

Tax Expenditures:
The Impact to State and Local Governments

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Abstract

Tax expenditures by state and local governments are growing. This practice creates two major issues: an increasingly regressive tax code which contributes to tax inadequacy, and the substitution of tax incentives for a coherent industrial policy. Tax expenditures are any exemption, credit, deduction, or exclusion from the payment of taxes. Such expenditures often remain unaccounted for, create little economic development, and leave state and local governments with reduced resources for funding basic services such as fire, police, schools, sewers, roads, and other capital improvements.

The economic landscape of America's fifty states looks for all intents and purposes like the fabled perfect storm. While neoclassical macroeconomists crow over GDP growth and productivity gains, state and local legislative leaders face continued budget deficits and mounting unemployment. How can this be? Research into federal tax expenditures by Bader, Huff, and Reynolds (2003) provides a starting point for understanding the conundrum in which states find themselves: committing ever more public resources towards economic development, only to find job growth shrinking.

Tax expenditures are any exemption, credit, deduction, or exclusion from the payment of taxes – and the states are awash with them (Brunori, 2001). In 1967, at the insistence of then Assistant Secretary of the Treasury, Stanley Surrey, the federal government began documenting its tax expenditures. Today, only half the states in the nation do the same. Thus, most states have no accounting for the enormity of the revenues forgone to tax expenditures. The states that do account for their tax expenditures still exclude many of the larger exemptions granted – a fact largely unknown even to state legislators. Predictably, the use of tax incentives in luring jobs and investment is growing, even if the results are dubious.

With expenditures running into billions of dollars per year even in small states, the impact on state and local budgets, and the programs they fund are equally predictable. As governments create favorable corporate tax provisions and regulatory treatment, popular programs like Medicaid, and Temporary Assistance to Needy Families (TANF), to core services like education (K-20), public safety (police, fire, and corrections), sewage treatment, and transportation infrastructure receive reductions. Needed improvements to dams, bridges, and water treatment facilities remain incomplete, funds being unavailable.

The recent budget crises faced by the states contributed to a total nationwide reduction in spending on higher education by 2.3% (National Council, 2003). Additionally, fifteen states cut spending on criminal justice and corrections, and eleven cut funding to K-12 education (National Council, 2003). The American Society of Civil Engineers recently estimated that the combined fifty states require \$1.6 *trillion* in infrastructure spending over the next five years, just to bring the nation's drinking water, wastewater, and solid waste systems (and roads, schools and other infrastructure items) up to "acceptable" levels (ASCE, 2003). That tax expenditures result in state and local governments reducing spending on requisite services and infrastructure is no surprise. The increasing use of expenditures has two other important correlations which are the subject of this paper. First, as governments commit their limited resources to various tax expenditure programs, state tax codes became increasingly regressive, creating inadequate tax revenues. Second, there is now undoubtedly a strong correlation between tax expenditure based industrial policy and the jobless recovery.

A Flagging Industrial Policy

"At the state level, only \$478 million was spent by state and local governments in 1981 on economic development aid (apart from tax incentives) including loans, grants, loan guarantees, interest subsidies, venture capital, and job training. Three years later, six times that amount will be spent by the states on ACRS (depreciation) alone" (Fischer, 1985). Now, not only have corporate tax collections fallen to their lowest levels in history (about 6% of most state budgets), but tax expenditures at the state level run in many cases into billions of dollars. The massive amount spent on ACRS generates incentives for companies to increase productivity (buy machines, layoff people). Other macroeconomic policies designed for economic growth

such as capital gains tax reductions provide incentives to merge, also causing layoffs, but increasing efficiency and productivity. The current federal administration continues in this vein, removing taxes and controls on capital. Thus, there now exists a strong bias towards expanding overseas rather than in the U.S., and towards improving efficiency and productivity by eliminating jobs (payroll) which constitutes corporate America's largest cost. The States meanwhile, attempting to forestall job losses and their economic base, caused, in part by federal policies, continue plunging headlong into the same policies.

North Carolina Attorney Bill Maredy sued Forsythe County for contributing \$4 million to Wachovia Bank's expansion in Winston-Salem. They had been in Winston-Salem since 1886. "It's in my judgment immoral on the part of government to deprive school, welfare, environment, streets, police protection, in favor of writing checks to some of the wealthiest entities in the world." Wachovia is among the nation's 20 largest banks (MPR [Smith], 1996). Maredy's objection contains not only moral dilemmas for governments, but economic ones as well: Forsythe County paid four-million dollars for jobs it already had. Out west, the city of Amarillo, Texas issued \$8 million checks to 1300 companies across the country – if they committed to creating 700 jobs in Amarillo (citation). The State of Ohio loses nearly \$19.3 billion annually from tax expenditures, and state fiscal experts admit that, "they are advanced without the use of cost-benefit analysis and are never subsequently evaluated to determine their continued usefulness" (Sheridan, 2002). These are but a few examples surrounding this tax based industrial policy, and its overall failure at creating the one thing most people think a strong economy is all about: jobs.

