POLICY BRIEF

AUGUST 5, 2009

CHRISTMAS IN AUGUST: SINGLE SALES FACTOR CREATES WINDFALL FOR A FEW, WORSENS STATE'S DEFICIT

Budget negotiators are considering a change in the way companies calculate their corporate income tax liability that would drain tax revenue from the state at a time when it is critically needed, provide a tax windfall for a small number of companies, and permanently increase the taxes paid by 10,000 corporations doing business in Pennsylvania.

Adoption of the single sales factor would save a few Pennsylvania companies millions of dollars in corporate taxes annually. The Department of Revenue estimates the change would cost about $100 million in 2009-10. Some negotiators have put the tax break on the table as "the price" for a temporary halt in the phase-out in the Capital Stock and Franchise Tax, one of the proposals on the table to solve Pennsylvania's budget crisis. The tax break, long sought by a small group of businesses, including PPG Industries[1], Hershey Foods and U.S. Steel, creates winners and losers. It worsens Pennsylvania's budget deficit and creates a new special-interest loophole when the Commonwealth should be closing loopholes rather than creating new ones.

The proposal changes the way companies allocate nation-wide income to Pennsylvania for tax purposes. Currently, the Commonwealth uses a formula that looks at a company's payroll, property, and sales in Pennsylvania to determine how much business they are doing in the state. The formula in use already puts more emphasis on sales, counting the sales portion of the formula at 70% and payroll and property each at 15%. Shifting to a 100% sales-based formula would benefit corporations with facilities and employees in Pennsylvania, and a higher proportion of sales outside the state. Many Pennsylvania companies who sell mostly in state would pay more under the plan.

The General Assembly should reject this special interest tax cut and focus on making the corporate tax system fairer for all corporations. By closing – rather than creating - tax loopholes, the state can find revenue necessary to avoid cuts to libraries, education, children's services and health care, and when the economy recovers, reduce the tax rate which would benefit all corporations doing business in the state.

[1] Pittsburgh Paint and Glass

1. Increasing the weight of the sales factor has not been an effective economic development device—in Pennsylvania or in other states.

As of 2001, eight states had changed from an equally weighted formula to a 100% or single sales factor (SSF) apportionment formula (Connecticut, Illinois, Iowa, Maryland, Massachusetts, Missouri, Nebraska, and Texas).[2] From 2001 to 2007, all eight states lost manufacturing jobs, with five of the states losing more than the national average. Only four states in the US during this period saw increases in manufacturing jobs, and none of these used a single sales factor method of apportionment.[3] If weighting the sales factor is stimulating to manufacturing, the evidence is not readily apparent.

Pennsylvania has already increased its sales factor weight—with no discernible positive effect on manufacturing. In 1999, Pennsylvania began shifting the weighting of the sales factor from 50% to 60%.[4] In 2007, the weight on the sales factor was increased further, from 60% to 70%.

While the 1999 change reduced the taxation of corporations having more payroll and property than sales in Pennsylvania, it had no visible positive impact on the number of manufacturing workers or operations in Pennsylvania. Since 2001 (the earliest year available in the current industry classification system), both the number of manufacturers and the number of manufacturing jobs have declined in Pennsylvania.[5] (Figure 1.)

Evidence suggests that investment and location decisions are primarily driven by factors other than state tax law in general or the weight of the sales factor in particular. Companies move facilities and jobs from states using a single sales factor to states where they do not—defying the logic behind heavily weighting the sales factor. For example, Nike, headquartered in Oregon, was a major force in lobbying for the enactment of SSF in Oregon. In September 2006, Nike announced it would consolidate its shoe shipping operation by moving 232 jobs from Oregon to Tennessee, a non-SSF state.[6] Rubbermaid closed its Centerville, Iowa, plant in 2006 to move production to a plant in Kansas.[7] Iowa uses a single sales factor, while Kansas uses an equally weighted formula.

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[2] "Single sales factor" means that profit is apportioned to a state based solely on their sales in that state compared to sales in the US. Under this system, property and payroll are not counted in the apportionment formula. In Connecticut and Maryland, the single sales factor is limited to manufacturers. In Massachusetts, the single sales factor is limited to manufacturers, defense contractors, and mutual funds. In the other states, the single sales factor applies to all industries.

[3] Michael Mazerov, "Stop the giveaway," *Pittsburgh Tribune Review*, February 15, 2008.

