CALIFORNIA BUDGET PROJECT

budget brief

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PROPOSITION 24: SHOULD THE STATE REVERSE RECENT BUSINESS TAX BREAKS TO MOVE THE BUDGET TOWARD BALANCE?

As part of the September 2008 and February 2009 budget agreements, the Legislature approved three permanent business tax reductions that, once fully implemented, will cost the state $1.3 billion or more per year. Proposition 24, which will go before the voters in November 2010, would repeal the three tax breaks. These tax breaks are distinguished by their cost, by the fact that they were approved at a time when the state faced enormous and ongoing budget shortfalls, and by the fact that most of the benefits would go to a tiny handful of corporations that will receive large tax breaks. Proposition 24 is sponsored by the California Teachers Association. This *Budget Brief* examines the three tax provisions that would be repealed and specific policy issues related to each, as well as issues related to the measure as a whole.

What Would Proposition 24 Do?

Proposition 24 would reverse the three permanent changes to California's tax laws, specifically:

- **Elective single sales factor apportionment.** Legislation approved in February 2009 allows multistate and multinational corporations to choose between two methods for determining the share of their profits that would be taxed in California beginning in 2011. Traditionally, California used a three-factor formula that takes into account the share of a corporation's property, payroll, and sales that are located in California. Under the recent change, corporations could choose to be taxed solely on the share of their sales that occur in California. Proposition 24 would require businesses to use the "double-weighted" sales formula that was in effect prior to February 2009.
- **Tax credit transfers.** Legislation approved in September 2008 allows corporations to transfer tax credits among members of a combined reporting group – a commonly controlled corporate "family." This provision applies only to corporate taxpayers and to both newly earned and previously accrued credits. Transferred credits could be used to reduce taxes beginning January 1, 2010. Previously, only a corporation earning a tax credit could claim that tax credit. Proposition 24 would reinstate the prior policy.
- **Net operating loss carrybacks.** A September 2008 law change allows businesses to "carry back" and deduct losses incurred against taxes in a prior year. Net operating loss (NOL) carrybacks allow businesses to claim refunds of taxes already paid in the prior two years by claiming a tax deduction if they incur a NOL. California previously allowed businesses to "carry forward" and deduct operating losses against future income. The September 2008 law allows businesses to carry back half of any loss incurred in 2011, 75 percent of any loss incurred in 2012, and 100 percent of any loss incurred beginning in 2013. The same law also extended the length of time businesses could carry losses forward and use NOL deductions from 10 to 20 years.[1] Proposition 24 would restore the 10-year carryforward period.[2]

What Impact Would Proposition 24 Have on the Budget?

Proposition 24 would repeal the three tax breaks, thereby preventing the loss of revenues from the state's General Fund. The Legislative Analyst's Office estimates that 2012-13 revenues would increase by $1.3 billion, with smaller increases in 2010-11 and 2011-12. Over half of the increased revenues would be attributable to the repeal of elective single sales factor (SSF) apportionment. Proposition 24 would repeal elective SSF and NOL carrybacks before these provisions take effect. It would also prevent businesses from entering into new agreements to share tax credits. The impact on previously signed agreements is uncertain.

Under current law, the Franchise Tax Board (FTB) estimates that adoption of:

- Elective SSF apportionment would reduce state revenues by $160 million in 2010-11, with the cost rising to $850 million in 2015-16;
- NOL carrybacks would reduce 2010-11 revenues by $30 million, with the cost rising to $530 million in 2013-14; and
- Tax credit sharing would reduce 2009-10 revenues by $80 million, with the cost rising to $415 million in 2015-16.[3]

Long-term forecasts released by both the Legislative Analyst's Office (LAO) and the Governor's Department of Finance (DOF) project that the state will face significant budget shortfalls for the foreseeable future. The DOF, for example, forecasts a shortfall of $6.3 billion in 2011-12, falling to $3.1 billion in 2013-14 even if all of the reductions proposed in the Governor's May Revision are enacted.[4] The LAO's forecast, prepared in November 2009, projected gaps of more than $15 billion per year through 2014-15.[5] Both of these estimates assume that the three tax provisions that would be repealed by Proposition 24 remain in effect.

How Would the Three Tax Breaks Work?

Elective Single Sales Factor Apportionment

California's corporate income tax taxes the income generated by corporate activity that is attributable to California. For corporations that only do business within the state, determining the income that is subject to state tax is straightforward – all of the income earned is taxed in California. For multistate and multinational corporations, determining the amount of income that is attributable to California is more complex. States traditionally used a formula that "apportioned" or allocated income based on the percentage of a corporation's total property, payroll, and sales within a given state. California used this approach prior to 1993. In 1993, California shifted to a formula that gave twice as much weight to the fraction of sales that occur within the state. This approach is called "double weighting" the sales factor.[6] Take, for example, a business with 40 percent of its property and payroll in California, but only 25 percent of its sales within the state. Prior to the recent change, 32.5 percent of the corporation's net income ("profits") would be allocated to California:

Net Income x (property factor + payroll factor + 2 x sales factor) / 4 =

Net Income x (0.40 + 0.40 + 2 x 0.25) / 4 = Net Income x 0.325

Under elective SSF apportionment, a corporation could choose to have 25 percent of its profits taxed in California, by choosing the formula solely based on the percentage of sales that occur in California. Corporations would also be allowed to change back and forth from one formula to the other as often as they wished.

Supporters of elective SSF apportionment argue that it rewards corporations with a disproportionate share of payroll and/or property in California. Critics argue that only one other state – Missouri – allows corporations to choose between multiple apportionment formulas on a year-by-year basis and that there is no evidence that states with SSF apportionment have stronger economies than those without.[7]

Who Would Benefit From Elective SSF Apportionment?

Estimates prepared by the FTB show that the benefits of SSF apportionment would be concentrated among a very few, very large corporations:

- Only 1.2 percent of the state's corporations would benefit from elective SSF at a cost of $850 million in 2015-16.
- Nine corporations – 0.001% of all California corporations – would receive tax cuts of more than $20 million – nearly one-third of the total cost of SSF apportionment (Figure 1).[8] These nine corporations would receive an average tax reduction of $29.3 million per firm. An additional 13 corporations' tax bills would be reduced by $10 million to $20 million.
- SSF apportionment would overwhelmingly benefit California's largest corporations; 80 percent of the benefits would go to companies with gross receipts in excess of $1 billion (Figure 2). These beneficiaries account for just 0.1 percent of all California corporations. Ninety-five percent of the benefits would go to 0.3 percent of the state's corporations.
- Twenty-eight utility corporations would receive tax cuts averaging $1.5 million per firm. This is significant since

How Should States Tax Corporate Income?

The US Constitution allows states to tax the portion of a business' income that has a rational relationship to that business' activities within a state and that is fairly attributable to the business' income-generating activities within the state.[9] For corporations that only operate within a single state, determining how much income to tax is easy: all of a firm's income is taxed in the state where it is located and conducts all of its activities. For firms that do business in multiple states and/or countries, the determination is more complex. Most states use a process known as "formulary apportionment." Formulary apportionment simply means that a formula is used to determine what share of a business' income should be taxed by an individual state or nation.