The State of Minnesota committed \$770 million to Northwest Airlines, facilitating construction of two repair facilities the company said would employ 2,000 high-paid maintenance workers. Minnesota made the loan to the company – but the company only ever built a small reservation center – employing low-skilled, low-paid employees – with a total employment level under 1,000 (Federal [Farrell],1996). In the mid 80's, developer Ian Ward promised officials in the hard strapped mining town of Hibing, Minnesota 100 jobs. He planned resuscitating a former tongue depressor factory into a chopstick factory. City officials committed four million dollars to the project, which never got off the ground (MPR [Zdechlich], 1996). The state of Minnesota now requires paperwork on tax expenditures, especially instances of TIF's – tax increment financing, a tool which uses property tax revenues for financing private development. Though Minnesota now documents these types of tax expenditures and makes records available to the public, the efficacy of their industrial policy remains questionable. In one well known example, a Minnesota Dairy Queen owner received \$275,515 in public financing to create one new job - at \$4.50 per hour (Minnesota, 1998).

While spending nearly \$300,000 for one sub-minimum wage job seems implausible, many instances of tax expenditure usage far surpass even that. Blue Water Fibre received about \$80 million in inducements from the State of Michigan for a paper-recycling mill and its 34 employees – a subsidy of \$2.35 million per job (Federal [Farrell], 1996). The State of Alabama spent nearly \$300 million attracting a new Mercedes Benz plant – a subsidy costing \$168,000 per job (MPR [Smith], 1996). Pennsylvania once provided a \$71 million incentive package to Volkswagen. The factory initially employed 6,000 people – then closed within ten years. Volkswagen had promised 20,000 jobs at the factory (MPR [Symposium], 1996). While high

paying jobs in manufacturing and information technology represent costly investments, states and municipalities spend comparable amounts attracting unskilled, low paying jobs as they send public money attracting major league sports teams.

Washington D.C. plans to lure Major League Baseball back to the city by providing \$339 million in incentives, mostly through increased taxes on the largest corporations in the city. The city's CFO says that the team may not generate enough revenue to cover the bonds issued by the city, and the shortfall could run up to \$2 million per year (Asher, 2003). Meanwhile, Washington D.C. posted a \$457 million budget shortfall, and made up the difference by "cutting services and capital spending and rolling back tax cuts" (Hsu, 2003). The Mayor, who supports the project at the same time laments, "the overtaxing of our citizens and deferral of critical investments continues to damage the viability of the District as a place to live and operate a business." Further, "Mayor Williams and aides singled out the postponement of spending on infrastructure for long-term growth, such as schools, roads and a \$1 billion-plus sewer system overhaul" but still finds building a stadium economically necessary and viable (Hsu, 2003). Some analysts, and the mayor, believe the stadium could be responsible for up to \$25 million per year in direct and indirect economic impact (Timberg, 2003). Still, Economist Andrew Zimbalist, a noted scholar on the economics of professional sports says of the project, "It doesn't pay off economically; money that goes to a baseball team tends to go to wealthy players and wealthy owners" (Timberg, 2003) The City of Washington D.C. is not the only municipality chasing a major league arena.

Portland, Oregon is considering a similar package in an attempt to lure the Montreal Expos: a \$150 million package of tax increases as the city's contribution to a \$350 million

stadium. Supporters contend that, “big-league baseball will bring both jobs and dollars to the state – without affecting services or other wise causing a drain on the economy” (So, 2003). But the city already has its woes: among the highest unemployment in the nation, and budget woes within the public schools and the health care system. Additionally, since 1979, the Oregon State Police force downsized from 665 officers to 329 officers (Marks, 2003). As Oregon and Washington D.C proved, resources are limited and costly tax expenditures on privately owned sports stadiums force cuts in critical state and local governments programs such as police protection, and spending on needed infrastructure improvements. The Portland and Washington D.C. proposals pale by comparison to some other stadium deals - the city of St. Louis and the state of Missouri gave the Los Angeles Rams \$720 million dollars as a relocation incentive (MPR [Symposium], 1996). Still, supporters of such economic development plans point to *job creation* as the Holy Grail. But the benefit of job creation via building stadiums is readily measurable.

