Executive Summary

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June 1, 2001

House Bill 2281B and the Single Sales Factor:
An Expensive, Ineffective, and Unnecessary Effort to Change the Business Climate

By Jeff Thompson and Charles Sheketoff

House Bill 2281B would cut corporate income taxes by 10.5 percent ($100 million) in future biennia by modifying the formula that determines how much of a multi-state corporation's net income can be taxed by Oregon. The bill would replace the state's current three-part corporate income tax apportionment formula with a "single sales factor." The bill is being promoted as a valuable economic development tool.

A review of the evidence suggests there is little reason to expect significant economic growth from a single sales factor. The proposal also primarily benefits a few large multi-state corporations. Specifically:

- The Legislative Revenue Office estimates that HB 2281B will generate fewer than 100 jobs in a state with 1.7 million employed, at a cost of $500,000 per job;
- The $101.3 million revenue loss will harm valuable public services that make an important contribution to economic growth, such as education and public safety;
- By design, HB 2281B fails to guarantee any new investment, while also rewarding firms for investment that would have been made anyway and rewarding companies making layoffs;
- Oregon's economy has performed better than those states with single sales factor formulas, and;
- HB 2281B will raise taxes on 5,700 companies doing business in the state, will provide little or no tax relief to most Oregon companies, and directs 64 percent of its tax relief to 17 of the state's largest companies.

Business-supported and academic research concludes that business taxes have little or no impact on economic growth. Taxes matter little because they constitute such a small part of businesses' costs. Furthermore, the public services that will be reduced make an important contribution to economic development. House Bill 2281B will further limit Oregon's ability to meet the state's needs in education, health care, and other public services.

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House Bill 2281B would cut corporate income taxes by $100 million in future biennia by modifying the formula that determines how much of a multi-state corporation's net income can be taxed by Oregon.[1] Currently Oregon taxes a portion of corporate net-income based on three factors: the amount of property, payroll, and sales a company has in Oregon. Employment and property each account for one-fourth of the portion of net income taxable in the state, while sales are "double-weighted" and account for half. The proposed new formula would only tax companies based on the amount of sales in Oregon. This method of apportioning corporate income is commonly called the "single sales factor."

Backers of the bill, primarily companies that stand to receive considerable tax cuts under the measure, claim that the bill will generate new jobs and economic development in the state.[2] These promises are overblown. Evidence from other states with single sales factor rules suggests little reason to expect significant new economic growth. Tax cuts only weakly effect economic growth, and the public services that would be curtailed due to the tax cut (public safety, education, infrastructure, and more) are themselves important influences on economic growth.

A number of the companies pushing the single sales factor acknowledge Oregon's insufficient public investment in areas like education, but they are now lobbying for HB 2281B to reduce their contribution to that public investment. These companies will see large tax cuts under HB 2281B regardless of whether they make future investments in Oregon, or whether they lay off workers. The benefits from HB 2281B are heavily concentrated among a handful of large companies, with most Oregon businesses getting little or nothing. The switch to a single sales factor also shifts the corporate income tax burden from companies that use public services heavily to those that use them much less intensively.

Revenue Loss from House Bill 2281B

Estimates by the Legislative Revenue Office show that HB 2281B will reduce net corporate income tax revenue by $101.3 million in the 2003-05 biennium (10.5 percent of the total tax) and $105.8 million in 2005-07.[3] The $100 million biennial tax loss is the net result of tax breaks to some companies partially offset by *increased* taxes from those companies on the losing end of the switch to the single sales factor. House Bill 2281B is expected to *reduce taxes* for about 2,500 companies, while *increasing taxes* for about 5,700. An analysis by the state Legislative Revenue Office shows that, had the change been in effect in 1998, 17 corporations with $1 billion or more in taxable income would have received over half of the total tax cut, averaging over $3 million in reduced taxes.[4]

The magnitude of this revenue loss is best understood in the context of the cost of funding state programs and services. The lost revenue from HB 2281B is equal to the *combined* Governor's proposed 2001-03 General Fund budgets for Vocational Rehabilitation, the Department of Transportation, Consumer and Business Services, the Department of Agriculture, and all of the economic and community development agencies, including the Oregon Employment Department, Housing and Community Services, and the Economic and Community Development Department. The tax cut in HB 2281B is also more than half of the proposed General Fund budget for the State Police. The tax cut in HB 2281B is over four times larger than the $22.5 million in state funding that Oregon's high-tech employers are seeking to establish a "top-tier" engineering school.[5]

