BTC Brief

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Cutting Corporate Income Taxes Won't Be an Economic Boon for North Carolina

BY CEDRIC D. JOHNSON AND ALEXANDRA FORTER SIROTA

DEEP CORPORATE INCOME TAX CUTS being proposed by state lawmakers will put at risk key public investments that North Carolina businesses rely on for an educated and skilled workforce, quality roads, police and fire protection, court systems that protect intellectual property, and innovative research coming out of North Carolina's universities.[1] While proponents claim that the tax cuts would spur job creation and economic growth, in reality they are likely to harm the economy, in both the short- and long-term.

Under the two main proposals, the corporate income tax rate would be lowered to 6 percent from 6.9 percent. Both proposals also would change the formula used to determine a multi-state corporation's income tax in North Carolina.[2] The state currently uses a formula based on a corporation's property, payroll and sales in North Carolina, with sales factored in more heavily. Under the proposals being considered by North Carolina lawmakers, the formula would change so that only the sales factor would be used.

Here are three reasons why the tax cuts won't work:

- **Corporate income tax cuts don't pay for themselves and put key investments at risk**

  Due to balanced budget requirements, North Carolina will not reap any short-term benefits from corporate tax cuts. That's because every dollar given away in a tax cut has to be made up for with a tax increase on another business or individual or with a cut to state services. So, at best, any benefit from a tax cut will be offset dollar for dollar, and result in no net economic gain in the short-term.

  One of the two proposals being considered, for example, would cost North Carolina $345 million in much-needed revenue once fully phased in.[3] The other proposal makes up for the cost by eliminating certain corporate tax breaks, expanding the sales tax, and diverting local revenues to state coffers.

  If lawmakers cut investments in education, transportation or public safety, all of which have been shown to boost the economy over the long haul, then North Carolina's economic future could be compromised.[4] Businesses themselves are directly harmed by such cuts. A well-educated, highly productive workforce, access to markets and suppliers, sound infrastructure, and a high quality of life for employees are more important to corporate leaders than state taxes, according to numerous surveys, studies and popular rankings of "business friendly" states.

  Cuts in public services can also lead to cutting or eliminating contracts with private businesses, which are then forced to lower wages, reduce worker hours, or cut jobs. Their workers then have less to spend in the economy.

MEDIA CONTACT:

ALEXANDRA FORTER SIROTA

Project Director

919/861-1468
alexandra@ncjustice.org

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P.O. Box 28068
Raleigh, NC
27611-8068

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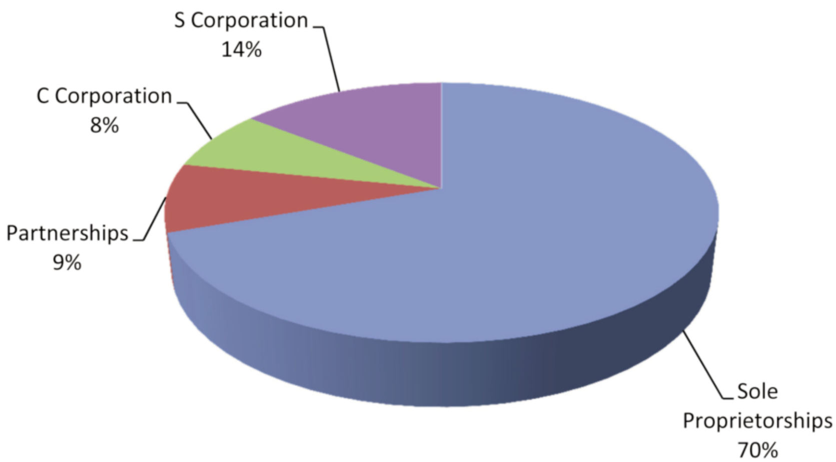
- **Small share of corporations will benefit**

  The proposed cut in the corporate income tax rate would benefit a relatively small share of businesses. Just 7 percent of North Carolina's businesses are even subject to the corporate income tax and, historically, most of the revenue collected has come from a very small number of corporations. In 2009, for instance, more than half (54 percent) of total corporate income taxes came from less than 3 percent of all corporations that filed income taxes.[5]

FIGURE 1: Only 8 percent of North Carolina Businesses are C Corporations and Subject to the Corporate Income Tax



SOURCE: NC Department of Revenue and Internal Revenue Service. The IRS includes Limited Liability Companies (LLC) ad Partnerships in the same category. Accordingly, LLCs are included w ith parternships in the chart.

Proposals to change the formula used to determine taxable state corporate income would largely benefit profitable, multi-state corporations with substantial property and personnel in North Carolina but much of their sales out of state. And the evidence is overwhelming that such a change would fail to produce growth, be a revenue-loser for the state, and put the government in the inappropriate position of picking "winners" and "losers" among businesses.

Around one-third of any corporate tax cut would flow to the federal government. This is because profitable corporations deduct state income tax payments from their federal corporate income tax returns. If they pay less state income tax, they will have less to deduct—for every dollar they save in state taxes, they will pay 35 cents to the federal government (based on the 35 percent federal tax rate on large, profitable corporations).