Stadiums overwhelmingly employ low-wage, unskilled workers – food and beverage vendors, parking attendants, ticket takers and the like. Stadiums also represent a huge drain on public safety services like police and fire – services Oregon already cut in their budget balancing quest. One need look no further than Florida in assessing the wisdom of adding hundreds of low-wage, low-skilled jobs – and using public money to do it. In 2003, Florida led the United States in job growth. Yet 40% of the jobs added paid less than \$24,297 per year. The leisure and hospitality industry (the same as a sports stadium) created a full 17,300 of the jobs. These jobs paid an average of \$17,106. Bruce Nissen, an economist and Director at the Center for Labor Research and Studies located at Florida Atlantic University said of Florida’s growth in low-wage

jobs, “The Achilles heel is the structure dependent on leisure, hospitality, and retail sales” (Florida, 2003). Worse yet, job growth lagged behind population growth, and increasing population means increasing demands on already stressed public services – hardly a model to which governments should aspire. No doubt though, using public money for luring sports teams will not cease any time soon – even if the jobs created by the expenditures are low-skill, low wage jobs.

While the hundreds of millions spent luring sports teams appears costly an ineffective, attracting high-wage manufacturing and information systems jobs comes at an even higher price. Boeing, in announcing its new jet, the 7E7, sought site selection bids from all 50 states and issued a 26 item “site selection criteria” to all bidders (Summary, 2003). Of the 26 items on Boeing’s wish list, nine related to public services – only one to taxes. Among Boeing’s chief concerns:

- Suitable runway provisions
- Port proximity
- Heavy traffic ways
- Proximity to rail lines
- Support services (fire, police, emergency and medical services)
- Training infrastructure
- Quality of public schools
- Availability of utilities (water, sewer, power, waste, telecommunications)
- Transportation enhancements.

Yet, as has been repeatedly shown, the states and their collection of municipalities spent years depleting their treasuries via tax expenditures, and now cannot afford costly and time consuming infrastructure improvements. Thus, they respond with the only tool in the shed: tax expenditures.

Washington State offered up the first deal to Boeing - \$3.2 in tax incentives over 20 years (Galloway, 2003). In the meantime, Washington struggles with a deadlocked legislature that has failed to pass any meaningful transportation measures resulting in some of the nation's worst traffic. The state has also spent years litigating the construction of a third runway at SeaTac International airport. Though the project has been on the drawing board for over a dozen years, the County overseeing the airport has yet to pour a single foot of tarmac. These transportation issues remain the top priority on Boeing's list, and have for two decades in Washington State, the location of their primary manufacturing plants. While no other state has yet to submit a deal, one has said they would construct an entire airport to attract the plant (as South Carolina did for BMW). Never the less, at least nine other states – South Carolina, North Carolina, Georgia, Texas, California, Alabama, Mississippi, Arizona and Colorado – prepared competitive bids (Nyhan, 2003). Boeing says the plant will employ up to 1,200 workers and cost \$500 million to build (Wallace, 2003). Assuming Washington State's bid of \$3.2 billion in incentives, this represents a \$133,000 subsidy per job, per year. The national average wage in the manufacturing sector is just shy of \$40,000 per year, meaning Washington State essentially pays Boeing's labor costs more than three times over, every year for the next 20 years. Certainly there are spill-over effects into the area's economy from a large manufacturing plant, but are they large enough to overcome the investment? In any case Economist Peter Fischer notes that, "Somewhat paradoxically, it is the state and local tax incentives that have been enacted explicitly to increase capital mobility (that is, "attract industry") that may have been the least successful in doing so. A large number of studies, ranging from surveys of firms to

statistical analyses of business location, have failed to confirm any significant effect of such tax incentives on location decisions.”

Why then a U.S. and state based industrial policy with no clear strategy excepting continuous and repeated tax abatements? Economist Peter Fischer concludes, “The corporations have found that a populace rendered desperate by economic disaster is easy prey for snake-oil salesmen offering promises of jobs, productivity, and new investment . . .it (corporate America) welcomes a tax policy that depletes public treasuries that must form the basis for long term economic growth” (Fischer, 1985). Indeed, former U.S. Treasury Secretary Paul O’Neill in his confirmation hearing said, “I never made an investment decision based on the tax code . . . If you are giving money away, I will take it. If you want to give me inducements to do something that I am going to do anyway, I will take it” (CBPP, 2001). What is certain is that tax expenditures now and for at least the near future, constitute the primary tool of state and regional economic development authorities, and a coherent national or state level industrial policy remains elusive.