The earliest formulas for apportioning, or allocating, income were based solely on the share of a business' property located within a state. Some formulas also included a "payroll factor" that looked at the share of compensation within a state. The choice of these two factors reflected the services – public safety, highways, the judicial system, schools, and universities – that businesses benefitted from by virtue of locating in a specific place. The use of property and payroll had the effect of allocating income to states where production activities took place. A sales factor was added to the formula to reflect the market where income-generating sales took place, originally to satisfy the interests of "destination" states where sales took place that would have had little basis to tax using a property and payroll based formula. The prevalence of a three, initially evenly weighted, factor formula dates to at least the 1940s when the National Tax Association "gave the states what the political situation seemed to demand: a three-factor formula … with each factor accounting for one-third of the total weight."[10]

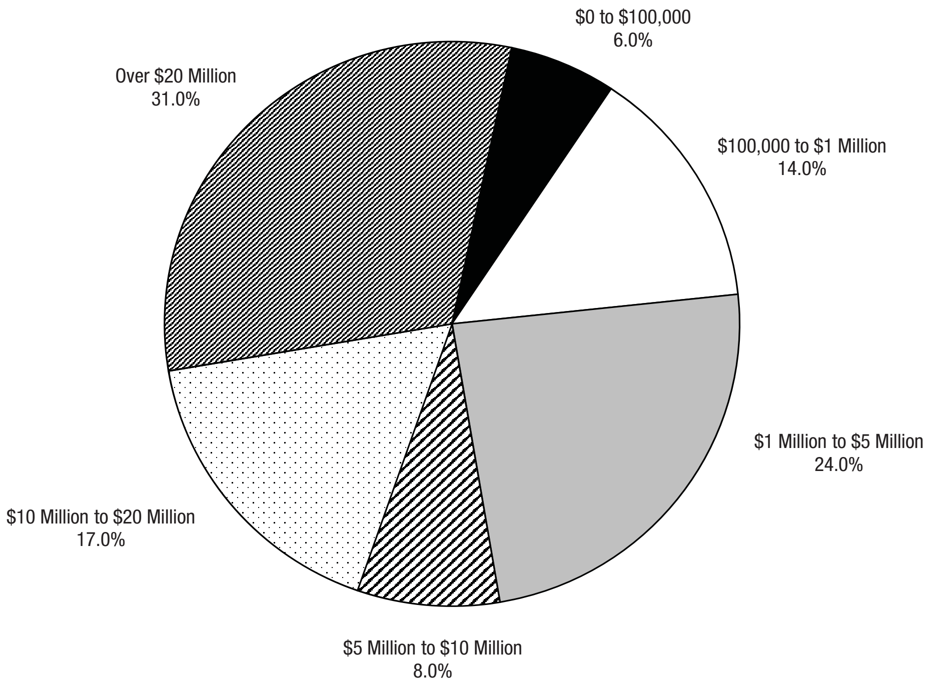
A set of rules, the Uniform Division of Income for Tax Purposes Act (UDITPA), initially developed in 1957 provides the framework for allocating income among states with corporate income taxes.[11] Over time, some states have moved away from the three, equally weighted factor formula towards formulas that more heavily weight or "superweight" the sales factor. Changes in the formula used to apportion income typically create winners and losers. A double-weighted or single sales factor formula, for example, increases taxes on corporations whose sales factors are greater than the average of their property and payroll factors. The precise impact, however, depends on the mathematical relationship between the share of a specific firm's payroll, property, and sales. Nearly all states that have adopted a superweighted sales formula, except California and Missouri, have applied that formula to all corporations.[12] A mandatory superweighted sales formula raises the taxes on some firms, while reducing taxes for firms that have disproportionate shares of in-state payroll and property. States have adopted the mandatory approach to provide both a carrot and a stick: the carrot of lower taxes for firms that locate in state and export out-of-state and the stick of higher taxes for firms that exploit the state's market by selling into the state without locating a proportionate share of business activities in the state. California's elective SSF formula created winners, but no losers, by allowing businesses to choose which formula would be used to calculate their California tax bill.

these firms are tied to California by virtue of the service they produce and the customers they serve.

Current Law Allows Corporations To Switch Formulas Annually To Minimize Their Tax Bill

The February 2009 law change allows corporations to choose – or "elect" – the apportionment formula that they use on a year-by-year basis. The LAO notes that, "firms will benefit from being able to switch from one formula to the other depending on whether they are having a good year or a bad year."[13] In high-profit years, for example, a California-based corporation would choose SSF apportionment to minimize the amount of income subject to tax by the state. In contrast, in bad years, California-based corporations that incur a loss could choose to allocate a greater share of their income to California using the double-weighted sales factor formula, to maximize their ability to claim a NOL deduction.[14] Out-of-state corporations would do just the opposite – in good years, they could reduce their California tax bill by using the double-weighted sales formula, while in bad years, they could maximize their ability to claim loss deductions by using SSF. Corporations that operate only in California, in contrast, would have all of their income taxed by California in good years and in bad.

Figure 1: Percentage of Elective Single Sales Factor Apportionment Benefit by Size of Tax Cut

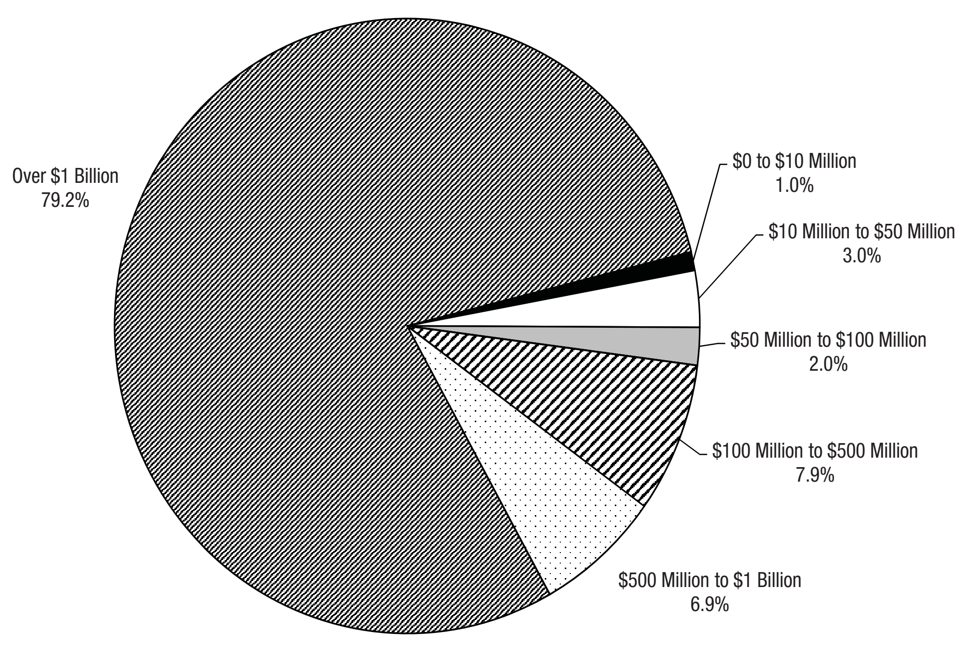


Total Cost = $850 Million in 2015-16

Source: Franchise Tax Board

Figure 2: Percentage of Elective Single Sales Factor Apportionment Benefit by Firm Size

Size of Gross Receipts



Source: Franchise Tax Board

Supporters of a Superweighted Sales Factor Are Lobbying for Federal Law Changes That Would Make It Harder for States To Tax Profits Based on Sales

Many of the corporations that have advocated for California to adopt SSF apportionment have also supported efforts at the federal level – also known as the Business Activity Tax Simplification Act (BATSA) – that would mean that the profits of particular corporations would no longer be subject to tax in particular states.[15] Taken together, these changes would substantially reduce corporate taxes paid to states in the aggregate.

