ECONOMIC PROGRESS REPORT
May 2014

The Economic Progress Institute

CORPORATE TAX CUTS ARE RISKY BUSINESS

Everyone in Rhode Island wants the same thing: a stronger economy with good jobs that help families to build a future. But tax cuts that some propose won't create this path to prosperity. Tax cuts have but a negligible effect on creating jobs and generating economic activity. What really works is investing in schools, transportation, and safe communities; helping entrepreneurs find markets and financing; and other tried and true building blocks of economic growth. Tax cuts will deplete the resources it takes to make these solid investments.

Proposals to cut the state's corporate income tax are particularly risky. They would reduce revenue in the short term on the wager that revenues will increase down the road because of economic growth. That's not a very safe bet. It is best to avoid these tax cuts and use the resources instead to support the services businesses need to grow and thrive.

If the state's corporate income tax rate is reduced, it should be done in conjunction with the adoption of "combined reporting," to help make up for revenue losses.

If policymakers do decide to reduce the corporate tax rate, then they ought to make up for the resulting revenue losses by adopting another tax policy that makes sure large, profitable, multi-state corporations pay their fair share for the services they use in Rhode Island. Known as "combined reporting," this sound reform would end many tax avoidance schemes that force Rhode Island-based businesses and residents to subsidize out-of-state companies by paying higher taxes, or losing essential services.

Why corporate tax cuts don't work

For several reasons, tax levels have only a negligible effect on economic growth or creating jobs, according to considerable serious research on what makes state economies grow.[1,2]

- State corporate income taxes are a tiny portion of the overall cost of doing business; saving so little money hardly affects business decisions. Nationally, corporate income taxes average less than three-tenths of one percent of total business costs. Corporate income taxes were just 5.4 percent of the average total state and local tax bill of Rhode Island businesses, according to research by the Ernst and Young accounting firm.[3] Proximity to markets and other factors such as availability, quality, and cost of labor and transportation are far more important than tax levels when businesses decide where to locate or whether to expand.

- Because businesses can deduct their state taxes when they calculate the federal taxes they owe, a cut at the state level would be partially negated by an increase in federal taxes.
- Much of the savings from any state corporate tax cut is likely to be passed on to out-of-state shareholders, who, if they spend the money at all, will do so where they live, not in Rhode Island.

Only a small number of businesses would get tax cuts anyway.

Not counting sole proprietorships owned by a single individual, there were close to 58,720 organized businesses in Rhode Island in 2012.[4] Almost 40,000 of these won't get any tax savings from the proposed rate cut because they are "S-corporations," partnerships, and limited liability companies that pay the corporate minimum tax at most. Even among the roughly 19,000 "C-corporations" that were subject to the corporate tax in 2012, more than 14,000 of them (77 percent) wouldn't have received the rate cut because after deductions and exemptions, their profits were so low that they were only subject to the minimum tax.

Most companies don't pay 9% now.

Few companies today pay the nine percent rate. Last year the state reported that the average effective corporate tax rate was 7.97 percent because of various exemptions, deductions, and credits. CVS, for example, paid an effective tax rate of 4.25 percent.[5]

Only 8 percent of businesses in Rhode Island would benefit from a corporate tax rate reduction.

Reducing the state's corporate income tax costs too much.

Reducing the corporate income tax to 7 percent from 9 percent would deprive Rhode Island of at least $30 million a year based on state revenue projections for the fiscal year that starts July 1, 2014.[6] Receipts – and the loss from tax cuts - are likely to increase, given current economic growth – making the losses even higher. Because Rhode Island must balance its budget every year, every penny lost through tax cuts would have to be made up by some combination of reduced services or increased taxes. This would threaten the state's economy as public services important to businesses and residents are reduced to make up for the lost revenue.

If the corporate income tax rate is reduced, Rhode Island should adopt "combined reporting," to help make up for lost revenue.

"Combined reporting" requires corporations to add together the profits of all members of a corporate family and divide those profits among the states according to the level of business activity conducted in each state. It shuts down the use of several common tax avoidance strategies employed by large, multi-state corporations. The state Division of Taxation found that if combined reporting were now in effect, corporations would have to pay $22 million to $25 million more a year in corporate income taxes.[7]

Over the past two decades Rhode Island has enacted various tax cuts in the hope of boosting the state economy. There were broad-based tax cuts, with the personal income tax, and more targeted reductions designed to entice wealthy people and businesses to invest in the state. It was an expensive lesson. For the reasons cited above, tax cuts just don't make the economy grow. The far better course is to devote our energies and resources to investing in schools, transportation, and other job creation building blocks that will make Rhode Island a first-class place to live and do business and to target for direct help small, entrepreneurial businesses that have the potential to grow quickly and create a significant number of jobs.

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[1] This research is summarized in Timothy J. Bartik and George Erickcek, "The Employment and Fiscal Effects of Michigan's MEGA Tax Credit Program," W.E. Upjohn Institute Working Paper No. 10-164, April 2010. See also: Robert Lynch, "Rethinking Growth Strategies," 2004, published by the Economic Policy Institute. Area Development Magazine, "8th Annual Consultants Survey", 2012

[2] Michael Mazerov: "Cutting State Corporate Income Taxes is Unlikely to Create Many Jobs", Center on Budget and Policy Priorities, September 14, 2010

[3] Andrew Phillips, et al (Ernst and Young), "Total State and Local Business Taxes: State-by-State Estimates for Fiscal Year, 2012," Council on State Taxation, July 2013.

[4] Rhode Island Division of Taxation, Business Corporations Tax – Statistics of Income All Returns – Tax Year 2012. http://www.tax.ri.gov/reports/index.php.

[5] Marcelo, Phil (2013, March 20). Jobs credit halves taxes paid by CVS. *Providence Journal*, Providence, R.I.

[6] November Revenue Estimating Conference, November 2013.

[7] State of Rhode Island Department of Revenue, Division of Taxation. Tax Administrator's Study of Combined Reporting. March 15, 2014.