The Shifting Burden and Increasing Regressivity

State tax codes increasingly rely upon taxing individuals through income and sales and excise taxes; there has been a calculated shift away from corporate taxation. This trend towards regressive tax instruments created fiscal instability and threatens tax adequacy. In 1950, personal income taxes constituted 9.3% of state revenues. By 1970, that portion had grown to 19%; by 1998, 34%. State lawmakers were shifting the burden to individual taxpayers. Sales and use taxes, (which are highly regressive) constitute nearly 1/3 of the average state budget. Thus 2/3 of every dollar raised and spent by state and local governments originates in the pocket of

an individual – likely an individual that is a low-moderate income earner. A certain correlation is the use of tax expenditures in job creation and economic growth efforts. (add in something about the fact that while legislatures shift the tax burden to low income earners, they at the same time are expanding the use of the state based EITC to eliminate poverty. Thus they shift the burden to low income folks, then relieve that burden – meaning no one is really paying taxes.

In the mid 1990s, through a series of tax expenditures, South Carolina attracted nearly 1,400 new businesses and created 200,000 new jobs. This economic growth brought 300,000 new residents – and a correspondingly high demand for government services. The demand for new infrastructure and government services in fact, far outstripped government revenues. Consequently, South Carolina's per capita crime rate climbed 19% between 1987 and 1997; four in ten homes remained unconnected to sewers; South Carolina posted the lowest SAT scores in the nation and was among the highest in infant mortality rates; 35 schools reported leaky roofs and two-dozen complained of worn out carpet (Hancock, 1999). At the heart of the state's problems: aggressive use of tax expenditures in efforts at jumpstarting the state's economy. As Jay Hancock of the South Carolina Sun reported: "BMW has never paid South Carolina's 5 percent tax on corporate profits and shows no signs of doing so for years . . . The company pays \$1 a year to lease its \$36 million piece of land. It pays no land tax to Spartanburg County . . . corporate income tax revenue has fallen by 6 percent since 1994 . . . other business-tax collections are languishing, too. Across the state, local property revenue on business equipment plummeted 13 percent from 1993-1997." As South Carolina's economy seemingly boomed, the state struggled with basic service provision – schools, roads, sewers – as local

legislators repeatedly created new tax expenditures as part of what emerged an unsuccessful economic development plan. During the same period, national manufacturing wage growth still outpaced South Carolina (Blanchard, 2003). At the height of South Carolina's expenditures, legislators and local lawmakers remained unaware of the totality of special tax financing packages. Municipalities in South Carolina nearly broke the bank with 200 tax abatement deals with individual corporations before keeping track of the transactions (Hancock, 1999).

With expenditures rising and revenues dwindling, legislators jumped into action. In Charleston County, property taxes shot up 35%. Additionally, county administrators implemented a one-percent countywide sales tax, a three-percent local phone tax, and a six-cent per gallon gas tax. Surrounding counties quintupled home inspection fees, increased trash fees, and implemented telephone taxes of their own. The State at one time considered a two-dollar toll on state highways (Hancock, 1999). Finally, under the weight of \$57 billion of infrastructure needs (Hancock, 1999), the state faced a budget deficit of \$700 million (Center for Budget and Policy Priorities, 2003). South Carolina though is not the only state or municipality that emptied public coffers with little or nothing to show for it.

The Center for Public Integrity in May of 2003, released a report stating that, "lobbyists and their employers in 39 states spent more than \$715 million wining, dining and generally influencing state lawmakers in 2002" (Center for Public Integrity, 2003). This is nearly half the amount spent lobbying all of Congress in 2002 (Political Money Line), illustrating that state based lobbyists find particular success with state legislatures and their accompanying treasuries. That \$715 million figure excludes the eleven states not reporting lobbying expenditures. The policies corporate lobbyists, accountants, and lawyers spend hundreds-of-

millions of dollars protecting or influencing, are hidden provisions in the tax code, provisions completely unknown to ordinary citizens, and rarely known even to most state lawmakers. South Carolina’s case study places regressivity in the forefront of the expenditure debate. As state and local coffers dwindled, legislators responded by raising the most regressive of all taxes, sales and excise taxes. While this example of increasing regressivity appears in plain site, others had a longer gestation period and still remains under the radar, even of most legislators.

In 1957, the Multi State Tax Commission adopted the “Uniform Division of Income for Tax Purposes Act” (UDITPA). This act created a formula for corporate income taxation based upon three things: 1) sales; 2) property; and 3) payroll. Thus, corporations pay income tax based upon a formula comprised of these three factors. Soon, states realized this formulation provided a means for influencing economic development. By altering the proportions of the formula, states issued tax breaks to certain types of business. “Double weighting” the sales factor reduces the tax liabilities of corporations having large amounts of property and large payrolls in state. Some states even moved to a “single sales factor” formula – income tax is based solely upon sales in the state – payroll and property are not considered. These formula alterations benefit large manufacturers – exporters - at the expense of local businesses selling most of their goods within the state. While these formulas benefit manufacturers, corporations are careful to pick and choose states for implementation. From a level playing field in 1957, Table I depicts the current status of the original three factor corporate income tax policy which at one time was uniform among all fifty states.

