burdens in 22 states and found that those burdens had no measurable impact on the location of new investments.

  - A large body of economic literature holds that the factors that truly attract corporations to a state and that enhance their productive capacity over the long run are a well-educated work force and a reliable, well-maintained physical infrastructure. As both of these factors depend upon a stable tax base, every dollar of corporate tax revenue lost to accounting schemes or ill-advised tax breaks is a dollar of productive investment foregone.

I. INTRODUCTION

The Massachusetts budget is in bad shape. Over the last two years, the state has experienced deep cuts in hundreds of programs, from education and health care to housing and human services. As one looks forward to the start of the fiscal year 2004 budget cycle, the news gets no better. If the economy rebounds in a reasonably healthy way over the next eighteen months, the gap between the amount of revenue available and the amount needed to maintain the level of services in the FY 2003 budget — which was cut dramatically from its FY 2002 level — will likely exceed $1.4 billion. If the economy continues to suffer or falls into a "double dip" recession, the budget deficit could reach $2.2 billion.[1]

The possibility that Massachusetts could face a budget deficit in excess of $1.4 billion during a period of economic expansion suggests that the state's ongoing fiscal crisis is more than just a cyclical problem caused by the recession that began nearly two years ago. The projection of a multi-billion dollar deficit using the most reasonably optimistic economic forecasts available instead demonstrates that the state is facing a structural deficit, a situation in which a state's revenue system does not provide adequate resources to maintain current spending levels, even in a growing economy. This problem will pose an enormous challenge over the coming year, one that will easily consume most of the political energy in the statehouse. The appropriate mix of tax increases and spending cuts will be a topic of major debate, while just which taxes should be raised and just which spending programs should be cut will obviously be enormously contentious.

In that context, it is useful to consider the efforts made to balance the FY 2003 budget. Spending cuts, while not equal across the board, affected most program areas to a greater or lesser degree. Especially hard hit were public health, housing, and a number of individual human services programs.

[1] Nolan, Sarah and Jim St. George, *The Crisis Continues: A Preliminary Look at the FY04 Budget*, Massachusetts Budget and Policy Center, November 12, 2002.

Tax increases were distributed in a more progressive fashion. While middle- and lower-income people will pay more as a result of a reduction in the personal exemption, investors and higher-income families will bear the major burden of the tax increase, due to the closing of the capital gains loophole and the freezing of the income tax rate. Decoupling from federal estate tax changes will also ensure that the wealthiest people in the state do not get a significant tax cut in the face of mounting budget deficits. The legislature deserves credit for having crafted a remarkably equitable tax package.

Importantly though, profitable corporations that use public services in Massachusetts were not asked to play any role in efforts to close the FY03 budget gap. This is particularly troubling since the ongoing erosion of the corporate income tax in Massachusetts has contributed substantially to the state's growing structural deficit. The tax debates of the 1990s — the tax cuts aimed at manufacturers and mutual fund companies spearheaded by Raytheon and Fidelity, respectively — tell only part of the story. While those two tax cuts alone are expected to cost the state nearly $200 million in FY04, it is quite likely that a variety of questionable accounting gimmicks and tax avoidance schemes drain far more than that from the state budget. At a time when budget cuts have ended access to health care for tens of thousands, when former Governor Swift has vetoed funding for early childhood education, and when public health programs that protect all of us have experienced devastating cuts, it is time to look closely at the state's corporate income tax system to ensure that businesses using Massachusetts services to earn sizable profits pay their fair share of state taxes.

It is time to look closely at the corporate income tax system in Massachusetts to ensure that businesses using state services to earn sizable profits pay their fair share of state taxes.

This paper reviews the declining contribution that the corporate income tax makes to state revenues, describes the major factors behind that trend, suggests several options for restoring the integrity of the corporate income tax, and responds to arguments that changes in the corporate income tax would harm the state's "business climate."

II. THE VANISHING CORPORATE INCOME TAX

There are three measures that can be used to assess the trend in corporate income tax revenues in Massachusetts over time: (1) the share of all taxes that the corporate income tax comprises; (2) the corporate income tax as a share of personal income, and; (3) the amount of revenue that the corporate income tax generates, adjusted for inflation. One would expect that, in a stable and equitable tax system, the first two measures would remain relatively constant over time. One would also expect that, in a growing economy, the third measure would rise commensurately.

The corporate income tax has declined as a share of all taxes, as a share of the economy, and in terms of the number of dollars it produces. As a result, individual taxpayers have had to bear an ever larger share of the tax burden in Massachusetts.

Data from 1968 to 2002 show that none of these expectations holds true. Rather, the corporate income tax has declined as a share of all taxes, as a share of the economy, and in terms of the number of dollars it produces. As a result, individual taxpayers have had to bear an ever larger share of the tax burden in Massachusetts, as reflected in the growth of the personal income and sales taxes.

Massachusetts Trends in Detail

There was a time, not so long ago, when corporate taxes provided a significant share of the total tax base in Massachusetts. In 1968, the corporate income tax (or "excise" tax as it is formally known) accounted for one in every six dollars of state taxes. As Figure 1 shows, that share has fallen relentlessly to just four percent today, or one in every 25 dollars of state taxes. While the trend is consistent throughout this 34-year period, that remarkable drop has been slightly more rapid since the late 1980s.

Figure 1

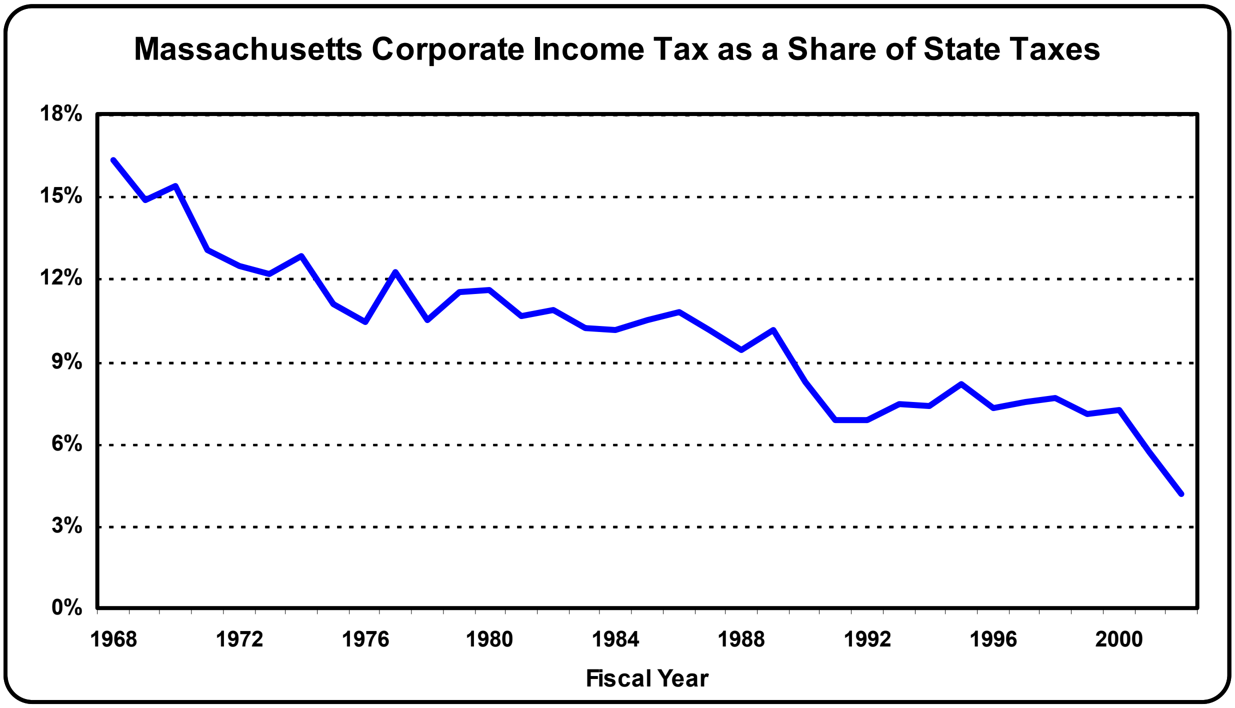
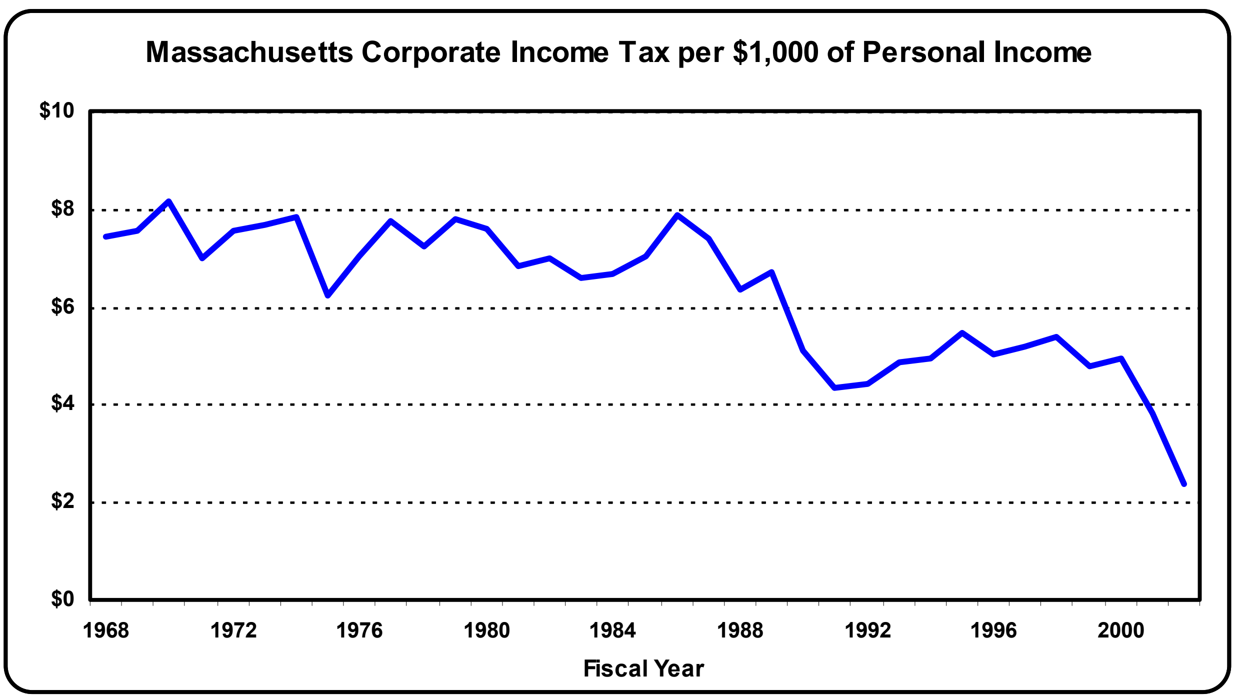