Under a formula that relies mostly or entirely on sales, a corporation that produces all of its goods in one state, but has all of its customers in other states, would have minimal or no corporate income tax liability in the state where its production occurs. However, if this same corporation did not have physical presence, or nexus, for tax purposes in its customers' states, then the activities it conducted in those states would be no longer deemed nexus-creating under BATSA and most of this corporation's profit would become "nowhere income" – profit not subject to tax by *any* state.

Taken together, SSF and BATSA would significantly increase the share of corporate profits that are not subject to tax in any state. Corporate tax policy expert Michael Mazerov writes:

> "The paradox of corporate support for the single sales factor formula is that the more successful corporations are at convincing the states in which they produce their goods and services that switching to the formula is good for economic development, the more likely it is that corporations based in all the other states will convince *their* state governments that they must adopt the formula for the same reason. If every state eventually switched to the single sales factor formula, corporations would lose most their tax savings; the tax reductions in their 'production states' would be substantially offset by tax increases in their 'market states' (the states where their customers are located). … Bills like H.R. 1956 would protect a large number of corporations from the higher tax liability they would otherwise experience in their 'market states' if those states also adopted the single sales factor formula … (and) would create a situation in which a substantial share of the aggregate profits of multistate corporations would be 'nowhere income' – profit not subject to taxation by *any* state."[16]

Tax Credit Transfers

Historically, California limited the use of corporate tax credits to the corporation that actually engaged in the activity that qualified it for a credit. Corporations were not permitted to transfer or "assign" a tax credit to another entity, even if that entity shared common ownership. Tax credit sharing allows a family of corporations to transfer credits from a corporation that may not have sufficient profits to claim a credit to another corporation that has sufficient profits. The September 2008 policy change allows taxpayers to share credits with other corporations that are related – members of the same combined reporting group, in tax terminology.[17] This change would apply to credits earned on or after July 1, 2008 or credits earned in prior years that are eligible to be carried forward into years beginning on or after July 1, 2008. Shared credits could be claimed for tax years beginning on or after January 1, 2010. This change in state law applies only to corporate taxpayers. Federal tax law does not allow sharing of tax credits among members of a commonly controlled group.

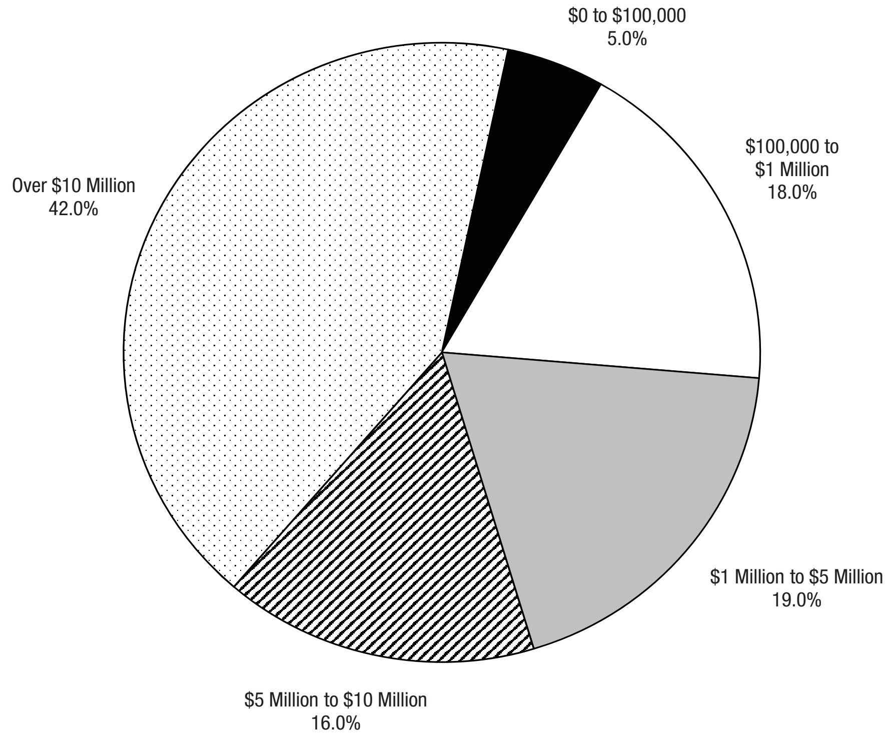
Proponents of Proposition 24 argue that allowing businesses to transfer tax credits encourages businesses to engage in activities that would not be cost-effective absent a tax preference and increase the revenue loss from the state's existing, and oftentimes very generous, tax credits. Moreover, proponents note that current law allows corporations to sell credits to another entity within a combined reporting group. Critics argue that this increases the likelihood that firms will engage in credit-generating activities that would not be worthy investments in the absence of a tax preference. Opponents argue that many corporations lack sufficient profits to use the tax credits they have accrued and that the ability to transfer credits "unlocks" the credits that would otherwise go unused.

Who Would Benefit From Tax Credit Transfers?

The benefits of tax credit sharing would be extraordinarily concentrated among a very few, very profitable firms.

- Only 0.3 percent of the state's corporations would benefit from tax credit transfers at a cost of $415 million per year in 2015-16.
- Six corporations – 0.001 percent of all California corporations – would receive tax breaks of more than $10 million from credit sharing (Figure 3). These tax breaks, which would average $29.1 million per firm, would cost the state a total of $174 million. An additional eight corporations would receive tax breaks of $5 million to $10 million per firm at a cost of $66 million.

Figure 3: Percentage of Credit Transfer Benefit by Size of Tax Cut



Source: Franchise Tax Board

- Credit sharing would also benefit California's largest corporations. Nearly nine out of every 10 dollars (87.0 percent) of revenues lost due to this provision would go to 229 firms – 0.03 percent of California corporations – that have gross receipts in excess of $1 billion (Figure 4).

Who Should Benefit From Tax Credits?

