CALIFORNIA
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April 24, 2002

SHOULD CALIFORNIA ADOPT A "SINGLE SALES" FACTOR FOR DETERMINING HOW MUCH CORPORATE INCOME TO TAX?

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. For multi-state corporations, determining the income that is attributable to California is more complex. Traditionally, states have used a formula based on three equally weighted factors to apportion income among states for tax purposes. The traditional formula apportioned 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. AB 2560 (Vargas) changes the formula used to apportion income to California for tax purposes to one based solely on sales. Only five of the 45 states with corporate income taxes currently use the single sales factor approach for all corporations, an additional three use the single sales factor approach for manufacturers.[1] Eleven use the traditional formula with three equally weighted factors. Twenty-one states, including California, use a double weighted sales formula.

Proponents argue that the single sales factor would reward businesses with significant investments in property and payroll in California. They claim that a single sales factor approach would provide an incentive for businesses to increase their investment and employment in California. However, there is little evidence that states have benefited from adopting the single sales factor approach and the Franchise Tax Board estimates that it would cost the state $195 million in lost revenues in 2002-03 and increasing amounts thereafter.

WHAT WOULD AB 2560 (VARGAS) DO?

AB 2560 (Vargas) would change the formula used to allocate income to California to one solely based on sales.[2] Specifically, AB 2560 would:

- Allocate income to California based on the percentage of total sales that occur within the state.
- Allow corporations that obtain 50 percent or more of their gross income from producing, refining, or processing of oil, natural gas, or minerals to choose between using the single sales factor or the traditional three factor formula based on property, payroll, or sales. This provision would provide special treatment to these corporations by allowing them

[1] 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 2001), p. 8.
[2] This analysis is based on AB 2560 as introduced.

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to use the method that results in the lowest tax liability.

- Require a corporation to use the double weighted sales formula to apportion income if:
    - Its California payroll falls below 90 percent of the taxpayer's payroll during any of the preceding three years; or
    - The average number of the corporation's employees ***everywhere*** falls below 90 percent of the average number of employees in the state during any of the preceding three years; or
    - The percentage change in its payroll compensation or employment in California is greater than the same percentage change in each state in which the taxpayer is engaged in business. (This provision appears counter to the intent of the bill and the proponents agree that it may be misdrafted).
    - Firms could continue to use the single sales factor if they do not meet the criteria described above due to a natural disaster, terrorism, or act of federal state or local government.

Some Corporations Would Receive Sizeable Breaks, Others Would Pay Same Or More

AB 2560 would substantially reduce corporate income tax revenues. The $195 million 2002-03 revenue loss is equivalent to a 3.3 percent across-the-board reduction in corporate tax revenues. However, not all corporations would benefit equally. Only 34,554 of the 481,036 – 7.2 percent– of the corporations filing California tax returns in 1999 have multi-state or multi-national operations. The remaining 92.8 percent of the state's corporations that operate solely within California would not be affected – positively or adversely – by AB 2560.

While the net impact of AB 2560 is a corporate tax reduction, many individual corporations would pay more. A study prepared by the proponents of a single sales factor found that 5,602 corporations would pay less and 8,413 corporations would pay more.[3] While proponents claim that the single sales factor is designed to benefit California corporations, their analysis finds that 2,292 California-based corporations would be among those that would receive a tax increase is the single sales factor approach were adopted.

Winners Win Big, Losers Lose Big

The LECG study suggests that AB 2560 would result in substantial disparities between the measure's winners and losers. On balance, the 37,740 corporations that apportion income would receive an average tax break of $2,570.[4] Taxes paid by the measure's winners would fall by 24 percent ($85,505), while taxes paid by losers would increase by an average of $45,644 (26 percent).[5]

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[3] William G. Hamm and Avinash K. Verma, *Apportioning Corporate Income: If California Adopts The Single-Factor (Sales) Apportionment Formula, What Will Be The Economic And Revenue Impact?* LECG, LLC (November 16, 2001). Hereafter referred to as the LECG study.
[4] Based on 1995–1997 averages that show a net revenue loss of $96 million. A more recent estimate shows a net revenue loss of $195 million in 2002-03, rising to $275 million in 2004-05. An industry-by-industry analysis is not available for the new revenue estimate. However, the disparities are likely to be much larger.