To finance such a tax cut, the Legislature would have to raise other taxes or reduce state services, or both. The state's May *Economic and Revenue Forecast* shows that General Fund and lottery revenues in 2001-03 are expected to be nearly $600 million lower than the amount needed to keep existing programs at their current capacity. The *Forecast* also painted a dim picture for the 2003-05 biennium and beyond, when HB 2281B would take effect.[6]

HB 2281B Won't Deliver Economic Growth

Economic growth promised by proponents of the single sales factor is unlikely to materialize because:

- Tax cuts have a weak impact on economic growth;
- Public services, which contribute to economic growth, are likely to be reduced as a result of the tax cut;
- The measure fails to ensure that any new economic activity will be generated;
- Some investment disincentives will be exacerbated as taxes are raised on thousands of businesses without any improvements in public services, and;

- The nature of such tax cutting schemes ensures that any limited growth incentives will be temporary, at best.

The Weak Effect of Business Taxes

In *Taxing Ourselves: A Citizen's Guide to the Great Debate over Tax Reform*, former Reagan administration economist Joel Slemrod and co-author John Bakija note "Politicians love to promise more and better jobs for voters, and so do advocates of tax reform… Aside from the natural tendency of interested parties to exaggerate, do such claims about jobs have any economic content? In a word—no."[7] Why? Because taxes are a relatively small portion of a business' budget. Labor, energy, transportation, material, and occupancy costs are far more important. Because taxes are such a small part of business costs, and inter-state differences in business tax burdens are relatively small, the relationship between state and local business taxes and economic growth is weak or non-existent.[8]

The projections for HB 2281 demonstrate just how little taxes impact employment. The Legislative Revenue Office predicts that HB 2281B would boost employment in Oregon by a mere 0.005 percent, generating only 100 jobs.[9] With an annual price tag of $50 million, that amounts to $500,000 per job. Between 1995 and 2000, Oregon's economy added 28,500 jobs a year. One hundred jobs in a state with 1.7 million employed is equivalent to rounding error.

Oregon's business community knows that taxes have only a limited impact on economic development. The findings of one recent study conducted for Associated Oregon Industries (AOI), the state's largest business lobby, "tended to confirm the conventional wisdom of the unimportance of taxes to [headquarter] location."[10] The AOI study showed that corporate headquarters tend to be located in states with higher taxes.

Findings from the AOI study are in-synch with most other research. A recent review of the literature showed that approximately one third of the studies find no significant relationship at all between business taxes and economic growth.[11] The studies that do identify a significant relationship indicate that business taxes only weakly impact growth. On average, these studies find that a 10 percent reduction in business taxes would generate only two percent growth in employment or new establishments over the long term. Commenting on the weak findings in the research literature, Deloitte corporate facility location consultant Robert Ady noted that "in the facility location process, taxes are not relatively important when compared with other cost factors… [S]ite selection data do not suggest any correlation between low taxes and positive economic growth, or between high taxes and slow growth."[12]

Politicians love to promise more and better jobs for voters, and so do advocates of tax reform… Aside from the natural tendency of interested parties to exaggerate, do such claims about jobs have any economic content? In a word—no.

--Joel Slemrod & John Bakija

Oregon is doing well without a single sales factor formula

Comparing employment growth in the states that have the single sales factor to those that do not demonstrates that there is little reason to expect this particular business tax cut to generate significant new economic growth. None of the seven states with single sales factor rules were among the top ten fastest growing states for manufacturing employment between 1995 and 2000.[13] Oregon, with its double-weighted sales formula, grew faster than every one of the single sales factor states during these years.

In 1997 Oregon had the fastest growing state economy in the country. After adjusting for inflation, Oregon's Gross State Product grew 7.2 percent in 1998, the most recent year for which data are available. Oregon's economy grew faster than the US average in every year from 1988 through 1998.[14] It also grew faster than the average of Western states in all but one of those years. This enviable economic performance occurred without a single sales factor formula.