Figure 2



Not all corporations are taxed under the corporate income tax, so it could be that the income tax has fallen as a share of state taxes while other corporate taxes have risen. The data, however, show that has not been the case. Instead of paying the corporate income tax, banks, insurance companies, and utilities pay specialized income taxes. If we combine all these corporate taxes — including the main corporate income tax — total corporate taxes have fallen from nearly one-quarter of all state taxes to less than one-tenth. Thus, whether defined as the corporate income tax alone or as a range of income taxes on various kinds of businesses, the steady decline of corporate taxes in Massachusetts is quite apparent.

The decline of the corporate income tax is likewise evident when measured relative to personal income. For instance:

- Figure 2 again shows a significant drop in the corporate income tax over the past several decades, from just short of $8 per $1,000 of personal income for much of the 1970s to scarcely $2 per $1,000 of personal income by 2002.

- When measured as a share of personal income, the corporate income tax was particularly stable over the 22-year period from 1968 through 1989. During that time, corporate taxes varied between $6.21 per $1,000 of personal income and $8.16 per $1,000 of personal income; as Figure 3 indicates, the average was $7.24.

- Beginning in 1989, however, the corporate income tax began to plummet, falling from $6.70 per $1,000 of personal income to just $2.36 per $1,000. Between 1990 and 2002, corporate taxes have averaged $4.67 per $1,000 of personal income, roughly two-thirds the level of the 1970s and 1980s. Thus, while the corporate income tax as a share of the total tax burden fell throughout the period, as a share of income, it only really began to fall off in the late 1980's.

Figure 4 shows the amount of revenue the corporate income tax generated, in inflation-adjusted dollars, from 1968 to 2002. While this figure does not exhibit the same sort of downward slope as Figures 1 and 2, the final result is the same. Just as the corporate income tax in 2002 was at its lowest point in over twenty-five years when measured as a share of state taxes or as a share of personal income, so too was it at its nadir when expressed in constant dollar terms. In 2002, corporate income tax revenue totaled $587 million in Massachusetts, 25 percent lower than at any point since at least the late 1960s.

Figure 3

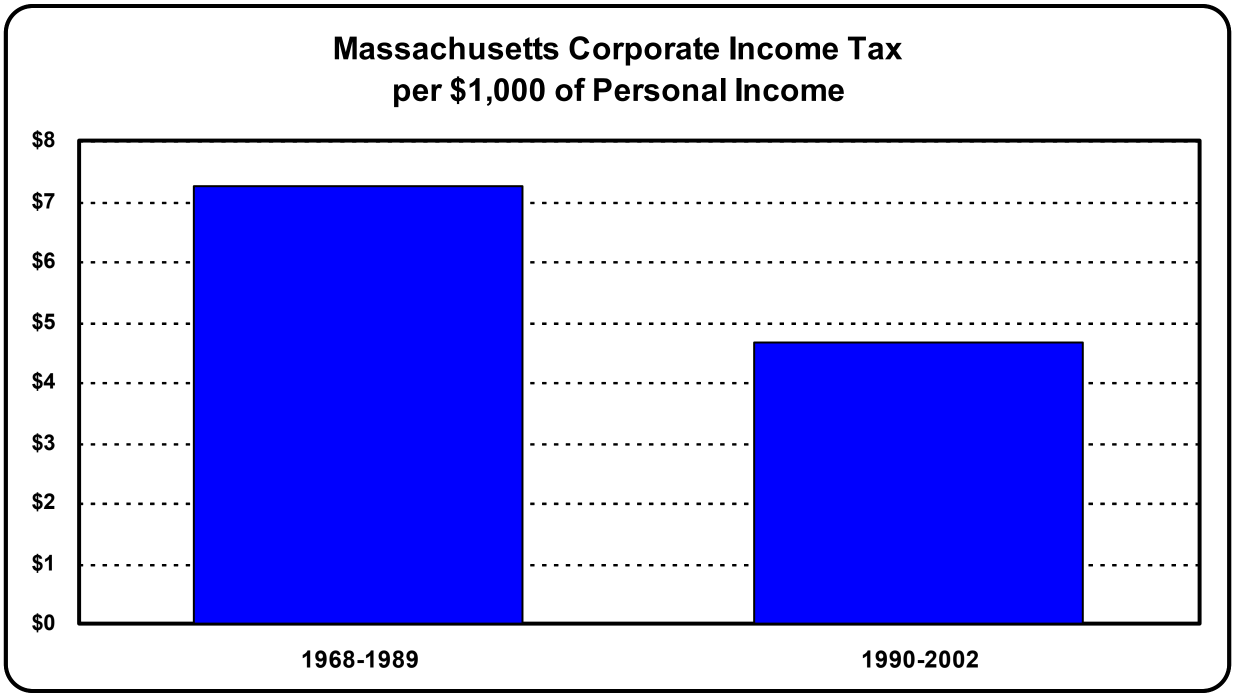
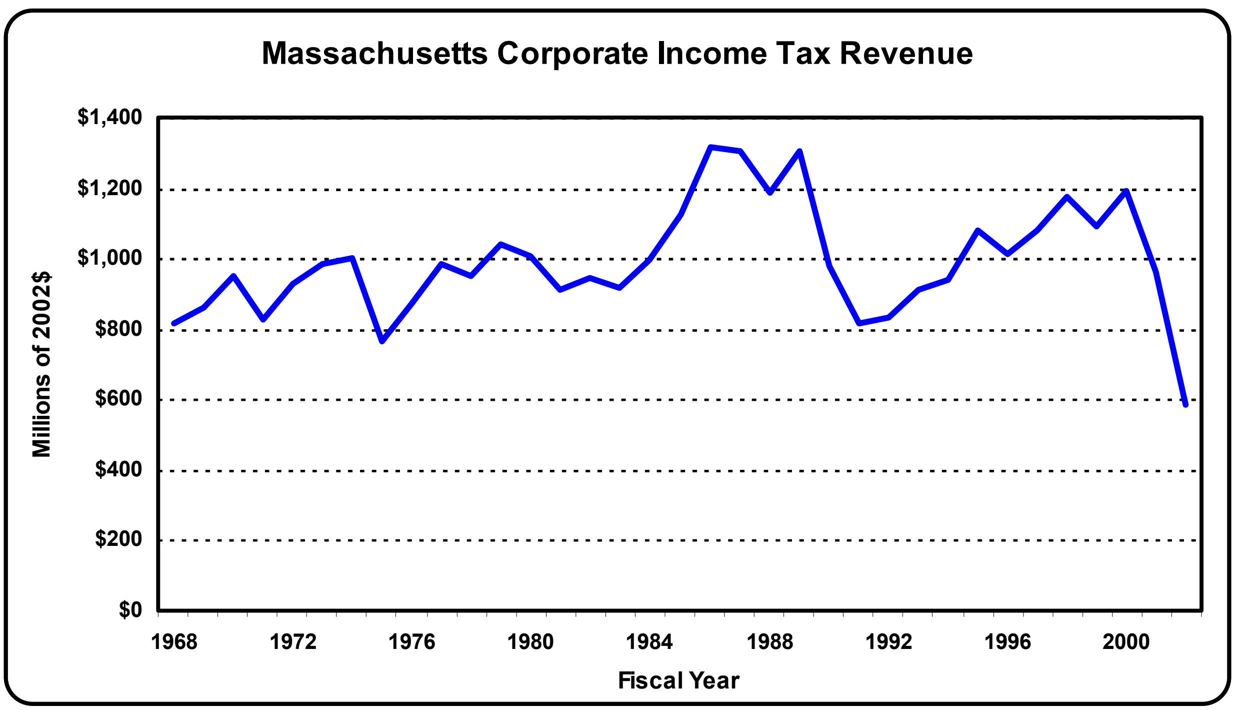
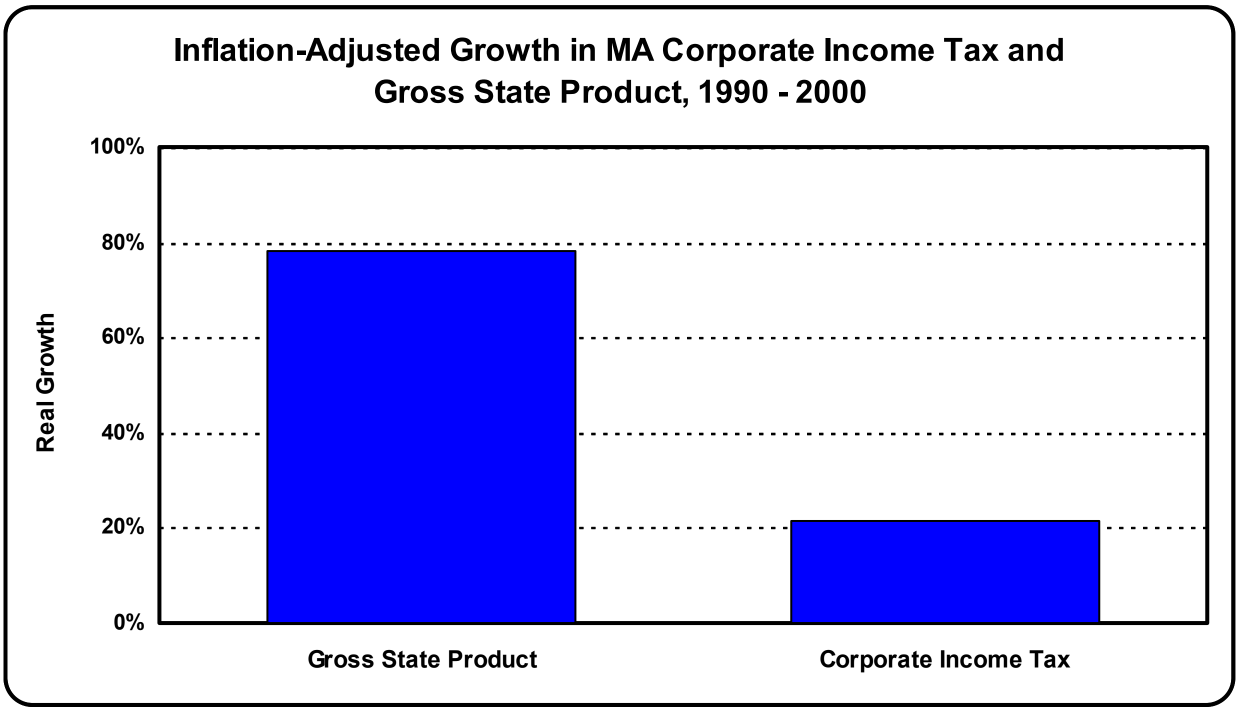