WHY DO THE WINNERS WIN?

The winners under a single sales factor are businesses where the share of property and payroll within the state exceeds the fraction of sales within the state. Mathematically, the single sales factor method benefits businesses where the sum of the property and payroll factor exceed two times the share of sales under California's current double weighted sales formula.

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. Under current law, the share of corporate income allocated to California would be calculated as follows:

Total Profit X (property factor + payroll factor + 2 x sales factor)/ 4 =

Total Profit X (0.40 + 0.40 + 2 X 0.25)/4 = Total Profit X 0.325

Under the single sales factor approach, the firm would allocate 0.25 percent of its profits to California. For a firm with $10 million in profits, the difference would amount to a $66,300 tax reduction.

While proponents argue that the single sales factor approach will benefit California-based corporations, California-based corporations that make a substantial fraction of their sales within the state would be penalized. For example, a corporation with 25 percent of its payroll and property in California and 50 percent of its sales within the state would pay more. Under current law, this hypothetical company would allocate income as follows:

Total Profit X (property factor + payroll factor + 2 x sales factor)/ 4 =

Total Profit X (0.25 + 0.25 + 2 X 0.5)/4 = Total Profit X 0.375

Under the single sales factor approach, this corporation would allocate 50 percent of its income to California. Based on the same $10 million in profit, this company would experience an $110,500 tax increase.

Winners under a single sales factor also win when states use a variety of approaches to apportion corporate income. If all states used the single sales factor approach, there would be no competitive advantage to using this methodology, since all corporate income would be taxed based on where the sale occurred. However, when states use different methods to apportion income, situations arise where not all income is allocated for tax purposes. This phenomenon is referred to as "nowhere income." To date, corporate lobbyists have pushed for the single sales factor approach in states where they have substantial amounts of property and payroll, while there have not been efforts to make this change in states that are predominantly market states. The Ford Motor Company, for example, supported enactment of the single sales factor approach in Michigan and opposed single sales factor in Illinois. Kraft lobbied for single sales factor in Illinois, while opposing the change in Maryland. AT&T lobbied for single sales factor

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[5] CBP calculations based on Hamm and Verma.

in New Jersey, while opposing it in Oregon.[6]

DOES CALIFORNIA'S CURRENT FORMULA DISCOURAGE FIRMS FROM EXPANDING EMPLOYMENT IN CALIFORNIA?

Proponents claim that the payroll factor in California's current formula acts as a tax on wages that discourages businesses from locating employment in California and that the property factor has a similar impact on capital investment. Hamm and Verma state that the payroll factor is an "implicit tax on jobs" and further note that "states that have reduced or eliminated these taxes have become relatively more attractive to multi-state corporations as locations for new investment and new jobs, causing other states, including California, to become relatively less attractive."[7]

In fact, states that use the traditional three-factor formula outperformed states that use "super-weighted" sales formulas with respect to manufacturing employment growth between 1995 and 2001 (Table 1). While total manufacturing employment declined during this period for states that use the double weighted sales formula, manufacturing employment in California actually increased by 6.2 percent, discrediting the proponents' claim that California has become a less attractive location for job growth

Table 1: Average Percentage Change in Manufacturing Employment, 1995 - 2001	
Single Sales Factor States	-2.6%
Double Weighted Sales Factor States	-4.6%
California	**6.2%**
Traditional Three Factor States	-1.1%
All Other States With Corporate Income Taxes	-4.2%

Similarly, a survey of recent major plant location and expansion decisions suggests that states using the single sales factor do not have a distinct competitive advantage.[8] *Site Selection Magazine*, the major trade journal for industrial location decision-makers, identified 61 facility investments valued at $700 million or more made in states with corporate income taxes between 1995 and 2001. Three of the five states that used the single sales factor during this period did not attract a single major plant expansion and only eight of the 61 facilities went to states using the single sales factor. California attracted nine of the 61, the most of any state, and more than the number of expansions that located in the eight single sales factor states combined.