**Table 1:
Current State Corporate Income Tax Apportionment Formulas**

Apportionment formula	States Employing them
Three factors, equally weighted	AL, AK, DE, DC, HI, MT, ND (financial institutions only), OK, RI, SD

	(financial institutions only), UT, VT
Three factors, sales double-weighted	AZ, AR, CA, CT (for manufacturing), FL, GA, ID, IN, KY, LA, ME, MD, MS (for certain manufacturers and locations, sales only for service and merchandising), NJ, NM, NY, NC, SC (for manufacturing), TN, VA, WV, WI
Three factors, sales triple weighted	OH, PA
Three factors, various weightings	MI (90-5-5), MN (75-12.5-12.5), NH (42.8-28.6-28.6), OR (80-?-?)
Two factors only	KS (property and sales only), CO (revenue and property)
Single sales factor	IL, IA, MA (for manufacturers, defense contractors, mutual funds) MO, NE, TX

In 1998, Michigan adopted what legislators called the “Single Business Tax,” rewriting state tax code so corporate tax liabilities are figured on sales only – the single sales factor formula. It was large Michigan manufacturers Ford Motor Company and Amway, both with significant property and payroll in state – and few in-state sales – who pushed the act (CBPP, 2001). That same year, Kraft Foods lobbied the state of Illinois (its home state) for the same provision. This time however, Ford Motor vigorously opposed Illinois’ adoption of the single sales formula since Ford sells a great deal of vehicles in Illinois but has little property or payroll expense there. Three years later, Kraft opposed Maryland’s adoption of the formula (CBPP, 2001). Shifting the tax burden away from corporate activities in Michigan and Illinois has its consequences: Illinois now has the 6th most regressive tax code in the nation and Michigan the 7th (McIntyre, 2003). Just how many hundreds of million of dollars in governments forgo due to these policies is yet unknown; however, there are many quantitative examples.

In 1995, in response to demands from Raytheon, Massachusetts enacted a single sales factor formula for defense contractors, manufacturers, and mutual fund companies. The change in tax policy cost the state \$80 million dollars annually. The chief beneficiary, Raytheon Corporation, proceeded to lay off 3,000 blue-collar workers after receiving the tax windfall from the state (CBPP, 2001). Massachusetts planned for such a possibility and implemented

“clawbacks” in the single sales tax policy – employers receiving the benefit must retain *payroll* at 1995 levels through the year 2000. Raytheon met this criterion by giving white-collar managers pay raises. The state then changed the *payroll* verbiage to *employment level*, with one state senator calling the state’s previous policy, “payoffs for layoffs.” Other states followed suit.

When Illinois adopted the single sales formula in 1998, they calculated the annual loss to local governments at \$63 million annually. That \$63 million accrued to just five companies, one of which was Motorola. Illinois, unlike Massachusetts failed to add clawbacks or performance guarantees into its new tax policy, and by 2001, Motorola had closed every manufacturing plant it had in the state (CBPP, 2001). Between 1998 and 2000, Illinois lost 30,400 manufacturing jobs, questioning the rationale of authoring tax policy which has no apparent effect on actual economic development. The State of Oregon figured that tax collections would drop by 14.8% should they adopt a single sales factor formula. Instead, they authored legislation taking effect in May of 2003, weighting sales at 80%. Practically speaking, some analysts conclude that once sales factor weighting reaches 70% or greater, property and payroll factors become statistically irrelevant (CBPP, 2001). This change in Oregon’s tax structure at least partially explains the state’s \$1.35 billion budget deficit, and has not had the desired impact on employment growth; Oregon led the nation in unemployment over the last few years. Lack of financial resources certainly led to reductions in spending on critical programs like the Oregon State Police, whom this year cut another 84 troopers. This cut in particular left 170 miles of desolate Oregon freeways known for drug trafficking, patrolled by only ten officers. Other states calculated annual losses - California \$96 million; Connecticut \$53

million; Maine \$6 million; New York \$39 million; and Wisconsin \$80 million – and decided against implementing a single sales factor formula (CBPP, 2001).