Figure 4



While the weak economy that began in 2001 certainly contributes to this falloff in corporate tax revenue, it is remarkable how little corporate taxes grew during the boom years of the last half of the 1990s. As is shown in Figure 5, the Massachusetts gross state product — the total value of goods and services produced in the state — grew by nearly 80 percent between 1990 and 2000, after adjusting for inflation. The state's corporate excise tax, however, grew by just over 20 percent during that same period. This certainly suggests that a large amount of economic activity in Massachusetts was not subject to the state corporate income tax.

Figure 5



Consequences for State Finances and for Individual Taxpayers

In FY 2002, Massachusetts experienced its first budget deficit in over a decade; in the end, policymakers used $1.5 billion from the state's rainy day fund to close the gap. The question is worth asking: How might things have been different if the corporate income tax had not been so badly eroded? Perhaps the simplest answer can be found by comparing the amount of revenue – in constant dollars – that the corporate income tax generated in FY 2002 with the amount of revenue it generated at some point in the past. For example, in FY 2002, the corporate income tax raised $587 million in revenue; in FY 1991, it produced $815 million, a difference of more than $227 million. While FY91 is a useful point of comparison – it was in the trough of the last recession in Massachusetts – it still does not reveal the full impact of the corporate income tax's decline, as the drop-off had begun several years earlier. If FY 1982 – another recession year – is used instead, the difference is $356 million.

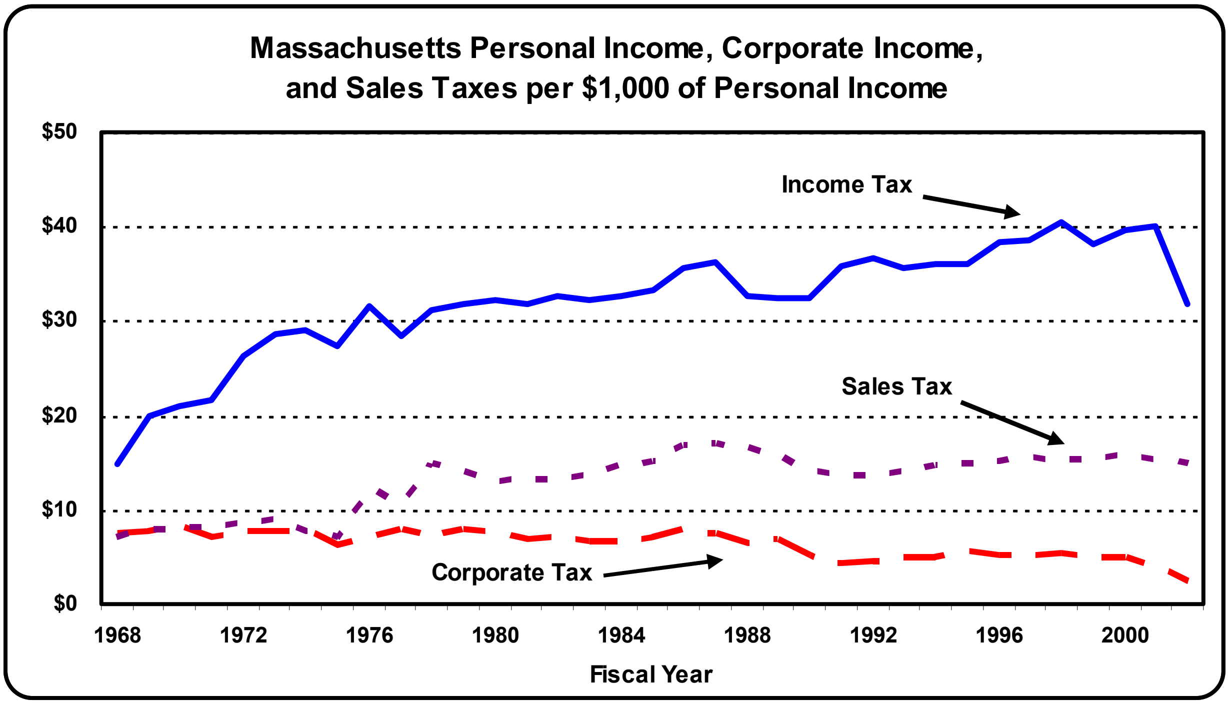
If corporate income tax revenue had remained constant as a share of personal income between FY91 and FY02, Massachusetts would have collected an additional $490 million this past fiscal year. If it had remained constant between FY82 and FY02, that figure grows to $1.1 billion.

Of course, as noted earlier, one would expect that corporate income tax revenue would grow as the economy grows. Therefore, considering what corporate income tax revenue would have been if it had remained constant as a share of personal income might be more instructive still. If corporate income tax revenue had remained constant as a share of personal income between FY91 and FY02, Massachusetts would have collected an additional $490 million this past fiscal year. If it had remained constant between FY82 and FY02, that figure grows to an astounding $1.1 *billion*. In other words, the corporate income tax could have provided over one billion dollars in additional revenue in fiscal year 2002 without consuming a larger portion of the economy than it did twenty years ago.

The consequences of this vanishing act for individual taxpayers have been even more profound. Figure 6 shows how the personal income tax, the sales tax, and the corporate income tax have changed as a share of income since 1968. At the start of that period, sales and corporate income taxes were nearly equal, both accounting for a little less than three-quarters of one percent of personal income; the corporate income tax actually accounted for slightly more than the sales tax at that point. The personal income tax amounted to 1.5 percent of personal income, about double the amount of both sales and corporate income taxes.

As the figure shows, personal income and sales taxes have both increased relative to personal income, while the corporate income tax has actually fallen. Today, the sales tax amounts to six times the size of the corporate income tax, while the personal income tax is 13 times as large. Throughout the more than three decades shown in the graph, policy makers have raised sales and personal income taxes, while largely leaving the corporate income tax alone. The 2002 tax increase – which doubled the tobacco tax and raised the personal income tax by closing the capital gains loophole, blocking an income tax rate cut, and reducing the personal exemption – is a perfect example of how personal income tax and consumption taxes go up while corporate taxes remain untouched.

Figure 6



The National Trend

The vanishing corporate income tax is not unique to Massachusetts; a number of reports from around the country show how corporate tax avoidance schemes seem to be driving corporate tax receipts down. A recent report in Ohio, for instance, found that the corporate income tax, which had accounted for 16 percent of all taxes in that state in the mid-1970s, fell to just 4.6 percent by 2002.[2] Relative to the size of the Ohio economy, the report found that corporate taxes there are at their lowest level in decades.

A national study that examined the role corporate taxes play in state finances suggests that the declining corporate income tax in Massachusetts is part of a national trend. Between 1979 and 2000, corporate taxes across the country fell from 10.2 percent of state taxes (among those states that levy a corporate income tax) to 6.3 percent, a very similar drop to the experience in Massachusetts.[3] That same study found that a review of the National Income and Products Accounts (see Figure 7) shows that:

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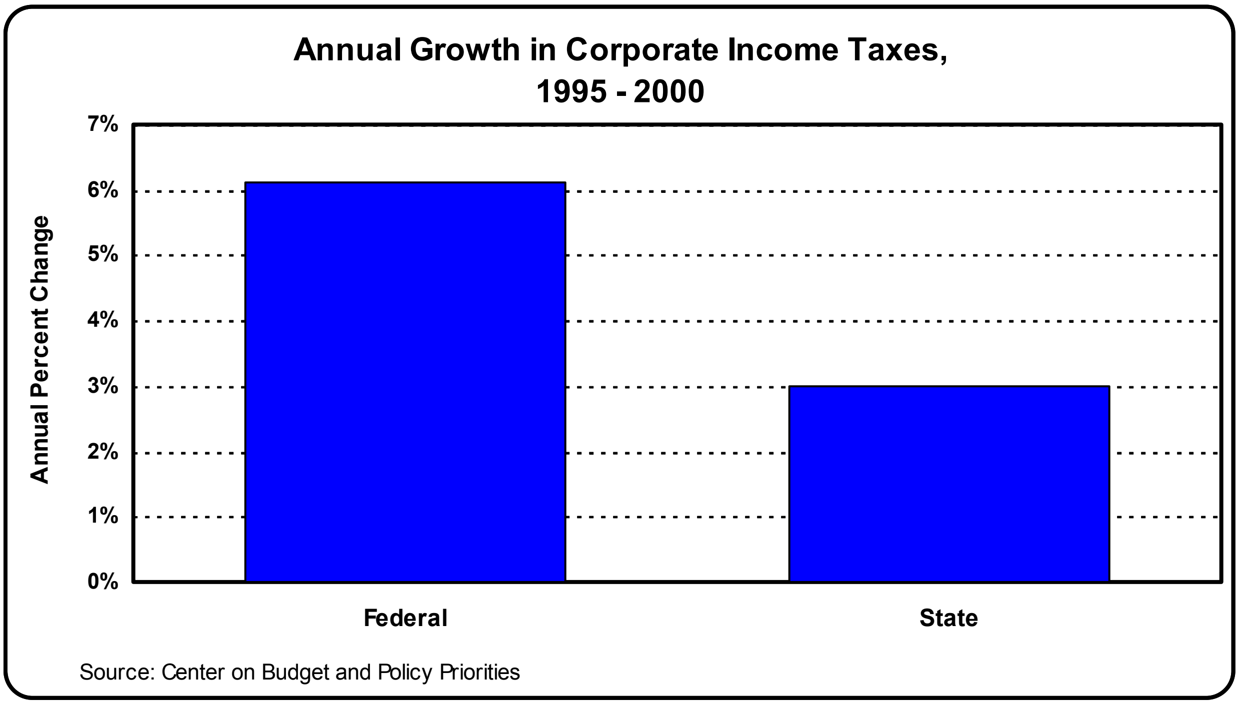
[2] Schiller, Zack, *Ohio's Vanishing Corporate Franchise Tax*, Policy Matters Ohio, October 2002.

[3] Mazerov, Michael, *Closing Three Common Corporate Tax Loopholes Could Raise Additional Revenue for Many States*, Center on Budget and Policy Policies, Washington, D.C., April 2002.

> …during the strong economic expansion of 1995-2000, state corporate income tax revenue grew at just half the rate of federal corporate tax revenue – an average of three percent annually versus six percent annual growth for the federal corporate income tax. Since corporate income tax rates at both the federal and state level were substantially stable throughout this five-year period, the relatively slow growth of state corporate tax receipts suggests that a significant share of corporate profit that is finding its way into the federal corporate tax base may be falling through the cracks at the state level.

Figure 7

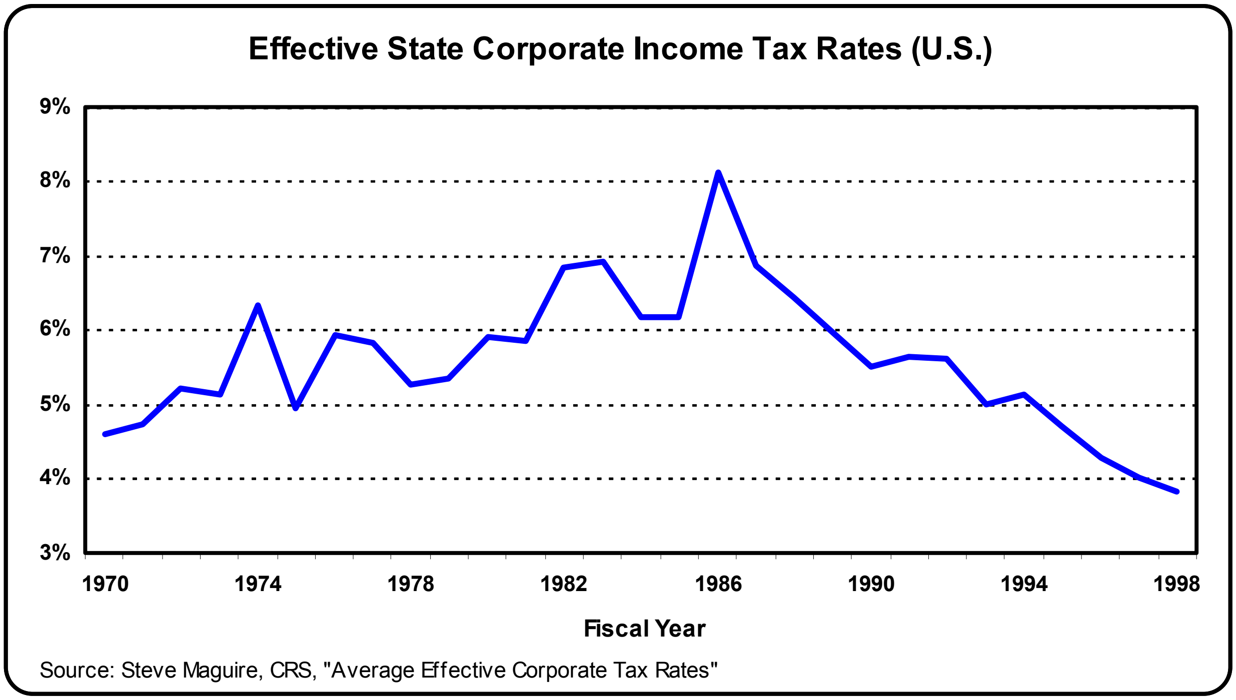


A particularly interesting study conducted by the Congressional Research Service estimated the effective tax rate for state corporate income taxes. In contrast to the statutory tax rate — the tax rate applied to reported corporate profits — the effective tax rate measures the share of corporate profits that is actually paid as state taxes, requiring, of course, an estimate of "true" corporate profits. This analysis found that the effective state corporate tax rate rose from 4.6 percent in 1970 to 8.1 percent during the economic boom of the 1980s, before plunging to 3.8 percent in 1998 (see Figure 8).[4] In other

[4] Maguire, Steve, "Average Effective Corporate Tax Rates," Congressional Research Service, 2000. Reprinted in *State Tax Notes*, September 4, 2000, pp. 647-650.

words, when the economy expanded during the 1980s, the effective state corporate tax rate rose substantially. During the economic expansion of the 1990s, however, the effective state corporate tax rate fell to its lowest level in decades.

Figure 8



An analysis published by the Federal Reserve Bank of Boston came to the same conclusion regarding falling effective tax burdens, although the specific figures generated by the analysis were slightly different. Robert Tannenwald, Assistant Vice President and Economist at the Bank and a former director of the Massachusetts Tax Study Commission, compared state corporate income tax payments relative to corporate profits.[5] He found that taxes as a share of profits rose steadily during the 1960s and 1970s, peaking in 1986, when state and local corporate income tax payments amounted to 7.6 percent of profits. After that, however, the corporate tax burden fell steadily to 3.9 percent of profits in 2000. As we have seen, this occurred while the rate of growth for federal corporate income taxes rose at twice the level of state corporate income taxes.

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[5] Tannenwald, Robert, "Are State and Local Revenue Systems Becoming Obsolete?" *New England Economic Review*, Federal Reserve Bank of Boston, Issue 4, 2001, pp 27-43.

III. THE CORPORATE SLEIGHT OF HAND

Corporate income taxes are falling relative to other state taxes, relative to personal income, relative to gross state product, and relative to corporate profits. These trends appear to be occurring in Massachusetts and across the country. That raises the obvious question, why are these trends occurring?

In increasing numbers and with increasing vigor, corporations are employing complex strategies to shift profits out of Massachusetts and into lower tax, or no tax, states.

By and large, these trends can be attributed to two factors: active corporate tax policy changes – that is, changes in tax law passed by the Legislature and approved by the Governor – and passive acceptance of aggressive tax avoidance strategies – that is, the failure by elected officials to prevent corporations from manipulating existing tax law to their advantage.

The first factor arises from the escalating "war among the states," the interstate competition for economic development that appears to leave *all* states worse off. Admittedly, states have been competing with each other for economic advancement since the founding of the nation. Indeed, the lack of cooperation among the states led to the failure of the Articles of Confederation and the subsequent adoption of the Constitution, which, through the interstate commerce clause, explicitly prohibits interference with the free flow of commerce among the states. Today, states are providing an ever-increasing array of tax inducements for corporations to relocate, or to remain, within their borders. As will be discussed later in this paper, this "race to the bottom" succeeds only in leaving the public services that are the true key to economic development – education, transportation, and public safety – chronically underfunded.

The second factor behind vanishing corporate tax revenues – aggressive tax avoidance by major corporations and policymakers' failure to respond – may well be more deleterious to the funding of public services. In increasing numbers and with increasing vigor, corporations are employing complex strategies – such as the use of passive investment corporations (PICs) or transfer pricing mechanisms – to shift profits out of Massachusetts and into lower tax, or no tax, states like Delaware or Nevada, thus drastically reducing their corporate tax liability in the Commonwealth. In the end, these creative accounting schemes likely drain far more from the state revenue stream than the more obvious tax breaks that the state handed out during the 1990s.

Ironically, while explicit tax breaks intended to lure corporations to the Commonwealth were the subject of contentious legislative debate and extensive media coverage, almost no attention was paid to the likely more damaging loopholes that corporate lawyers and accountants were quietly pulling open at the same time. In the wake of the Enron debacle, more light is being shed on these practices, but, while officials from Enron and other scandal-wracked corporations likely violated a variety of laws in overstating corporate profits to boost share prices, corporations' manipulation of profits at the state level to avoid paying taxes may be perfectly legal. Of course, such behavior is legal in a way that only a lawyer could love, as it comports solely with the letter of the law and not with the spirit in which it was originally enacted. Thus, closing corporate tax loopholes would undoubtedly generate additional tax revenue for the Commonwealth, but the reality is that closing those loopholes would merely require corporations to pay the taxes that policymakers intended them to pay in the first place.

Corporate Income Taxes and the Apportionment Formula

In order to understand the impact of both of these factors, it is first necessary to understand how the corporate income (or excise) tax works, and in particular, how a company that operates in states in addition to Massachusetts may be taxed. When a company operates in more than one state, it is not always obvious how much of that company's profits should be taxable in any one state. Imagine, for instance, a manufacturer that makes parts for a consumer product in three different states, puts them together in a fourth state, houses the final product in a central location for future delivery, and has stores to sell the product in 20 states. How much of the total profit the company makes should be attributed to the states in which each of the components was made, to the state in which the final assembly took place, to the state in which the product was warehoused, and to the states in which the product was sold?