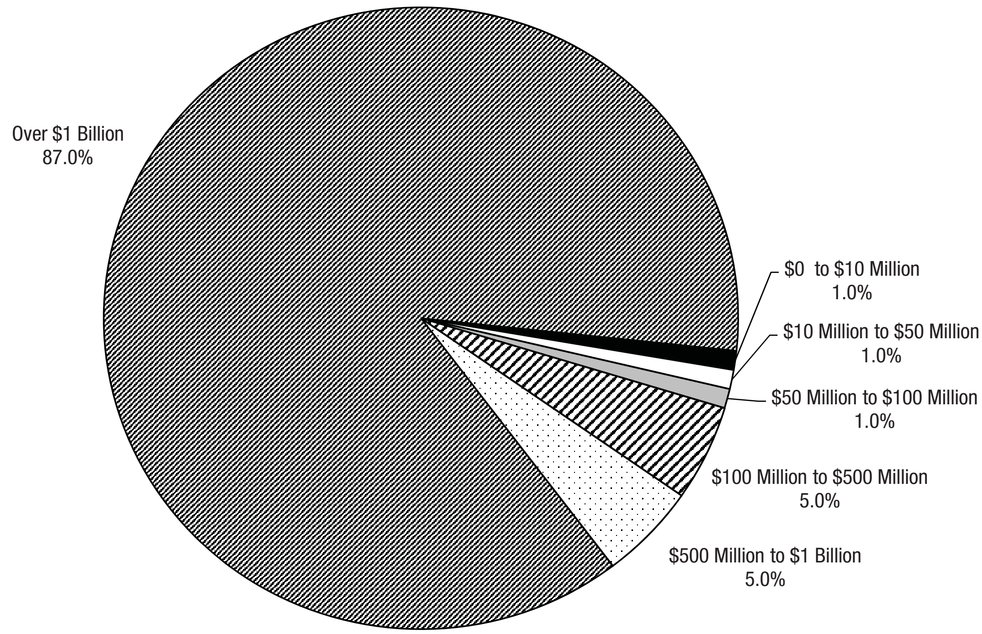
California's prior restrictions on the use of tax credits was based on the belief that tax credits should be used to encourage businesses to engage in specific types of activities, such as research and development, or invest in particular areas, such as enterprise zones, and that allowing broader use of credits would encourage businesses to shelter income from activities that were totally unrelated to activity related to a credit. Opponents of Proposition 24 argue that many tax credits go unused because corporations lack sufficient profits to utilize fully the credits that they have earned. Supporters argue that the risk the credits will not be fully used is factored into the size of the state's credits – which are often larger than comparable credits in other states – and that the purpose of a credit is to reduce taxes paid on income related to the purpose of the credit, not taxes paid on income from an unrelated activity.

Net Operating Loss Carrybacks

California historically allowed businesses that incur a loss attributable to their business operations to carry that amount forward and deduct it in a future year, thereby reducing the income subject to tax. Over the past two decades, the amount of losses that could be carried forward and the number of years that a business could carry a loss forward have been extended on several occasions. The September 2008 law change allows businesses to carry back half of any loss incurred in 2011, 75 percent of any loss incurred in 2012, and 100 percent of any loss incurred beginning in 2013. The same law also extended the length of time businesses could carry losses forward and use NOL deductions from 10 to 20 years.[18] Proposition 24 would eliminate businesses' ability to claim refunds of prior years' taxes through the use of NOL deductions and would restore the 10-year carryforward period. The new law applies to businesses that file as either a corporation or a personal income taxpayer. Currently, a minority of states with corporate income taxes allow NOL carryback deductions. Twenty-five states and the District of Columbia allow carryforwards, but not carrybacks, while 19 states allow carrybacks.[19]

Figure 4: Percentage of Credit Transfer Benefit by Firm Size

Size of Gross Receipts



Source: Franchise Tax Board

A NOL deduction reduces the amount of income that is subject to tax. For a corporation, a $1 million NOL deduction translates into $88,400 in lower taxes ($1 million x the 8.84 percent corporate tax rate). For businesses that file as personal income taxpayers, a $100,000 NOL deduction translates into a $9,300 tax reduction for filers with incomes in the top personal income tax bracket ($100,000 x the 9.3 percent top personal income tax rate).[20]

Who Would Benefit From NOL Carrybacks?

While the benefits of NOL carrybacks will be more broadly distributed than those of SSF apportionment or credit sharing, estimates prepared by the FTB show that most of the revenue loss attributable to NOL carrybacks would go to relatively few taxpayers with extraordinarily large losses. Sixty percent of the cost of NOL carrybacks would go to 0.23 percent of the businesses claiming carryback deductions for losses in excess of $5 million (a $5 million loss translates into a tax reduction of $442,000). In contrast, 83 percent of the carrybacks would be claimed by businesses with losses of less than $50,000, an amount that translates into a tax reduction of no more than $4,420. Overall:

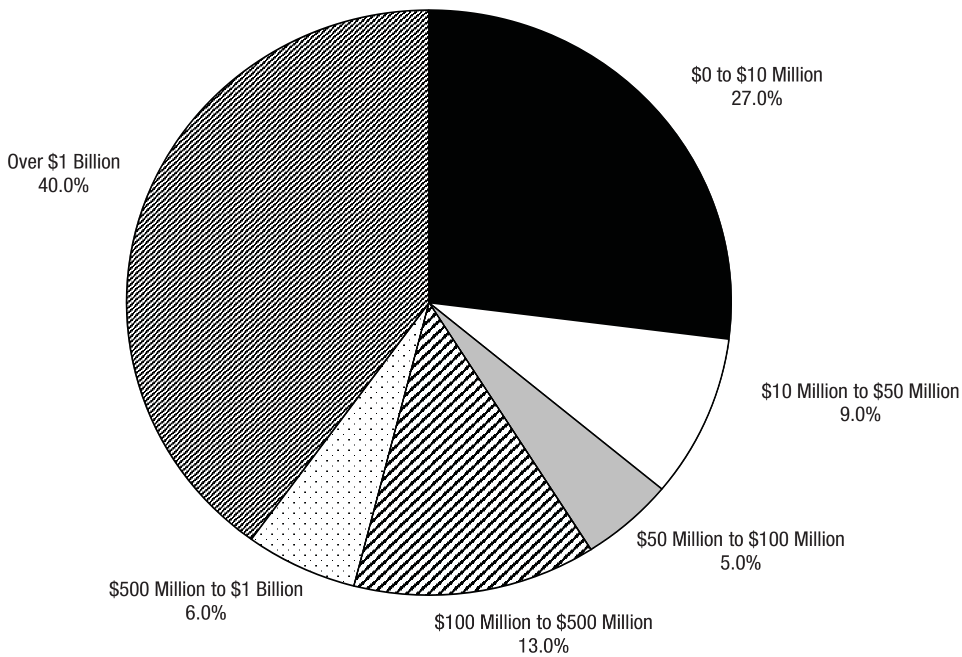
- About one-sixth of the state's corporations would benefit from NOL carrybacks, along with an unknown number of businesses that file as personal income taxpayers.
- More than one-quarter (28 percent) of the benefits of loss carrybacks would go to firms that claim deductions in excess of $100 million. At the state's 8.84 percent corporate tax rate, a deduction of $100 million would offset the tax on $1.1 billion of profits.
- Corporations with gross receipts in excess of $1 billion would claim four out of every 10 dollars of loss carryback deductions (Figure 5).
- Almost one-quarter (23 percent) of the benefits of NOL carrybacks would go to holding companies. Real estate firms would claim 11 percent of the benefits and banks, savings and loans, and other financial corporations would receive an estimated 16 percent of the benefits.[21]

How Would the Elimination of Carrybacks Affect Losses Incurred During the Recent Downturn?

The September 2008 law change only applies to losses incurred in tax years beginning on or after January 1, 2011. Proposition 24 would have no impact on businesses' ability to claim deductions for losses incurred prior to that date. Moreover, to claim a NOL carryback deduction, a business would need to have made a profit during one of the prior two years. Thus, a business that incurs a loss in 2011 – the first year that NOL carryback deductions are allowed – would claim that deduction in 2012, after the close of the 2011 tax year, against income earned and

Figure 5: Percentage of NOL Carryback Deductions by Firm Size

Size of Gross Receipts



Source: Franchise Tax Board

taxes paid in 2010 or 2009. Similarly, the elimination of NOL carrybacks would not affect "startups," since new firms would not have earned a profit in a prior year against which they could deduct a loss. If the voters approve Proposition 24, new and existing businesses would retain the ability to carry their losses *forward* and deduct them against profits earned in future years.