As a consultant to the State of Alabama, Dr. William Raabe, Professor of taxation at Samford University in 1999 recommended the State move to a double-weighted sales factor so Alabama would be more in line with the tax policies of neighboring states. His report to the state noted that, “Alabama Department of Revenue modeling done with respect to this study suggests that double-weighting apportionment would have reduced Alabama corporate income tax revenues by about \$1.1 million in 1999.” Total corporate income tax collections in the State of Alabama that year were \$26 million, so double weighting the sales factor would reduce corporate tax collections by 4%. Meanwhile, local businesses and non-export based businesses, conceded Dr. Raabe, would face increasing tax burdens (Raabe, 1999). Said another way, “vertical equity” suffers – those less able to pay bear more of the burden. Said another way, regressivity increases. Policy makers further confound things by promising to “support small business,” i.e., cut small business taxes, at the same time they push the burden onto them. This mimics the individual situation of individual taxpayers getting a tax increase, then an EITC credit.

The result of this “race to the bottom” policy making, according to many observers, has not been net economic growth, but merely states losing business to other states. Using the Alabama example, Florida, Georgia, Mississippi, and Tennessee immediately lose their competitive advantage if Alabama moves to a double-weighted sales factor. Why then are lawmakers so willing to amend the tax code when so few benefit, the competitive advantage lasts only in the short term, and so little real economic development results? Whatever the

answer, the double-weighted sales factor and the single sales factor, despite the evidence against them, are the de-facto standards in state level tax policy

Another well-known expenditure results from the PIC, or passive investment corporation. Under this measure, corporations lease their logos and other intellectual properties from subsidiaries under their control. These subsidiaries typically locate where there is no state corporate income tax. Thus, corporations transfer profits to the subsidiary as payments for use of their intellectual properties. Without being, no one has explained PIC's better than the Center for Budget and Policy Priorities' Michael Mazerov:

“Profits of the operational part of a business that would otherwise be taxable by the state(s) in which the company is located are siphoned out of such states by having the tax-haven subsidiary charge a royalty to the rest of the business for the use of the trademark or patent. The royalty is a deductible expense for the corporation paying it, and so reduces the amount of profit such a corporation has in the states in which it does business and is taxable. Moreover, the “profits” of the PIC are often loaned back to the rest of the corporation, and a secondary siphoning of income occurs through the payment of deductible interest on the loan.”

Unlike other tax expenditures where lawmakers have simply failed to calculate the cost and account for them in expenditure budgets, profits transferred into PICs are *confidential*. States at times challenge income tax filings by corporations, and these court cases list the amounts in question, giving lawmakers a glimpse into the amount of forgone state treasury revenue.

The Toys R' Us PIC “earned” \$55 million in 1990 by licensing its name and trademark, among other things, to the parent corporation. That \$55 million, like the examples following, escapes any sort of taxation by any state. The PIC affiliated with The Limited group of stores (Victoria's Secret, Lane Bryant, Express) earned \$949 million between 1992 and 1994 by licensing trademarks back to the parent stores. Kmart's PIC earned \$1.25 billion dollars

between 1991 and 1995 using the same method. These three examples just scratch the surface of the widespread use of PICs. Other well known companies utilizing PICs to avoid taxes include Shell Oil, Colgate-Palmolive, Pepsico, Nabisco, General Electric, and Enron – all of whom share (or shared) a common corporate headquarters in Delaware (CBPP [Loopholes], 2003).

Delaware and Nevada represent the two most popular states for PIC incorporation since neither state levies corporate income taxes. As of 1998, Delaware boasted 6,000 PICs, and Nevada listed 132,000 businesses with no employees – likely PICs. One building in Delaware hosts 700 “corporate headquarters” on just five floors of a relatively small office building. Many states disallow the usage of PICs through one mechanism or another. Still, twenty-two states allow resident corporations to transfer income out of state in order to escape taxation.

The Multistate Tax Commission reported in the summer of 2003 that exotic tax sheltering vehicles such as PICs, the creation of “nowhere income,” offshore tax havens, and shifting U.S income to other nations cost states between \$8.32 billion and \$12.38 billion in corporate income tax revenues (Multistate, 2003). “Nowhere income,” is income earned by a corporation which escapes taxation by any state, as if it the corporation earned it, “nowhere.” Currently, twenty states allow their resident corporations to escape taxation by allowing creation of nowhere income. Most states have on the books a “throwback rule” stating that if a resident company earns profits in a state where there is no tax, the profits are “thrown back” to the resident state for the purposes of income taxation. The twenty states without the throwback rule thus allow its resident corporations tax freedom on 50-100% of their profits - nowhere income - subject to no tax (CBPP [Loopholes], 2003).