The individual investment behavior of one of the Oregon companies pushing for the single sales factor formula reveals that the formula is inconsequential for economic development. Of Intel's six major plant location/expansion investments (those valued at $700 million or more) between 1995 and 2000, the four largest went to states without the single sales factor.[15] Nationwide, only six of the fifty-one location/expansion investments of this size made by any company went to single sales factor states. Four of those investments were made in Texas, in-line with that state's share of US economic output. Each of the companies that are advancing this tax law change, which will likely save them millions of dollars, invested in Oregon without a single sales factor formula.[16]

High Tech Wants to Have Its Cake and Eat It Too

High-tech employers in Oregon have emerged as some of the strongest supporters of funding for public education. The companies recognize how important an educated workforce is for their own and the state's economic performance. In a recent editorial, Jim Johnson, Intel's top manager in Oregon, and Rick Wills, President and CEO of Tektronix, noted that "Oregon cannot expect to sustain the economic growth we have seen in recent years if we do not invest in our higher education system."*

Both Intel and Tektronix are now part of a cadre of corporations calling for the $100 million cut in corporate income taxes in HB 2281. Since education constitutes more than 57 percent of all General Fund spending in Oregon, it is not feasible to implement single sales factor legislation without shortchanging education budgets. New spending initiatives, such as a top-tier engineering school, would become almost impossible.

By calling for tax cuts and more spending, Oregon's high-tech employers appear to want to have their cake and eat it too. In their recent op-ed, Johnson and Wills wrote "...as the Legislature faces tough choices in allocating limited resources to many important programs, it is important for all Oregonians to communicate to our elected representatives in Salem that a strong, well-funded higher education system is vital if we are to sustain long-term economic growth." Apparently the same message needs to be communicated to Intel and Tektronix regarding the corporate tax cuts they are supporting.

* Johnson, Jim and Rick Wills, "Oregon Best Invest in High-tech Higher Education," *Oregonian*, May 20, 2001.

Not only has Oregon's economy performed remarkably well without a single sales factor formula, but there is little basis to conclude that Oregon's business tax burden is unreasonable. In fact, over the last twenty years, the effective total state and local business tax burden in Oregon has declined. According the Utah State Tax Commission, Oregon's effective business tax burden was 3.6 percent in 1984-85, and had declined to 2.2 percent by 1999-2000.[17] Compared to other states in the region, Oregon's business tax burden is already low. Among seven Western states, including Washington, California, Idaho, Utah, Arizona, and Colorado, Oregon has the lowest business tax burden.[18]

The weight of economic evidence suggests that Oregon has done well and will continue to do well without a single sales factor formula.

The Economic Importance of Public Services

The economic importance of public services is recognized by Oregon businesses and has been documented in the research literature. As the Oregon Business Council has noted, "Good public services, including infrastructure, education, public safety, and transportation, are critical to a growing and prosperous economy..."[19] Because they are funded through tax dollars, the limited gains associated with tax cuts are offset, partly or entirely, by losses associated with decreased public services. [20] The net effect is uncertain. Much of the research, however, concludes that the positive impacts of public services are strong enough that they can cancel out or outweigh losses associated with higher taxes.[21]

High quality education and training services are particularly important for businesses. According to Deloitte corporate location consultant Robert Ady, "The single most important factor in site selection today is the quality of the available work force. Companies locate and expand in communities that can demonstrate that the indigenous work force has the necessary skills required by the company or that have the training facilities to develop those skills for the company."[22] Numerous polls of business owners conducted in recent years confirm that education and workforce quality are critical issues for small businesses, as well. Reporting on one such poll, the *Portland Business Journal* wrote "Education is the [number one] concern of small-business owners, beating out affordable health care and tax cuts..."[23]

Other public services besides education, such as public safety and infrastructure, including roads and bridges, are important to economic growth. Much of this infrastructure is badly in need of repair in Oregon. In its 2001 *Report Card for America's Infrastructure*, the American Society of Civil Engineers (ASCE) notes that Oregon faces serious needs in the areas of roads and bridges, water infrastructure, and schools.[24] The ASCE Report Card documents dozens of schools with extensive repair needs, ranging from bad plumbing to crumbling roofs, and notes that 22 percent of the state's bridges are "structurally deficient or physically obsolete." These are just part of a long list of ongoing maintenance, repair and construction needs that will cost billions of dollars, and have an important impact on the state's livability and economic environment.