NOL Carrybacks Require the State To Refund Taxes That Have Already Been Spent Through the Budget

While elective SSF apportionment and tax credit sharing would reduce state tax revenues in the year that they are owed, NOL carrybacks would have a different impact on the state budget – one that raises particular policy concerns. As noted above, businesses claiming NOL carrybacks would do so by filing for a refund of taxes paid in a prior year. Specifically, businesses could "look back" and use a NOL carryback deduction to reduce taxes paid during the two prior years.[22] For example, a business with a loss for the 2015 tax year that paid taxes in the prior year could claim a refund of some or all of the taxes it paid in 2013 or 2014 by filing an amended tax return that reflected the deduction of the 2015 loss. The ability to do so raises a number of important fiscal considerations for the state including the fact that taxes paid by the business in the example above would have been spent through the budget. Businesses are most likely to claim NOL carrybacks during an economic downturn, when state revenue collections are likely to be depressed. Thus, carrybacks would have the effect of magnifying the impact of a downturn on business tax revenues, since revenue collections would be depressed due to both the impact of a downturn as well as the requirement to refund taxes paid in a prior year when the economy was strong.

The interaction between NOL carrybacks and the state's school spending guarantee is particularly perverse. NOL carrybacks would reduce revenues that supported a level of school spending used to calculate the spending guarantee for the next fiscal year. The state would then be required to continue that higher level of spending in a subsequent year when a carryback deduction was claimed to obtain a refund on previously paid taxes.

When businesses carry back a NOL deduction, they file an amended tax return and claim a refund of taxes paid in a prior year – taxes that were already collected and taxes that were spent in the year that they were owed. The magnitude of the revenue loss attributable to loss carrybacks – over $500 million at full implementation – is significant. The impact of loss carrybacks is particularly troublesome because businesses are likely to claim NOL deductions in bad budget years based on profits earned and taxes paid in prior good economic times. Thus, allowing businesses to claim tax deductions for prior years will likely exacerbate California's persistent budget problems. Loss carryback deductions will cost the state an estimated $30 million in 2010-11, with the cost rising to $530 million in 2013-14 and similar amounts thereafter. tax cuts averaging $7.6 million.

Double Dipping

A number of firms would benefit from more than one of the three tax breaks that would be repealed by Proposition 24. According to estimates from the FTB, once the three tax breaks are fully implemented, about one-third of the cost – $420 million – would be attributable to 210 "double-dippers" – corporations that will benefit from both elective SSF apportionment and the ability to share tax credits among members of a combined reporting group. Of this group:

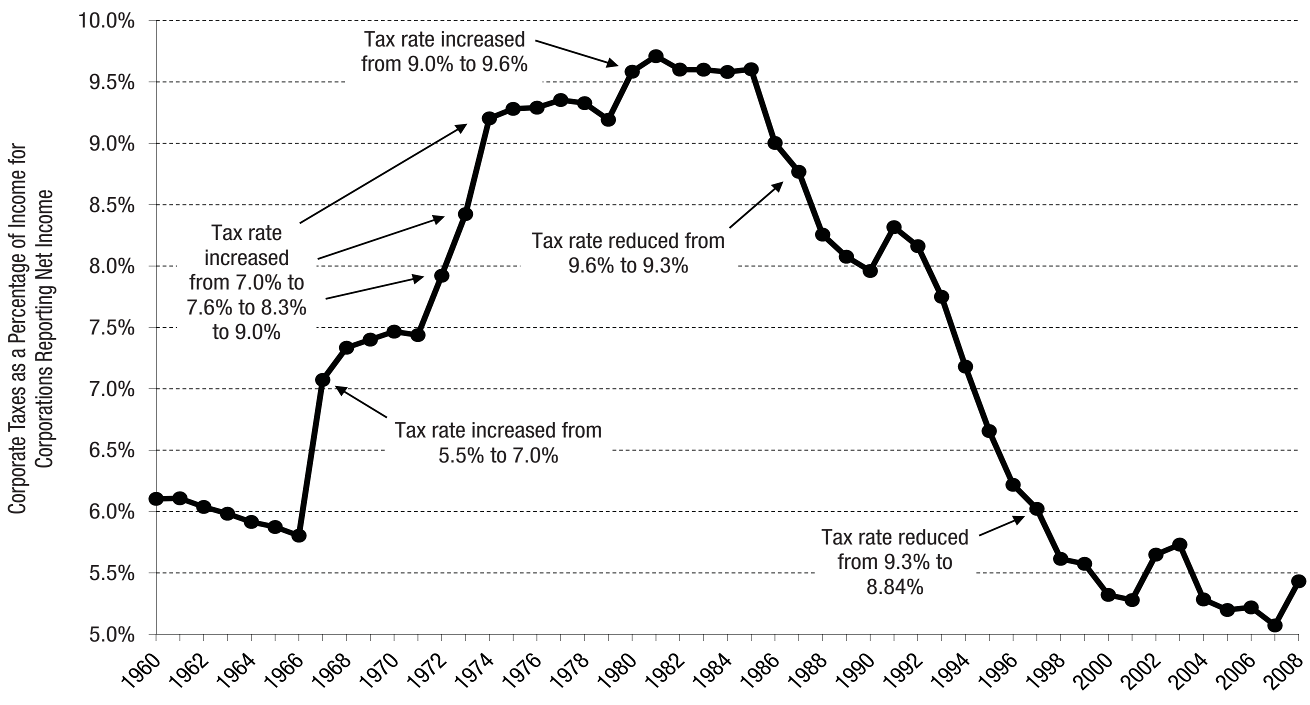
- Ten corporations – 0.001 percent of the state's corporations – would receive combined tax breaks in excess of $20 million each per year, with an average tax cut of $24.8 million per year.
- 95 percent of the benefits of double-dipping ($399 million) would go to 79 corporations with annual gross receipts in excess of $1 billion. These extraordinarily large corporations would receive average annual tax cuts of $5.1 million.
- While about half (54 percent) of the benefits of double-dipping would go to 145 manufacturing firms, 17 retail and wholesale trade corporations would see their tax bills reduced by an average of $1.5 million each per year, and 21 information technology corporations would receive annual tax cuts averaging $7.6 million.