There are two main vehicles corporations use in creating nowhere income; most commonly corporations exploit differences between state apportionment formulas (where one state has a single sales factor formula or some derivative, and others have traditional three-way apportionment formulas). Catalog and Internet sales – remote sales – also create nowhere income via public-law 86-272. This law, known almost exclusively to tax policy specialists, states that out-of-state corporations are exempt from a state’s corporate income tax if the corporation meets four criteria: 1) the corporation’s product consists of goods; 2) the sale is approved and executed out of state; 3) the goods sold are shipped into the state; and 4) the company owns no facilities or inventory in the state. No evidence exists that states, even amidst massive budget shortfalls, are seriously addressing the issue of nowhere income. Nor are states addressing the issue of how business income is defined.

Thirty-nine states define business income in a manner which reduces collection of corporate income taxes (CBPP [Loopholes], 2003). On this subject, there has been virtual legislative inertia. Only two states have made any move whatsoever to tighten their definition of business income, though tax policy literature has recommended this needed change for some time. Very little quantitative analysis exists on the issue of defining business income, but indeed states are losing significant revenues through ill-constructed corporate tax law.

As an example, the State of Idaho defines “business income” as,

“income arising from transactions and activities in the regular course of the taxpayer’s trade or business and includes income from the acquisition, management, or disposition of tangible and intangible property when such acquisition, management, or disposition of constitutes integral or necessary parts of the taxpayer’s trade or business operations. Gains or losses and dividend and interest income from stock and securities of any foreign or domestic corporation shall be presumed to be income from intangible property, the acquisition, management, or disposition of which constitute an integral part of

the taxpayer's trade or business; such presumption may only be overcome by clear and convincing evidence to the contrary" (Idaho, 2003).

Considering that definition there is little doubt as to why tax law alienates even policy stalwarts.

Professor Walter Hellerstein recommends states simplify that definition to read, "Business income means all income which is apportionable under the Constitution of the United States."

The reason Hellerstein recommends this is not merely mechanical. Because so many states have such convoluted definitions of business income, corporations frequently challenge states ability to levy income taxes on certain transactions. Besides "business income" there is also "non-business income," which corporations are taxed upon only in their state of residence (if there is a corporate income tax in that state). Non-business income results from extraordinary transactions such as a divestiture, the selling of property, or other "non-business" related transactions. Increasingly, corporations contest how states classify certain transactions for the purposes of apportioning income. Certain transactions that the courts have ruled are apportionable business transactions are recorded by corporations as "irregular" and thus non-apportionable (Hellerstein, 2001). This of course costs states potential revenues, and adds to states litigation expenses. Quantifying the loss to states is difficult, but some analyses exist.

In 2002, The State of North Carolina took Hellerstein's advice, amending its definition of business income in Senate Bill 1115. The Fiscal Research Division of the North Carolina General Assembly estimated that revising their definition of business income would provide the state nearly \$290 million in additional revenues between 2002 and 2007. North Carolina passed this measure with little to no opposition, yet only one of the 24 states with non-conforming definitions followed, prompting one analyst to surmise ignorance and inertia on the part of state legislatures as the prime reason for not amending this law. North Carolina's analysts

believe the state will see an increase of 9% of forecasted revenues; so could other states if only they followed North Carolina's lead. New Jersey also tightened its definition of business income and closed several other common loopholes after Governor McGreevey reported that 30 of the state's 50 largest employers paid only \$200 in state income tax (New, 2003). Business income definitions and corporate income tax formulae represent arcane yet costly subjects. More easily understood, and completely contrary to a growing U.S. economy, is the prevalence of offshore tax havens.

There are two chief methods corporations use in escaping taxation by the American states, reincorporating or "inverting" the corporate structure, and selective pricing of goods and services between different nations. The Multistate Tax Commission calculates revenue losses to the states from offshore sheltering activities by corporations at \$5.3 billion annually (in 2001 dollars) (Multistate, 2003). California alone loses an estimated \$937 million.

Some U.S. corporations have reincorporated in countries such as Bermuda to escape taxation by the United States federal government and the combined states. Some organizations estimate that 140,000 International Business Corporations (IBC's) of various forms, come into existence each year, the British Virgin Islands, Panama, and Costa Rica are particular favorites for creating corporate "inversions." The term "inversion" describes the method in which U.S. corporations become overseas corporations with U.S. holdings. Under this tax avoidance scheme, a U.S. corporation establishes a holding company in a country such as Bermuda. That holding company then purchases the U.S. company and thus becomes a non-American corporation. Companies using this strategy include well-known firms such as Fruit of the Loom, PricewaterhouseCoopers Consulting, Ingersoll-Rand, and Tyco (Barry, 2002). Members of the

U.S. House of Representatives and Senate circulated at least five bills in 2002 outlawing this practice. So far however, those favoring this policy succeeded in killing any attempts to outlaw corporate inversions. Typically, job losses do not follow these inversions as the new offshore based corporation merely establishes a subsidiary headquarters by opening a small office in the new host country. Thus, the people favoring this provision say instead that the Federal Government should reduce the corporate income tax burden. With corporate income taxes representing less than 10% of the total cost of doing business for the average U.S. corporation, concluding that corporations relocate overseas because of an onerous tax burden is difficult to say the least (Cline, 2003). What is certain is that international sheltering costs states significant revenues. West Virginia loses an estimated \$39 million annually, or 35% of its total budget. Florida loses an amount equal to 25% of its budget; 28 additional states lose nearly one-fifth of their entire budget.