Raising Taxes on Some Businesses

Single sales factor formula proponents stress the positive economic incentives created by reducing taxes on Oregon businesses. While the evidence suggests that the single sales factor is a weak incentive, it may act as a disincentive in certain cases. House Bill 2281B raises taxes for 5,700 businesses. These businesses face tax increases since they have relatively little of their employment or property in the state. Switching to a single sales factor formula increases the portion of these companies' income subject to corporate income taxes. The combined total tax bill of companies facing an increase under HB 2281B would rise by almost 40 percent. [25] With higher taxes and declining public services in Oregon, these companies will lose with a single sales factor.

Under federal law (Public Law 86-272) Oregon cannot tax the income of a company whose only presence in the state is a limited sales staff.[26] The tax increase and service reductions associated with HB 2281B could make it worth a company's trouble to go through the effort to avoid taxation altogether by divesting itself of its limited Oregon property and non-sales employment.

The converse is also true. Companies that only sell to Oregon residents and have no property or non-sales employment in Oregon would face a considerably increased tax bill if they expand their operations in the state under HB 2281B than they would under current law. The measure could act as a disincentive to invest in Oregon and begin paying Oregon taxes.

Temporary Tax Advantage Boost

In-state companies benefit from a single sales factor formula primarily because it allows some of their income to go untaxed. Untaxed income, or "nowhere income," results because states have different formulas for determining the portion of corporate income that is taxable.[27] The gains to companies benefiting from HB 2281B depend on other states not adopting single sales factor rules, as well. When other states adopt the single sales factor formula, the taxes these companies avoid paying in Oregon will be paid in another state.

If adoption of the single sales factor rule is the powerful economic development tool that proponents claim, then other states will likely adopt the rule. When widespread adoption occurs, tax benefits will largely be erased, but businesses around the country will pay very low corporate income taxes in the states where they produce, and higher taxes in states where they have little physical presence. [28]

No Guarantee of New Investment

Adopting the single sales factor formula will reduce the Oregon income taxes of many corporations. It is far from certain that any of the promised new investments or jobs will occur. The tax incentive in HB 2281B is structured without performance requirements, giving tax cuts to companies regardless of their future investment and employment in Oregon. In fact, some of the companies supporting HB 2281B, including Tektronix and Freightliner, have been laying workers off in the state.[29] A tax cut for these companies would be a reward for cutting employment.

At the same time, tax incentives that lack strong performance requirements also reward companies for investments that would have taken place even without the incentive. This inevitability was brought out by Treasury Secretary Paul O'Neill's confirmation hearing testimony. Commenting on tax incentives, the former Alcoa Chairman and CEO said, "I have never made an investment based on the tax code... If you are giving money away, I will take it. If you want to give me inducements for something I am going to do anyway, I will take it. But good business people do not do things because of inducements..."[30]

The companies lobbying for HB 2281B are not planning to leave Oregon and many have already made plans for considerable in-state investments and expansions. Adidas, Columbia Sportswear, and Louisiana Pacific, for example, have recently moved into, or are in the process of preparing, new headquarters in the Portland Metropolitan area.[31] Intel is committed to building a new research campus in Washington County in addition to investing billions of dollars in the area.[32] These investments will occur regardless of whether a single sales factor formula is adopted.[33] Investments that would have occurred anyway cannot be counted as a benefit from a tax cut.

Questionable Tax Policy

In addition to having weak economic impacts, a single sales factor also represents questionable tax policy. It weakens the link between the use of public services and payment for those services by corporations. Oregon's current three-factor formula taxes companies that have property and employment in the state because these companies are the heaviest users of highways, public safety, education, and other services. The proposal in HB 2281B, on the other hand, shifts the corporate income tax burden to companies that use the state's public services less frequently because they have little presence in Oregon.

Also, tax relief from HB 2281B is directed primarily to the biggest companies, providing little to small businesses. Seventeen of the largest companies in Oregon, with taxable incomes over $1 billion each, will capture 64 percent of the relief, with average tax cuts over $3 million annually.[34] The 2,400 smallest companies in Oregon, with taxable income under $500,000, will get average tax cuts of less than $200. A handful of companies with a national and global presence receive huge tax breaks under HB 2281B, while most Oregon companies will see a very small or no tax cut whatsoever.

