November 23, 2009

To: Chuck Sheketoff, Oregon Center for Public Policy

From: Rosanne Altshuler and Kim Rueben, Tax Policy Center

Re: Examination of Oregon’s Proposal to Raise the Top Corporate Tax Rate and Top Personal Income Tax Rates

In response to your request, we looked at Measures 66 and 67 and the Statesman Journal article by Randall Pozdena, “Raising Oregon’s corporate tax rate will cost 43,000 jobs,” as well as the Cascade Policy Institute article by William Conerly, “Taxing the ‘Wealthy’ More Will Cost 36,000 Oregon Jobs.” Below are some quick reactions that show why we believe the Pozdena and Conerly job-loss claims are without merit.

Most states, including Oregon, are currently running budget deficits due primarily to the decline in revenues resulting from the recession and increased spending needs related to income and job loss. Given constitutional requirements to balance the state’s budget this presents a host of unattractive options: increasing taxes, cutting programs or both. Since all feasible taxes have drawbacks, any critique of a proposed tax increase should compare the consequences of the change to alternative tax increases or spending cuts. Further, critiques of tax increases in Oregon should recognize that since the state does not impose a general sale tax, other taxes imposed will have to be higher, all else equal, to raise the same amount of revenue as states that do impose sales taxes.

Pozdena argues that while any increase in taxation is injurious to investment and job growth, raising the corporate income tax rate would be particularly detrimental for Oregon since it would result in a cumulative (Federal plus state) rate higher than imposed in Japan or Sweden. We find many problems with Pozdena’s analysis.

First, Pozdena fails to address the fact that if the tax measures are defeated at the ballot box the state will have to reduce its spending further or find other revenue sources. Given that some of Oregon’s spending is currently being used to match federal funds, any drop in state revenue would mean a loss of even more funding, including stimulus dollars. The analysis fails to acknowledge that the state dollars raised by the measures will bring additional federal dollars into Oregon.

Second, Pozdena wrongly uses results from cross-country econometric studies of taxes and economic growth to derive wide ranging estimates of how economic activity in Oregon would be
affected by an increase in the statutory corporate tax rate from 6.6 percent to 7.9 percent in 2009 and 2010. He ignores the fact that these are in part temporary rate increases (falling to 7.6 percent in 2011) and that they only apply to profits in excess of $250,000 (in excess of $10 million starting in 2013). Added to these shortcomings, Pozdena’s effort to draw conclusions regarding how activity in a particular U.S. state, Oregon, would respond to changes in its statutory corporate tax based on the Lee and Gordon (2005) paper is fraught with a host of serious problems.

1. Lee and Gordon use econometric techniques to measure the extent to which differences in statutory corporate income tax rates across countries explain differences in growth rates. Statutory tax rates are found to be negatively correlated with average economic growth rates. To create a large sample of countries for the study, Lee and Gordon include both industrialized and non-industrialized countries. In his review of the literature on taxes and economic growth, Myles (2009) explains that the inclusion of a wide range of countries induces aggregation bias since industrialized and non-industrialized countries can have sharp differences in the relationship between taxation and economic growth. In fact, Lee and Gordon report that the tax effect is near zero for OECD countries which are, presumably, the ones that are most directly comparable to the U.S. states. A similar study by Garrison and Lee (1992) finds that the corporate tax rate is significant only among non-industrialized countries. Thus, one cannot rule out that the relationship between corporate tax rates and economic growth used by Dr. Pozdena to derive his estimates is valid only for non-industrialized countries.

2. Pozdena implicitly and wrongly assumes that results from cross-country studies of corporate income tax effects can be applied to U.S. states. Unlike countries, U.S. states that impose corporate income taxes typically use apportionment formulas to calculate state corporate income tax liabilities for corporations that derive multi-state income. For example, Oregon’s tax on corporate net income is based on net income calculated for U.S. federal corporate tax purposes but is only applied to the percentage of net income that corresponds to sales within the state (“single sales factor apportionment”). If half of a corporation’s receipts are generated in Oregon, for example, then the corporation will apply the Oregon corporate tax rate to one-half of net taxable income. The Oregon Legislative Revenue Office reports that more than one-third of corporate returns in 2006 were from multi-state firms. These firms account for almost 90 percent of corporate liability in that year. The cross-country studies say nothing about how apportioned taxes affect economic growth and thus are not applicable.