**Table 2:
Average Estimated Annual Losses to International Sheltering**

State	Annual Budget	Loss to Intl. Shelters	% of budget	State	Annual Budget	Loss to Intl. Shelters	% of budget
Alabama	174	31	18%	Missouri	236	43	18%
Alaska	400	0	0%	Montana	82	11	13%
Arizona	541	73	13%	Nebraska	138	19	14%
Arkansas	186	34	18%	Nevada	0	0	0%
California	6899	937	14%	New Hampshire	350	48	14%
Colorado	340	46	14%	New Jersey	1301	235	18%
Connecticut	413	75	18%	New Mexico	191	34	18%
DC	230	42	18%	New York	3199	577	18%
Delaware	207	0	0%	North Carolina	724	131	18%
Florida	1138	287	25%	North Dakota	63	9	14%
Georgia	691	125	18%	Ohio	663	120	18%
Hawaii	60	8	13%	Oklahoma	167	30	18%
Idaho	142	19	13%	Oregon	323	44	14%
Illinois	2217	301	14%	Pennsylvania	1401	253	18%
Indiana	825	149	18%	Rhode Island	78	14	18%
Iowa	167	30	18%	South Carolina	192	35	18%
Kansas	237	32	14%	South Dakota	43	0	0%
Kentucky	361	65	18%	Tennessee	673	122	18%
Louisiana	293	53	18%	Texas	1960	366	19%
Maine	96	13	14%	Utah	163	22	13%

Maryland	501	90	18%	Vermont	45	8	18%
Massachusetts	1212	219	18%	Virginia	364	66	18%
Michigan	2102	78	4%	Washington	2012	146	7%
Minnesota	732	99	14%	West Virginia	113	39	35%
Mississippi	203	38	19%	Wisconsin	537	89	17%
				Wyoming	0	0	0%

Budget and loss figures in millions of dollars

Yet another tax expenditure existing under the radar is the net operating loss carry back. Twenty states allow businesses the option of filing amended tax returns in years where the business makes a profit. The business simply takes current losses, and “carries them back” to offset the profits made in previous years. This nets all businesses – corporations on down to sole proprietorships – actual cash refunds from state coffers. The flip side of this issue is the net operating loss *carry forward* in which a business carries forward losses from prior years to offset current profits. Economists agree there is some rationale for this sort of income averaging, but the practice of “carry backs” is favored only in the ranks of corporate law and accountancy departments. Again, while there is no exact accounting for the total costs of this measure, businesses use it to great advantage. During the depths of the recent economic downturn, Q3 2001 corporate income tax collections fell 32% from the same period the year prior; sales, personal income, and corporate income taxes combined fell only 10% (CBPP [Carryback], 2003). All of these policies – single and double weighted sales formulas, PIC’s, loose definitions of income, and offshore tax havens – exist at the will of state legislators. Thus, by not rectifying these distortions in law, legislators unwittingly signify support for a more regressive tax code. All of these examples create regressivity, or “vertical inequity” in the tax structure since they ultimately shift the burden of taxation to those with a lesser ability to pay. The result of that type of policy is what we are seeing now all across the country: inadequate state revenues.

Conclusion

Corporate tax loopholes so confound state tax codes that no accounting exists for the total loss of revenue to the combined states. Tax experts believe that corporations should indeed pay income taxes since they, like individuals, receive many government services. Getting corporations to pay for them has been the problem. In the State of Idaho, personal income taxes made up 50% of the budget in FY 2002; corporate income taxes constituted 4% (State of Idaho, 2003). Expressed in dollar figures, corporate income taxes equaled about one-tenth what individuals paid. Forty-seven states levy some form of corporate income tax, even if those taxes levied are comparatively paltry. Some tax expenditure vehicles such as pass through organizations – LLCs, LLPs, etc. – are so common discussion of them is excluded from this paper. In the end, states facing budget crises, and ever dwindling revenues from the corporations whom they host would do well to address the use of the myriad expenditure vehicles discussed in this paper. Though all that is really at stake for most states is the stability, adequacy, and sustainability of the tax code, and a few million jobs.

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