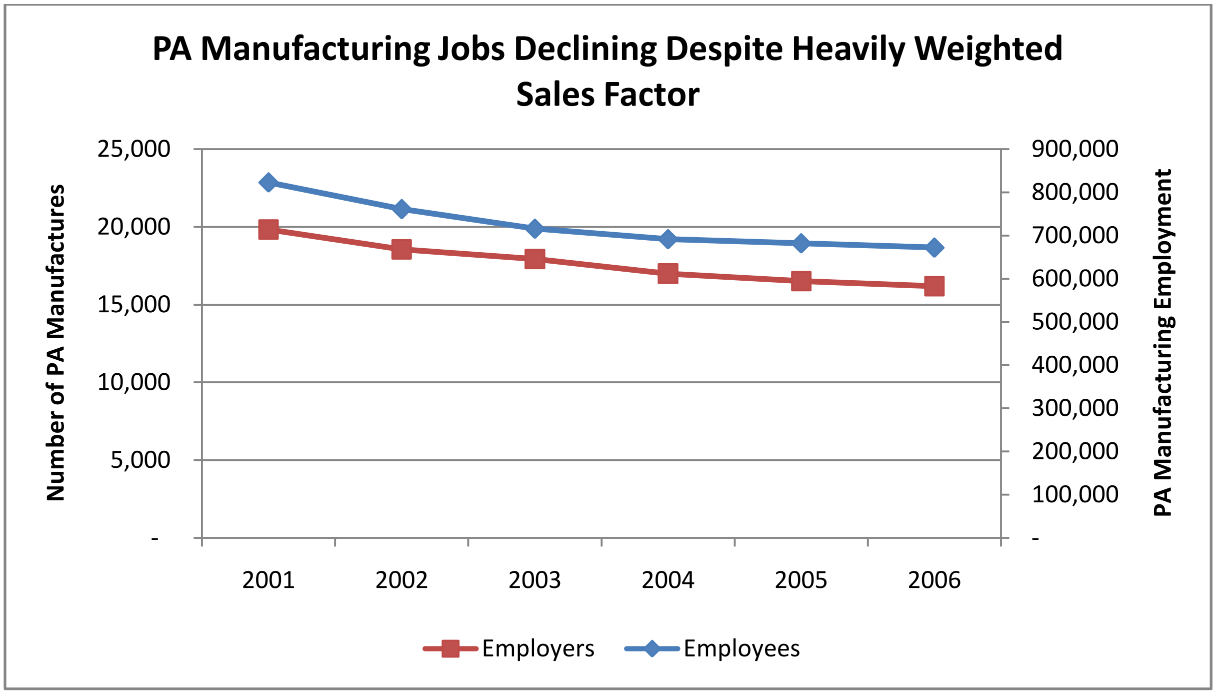
[4] Prior to 1999, Pennsylvania "double weighted" the sales factor compared to the other two factors, property and payroll. The sales factor counted for 50% of apportionment, while property and payroll each counted 25%. In 1999, the sales factor was increased to 60% of the total apportionment value, with the property and payroll factors dropping to 20% each.

[5] US Bureau of Labor Statistics. Annual private manufacturing establishments and employees (NAICS 31-33).

[6] John Scruggs, "Nike will consolidate distribution centers in Memphis," *Memphis Business Journal*, September 19, 2006 http://memphis.bizjournals.com/memphis/stories/2006/09/18/daily19.html.

[7] "Centerville Rubbermaid Factory to Close," *Sioux City Journal*, July 15, 2006 http://www.siouxcityjournal.com/articles/2006/06/15/news/latest_news/7f54f58c06e55c5f8625718e004ac85b.txt.

Figure 1.



Source. US Bureau of Labor Statistics. Annual private manufacturing establishments and employees (NAICS 31-33)

In 2002, Black and Decker moved 450 jobs overseas from Maryland, a single sales factor state. Responding to questions about the move, the company replied, "The decision to transfer certain production from our Easton plant to Mexico is part of a comprehensive restructuring of our entire global manufacturing network, and thus, is based *on a range of considerations well beyond Maryland tax law*" (italics added).[8]

2. **Changing the sales factor could be a tax windfall for certain multistate corporations – costing the state up to $100 million per year.**

If SSF is enacted, a few multistate corporations could receive a significant reduction in taxes without their creating a single job or making any further investment in Pennsylvania. The corporations can do what they choose with the proceeds—whether it be dividends for worldwide investors or building new facilities in China, Vietnam, or Mexico. These decisions are driven by rates of return of the investment—not by state tax policy. Multistate corporations could even reduce their footprint in Pennsylvania (by firing employees and closing facilities) and still be eligible for the tax bonus.[9]

[8] Dan Rodricks, "A 'teachable moment' in corporate taxes world," *Baltimore Sun*, February 15, 2002.