Traditionally, states have answered this question by distributing, or "apportioning," corporate profits based on three factors: property such as land and equipment, payroll, and sales. More specifically, each state only taxes a given fraction of the profits earned by a corporation that operates in more than one state. That fraction is found by using what is known as the equally-weighted, three-factor apportionment formula, which averages the share of the corporation's total property that is situated in the state, the share of the corporation's total payroll that is located in the state, and the share of the corporation's sales that are made in the state. This formula is the result of a broad consensus that states that provide services to a corporation's property and workers, as well as states that provide a market for the corporation's output, should be able to tax a portion of the corporation's profits.

To illustrate, assume in the case above that one of the states where the product was sold is where the majority of parts are manufactured. Thus, the state may represent just 10 percent of total sales, but perhaps 30 percent of payroll and 50 percent of property. Using the equally-weighted, three-factor apportionment formula, which many states still employ, the state would be able to tax 30 percent of the company's profits. In its simplest form, the equation would work like this:

$$(10\,\% + 30\,\% + 50\,\%) \div 3$$

$$= 90\,\% \div 3$$

$$= 30\,\%$$

A key advantage to each state using the same apportionment formula is that it ensures that corporate profits are taxed once and only once. If every state were to use the equally-weighted, three-factor apportionment formula, then every multi-state corporation would pay taxes on all of their profits somewhere. Conversely, deviations from the uniform apportionment formula permit corporations to earn profits that are not taxed anywhere. This not only drains away resources for state-funded services, but also gives multi-state corporations a significant advantage over smaller, locally-owned and operated businesses. Moreover, once one state deviates from the traditional, three-factor formula, it encourages other states to do the same, further compounding these problems.

Active Tax Policy Changes

Unfortunately, Massachusetts has been in the vanguard in the economic war among the states, a role that has had a marked impact on corporate tax receipts. Between 1991 and 2001, eight changes in corporate tax law were enacted; the Department of Revenue estimated in February of last year that such changes will reduce state tax revenue by $382 million in FY 2004.

Single Sales Factor

The two most well known of these changes in tax law – commonly referred to as the Raytheon and Fidelity tax breaks, after their principal proponents and beneficiaries – dramatically altered the apportionment formula described above. In 1995, the Lexington-based defense contractor, Raytheon, convinced the Legislature and the Governor to change the state's apportionment formula so that, rather than basing Raytheon's tax liability on the company's payroll, property, and sales in Massachusetts, it would be based solely on the sales that Raytheon made within the Commonwealth. In other words, the apportionment formula was modified so that only a single factor – the sales factor – would be used to determine Raytheon's tax liability. (In the end, the legislature expanded the tax break so that all manufacturers, not just defense contractors like Raytheon, could use the single sales factor apportionment formula). Less than a year later, Fidelity Investments pushed for, and received, the same tax break for mutual fund companies.

The reason Raytheon, Fidelity, and other large corporations supported this change is that a single sales factor apportionment formula significantly reduces the tax liability of corporations that have the bulk of their actual operations – that is, employees and property – within Massachusetts, but that make the majority of their sales outside the Commonwealth – whether in other states, to the federal government, or in foreign countries. Assume, for instance, that 40 percent of Raytheon's workforce and 60 percent of its property, but only 10 percent of its sales, were in Massachusetts. Under the apportionment formula that Massachusetts used prior to 1995, 30 percent of its profits would be taxable in Massachusetts.[6] Under the single sales factor formula, just 10 percent of its profits are taxable in Massachusetts. Just as importantly, since many states continue to use the traditional, equally-weighted, three factor apportionment formula, the share of these corporations' profits subject to tax would not go up in any other state just because it went down in Massachusetts. Consequently, *a portion of manufacturers' and mutual funds' profits are now not taxed by any state.*

[6] Prior to 1995, Massachusetts double-weighted sales in its apportionment formula, but still included both payroll and property. Accordingly, the portion of a company's profit subject to taxation in Massachusetts was found by doubling the proportion of its sales in Massachusetts, adding that figure to the sum of the shares of its payroll and property in Massachusetts, and dividing by four, or ((10 % * 2) + 40 % + 60 %) / 4 = 30 %.

Additional Tax Changes

In addition to the Raytheon and Fidelity tax breaks, Massachusetts enacted several other major corporate tax cuts between 1991 and 2001, including:

- **Banks**

  Banks are subject to a separate tax in Massachusetts. In 1995, legislation was enacted reducing the basic rate for the bank tax from 12.54 percent to 10.5 percent by 1999. According to the Department of Revenue, this change will result in a loss of $32 million in tax revenue in FY 2004.

- **Insurance companies**

  Insurance companies are also subject to a different tax than the usual corporate excise. Legislation adopted in 1998 eliminated the 14 percent tax on life insurers' net investment income, as well as the 1 percent tax on property and casualty insurers' gross investment income. The same legislation granted a partial tax credit for taxes paid in states other than Massachusetts. All told, these changes are expected to reduce tax revenue by $39 million in FY 2004.

- **Research and development tax credit**

  As a result of legislation enacted in 1991, corporations that make certain research and development (R&D) expenditures may claim a credit against taxes due. The value of the credit is equal to 10 percent of qualified research expenses each year in excess of a base amount, plus 15 percent of basic research expenses in excess of a base amount. The credit is limited to the first $25,000 of taxes due plus 75 percent of any taxes due in excess of $25,000. Unused credits may be carried over to subsequent years. The Department of Revenue projects that the R&D credit will reduce state tax revenues by $94 million in FY 2004.

- **Investment tax credit**

  Similarly, certain corporations – manufacturers as well as companies engaged in research and development, commercial fishing, and agriculture – can claim a credit against taxes due for investments in tangible property. In 1993, the value of the credit was "temporarily" increased from one percent of the cost of such investments to three percent of the cost. However, the value of the credit can not exceed 50 percent of a corporation's total tax liability, although, again, unused credits may be used to reduce future tax liabilities. The estimated revenue loss associated with this change is $13 million for FY 2004.

Corporate Tax Avoidance Strategies

At the same time that these overt tax breaks were being debated on Beacon Hill and in the press, corporations were busy covertly reducing their tax burdens in Massachusetts, with almost no resistance from state policymakers. Specifically, creative corporate accountants and lawyers devised two major ways to manipulate the method of apportioning profits among states in order to lower their clients' tax liabilities:

- **Passive Investment Corporations (PICs)**

  A PIC is a subsidiary set up in a state (typically Delaware or Nevada) that does not tax income from interest, royalties, or other forms of "intangible income." The tax-haven subsidiary typically holds the company's trademark or patents and then charges the parent company royalties for using them. Since the payments for royalties are considered a cost of doing business for the parent company and are therefore tax deductible, much or all of the parent company's profits are shifted to the subsidiary in the non-taxing jurisdiction. The dodge thus allows companies to evade most or even all of their corporate income tax obligations.

  Because state corporate tax records are confidential, it is impossible to estimate with any accuracy the amount by which corporations in Massachusetts are ducking their legitimate tax burden. One national study of the phenomenon, however, called the total state tax loss "enormous." The study suggests that most U.S. corporations have probably set up these PICs; as of 1998, there were some 6,000 PICs in Delaware alone, with between 600 and 800 new ones being created each year. Records from individual legal cases confirm the speculation that the amount of revenue lost by states through these accounting gimmicks is substantial.[7]

- **Transfer Pricing**

  An alternative to setting up a PIC in a tax-favored location is simply to use internal transactions to shift profits into low-tax or even no-tax states. In this case, businesses with operations in multiple states "sell" components or products from one branch of the business to another branch located in a different state at prices in excess of what would prevail on the open market. Returning to the example used earlier, if the manufacturer sells the components of a product to a subsidiary at an excessively high price, the component manufacturer may make a substantial profit while the subsidiary that provides the final production may make little or no profit.

[7] Mazerov, *op cit.*

> If it just so happens that the component manufacturer is in a low-tax state while the final producer is in a high tax state, the company may claim that is merely a fortuitous coincidence. State laws and various accounting rules require that these transactions be valued at a fair market rate, but determining what that is in many cases can be as much art as science.

These tax minimization strategies share several common features.

- First, they take advantage of differences in states' tax codes, essentially playing the states off against each other, draining state coffers, and starving the very services vital to true economic development.

- Second, these strategies are only available to larger multi-state or multi-national businesses. Smaller firms that operate largely or entirely within one state's borders have no profits to apportion, so they continue to bear the full corporate tax while others — perhaps their competitors — benefit from these tax avoidance schemes.

- Third, these strategies are exceptionally good investments for corporations to make. One study of multi-state tax planning concluded that the typical corporation in the study would reduce its total state tax burden by $100 for every $1 it spent on outside tax attorneys, accountants, and consultants.[8]

- Fourth, the holes in the Massachusetts tax code that allow corporations to manipulate reported profits in order to reduce taxes could easily be closed.

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[8] Gupta, Sanjay and Mills, Lillian, *Multistate Tax Planning: Benefits of Multiple Jurisdictions and Tax Planning Assistance,* unpublished working paper, available through the Social Science Research Network Electronic Library (http://www.ssrn.com)

IV. STRATEGIES FOR HALTING THE EROSION OF THE CORPORATE INCOME TAX

There is no shortage of strategies available to combat the erosion of state corporate tax revenue and to ensure that profitable businesses pay an appropriate share of state taxes. The recommendations that follow fit into four categories:

- policies that would close loopholes opened by creative corporate accountants, ensuring that corporations pay the level of taxes intended by policy makers;
- policies that would roll back special-interest tax breaks enacted in recent years;
- policies that would promote the fair taxation of corporations, ensuring that their profits are fully subject to states' corporate income taxes and creating a more meaningful corporate minimum tax, and;
- policies that would improve disclosure and accountability, allowing the public and the press to monitor corporate tax compliance.