AB 2560 WOULD REWARD FIRMS THAT REDUCE THEIR EMPLOYMENT IN CALIFORNIA

AB 2560 includes a provision that limits use of the single sales factor to firms that maintain their California payroll at least 90 percent of the level of any of the three preceding years and

[6] Personal communication, Michael Mazerov, Center on Budget and Policy Priorities (April 23, 2002).
[7] Hamm and Verma, p. 1.
[8] Mazerov, pp. 36-37 and Site Selection Online, *2001's Biggest U.S. Corporate Facilities* downloaded from http://www.siteselection.com/issues/2002/mar/p138/side_02.htm on March 11, 2002.

maintain total employment ***everywhere*** at least 90 percent of historical levels within California. According to the measure's supporters, this provision is designed to limit the measure's benefits to "good corporate citizens" – firms that maintain jobs and payroll in California. However, under the language in the bill, a firm could substantially reduce employment in California and still qualify for reduced taxes. Take, for example, a firm with 1,000 employees in California – 990 employees with an average salary of $35,000 per year and 10 executives earning $1 million each. Assume that employees earning $35,000 per year receive annual pay increases of 3 percent, while the executives receive 10 percent annual increases. As shown in Table 2, this hypothetical company could lay off nearly two-thirds of its California workforce over a five-year period and still qualify for the tax break provided by AB 2560.

Table 2:
Firms That Engage In Systematic Layoffs
Could Claim Tax Breaks:
A Hypothetical Example

Year	Employment
1	1,000
2	810
3	648
4	503
5	372

This hypothetical example described above is similar to what happened in Massachusetts, where Raytheon, a major employer in that state, lobbied for the single sales factor for defense contractors. After the state adopted the single sales factor in 1995 at the company's urging. The Massachusetts measure required firms to keep payroll, but not employment, at 90 percent of prior levels, Raytheon laid off 3,000 Massachusetts blue-collar workers, while retaining engineers and managers. The company continued to qualify for the tax break due to increases in executive and professional worker salaries. The author of the Massachusetts legislation, State Senator Susan Fargo, has labeled the single sales factor for defense contractors "payoffs for layoffs."[9]

The Raytheon example is not unique. Black and Decker lobbied successfully for single sales factor in Maryland last year and announced 450 layoffs earlier this year. Motorola, one of the strongest proponents of the single sales factor approach in Illinois, has announced 4,800 layoffs in that state since it adopted the single sales factor method in 1998.[10] SBC Ameritech, Nalco, John Deere, and BP/Amoco all lobbied for single sales factor in Illinois and announced major layoffs subsequent to the provision's enactment.[11] In response to declining corporate tax collections, substantial layoffs among the method's proponents, and a substantial budget deficit, Illinois lawmakers are serious considering reversing their adoption of the single sales factor approach.

[9] Mazerov, p. xi.
[10] Good Jobs Illinois, *Single Sales Factor: A Bad Idea Whose Time Is Up* (April 2002).
[11] Good Jobs Illinois.

EVEN THIS PROTECTION IS MINIMAL AND HAS MAJOR LOOPHOLES

The minimal protections that proponents claim are designed to limit the benefits of AB 2560 to firms that are committed to California have a major loophole. The measure would permit firms to reduce their employment and payroll by more than 10 percent if the reason for the reduction is attributable to a natural disaster or government action. The language for this exception is vague and could be interpreted to cover virtually any government action that a corporation deemed counter to its business interests. For, example a corporation could cite the recent increase in unemployment insurance or workers compensation benefits as a government action that necessitated a reduction in employment. Similarly, a firm could claim that it reduced employment or payroll if the state or a local government increased environmental regulations or if the state or a local government failed to renew a contact for goods or services.