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Treasury Secretary Paul O'Neill, at his confirmation hearing

Conclusion

Experience shows that economic growth associated with cutting business taxes is weak at best. Single sales factor proposals are no different. No long-term economic advantage will accrue from a single sales factor, since any incentive fades as other states adopt the formula.

Instead of giving sizeable tax breaks to some of the richest companies in Oregon, which are far from guaranteed to produce any new investment, the state could opt to improve the business climate by making long-overdue public investments in education and infrastructure.

The drive for a "single sales factor" represents the latest skirmish in a zero-sum economic war between states. Rather than playing this wasteful game and, if they are lucky, stealing a few jobs from another state, officials in Oregon should take the high road and work for solutions at the federal level that will prevent corporations from playing one state off another in the endless drive to eliminate state tax burdens. If this pointless competition does not end, the result will be reduced tax revenue and deteriorated public services without the promised economic benefits.

Endnotes.

[1] Special thanks to Michael Mazerov, of the Center on Budget and Policy Priorities, and Aileen Clymer, intern at OCPP, for their help.

[2] In testimony on another single sales factor bill, Paul Phillips, representing the "Smart Growth Coalition," the primary lobbying group on this issue, claimed that the single sales factor "could truly be one of the most significant statewide economic development or employment generators Oregon has witnessed for some time." Testimony on HB 2558 by Paul Phillips on April 9, 2001.

[3] Legislative Revenue Office Revenue Impact Statement on HB 2281A-4, May 24, 2001. Proponents of tax cuts benefiting businesses typically claim that the "static" estimates of revenue loss overstate the actual revenue loss because of dynamic feedback effects that will increase corporate income and therefore corporate income tax revenue. In its Oregon Tax Incidence Model, the Legislative Revenue Office estimates the dynamic revenue effect, and finds it to be relatively small, just $4.2 million in 2003-05. It is also possible, though, that the revenue estimates of a single sales factor might actually *underestimate* the revenue loss. Some of the expected increased revenue from the increased taxes on many businesses, which partially offsets the decreases that many businesses face, might not occur.

[4] OCPP analysis of Legislative Revenue Office data.

[5] See http://www.oregonetic.org/current-tier1.htm.

[6] See Sheketoff, Charles and Jeff Thompson, *Dim and Dimmer: Forecasts of State Revenue and Federal Discretionary Spending in Oregon*, Oregon Center for Public Policy, May 21, 2001. Available at www.ocpp.org/2001/es010521.htm.

[7] Slemrod, Joel and John Bakija, *Taxing Ourselves: A Citizen's Guide to the Great Debate over Tax Reform*, MIT Press, Cambridge, 2000, page 122.

[8] Corporate location consultant Robert Ady finds that taxes account for just four percent of the "geographically variable operating costs" of manufacturing firms. Ady, Robert, "Discussion," *New England Economic Review*, March/April 1997, page 79. For a discussion of the modest differences in the business tax climate among states see Tannenwald, Robert, "State Business Tax Climate: How Should It Be Measured and How Important is it?," *New England Economic Review*, January/February 1996.

[9] OCPP analysis of LRO OTIM results for HB 2281B.

[10] Gates, Bruce and Fred Thompson, *Luring, Growing, and Retaining Headquarters and Management Offices*, Atkinson Graduate School of Management, Willamette University, 2000. According to Gates and Thompson, the important factors for attracting and keeping corporate headquarters include: 1) strong research and development and venture capital networks, 2) effective forums for inter-industry collaboration and idea sharing, including hospitals and universities, and 3) "well-developed service infrastructure, especially including communications and high quality air-service."

[11] Wasylenko, Michael, "Taxation and Economic Development: The State of the Economic Literature," *New England Economic Review*, March/April 1997.

[12] Ady, Robert, "Discussion," *New England Economic Review*, March/April 1997, page 80.

[13] 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, April 2001.

[14] Thompson, Jeff and Michael Leachman, *Prosperity in Perspective: The State of Working Oregon 2000.* Oregon Center for Public Policy. September 2000, page 8.