Pozdena compares the cumulative corporate tax rate in Oregon with those in Japan and Sweden. We believe multinational corporations likely make location decisions in steps, first deciding whether to locate in a particular country and then deciding where to place operations within that country. Thus cross-country comparisons of cumulative federal and Oregon corporate tax rates (which given single sales tax factor apportionment would not be the effective rate faced by the corporation) are misleading.
A better approach to understanding the effects of state tax rates is to examine how Oregon’s marginal tax rates compare to those of other states. Seventeen other states have top marginal tax rates over 8 percent and another eight have tax rates between 7 and 8 percent. Thus Oregon’s corporate tax rate would be in the middle of those found across the nation if the top marginal rate was increased from 6.6 to 7.9 percent. Indeed, this higher rate is only applied to Oregon taxable income above $250,000 in 2009 and 2010, while many other states have higher, flat rates. (As noted above, beginning in 2011 the rate falls to 7.6 percent and will only apply to net income above $10 million in 2013.) The fact that Oregon is using a 100 percent sales apportionment factor means that the income tax is based on the portion of sales within Oregon, so any economic activity that resulted in sales outside the state1 would not be subject to Oregon taxation. Thus for those companies with sales throughout the country --- which account for almost 90 percent of corporate tax liability --- the actual amount of corporate tax levied is only dependent on sales within Oregon so liability will be a fraction of total profits. Effective tax rates will be higher for companies with Oregon taxable income above $10 million that primarily do business in Oregon (that are probably less mobile than companies that generate out of state sales).

Pozdena also ignores the fact that in Oregon, due to a variety of corporate tax preferences, many firms have little or no tax liability. In fact, about two-thirds of Oregon’s corporations pay the current $10 minimum tax. While the measure that voters will be asked to approve increases the corporate minimum tax, the maximum tax will be no more than 0.15% of Oregon sales. For the highest minimum tax to be applied, $100,000, a firm would have to make Oregon sales greater than $100 million while not realizing a taxable profit or have taxable profits coupled with tax credit subsidies that reduce tax liability below $100,000.

Corporations usually choose locations based on the overall costs and benefits they expect to realize in a given place. Thus they will consider more than just the corporate income tax and the overall mix of taxes paid and services received by locating in a specific location (in addition to labor costs and other non-governmental factors). While the corporate income tax (and personal income tax) may place a drag on the economy, the lack of a retail or wholesale sales tax in Oregon tends to encourage productive activity. Indeed, a 2008 Ernst and Young (E&Y) study of total state and local business taxes found that Oregon had one of the lowest ratios of 2006 business taxes paid as compared to 2006 state and local expenditures that benefit business. This study includes corporate income and franchise taxes but also examines property and sales/excise taxes paid by businesses. (Note the Pozdena study and the E&Y study are examining what entity pays these taxes and not examining the final incidence of the listed taxes.) The E&Y study found that businesses in Oregon paid state and local business taxes that comprised 3.7 percent of GSP, significantly below the 4.9 percent of GSP found in the United States and one of the lowest rates in the country.

State spending can also affect corporate location decisions. If the two measures fail and Oregon has to cut spending on infrastructure and education further, for example, that would also make Oregon a less attractive place to work and do business.

In summary, the Pozdena arguments against the increase in the Oregon corporate tax and his
calculations of job losses are based on irrelevant cross-country studies. While any tax increase may affect economic growth and employment, Pozdena’s analysis does not support the conclusion that the proposed increase in the Oregon corporate tax will significantly reduce employment or economic growth.

We would also like to address the arguments Bill Conerly has raised against Measure 66, the legislation that would raise top marginal tax rates for personal income taxpayers. While Oregon’s income tax rate is already high by national standards, it has no sales tax. California has an even higher income tax rate and it also imposes sales taxes. Washington levies no income tax, but levies a substantial sales tax. Comparing Oregon to its neighbors, given California has also increased its top marginal tax rate, it is not clear to us that an increase in the top individual tax rates would have a sizable negative impact. This differs from the conclusion of Mr. Conerly; however, we are not at all confident in the model he used to derive his estimates. Understanding the attractiveness of a state to both individuals and businesses needs to take into consideration all of the factors that affect individuals’ choice of location, including quality of life and public services (e.g. schools, roads and public safety). We are aware of our colleague Len Burman’s 2005 critique of Conerly’s previous analysis. Len noted, for example, that Conerly wrongly cited one of Len’s published studies and had wrongly claimed that cutting taxes on capital gains can result in increased revenues for the state. We have no reason to believe the jobs numbers Conerly is producing today are any more valid than the numbers he produced four years ago with the same model that Len documented was created with fatally flawed assumptions.

While the new tax rates at first blush seem relatively high, they are, in part, a temporary measure to an unprecedented problem. Beginning in 2012, the legislation will permanently apply a 9.9 percent marginal tax rate to taxable incomes above $250,000, an increase from 9 percent. The legislation will also permanently phase out the deductibility of federal taxes, a deduction that only a handful of other states currently have because it undermines the progressivity of the income tax. It is important to note the Oregon Legislative Revenue Office estimates that initially only 2.5 percent of personal income tax filers are expected to have higher state tax liability under HB2649, and only 3.6 percent in 2013.

Even with the increases in both the income and corporate taxes, Oregon will remain in the middle of the pack in terms of per-capita taxes (moving from 34th to 31st) and is still estimated to have one of the lowest business tax burdens (moving from 3rd lowest to 5th). Raising taxes is never popular; however, the two measures are reasonable responses to the unprecedented drop throughout the nation in state tax revenues due to recent economic crisis. We believe these measures will help ensure that Oregon has sufficient revenue to maintain essential services including spending on education and health care. The claims by Pozdena and Conerly are without merit.

1 This is for sales not picked up by the throwback rule.