OIL COMPANIES WOULD HAVE THE BEST OF BOTH WORLDS

AB 2560 would allow businesses that derive at least 50 percent of their gross income from producing, refining, or processing of oil, natural gas, or minerals to chose between the current double weighted formula or the new single sales factor approach. Proponents provide no rationale for allowing one class of firms to choose the formula that results in the lowest taxes. While some might argue that these firms have assets that could not be relocated out of California, the same argument could be given for agriculture, tourism, and other industries that rely on the natural resources of California.

WOULD A SINGLE SALES FACTOR INCREASE OR DECREASE STATE REVENUES?

Proponents of the single sales factor approach contracted with the consulting firm LECG, LLC to analyze the impact of a single sales factor on state revenues and economic activity.[12] The LECG report used a version of the state's dynamic revenue model as well as a methodology developed by researchers Austan Goolsbee and Edward L. Maydew to analyze the impact of the single sales factor.[13] The LECG report claims that California would experience a substantial gain in manufacturing employment and that corporate income tax revenues would increase, rather than decrease, if the state adopts a single sales factor within a 12 month period.

These findings are counter to the experiences of other states, as cited above, and the report uses a number of extremely questionable assumptions to reach these conclusions. Specifically, the LECG report:

- ***Assumes that businesses that receive tax cuts would respond to the incentive effect of the single sales factor, while those with tax increases would not.*** The LECG analysis only looks at one side of the impact of shifting to a single sales factor – the impact on "winners" – when analyzing the effect on state revenues and ignores the

[12] Hamm and Verma.
[13] Austan Goolsbee and Edward L. Maydew, *Coveting thy neighbor's manufacturing: the dilemma of state income apportionment*, *Journal of Public Economics 75* (2000).

impact on "losers."[14] Using this assumption, LECG concludes that California would gain 5,173 jobs once the impact of the policy change is fully phased in (mid-range, with a low of 1,943 to high of 9,371).[15] A proportionate reduction in the estimate of job growth, reflecting the **net** impact on corporate tax payments results in a mid-range estimate of 906 new jobs – without taking into account any jobs that would be lost as a result of reduced corporate tax revenues (i.e., public workers who would lose their jobs or private sector workers that would lose their jobs due to lower state spending).

- ***The Goolsbee and Maydew model may not provide a blueprint for California's future.*** At the heart of the LECG report is an analysis based on employment trends in states that previously adopted a "superweighted" sales factor. The results of this analysis are then used to predict the impact on such a policy change on California. There are several problems with this approach. First, California has adopted a double weighted sales factor. This would suggest that the state has already realized some of the benefits predicted by the Goolsbee and Maydew model. Second, Goolsbee and Maydew look only at private sector employment. Thus, their model does not capture any negative impact on public sector employment – teachers, health care workers, or prison guards – that might be associated with lower corporate tax collections. Finally, as the LECG report notes, Goolsbee and Maydew have revised their analysis in response to changing state policies. The revised Goolsbee and Maydew model predicts a smaller impact on employment that does the original research. This suggests that the as more states adopt "super-weighted" sales factors, the impact on employment may diminish.[16] Finally, an examination of recent manufacturing employment trends show that states' experiences vary significantly. Between 1995 and 2001, the change in manufacturing employment among states that use the single sales factor approach ranged from a low of –9.9 percent in Missouri to a high of 4.5 percent in Nebraska. Manufacturing employment fell in four of the eight single sales factor states and rose in four. Thus, averages can be misleading and an analysis of prior trends in other states may not accurately predict what might happen in California in the future.

- ***Apportionment factors alone do not determine a business' tax burden.*** The LECG analysis assumes that the single sales factor alone will make a difference in business' location choices. State taxes constitute a small fraction of a firm's cost of doing business; estimates suggest that all state and local taxes account for approximately 2 percent of a firm's expenses. Thus even a large increase or decrease in corporate income taxes would have a minor impact on the cost of locating in a particular state. Moreover, since state corporate income taxes are deductible from a corporation's federal taxes, each dollar paid in state taxes costs $0.65 net of the interaction with federal taxes. In other words, for each $1 million the state loses in tax revenues, businesses save $650,000 in combined state and federal taxes. Other factors including wages, land, workers compensation, and transportation have a much

[14] Hamm and Verma, p. 58: "The table makes no allowance for the behavioral changes on the part of those firms that will pay more in Bank and Corporation taxes as a result of the policy change (the "losers")."
[15] Hamm and Verma, p. 57.
[16] Compare, for example, Goolsbee and Maydew (2000) to Hamm and Verma.

larger impact.