- **Corporations are Unlikely to Expand or Relocate Because of State Income Tax Cuts**

  There is little reason to believe that a cut to the corporate income tax will result in substantial investment in North Carolina or relocation of headquarters to the state.[6] State and local taxes are typically only 2 percent or less of business costs.[7] Expenses for labor, property, equipment, and transportation are much more substantial.

  Far more important to businesses' decisions about hiring is whether there is customer demand. Today demand is low, which is why so many companies across the nation are sitting on record profits rather than expanding. A business that gets a tax cut will not hire if it doesn't feel it can sell more of what it makes. And when demand does increase, businesses will hire whether they have gotten a tax cut or not.

  Even a very large cut to all state and local corporate taxes would have only a very small impact on economic performance over the long-term. Cutting businesses' total state and local tax bill by 10 percent would likely boost economic output and jobs by just 2 to 3 percent above where it otherwise would be over a 10- to 20-year period.[8] That is a very small result for a big tax cut that will cost schools, health care and other services dearly. The benefit would be even smaller if decreased business activity caused by cuts to public services were factored in. Because the corporate income tax is significantly less than 10 percent of total state and local taxes paid by corporations in North Carolina, even eliminating the tax outright would generate, at best, very modest growth in output.

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North Carolina's Corporate Income Tax Enables Wise Investments

Despite its modest impact on business, the corporate income tax is an important resource for North Carolina. It supplies 6 percent of all state tax revenue and helps make key investments that position North Carolina for a prosperous future, including investments that businesses depend on. For example, the amount raised through the corporate income tax in 2012 is equivalent to the entire state budget for North Carolina's community colleges and vocational training schools.

Many profitable corporations operating in North Carolina already pay much less than the statutory 6.9 percent rate, because of tax breaks. Of the 12 Fortune 500 companies headquartered in North Carolina,8 paid a state corporate tax rate of less than 5 percent after taking account of tax breaks, estimates show.[9]

Cutting the state corporate income tax rate would simply give away much-needed revenue that pays for schools, roads, and other public services, despite evidence that few if any jobs would result. Instead, most of the benefit would go to a relatively small number of profitable corporations, many of which are headquartered outside of North Carolina.

APPENDIX: Proposed Changes to Corporate Income Tax

SENATE BILL 394

Major changes to the corporate income tax include:

- Reduces tax rate to 6 percent from 6.9 percent.
- Shifts from a 50% to a 75% sales factor apportionment of business income, with intention of eventual shift to single sales factor apportionment
- Closes most major tax loopholes except those related to research and development and low-income housing.
- Modifies expensing and accelerated depreciation allowance rules.

Also makes changes to the franchise tax:

- Replaces franchise tax with a business privilege tax.
- Lowers tax rate to $1.25 per $1,000 from $1.50 of a business entity's net worth.
- Expands tax to all businesses with limited liability protection.

SENATE BILL 642

Major changes to the corporate tax include:

- Immediately lowers tax rate to 4.9 percent from 6.9 percent.
- Does not close any tax loopholes.

SENATE BILL 677

Major changes to the corporate tax include:

- Lowers tax rate to 6 percent from 6.9 by tax year 2016.
- Adopts a single sales factor apportionment of business income.
- Closes most major tax loopholes except those related to research and development and low-income housing.
- Modifies expensing and accelerated depreciation allowance rules.

Also makes changes to the franchise tax:

- Increase sales factor apportionment for franchise tax to 100 percent by 2016.

1 See appendix for details on corporate income tax cut proposals.

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2 Multi-state corporations pay taxes on just a portion of their profits in each state in which they do business. In most states, the amount paid is determined using a formula based on the shares of their total property, payroll, and sales located in each state.

3 Estimate provided in fiscal note for Senate Bill 677, provided by Fiscal Research Division.

4 Jeff Thompson, "Prioritizing Approaches to Economic Development in New England: Skills, Infrastructure, and Tax Incentives," Political Economic Research Institute, U. of Mass., 2010.

5 Total corporate income tax liability is before net operating losses (NOL) are accounted for. After accounting for NOLs, the number of corporations with positive net taxable liabilities decline.

6 Peter S. Fisher, "Corporate Taxes and State Economic Growth," Iowa Fiscal Partnership, Revised February 2012. http://www.iowafiscal.org/2011docs/110209-IFP-corptaxes.pdf

7 This is based on data averaged over three years 2001-2003 from two sources: U.S. Internal Revenue Sources, Statistics of Income, Integrated Business Data for all U.S. Businesses, showing total deductions for business costs on tax returns, at http://www.irs.gov/uac/SOI-Tax-Stats-Integrated-Business-Data; and a 2012 report by the Council on State Taxation, which estimates total state and local taxes paid by businesses, available at http://www.cost.org/WorkArea/DownloadAsset.aspx?id=81797.

8 Timothy J. Bartik, "Solving the Problems of Economic Development Incentives," Growth and Change, Spring 2005, p. 142.

9 Special data request. Institute on Taxation and Economic Policy, April 2011.

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