[15] Analysis of data from *Site Selection Magazine*, contained in Mazerov, *The 'Single Sales Factor' Formula*, pages 36-38.

[16] Member corporations of the "Smart Growth Coalition" include Intel, Tektronix, Adidas, Nike, Columbia Sportswear, Kindercare, Schnitzer Steel, and Louisiana Pacific.

[17] Utah State Tax Commission, *Western States' Tax Burdens*, various years and preliminary release for 1999-2000. The tax burden measure in the Tax Commission's report is total state and local taxes for businesses as a share of Gross State Product.

[18] Overall, Oregon remains a relatively low-cost state for businesses. In its 2000 "Business Cost Index," which includes unit labor costs, taxes and energy costs, the economic consulting firm Economy.com found that Oregon's is among relatively low-cost states. Economy.com also reported in its most recent "Business Vitality Index" that Corvallis has the healthiest economy of any community in the country. Koretz, Gene, "The Lure of Low Business Costs: Will The Pricey Regions Suffer?," *Business Week*, January 15, 2001.

[19] Oregon Business Council, *A Vision For Public Finance in Oregon*, April 15, 1998, page 2.

[20] Summaries of the research literature on the economic impacts of public services can be found in Fisher, Ronald, "The Effects of State and Local Public Services on Economic Development," New England Economic Review, March/April 1997, and also in Bartik, Timothy, "Growing State Economies: How Taxes and Public Services Effect Private-Sector Performance," in *The End of Welfare? Consequences of the Federal Devolution for the Nation*, edited by Max Sawicky, Economic Policy Institute, 1999, ME Sharpe, New York.

[21] Bartik, "Growing State Economies," page 120.

[22] Ady, Robert, "Discussion," *New England Economic Review*, March/April 1997, page 81.

[23] Hoover, Kent, "Small Businesses Fret Over Schools," *The Portland Business Journal*, March 24, 2000.

[24] The ASCE report card can be found on the web at www.asce.org/reportcard/index.

[25] LRO data show that, if the un-amended HB 2281 was implemented in 1998, the total tax liability of the companies facing a tax increase would rise by forty percent, going from $111.6 million to $156.2 million. The amendment to HB 2281B that allows interstate communication and utility companies to opt to keep the double-weighted sales formula will reduce the tax increase by several million dollars, but the overall increase will remain close to 40 percent.

[26] The role of Public Law 86-272 is discussed in Mazerov, *The Single Sales Factor*.

[27] See Mazerov, *The 'Single Sales Factor'*, for a discussion of "nowhere income" and the single sales factor.

[28] As noted in a recent *State Tax Notes* article, "As more states turn to the heavily-weighted sales formulas, the long-term gains may never materialize." Smith, James K, "Guide to Corporate Income Tax Apportionment, Part I," *State Tax Notes*, November 20, 2000.

[29] Hunsberger, Sarah, "Layoffs, Closures Help Clog Clackamas County Career Center," *Oregonian*, 4/19/2001. Yin, Su-Jin, "Tektronix Job Cuts Increase to 1,653," *Oregonian*, 8/27/1999.

[30] Quoted in Mazerov, *The 'Single Sales Factor'*.

[31] Leeson, Fred, "LP Leases Space in Fox Tower Downtown," *Oregonian*, 11/23/1999. Dworkin, Andy, "Columbia Sportswear Closes Deal on New Headquarters," *Oregonian*, 11/2/2000. "Adidas to Buy US Headquarters Site," *Portland Business Journal*, 4/20/2000.

[32] Yin, Su-Jin, "Intel Will Build R&D Campus," *Oregonian*, 7/11/2000. Williams, Elisa and Don Hamilton, "Oregon's Intel Chips In," *Oregonian*, 7/16/2000.

[33] Freightliner has also made plans to expand its production facilities and headquarters on Swan Island, but they have been put on hold because of the slowing heavy truck market associated with global and national economic slowdown. *Oregonian*, August 15, 2000.

[34] Tax cuts for large companies calculated by OCPP from LRO data. LRO presents tax cut data for 1998, which understates the size of the cuts expected for years in the 2003-05 biennium. "Taxable income" is federal taxable income.