In some cases, such as rolling back the tax breaks passed in recent years, there are reliable Department of Revenue estimates of the revenue that would be generated by changing current law. In many cases, however, it is impossible to determine how much revenue is lost as a result of these loopholes, and thus it is impossible to determine how much would be generated by closing them. The very fact that policy makers don't know how much the loopholes cost, however, speaks volumes about the need for greater attention toward, and information about, these very tax breaks and loopholes.

Closing Accounting Loopholes

- **Institute Combined Reporting**

  The best way to ensure that corporations cannot use fancy accounting gimmicks to avoid paying taxes in Massachusetts is simply to institute combined tax reporting, currently used by 16 states. Under this system, all the interlocking and subsidiary corporations in a corporate "family" are treated as a single business, no matter where an accountant deems profits to occur. This would solve the problem of passive investment corporations, as well as other accounting schemes such as "transfer pricing" that allow corporate accountants to pick and choose where income is declared. Within this combined corporate report, then, Massachusetts would apportion its share of profit and thus taxes, sharply limiting the opportunities for creative tax avoidance schemes.

- **Ban Passive Investment Corporations**

  Short of requiring combined reporting, the legislature could enact legislation that attempts to ban the use of passive investment corporations and other forms of accounting manipulations. For instance, Ohio, Alabama, Connecticut, Mississippi, and North Carolina all have provisions in their tax codes that, in essence, prohibit companies from deducting payments to closely-related subsidiaries for the use of trademarks and patents. While this is less comprehensive than combined reporting, it may still impede the ability of corporations to play fast and loose with state tax laws.

  On the other hand, the weakness of this second-best alternative was shown recently in a Supreme Judicial Court ruling that rejected Massachusetts' efforts to make the paint manufacturer Sherwin-Williams pay reasonable taxes on its profits in Massachusetts.[9] Sherwin-Williams, headquartered in Cleveland, set up two subsidiaries in Delaware that "managed" the company's trademarks; Sherwin-Williams then paid $47 million in royalties to use those trademarks. Massachusetts claimed that the subsidiaries and royalties were a "sham transaction" that shouldn't reduce the company's tax obligations, but the SJC ruled the arrangement was valid. While it is unclear at the present time how this ruling will affect other corporate tax cases in Massachusetts, it certainly does not bode well for efforts to collect taxes from businesses earning profits in Massachusetts without legislative action.

[9] *The Sherwin-Williams Company v. Commissioner of Revenue*, SJC-08516, October 31, 2002.

- **Change the Treatment of One-Time Income**

  Not all corporate income earned by multi-state or multinational businesses is necessarily subject to the kind of apportionment rules described earlier. While income earned in the normal course of business (sometimes called "business income") is apportioned among the various states in which a company does business, federal law permits states to tax income from irregular transactions such as the sale of property (called "non-business income") in the state in which the transaction takes place.

  Massachusetts is one of a handful of states that apportions non-business income the same way business income is apportioned. This creates obvious incentives for corporate accountants in Massachusetts to be quite flexible in the kinds of income they determine to be non-business income, potentially leaving a significant amount of income subject to apportionment. Again, if Massachusetts does not tax the full value of non-business income while other states only tax non-business income from within their own borders, a significant amount of corporate profits may ultimately be free of state taxation altogether.

Rolling Back Special Interest Tax Breaks

- **Eliminate Single Sales Factor for Manufacturers**

  When Raytheon lobbied for the adoption of the single sales factor apportionment formula in 1995, it argued that abandoning the traditional three-factor formula would remove a significant disincentive to expansion and, thus, would lead to job growth in Massachusetts. It is now quite clear that this experiment – attempting to use corporate tax policy to trump underlying economic factors – has failed. Since 1995, Raytheon has moved most of its manufacturing jobs out of Massachusetts; as Senator Susan Fargo has said, the state's tax break essentially paid for the moving vans. What's more, as is discussed in greater detail later in this paper, employment in the

> ***It is now quite clear that this experiment – attempting to use corporate tax policy to trump underlying economic factors – has failed. Since 1995, Raytheon has moved most of its manufacturing jobs out of Massachusetts.***

manufacturing sector – which, as a whole, received the same tax break as Raytheon – has continued to fall since the passage of single sales factor. Since 1995, Massachusetts has lost nearly 50,000 manufacturing jobs, more than 10 percent of all manufacturing jobs in the state. The rate of manufacturing job loss in Massachusetts since the tax cut was passed has exceeded the national average.

Ending this failed experiment – and repealing the single sales factor for manufacturers – would raise $66 million in additional revenue in FY 2004, according to the most recent Department of Revenue estimates.

- **Eliminate Single Sales Factor for Mutual Fund Companies**

In 1996, Fidelity Investments used the same strategy as Raytheon in its efforts to establish single sales factor for mutual fund companies, suggesting that it would move jobs out of Massachusetts if the old formula was maintained. Again, the strategy was successful. Fidelity and other mutual fund companies are now taxed only on the value of profits attributable to sales to Massachusetts investors; profits from out-of-state investors are not taxed in Massachusetts or, in many cases, any state in the nation. Of course, the announcement late last year that Fidelity intends to cut its workforce by more than five percent – or nearly 1,700 employees – has scarcely bolstered the case that tax subsidies can overpower the fundamental economic forces that determine changes in employment patterns.[10]

The Department of Revenue suggested early last year that eliminating the single sales factor for mutual fund companies would raise $133 million in FY 2004; in light of the weak stock market in recent months, the actual revenue gain from closing this loophole may be less than this amount.

Ensuring Fair Taxation of Corporations

- **Institute a "Throwback" Rule**

As described earlier, a corporation that does business across state lines uses an apportionment formula to determine the share of its reported profits that is subject to state taxes in each state where it does business. Federal law, however, establishes a minimum presence or "nexus" that any goods-producing company must have in a state before it is subject to that state's corporate income tax. Presumably intended to protect companies from facing trivial tax burdens in states where their presence is quite minimal, the statute again allows for creative corporate accountants to generate income that is not subject to taxation in any state, known as "nowhere income."

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[10] Healy, Beth, "Fund Giant Fidelity Set to Eliminate 1,695 Jobs," *The Boston Globe*, October 1, 2002

Most states use what is called a "throwback rule" to ensure that corporations pay state taxes on their profits. Specifically, the throwback rule stipulates that sales made in jurisdictions in which the corporation is not subject to state taxation (whether due to nexus rules or because the sale is overseas or to the federal government) are "thrown back" into the sales factor of the home state. This move ensures that a corporation's profits are fully subject to state taxation.

Again, the absence of public disclosure of state corporate tax returns makes it difficult to estimate the value of this tax change. However, a national study of corporate tax loopholes suggests that upwards of half of resident corporate profits may end up as "nowhere income" in states, like Massachusetts, that do not have a throwback rule.[11] It is important to emphasize here that closing this gap in the state tax code — as most of the states with corporate income taxes have done — would not subject corporations to double taxation; it would merely assure that corporate profits are subject to tax in *one* state.

- **Increase the Corporate Minimum Tax**

There are nearly 150,000 corporations registered in Massachusetts. In a typical year, three-quarters of those businesses pay the corporate minimum tax of $456. If the minimum were raised to $700 just to adjust for inflation since it was last increased in 1989, it would raise $27 million.

Improving Public Disclosure and Accountability

- **Reinstate Corporate Disclosure**

To what extent do corporations use accounting schemes to avoid paying taxes? What companies have stores and employees in the Commonwealth, make sales and profits here, and yet still pay no taxes in Massachusetts? No one really knows. The Department of Revenue has access to the information, but under current law the DOR is prohibited from making this information public. Corporate tax returns are considered confidential, meaning that there is no way for voters, journalists, analysts, activists, or even legislators to know who is paying taxes and who isn't.

[11] Mazerov, *op. cit.*, p. 6

This information – who makes profits in Massachusetts but does not pay taxes – can be incredibly powerful. In March of last year, New Jersey Governor Jim McGreevey proposed a major overhaul of the state's corporate business tax to help address the state's budget deficit. In support of his proposal, he revealed that, of the 50 largest corporations in New Jersey, 30 paid only the state's corporate minimum tax – a mere $200 each – in 1999. Because New Jersey law also considers corporate tax returns confidential, he could not release the names of those corporations; all he could do was use the raw numbers in his call for closing corporate tax loopholes. While a version of the Governor's proposal was ultimately enacted, if corporate tax return data had been publicly available, it would not have taken such extraordinary steps by the Governor to build the case for reform.[12]

Massachusetts voters thought they had solved this problem once. In 1992, they enacted an initiative that required publicly traded companies doing business in Massachusetts to make public the sort of state tax information that they routinely make public on a national basis. When the law went into effect, there were some striking stories about, for instance, companies using job creation tax credits while laying off workers. The public outcry led to swift legislative action.

"Anonymous disclosure" has proven to be as ineffective as it is oxymoronic.

Unfortunately, rather than reining in unwarranted tax subsidies, the legislature gutted the disclosure initiative. The legislature changed the filing requirements such that all reports would be anonymous, once again making it possible, to use the words of former Alabama Governor Don Sieligman, for "giant out-of-state corporations [to] freeload on the backs of … school children."[13]

"Anonymous disclosure" has proven to be as ineffective as it is oxymoronic. Massachusetts is no closer today to holding multi-state corporations accountable for their tax avoidance schemes than it was before the initiative was passed; indeed, there is good reason to believe that corporate tax avoidance has escalated during the intervening years. It's time to re-enact the measure passed by the voters in 1992.

[12] Forsberg, Mary E., *A Question of Balance: Taxing Business in the 21st Century*, New Jersey Policy Perspective, forthcoming.