Corporate Tax Payments Have Fallen as a Share of Profits and of State Revenues

Over the past three decades, corporate income tax revenues have declined substantially as a share of corporate profits and as a share of state General Fund revenues (Figure 6 and Figure 7). At the same time, profits reported for state tax purposes have increased significantly (Figure 8). The drop in corporate tax payments as a share of profits and state revenues reflects legislated policy changes as well as aggressive tax planning.[23] As corporate tax payments have declined as a share of General Fund revenues, personal income tax revenues' share of the General Fund has increased.[24]

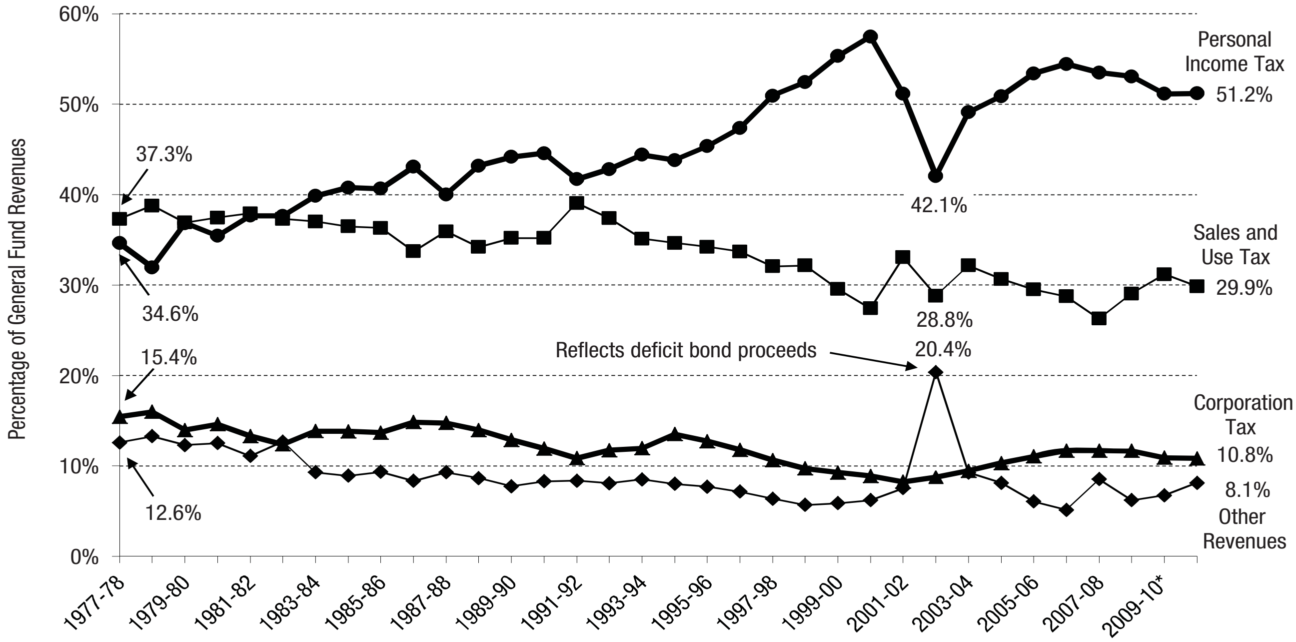
Corporate income tax payments as a percentage of corporate profits have fallen by nearly half since 1981. While tax payments as a share of profits increased in 2008 – in part due to a sharp

Figure 6: The Share of Corporate Income Paid in Taxes Has Fallen by Nearly Half Since 1981



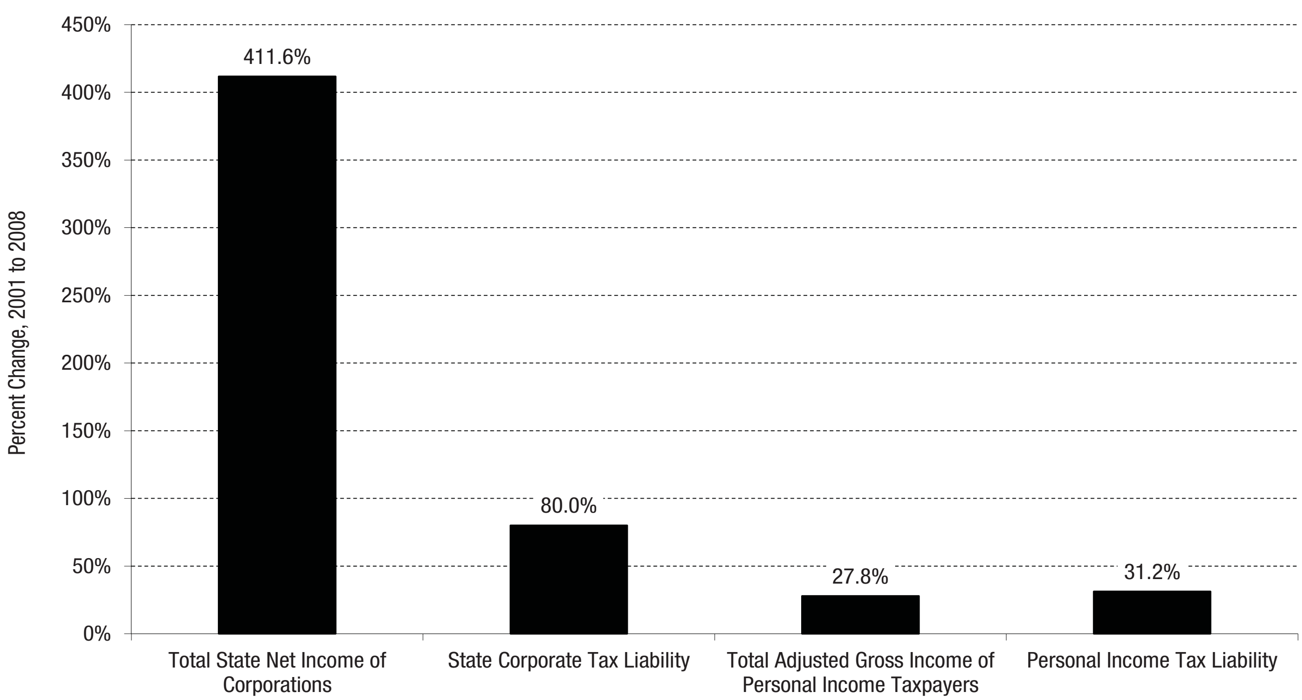
Source: Franchise Tax Board

Figure 7: Corporate Income Tax Revenues Have Dropped Substantially as a Share of the Budget



* 2009-10 estimated and 2010-11 projected.
Note: Excludes loans and transfers.
Source: Legislative Analyst's Office

Figure 8: Recent Growth in Corporate Profits Has Outpaced Growth in Corporate Tax Payments



Source: Franchise Tax Board

drop in profits due to the economic downturn – they remained lower than at any time during the 1960s, 1970s, 1980s, or 1990s. Moreover, this drop does not reflect a reduction in corporate profits. Between 2001 and 2008, the FTB reports that the total net income of corporations reported for California tax purposes rose by 411.6 percent, while corporate tax payments increased by just 80.0 percent. In contrast, the total adjusted gross income of personal income taxpayers increased 27.8 percent during the same period, while personal income tax liability increased by 31.2 percent.

No Free Lunch

A recent CBP *Brief* noted that, "some proponents of tax cuts argue that reducing taxes could spur economic growth and cause a net increase in state tax revenues" and concluded that "these claims fail to hold up under scrutiny."[25] While no independent assessment of the impact of the three provisions addressed by Proposition 24 is available, findings of other studies looking at the impact of corporate tax reductions provides some evidence of the likely impact of these three provisions and their repeal on the budget and the state's economy.