[9] For example, a company has two plants, both in Pennsylvania. These plants employ 90% of the company's employees in the US (property and payroll factors are 90%). The company has sales across the US with only 10% of those sales in Pennsylvania (sales factor is 10%). If the company moves facilities, it can still benefit from the sales factor weighting. As long as the company has higher Pennsylvania property or payroll factors (say 11%, after moving most of its employees and property out of state) than its 10% sales factor, it still receives a tax benefit from the heavily weighted sales factor.

An analysis conducted by the Pennsylvania Department of Revenue indicates that the change affects about half of the corporations who pay CNIT (71% don't, as of tax year 2002).[10] The shift in the apportionment factor was projected to increase the taxes paid by 10,500 corporations, while reducing taxes for 4,380 companies.[11]

Even though roughly twice the number of companies pay more under SSF than those that pay less, those receiving the tax reduction pay significantly less – to where the net revenue impact of the proposal is a loss of up to $100 million per year.[12]

3. Increasing the sales factor would be unfair to smaller local and regional businesses.

This tax change would disproportionately benefit corporations having high out-of-state sales, mostly large, multinational corporations. Many smaller or regional corporations that have all or much of their sales in Pennsylvania do not receive this tax benefit—despite heavy investment in Pennsylvania. Some businesses (those with modest investments in Pennsylvania but a larger percentage of sales in Pennsylvania) will have their taxes *increase*. The intentional favoring of certain businesses over others is unfair.

This policy violates one of the basic principles that fiscal experts rely on to evaluate good vs. bad tax policy—the benefit principle, which states that entities benefitting from public investments and other spending financed with tax revenue should contribute to those investments. Companies with large numbers of facilities and employees in Pennsylvania depend on Pennsylvania's education system, roads, bridges, airports, and other public investments, and they should help pay for what they use.

4. The Pennsylvania Business Tax Commission offered a better solution to fix the business tax system.

Business groups claim that Pennsylvania's corporate tax system reduces our competitiveness, typically citing the state's 9.99% Corporate Net Income Tax rate as a deterrent to investment, and suggesting a rate reduction and other changes to fix the system.[13] To address these concerns, the Pennsylvania Business Tax Reform Commission was established, convening business and government officials to examine the issue and to make recommendations. In 2004, the Commission offered a fair plan to reduce the tax rate for all corporations, including apportionment and other changes, without jeopardizing overall

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[10] Pennsylvania Department of Revenue, *Tax Year 2002 Statistics on Capital Stock/Franchise Tax and Corporate Net Income Tax*, July 2007, http://www.revenue.state.pa.us/revenue/lib/revenue/2002_corp_tax_stats.pdf.

[11] According the Pennsylvania Department of Revenue, the projections are based on 2003 tax return data comparing taxes due using the current weighting of apportionment factors (70% sales, 15% property, and 15% payroll) and 100% sales. .

[12] Pennsylvania Department of Revenue*, Fiscal Analysis of HB 1186, PN 1465*.

[13] "Improving Business Taxes," *Pittsburgh's Future*, http://www.pittsburghfuture.com/businessclimate/businesstaxes.html.

state revenues. The Commission recommended that the Commonwealth finance the plan by adopting combined reporting, which closes many corporate loopholes and makes the system fairer for corporations that do not apportion. Adopting the Commission's recommendations makes the tax system fairer, reduces the tax rate, and can be paid for without increasing personal income taxes or cutting services.

5. If Pennsylvania businesses pay less, Pennsylvania citizens will end up paying more.

Businesses and individuals benefit from government services, and both share a responsibility to pay for them. Yet, over the past 20 years, the tax load has been increasingly borne by individuals. Businesses have received over $1 billion in tax cuts in this decade. The Capital Stock and Franchise Tax is being phased out and has left a hole in the state's budget that must be filled with other tax revenue. The amount of General Fund spending financed from the Corporate Net Income Tax has declined from 14% in 1972 to 9% in 2007. Apparently, businesses have better lobbyists than working people do.

As a society, we have agreed on a group of functions and services performed by state government. If businesses continue to pay less of the freight, the difference will have to come from somewhere—and the likely group is individuals.

Increasing the sales factor is the wrong answer at the wrong time for the citizens of Pennsylvania.