[13] "Alabama Governor Plans to Raise Taxes," www.charlotte.com, October 2, 2002

- **Establish Performance Standards for Tax Subsidies**

  Too many corporations use state tax incentives without providing the kind of public benefits that warrant subsidies. The issue goes far beyond Raytheon promising job growth and then moving their jobs out of state. A classic example was unearthed by the *Boston Globe* last year, when they found that Sean Healey, the husband of Lieutenant Governor Kerry Healey, took a $1 million "distressed area" tax break to move his investment company into what the *Globe* describes as "one of the most exclusive enclaves in the state."[14]

  If the state is going to hand out tax subsidies — and in most cases there is little or no economic justification for doing so — state officials should at least ensure that development assistance comes with some strings attached. If businesses are going to use public money to improve their bottom line, the public should insist that they meet certain standards such as paying a living wage and providing health benefits. Moreover, tax subsidies should only be granted on the stipulation that if a company doesn't live up to its obligations, it will pay the money back.

- **Sunset Tax Expenditures**

  Like every state, Massachusetts uses public resources to achieve policy goals in a variety of ways. While the most typical method is through the budget – the normal line item appropriations process – the state also uses tax expenditures to pursue those goals. In its annual tax expenditure budget, the Executive Office of Administration and Finance defines tax expenditures as "provisions in the tax code, such as exclusions, deductions, credits, and deferrals, that are designed to encourage certain kinds of activities or to aid taxpayers in special circumstances." The report goes on to acknowledge that the fiscal impacts of tax expenditures "are just like those of a direct government expenditure" and thus should be subject to "the same kind of analysis and review that the appropriations budget receives."[15]

  Tax expenditures, however, are *not* subject to analysis and review like normal appropriations. While normal on-budget programs need to be approved every year, off-budget programs that operate through the tax code are never routinely reviewed and need no periodic approval. That would be like starting a program for health care or highway maintenance, and then never considering whether the program was working as intended.

[14] Ebbert, Stephanie, "Tax Break 'Windfalls' Questioned," *The Boston Globe,* May 19, 2002.

[15] Executive Office for Administration and Finance, Commonwealth of Massachusetts, *Tax Expenditure Budget – Fiscal Year 2003*, January 2002, p. 1

In order to ensure that state corporate tax expenditures receive at least some regular review, every tax expenditure listed in the state's tax expenditure report should expire on a regular basis, perhaps every five years. Part of the budget process, then, would be to review one-fifth of the tax expenditures each year. Legislators would determine whether the tax expenditure meets the goals established at a reasonable cost, and whether the cost is appropriate in light of other potential uses for that money. If appropriate, the legislature would reauthorize the tax expenditure. If, instead, the legislature deemed there were more important priorities, the money would be re-directed, as occurs throughout the normal budget process.

V. IMPACT OF CORPORATE TAX POLICY ON JOBS AND ECONOMIC DEVELOPMENT

Some will argue that efforts to halt the erosion of the corporate income tax – whether as an equitable end itself or as a means of addressing the state's fiscal crisis – would have dire consequences in the current economic environment. They will contend that such efforts would be counterproductive, harming the very corporations that are struggling to remain in business. They will also likely claim that efforts to bolster the corporate income tax would damage the seemingly always fragile "business climate", which would in turn hinder the state's economic recovery by deterring corporations from locating in Massachusetts, by driving corporations currently based in Massachusetts out of state, or by placing excessive burdens on resident corporations that are trying to expand.

Extensive research and thoughtful economic analysis demonstrate that these claims have little or no merit. As a response to state budget deficits, targeted tax increases are less detrimental to economic recovery than spending cuts. Moreover, such tax increases would not be borne by businesses losing money due to the economic downturn, nor would they influence, to any meaningful degree, the decisions made by the corporations that would bear them, including the decision to establish a presence in, or to depart from, a particular state. Indeed, there is substantial evidence that past attempts by the Commonwealth to influence corporate decision-making through the tax code – namely, in the form of the single sales factor tax breaks granted to manufacturers – have proven unsuccessful. Finally, inefficient corporate tax policy – whether attributable to benign neglect or active alteration – precludes the kinds of investments in education, infrastructure, and other public services that do spur economic development.

Tax Increases are Less Detrimental than Spending Cuts to Economic Recovery

The belief that states should not raise taxes during a recession arises from a fundamental misunderstanding of both the economic principles that guide federal fiscal policy and their applicability at the state level. Nationally, conservatives and liberals agree that the federal government should counter a recession by stimulating demand. Typically, this is accomplished by a combination of tax cuts and increased spending. The resulting increase in the federal deficit – so long as it is a temporary phenomenon restricted to the recession – is considered a reasonable price to pay to stimulate the economy.

The federal role in stimulating the economy, however, cannot be transferred to the states. For the most part, deficits are not an option; every state save Vermont has a balanced budget requirement. Thus, unlike federal policies, any state tax cut must be matched with a spending cut. Without the option of stimulating the economy through deficits, the best state officials can hope for is to do no harm. The question, of course, is what that means in concrete terms.

During times of recession, states with balanced-budget requirements are better off pursuing tax increases on high-income individuals, since they inflict less damage on the economy than cuts in either direct spending or transfer payments to low-income individuals.

In a study released in 2001, Joseph Stiglitz, a recipient of the Nobel Prize for Economics, and Peter Orszag, a Senior Fellow at the Brookings Institution in Washington, DC, examined this dilemma.[16] They found that, during times of recession, states with balanced-budget requirements are better off pursuing tax increases on high-income individuals, since they inflict less damage on the economy than cuts in either direct spending or transfer payments to low-income individuals.

The logic behind their finding is as follows. As suggested earlier, during a recession, policymakers should attempt to encourage demand and consumption as much as possible. However, high-income individuals save considerable portions of their income. While saving is important over the long term, it reduces demand and consumption in the short term. Hence, a tax that generates $100 in revenue from a wealthy individual might

[16] Orszag, Peter and Joseph Stiglitz, *Budget Cuts vs. Tax Increases at the State Level: Is One More Counter-Productive than the Other During a Recession?*, Center on Budget and Policy Priorities (Washington, DC, November 6, 2001).

reduce personal consumption in the state by only $50 to $75. In contrast, when the state spends money, it is immediately pumped into the economy. Consequently, a spending cut of $100 reduces consumption in the economy by $100. While both actions reduce consumption, the tax increase reduces consumption less and thus is less damaging to the economy.

Their finding is particularly relevant in the debate over corporate tax policy. The burden of any corporate tax increase falls largely on the investors and shareholders who own the corporations affected; conversely, investors and shareholders are the beneficiaries of any corporate tax cut.[17] For instance, using a micro-simulation model developed by the Institute on Taxation and Economic Policy, a 1998 TEAM Education Fund study determined that tax cuts enacted in Massachusetts during the 1990s for banks, insurance companies, and other corporations cost the state $244 million and that "the benefits [of those tax cuts] accrue largely to those with high incomes."[18] Thus, corporate tax increases in response to the state's fiscal crisis would not only be consistent with Stiglitz' and Orszag's analysis – that is, they would be far less damaging to the economy than spending cuts – but they would also fall principally upon those who benefited from sizable tax cuts over the past decade.

Corporate Tax Policy Changes Will Not Harm Struggling Businesses

Opponents of corporate tax increases observe that, given the current state of the economy, many businesses are struggling to survive. They contend that, because faltering businesses are not earning profits, tax increases would not generate much revenue, but would further hinder businesses' ability to rebound from the recession. There are a number of shortcomings in this argument:

- Even in this recession, corporations *are* making profits; thus, closing corporate tax loopholes could produce some of the revenue needed to protect state services. According to the Congressional Budget Office, the federal corporate income tax generated $174 billion in revenue in fiscal year 2001 (which, at the federal level, ran from October 2000 to September 2001) and is expected to produce $123 billion for FY 2002.[19] While these figures do suggest a decline in corporate

[17] Harberger, A.C., "The Incidence of the Corporation Income Tax" *Journal of Political Economy*, 1962:70.

[18] Ettlinger, Michael P. and James R. St. George, *Pennies from Heaven? The Distributional Impact of Massachusetts Tax Cuts in the 1990s*, TEAM Education Fund, 1998.

[19] Congressional Budget Office, *Where Did the Revenues Go?*, August 13, 2002.

profitability, they also reflect the fact that corporations are still earning sizable profits, even during a period that encompasses the whole of the current recession. The same is true in Massachusetts. Data released by the Office of the Comptroller in October show that the Commonwealth collected $945 million in corporate income taxes in FY01 and $587 million in FY02.

- The corporate income tax is imposed only on profitable businesses. A company that is genuinely unprofitable won't pay taxes under any set of accounting rules. The proposals described in this paper are largely intended to ensure that businesses that *do* make profits are not able to hide them and avoid their fair share of financing important state services.

- Any detrimental impact of corporate income taxes on struggling businesses is further mitigated by a provision in the Massachusetts tax code known as the "net operating loss carry-over." As a result of this provision, a company that has sustained a loss in a given year can use that loss (or carry it over) to offset future profits – and thus lower its tax liability – for up to five years. Consequently, even businesses that have fared the worst during the recession will not experience the full effect of efforts to plug the holes in the state's corporate income tax for some time to come.

  In fact, the most recent tax expenditure budget compiled by the Executive Office for Administration and Finance estimates that the net operating loss carry-over reduced corporate tax revenue in the Commonwealth by $119.5 million in FY01. In other words, this provision offset more than 10 percent of the cost of the corporate income tax in a year preceded by close to a decade of robust economic growth. One can reasonably expect it to have an even greater ameliorative effect over the next several years.