In the mid-1990s, the state's DOF developed a "dynamic revenue analysis" model.[26] This model was designed to assess the direct, indirect, and behavioral impact of tax changes on state revenues. Specifically, the dynamic model took into account the impact of tax policy changes on state spending, as well as the "feedback" impact on consumer spending, investment, and employment.[27] The DOF estimated that a corporate income tax reduction with a $1 billion direct impact on state revenues would result in an $816 million revenue loss after taking into account the indirect and "feedback" impacts of the tax reduction.[28] Thus, while the tax cut would result in some additional economic activity, the amount of that activity is far less than what would be needed to offset the revenues lost because of the tax cut.

Other analyses of national policy proposals suggest that business tax cuts are a costly and ineffective tool for stimulating economic growth. A recent research report by Princeton economist Alan Blinder, former Vice Chairman of the Board of Governors of the Federal Reserve System, and Mark Zandi, Chief Economist of Moody's Analytics, estimated that loss carrybacks and corporate tax rate reductions resulted in the least "bang for the buck" of options considered for stimulating the national economy.[29] While the proposals examined by Blinder and Zandi are not identical to those addressed by Proposition 24, their results suggest that business tax breaks are less effective than targeted spending at encouraging economic growth. Each dollar of revenue lost due to a corporate tax rate reduction resulted in a $0.32 increase in economic growth, while each dollar of revenues lost due to loss carryback rebates resulted in a $0.22 increase in Gross Domestic Product (GDP). In contrast, a dollar spent on public infrastructure resulted in a $1.57 increase in GDP, and a dollar spent on increased food stamp benefits resulted in a $1.74 increase in GDP.[30]

Do Business Tax Breaks Promote Economic Growth?

Opponents of Proposition 24 argue that repeal of the three tax cuts would be detrimental to California's "business climate," while supporters argue that the revenue loss attributable to the three tax breaks would require spending reductions that would compromise the state's long-term competitiveness by reducing support for education and other public investments. Independent research concludes that business tax breaks have little impact on job creation and may reduce, over time, states' economic competitiveness by limiting resources available for education, infrastructure, and other public investments. While a comprehensive review of the literature is beyond the scope of this *Brief*, recent studies examining links between taxes and business location conclude that:

- "More recent surveys – those conducted since the dramatic rise of anti-tax sentiment in the early 1980s – have tended to suggest that taxes and tax incentives do play some role in investment decisions. However, there are good reasons to view these recent surveys somewhat skeptically. Business people have an incentive to exaggerate the positive effects of tax incentives upon their investment decisions. They know that their answers may influence future public policy toward their businesses."[31] After reviewing statistical studies examining the impact of business tax incentives, the same author concludes that, "statistical and econometric studies are nearly unanimous in concluding that state and local tax incentives fail to attract a significant number of new businesses, create numerous jobs, or substantially enhance state economic performance. Some studies find that taxes have a positive economic effect, some conclude that taxes have no discernible effect, and some – particularly many of the recent studies – suggest that taxes have a negative impact on the economy. Most of the studies in the last group, however, find that the negative effect is small and dependent upon the unrealistic assumption that public spending remains constant as taxes change."[32]
- "Tax incentives cannot be expected to transform regional economies because they do little to alter the productive capacity of a region. Some modest number of jobs may be created for a time, but tax incentives and subsidies deplete the resources available for public investments that can

actually improve a region's infrastructure and increase the skills of the workforce."[33]

- "I find it difficult to be convinced that taxes are an important factor in explaining differences in business location decisions and economic activity between states or regions. … I have seen firsthand state policymakers grasping for straws. I simply do not think that the evidence allows us to comfortably advise lawmakers that reducing the corporate income tax rate or the personal income tax rate will revive a flagging state economy."[34]

Even studies that find some positive linkage note that jobs come at a high cost, that the net impact on public revenues will be negative, and that other types of investments can have a larger impact on regional economies:

- "In short, state and local tax cuts and incentives are not effective for stimulating economic activity or creating jobs in a cost-efficient manner. On the contrary, by forcing reductions in public services, tax cuts and incentives may retard economic and employment growth. … Econometric studies … suggest that public services such as education and infrastructure spur economic growth and influence business location decisions."[35]
- "Research suggests that financial incentives are likely to have modest although possibly important effects on business location decisions, but at a large cost per new job. A 10% reduction in state and local business taxes will increase the long-run business activity and employment in a state, or the number of new plants choosing the state, by about 2% or 3%. While this job creation may provide significant economic benefits for state residents, this growth will not pay for itself. That is, the expansion of the tax base is insufficient to offset the loss of revenue from the business tax reduction."[36] The same study noted that, "in the long run, the annual jobs impact of universal preschool is over twice that of business subsidies."[37]

Proponents Argue

Proponents of Proposition 24 argue that the measure "ends $1.3 billion in special tax loopholes for big corporations that don't require the creation or protection of one single job in California" and that it "ensures that a few big corporations pay their fair share of state taxes at a time when the state is making drastic budget cuts to public schools, health care and public safety."[38]

Opponents Argue

Opponents of Proposition 24, largely businesses and business trade associations, argue that the measure "would reverse recent state tax updates that are desperately needed to grow our economy and put Californians back to work" and that "it would take us a giant step backward on California's road to economic recovery."[39]

Conclusion

The fundamental policy choice raised by Proposition 24 is whether the state should continue to provide three large tax breaks to businesses at a time when budget shortfalls are projected for the forseeable future. Voters should consider how the state could best use the resources in question – approximately $1.3 billion at full implementation – to promote the economic well-being of all Californians.

Jean Ross prepared this Budget Brief. *This* Budget Brief *is designed to help voters reach an informed decision based on the merits of the issues. The CBP was founded in 1994 to provide Californians with a source of timely, objective, and accessible expertise on state fiscal and economic policy issues. The CBP engages in independent fiscal and policy analysis and public education with the goal of improving public policies affecting the economic and social well-being of low- and middle-income Californians. General operating support for the CBP is provided by foundation grants, subscriptions, and individual contributions. Please visit the CBP's website at www.cbp.org.*

ENDNOTES

[1] The same bill also suspended businesses' ability to claim NOL deductions in 2008 and 2009 and extended the period of time losses earned in 2008 could be carried forward by one year and extended the period of time losses earned prior to 2008 could be used for two years. The suspension did not apply to businesses with net income subject to tax of less than $500,000.

[2] The September 2008 law change extended the carryforward period for losses incurred in 2008 by one year and the carryforward period for losses incurred prior to 2008 by two years. Proposition 24 would not affect this extension.

[3] Franchise Tax Board, *Impact of 2009 Budget Legislation* (December 4, 2009) and *Revenue Impact of September 2008 Budget Legislation* (November 25, 2009). The interaction between NOL carrybacks and tax credit sharing would reduce the combined revenue loss from these two provisions by $35 million in 2010-11, $105 million in 2011-12, and smaller amounts thereafter. Some estimates have suggested that the loss from elective SSF could be much larger; see, for example, Senate Floor analysis of ABX3 15 (February 14, 2009) downloaded from http://www.leginfo.ca.gov/pub/09-10/bill/asm/ab_0001-0050/abx3_15_cfa_20090214_174915_sen_floor.html on September 8, 2010, which stated that "the estimated annual revenue loss will be approximately $700 million, eventually growing to $1.5 billion."

[4] Department of Finance, *General Fund Multi-Year Projection at 2010-11 May Revision,* downloaded from http://www.dof.ca.gov/reports_and_periodicals/documents/General_Fund_Multi-Year_Projection_at_2010-11_May_Revision.pdf on September 8, 2010. For a review of the Governor's May Revision proposals, see California Budget Project, *Governor Releases May Revision With, As Promised, "Absolutely Terrible Cuts," No Tax Increases* (Updated May 19, 2010).

[5] Legislative Analyst's Office, *The 2010-11 Budget: California's Fiscal Outlook* (November 2009), p. 6 downloaded from http://www.lao.ca.gov/2009/bud/fiscal_outlook/fiscal_outlook_111809.pdf on September 8, 2010.

[6] The 1993 shift to double-weighted sales and 2009 shift to SSF apportionment exempted firms in certain industries, including agriculture; savings and loans; banking; financial services; and extractive industries, including oil refining. Firms in these industries are required to use the equally weighted three-factor formula.

[7] Currently 17 states use SSF; three states – including California – have enacted but not yet implemented SSF apportionment. Fifteen states use the double-weighted formula currently used in California, eight use the traditional equally weighted three-factor formula, and five have no corporate income tax. Utah allows corporations to choose between two formulas, but requires the choice – known as an election – to be made for a period of five years. See Legislative Analyst's Office, *Reconsidering the Optional Single Sales Factor* (May 26, 2010). For an extensive discussion of the issues related to SSF apportionment, see Michael Mazerov, *The "Single Sales Factor" Formula for State Corporate Taxes: A Boon to Economic Development or a Costly Giveaway?"* (Center on Budget and Policy Priorities: September 2005).

[8] This and all subsequent estimates of the benefits by firm size, tax reduction, and industry are based on the 2015-16 revenue loss.

[9] This review draws heavily on material presented in Richard D. Pomp, *State and Local Taxation, 6th ed., Vol. 2* (2009), pp. 10-1 – 10-52.

[10] Richard D. Pomp, *State and Local Taxation, 6th ed., Vol. 2* (2009), pp. 10-13 – 10-14 and Legislative Analyst's Office, *Reconsidering the Optional Single Sales Factor* (May 26, 2010), p. 11.

[11] Richard D. Pomp, *State and Local Taxation, 6th ed., Vol. 2* (2009), p. 10-1.

[12] California's double-weighted sales factor formula applied to all corporations except those in specifically excluded industries, as noted above.

[13] Legislative Analyst's Office, *Reconsidering the Optional Single Sales Factor* (May 26, 2010), p. 9.

[14] Net income can be a positive or a negative number. A business that paid taxes in a prior year, but then incurred a loss, might wish to allocate a greater share of its losses to California to increase the size of the NOL carryback deduction that it could claim in order to maximize its refund of taxes paid in one of the prior two years.

[15] Supporters of BATSA have included the American Electronics Association, Apple Computer, Cisco Systems, the Motion Picture Association of America, and the Walt Disney Company.

[16] Michael Mazerov, *Federal "Business Activity Tax Nexus" Legislation: Half of a Two-Pronged Strategy to Gut State Corporate Income Taxes* (Center on Budget and Policy Priorities: November 30, 2005), p. 8.

[17] The budget agreement also limited the use of business tax credits to no more than 50 percent of the tax owed. Prior to this change, which applies to the 2008 and 2009 tax years, businesses could offset as much as all of their tax liability with credits. To offset the impact of this limit, the length of time businesses can carry tax credits forward was extended by two years. The limitation does not apply to businesses with taxable incomes of less than $500,000.

[18] The same bill also suspended businesses' ability to claim NOL deductions in 2008 and 2009, extended the period of time losses earned in 2008 could be carried forward by one year, extended the period of time losses earned prior to 2008 could be used for two years. The suspension did not apply to businesses with net income subject to tax of less than $500,000.

[19] Michael Mazerov, *Minority of States Still Granting Net Operating Loss "Carryback" Deductions Should Eliminate Them Now* (Center on Budget and Policy Priorities: May 11, 2009). Five states do not have corporate income taxes.

[20] In 2011, the top personal income tax rate, excluding the "millionaire surcharge," will be 9.3 percent.

[21] These estimates assume the law had been in effect in 2007. The distribution of deductions claimed by industry may vary due to the differential impact of the recent economic downturn on different industries.

[22] The ability to claim NOL carrybacks would be phased in. Businesses could use half of a NOL in 2011, and 75 percent in 2012, and the full amount of a NOL thereafter.

[23] For a review of factors contributing to the decline in corporate tax payments, see Allen Prohofsky, "Trends in California Corporation Tax Revenues," *State Tax Notes* (November 17, 2003).

[24] Sales taxes, a portion of which are paid by businesses, have also declined as a share of General Fund revenues.

[25] California Budget Project, *No Free Lunch: Tax Cuts Widen Budget Gaps* (July 2010).

[26] Department of Finance, *Dynamic Revenue Analysis for California* (Summer 1996).

[27] Jon David Vasche, *Whatever Happened to Dynamic Revenue Analysis in California?* (September 2006).

[28] Department of Finance, *Dynamic Revenue Analysis for California* (Summer 1996), p. 129.

[29] Alan S. Blinder and Mark Zandi, *How the Great Recession Was Brought to an End* (July 27, 2010).

[30] Alan S. Blinder and Mark Zandi, *How the Great Recession Was Brought to an End* (July 27, 2010). "Bang for the buck" was estimated by the one-year dollar change in Gross Domestic Product for a given dollar reduction in federal tax revenue or increase in spending.

[31] Robert G. Lynch, *Rethinking Growth Strategies: How State and Local Taxes and Services Affect Economic Development* (Economic Policy Institute: 2004), p. 22.

[32] Robert G. Lynch, *Rethinking Growth Strategies: How State and Local Taxes and Services Affect Economic Development* (Economic Policy Institute: 2004), p. 25.

[33] Jeffrey Thompson, *Prioritizing Approaches to Economic Development in New England: Skills, Infrastructure, and Tax Incentives"* (Political Economy Research Institute, University of Massachusetts, Amherst: August 2010), p. 13.

[34] Therese J. McGuire, "Do Taxes Matter? Yes, No, Maybe So," *State Tax Notes* (June 9, 2003), p. 889, downloaded from http://services.taxanalysts.com/taxbase/eps_pdf2003.nsf/DocNoLookup/13758/$FILE/2003-13758-1.pdf on September 3, 2010.

[35] Robert G. Lynch, *Rethinking Growth Strategies: How State and Local Taxes and Services Affect Economic Developmen*t (Economic Policy Institute: 2004), p. 47.

[36] Timothy Bartik, *What Works in State Economic Development,* W.E. Upjohn Institute for Employment Research, pp. 17-18, downloaded from http://www.familyimpactseminars.org/s_wifis27c02.pdf on September 3, 2010.

[37] Timothy Bartik, *What Works in State Economic Development,* W.E. Upjohn Institute for Employment Research, p. 24, downloaded from http://www.familyimpactseminars.org/s_wifis27c02.pdf on September 3, 2010.

[38] Yes on 24, The Tax Fairness Act, downloaded from http://yesprop24.org/ on September 15, 2010.

[39] No on 24, *Questions and Answers About Proposition,* downloaded from http://www.stopprop24.com/get-the-facts/frequently-asked-questions/ on September 8, 2010.