Corporate Tax Policy Has Little Impact on Economic Development

A considerable body of economic literature suggests that, in reality, state corporate tax policy has very little to do with economic development. To cite one example from this literature, a 1996 study by Robert Tannenwald examined business tax burdens in 22 states and found that those burdens had no measurable impact on the location of new investments.[20] Moreover, as Michael Mazerov of the Center on Budget and Policy Priorities has observed:

[20] Mazerov, *op. cit.*, p. 11

> earlier work by Tannenwald [has shown that] state corporate income taxes account for only about 15 percent of total state and local taxes paid by businesses. Thus, even if one accepted the premise that interstate differences in business tax burdens affect business location decisions, the corporate tax alone seems unlikely to be a major factor.[21]

No better summation of this reality is available than that offered by the former Secretary of the Treasury, and the one-time Chairman of Alcoa, Paul O'Neill. In his confirmation hearing before the Senate Finance Committee on January 18, 2001, Mr. O'Neill remarked:

> I never made an investment decision based on the tax code. If you make an investment for 20 years and you do not know pretty well how that investment is going to pay for the cost of capital, assuming the status quo ante with the tax system, then you are not a businessman, you are a gambler.
>
> . . . 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.[22]

Single Sales Factor Is a Flawed Method of Spurring Economic Growth

Notwithstanding this demonstrably weak link between corporate tax policy and economic development, Massachusetts policymakers have, over the past decade, attempted to lure or to retain businesses by altering the tax code. As detailed earlier, these attempts culminated in the adoption of the single sales factor apportionment formula for manufacturers in November 1995 and for mutual fund companies in August 1996. Yet, the single sales factor has been described as "a relatively ineffectual, potentially counterproductive, and not cost-effective incentive for job creation and investment."[23]

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[21] *Ibid.*, p. 12

[22] Hearing before the Committee on Finance, United State Senate, 107th Congress, 1st Session, on the Anticipated Nomination of Paul O'Neill to Be Secretary of the Treasury, January 17, 2001, S. Hrg. 107-5.

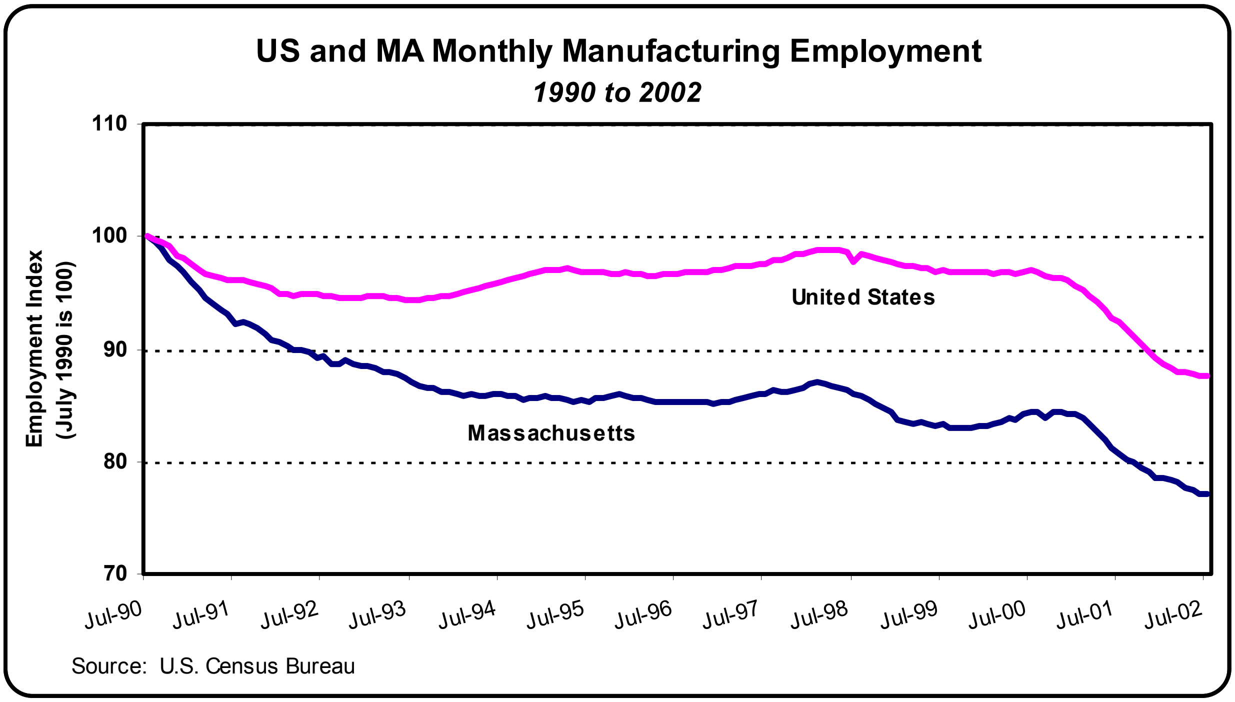
[23] Mazerov, Michael, *The "Single Sales Factor" Formula for State Corporate Taxes: A Boon to Economic Development or a Costly Giveaway?*, Center on Budget and Policy Priorities (Washington, DC, September 2001), p. 25-40.

This description seems apt when one understands that the single sales factor creates incentives that could not only encourage corporations to leave a state that adopts it, but also discourage firms from hiring additional employees or pursuing new investments in that state. Firms that have a relatively large share of their total sales, but only a comparatively small fraction of their total property and payroll, in a state that adopts the single sales factor would experience a tax increase as a result of the change. This might well prompt them to sell their physical assets in the state and to relocate their employees out of state, since federal tax law prohibits states from levying corporate income taxes on corporations that do not have a physical presence in-state. Similarly, firms that make a considerable portion of their sales in a state with a single sales factor, but are exempt from that state's corporate income tax because it does not have a physical presence there, may well avoid hiring more employees or purchasing property in that state, since doing so would create a physical presence and subject it to the state's corporate income tax. Either way, these incentives could overwhelm any positive impact of the single sales factor.

Moreover, existing evidence certainly appears to support the notion that the single sales factor is an ineffective policy tool, as it has had a decidedly mixed track record in promoting development in the manufacturing sector. Five states – Nebraska, Texas, Iowa, Massachusetts, and Missouri – have had a single sales factor apportionment formula in place for manufacturers since 1995. Between 1995 and 2000, manufacturing employment grew 6.9 percent in Nebraska, 5.2 percent in Texas, and 4.3 percent in Iowa, all while manufacturing employment nationally fell by 0.3 percent. However, manufacturing employment in Massachusetts and Missouri declined even more sharply, dropping 2.3 percent and 4.1 percent respectively. What's more, among the ten states with the fastest rates of employment growth in the manufacturing sector between 1995 and 2000, five – North Dakota, Kansas, Vermont, Oklahoma, and Montana – still used the traditional, equally-weighted, three factor formula to apportion manufacturing profits. In short, the single sales factor does not appear to be a particularly effective means of preventing job losses, nor does it seem to be any more effective in promoting job growth than any other apportionment formula.

As Figure 9 indicates, allowing manufacturers to use the single sales factor apportionment formula has hardly helped to stem the flow of those jobs out of Massachusetts. More specifically:

Figure 9



- Between July 1990, the start of the most recently completed economic cycle, and November 1995, when the single sales factor for manufacturers was enacted, the number of manufacturing jobs in Massachusetts declined from 521,100 to 447,700, a drop of 14.1 percent.

- The enactment of the singles sales factor failed to halt, let alone reverse, this trend. Between November 1995 and March 2001, the end of the most recently completed economic cycle, the Commonwealth lost an additional 13,400 manufacturing jobs, bringing total employment in that sector to 434,300.

- Furthermore, Massachusetts continued to experience more severe manufacturing employment losses than the United States as a whole even after single sales factor was signed into law. Between November 1995 and March 2001, manufacturing employment in the United States fell 2.0 percent, while in Massachusetts it fell by 3.0 percent.

- Worse still, since the onset of the recession last March, another 32,000 manufacturing jobs have left Massachusetts.

Inefficient Corporate Tax Policy Prevents Productive Economic Investments

In the end, the factors that truly attract corporations to a state and that enhance their productive capacity over the long run are a healthy, well-educated work force and a reliable, well-maintained physical infrastructure. In fact, three economists reviewing the existing literature on this topic for the District of Columbia observed that:

> Labor force availability and quality, for example, appear to be more important for explaining differences across locations in economic activity. How taxes are spent tends to be important, important enough that high relative taxes may not be a deterrent to economic growth if the revenues are used to finance services of value to business, such as education and transportation infrastructure. The studies do make clear that a policy of cutting taxes to induce economic growth is not likely to be efficient or cost-effective in the general case . . . the evidence does not support the blanket use of tax incentives in the name of economic development.[24]

Obviously, the state plays a major role in creating and fostering these key services. Just as obviously, the state needs resources to accomplish those ends. Yet the current corporate tax structure in Massachusetts acts more like a sieve than a reservoir, allowing resources that could be dedicated to smaller class sizes, reduced tuition at state universities, renovated roads and bridges, or expanded public transportation to drift away. In short, every dollar of corporate tax revenue lost to accounting schemes or ill-advised tax breaks is a dollar of productive public investment foregone.

[24] *Ibid.*, p. 30

VI. CONCLUSION

Just as it did at this time a year ago, the Commonwealth faces a sizable budget deficit in the coming fiscal year. Under a relatively optimistic set of assumptions, that deficit will likely exceed $1.4 billion; less fortuitous circumstances could push the deficit up to or beyond $2.2 billion.

In the course of the intervening year, the list of options for addressing this deficit appears to have shrunk. The state's rainy day fund is almost completely gone, while the spending cuts and personal income tax increases adopted in FY 2003 certainly have not created an appetite for more of the same. However, there is one option that policymakers have not yet fully explored – the restoration of an effective corporate income tax in Massachusetts.

Over the past three decades, the corporate income tax in Massachusetts has declined as a share of all tax revenues, as a share of personal income, and as a share of gross state product, declines that have contributed greatly to the structural deficit the Commonwealth must now confront. For instance, if corporate income tax revenue had remained a constant share of personal income since 1991, Massachusetts would have collected an additional $490 million in revenue in 2002. Policymakers could reverse this decline and ensure that corporations pay their fair share of taxes in any number of ways – by putting an end to corporate tax avoidance through the use of combined reporting, by fixing the multiple problems associated with the state's apportionment formula, or by creating a meaningful corporate minimum tax. Whatever specific strategies are used, fixing the corporate income tax will help close the state's structural deficit without sacrificing the very investments that are key to Massachusetts' long-term economic prospects.