The LECG report does not attempt to compare the total costs or even the total tax burden between states with and without a single sales factor. In particular, Proposition 13's one percent property tax rate and reassessment only upon change of ownership provisions result in substantially lower property tax costs for firms, especially those that are land and capital intensive. These savings often times outweigh the impact of corporate income taxes. Studies using the representative firm approach to comparing tax burdens generally find California to be a relatively low tax location for doing business.

- ***The assumption of an immediate impact on employment and revenues is unrealistic.*** The LECG report assumes that "the policy change will have a favorable impact on General Fund revenues virtually from day one."[17] Businesses carefully evaluate major plant and investment decisions. Once made, it may take several years to acquire a site, obtain necessary environmental and land use approvals, and construct and occupy a new facility. To the extent the single sales factor does encourage additional investment, the positive effect of the policy change are likely to occur over a number of years, not immediately as the LECG report assumes. In the meantime, the state would bear the brunt of the full "static" cost of the tax reduction, without offsetting revenue increases. In fact, the fact that Goolsbee and Maydew show an immediate impact on employment suggests that there are significant problems with their methodology and that the correlations found in their analysis may be the result of other factors.

  There is no evidence that a tax reduction, such as the shift to a single sales factor, would pay for itself. The Department of Finance's (DoF) report on its dynamic revenue estimating model found that a corporate income tax change with an estimated $1 billion "static" General Fund revenue loss would result a dynamic General Fund revenue reduction of $844 million.[18] The DoF found a much smaller increase in employment than the LECG projection. Moreover, they found that "all of the increase in employment is accounted for by in-migration." In other words, none of the new jobs went to existing California jobseekers.

- ***There is no such thing as a free lunch.*** Goolsbee and Maydew, the researchers that devised the methodology used by the LECG report, concluded that the average state that adopted the single sales factor would experience an increase of approximately 11,800 manufacturing jobs. These jobs are not "new," they are jobs that are relocated from other states or that would have located elsewhere in the absence of the policy change. Goolsbee and Maydew calculate that the 11,800 increase in a state that adopts single sales factor would be offset by a reduction in jobs of other states of 12,500 for a net reduction of 700 jobs.[19] Moreover, Goolsbee and Maydew look only at the impact on private manufacturing firms in response to the shift to single sales factor. They do not take into account the impact of reduced public spending – such as fewer teachers, prison guards, or less money spent on health care services – in response to lower corporate tax revenues.

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[17] Hamm and Verma, p. 65.
[18] P. Berck, et al, *Dynamic Revenue Analysis for California*, California Department of Finance (Summer 1996), p. 129.
[19] Goolsbee and Maydew, p. 140.

- ***The race to the bottom.*** Goolsbee and Maydew admit, "state decisions negatively affect employment in other states with the aggregate effects of state apportionment changes approximately equal to zero."[20] As a result, they note "the country might be better off if the apportionment formulae were set at the federal level as in a standard race-to-the-bottom type argument by preventing the beggar-thy-neighbor changes at the state level."[21] Any beneficial impact on a state's economy from adopting the single sales factor will be diminished to the extent other states make the same change. Many observers believe that if California adopted the single sales factor approach, many, if not most, other states would follow suit. Once they did, California's competitive advantage would be lost and the state would be left with only the negative impact attributable to the loss of corporate tax revenues. Thus the benefits, which are likely to be more minimal than proponents suggest, will likely be short lived at best.

CONCLUSION

AB 2560 would significantly erode California's corporate income tax collections. Corporate income tax collections have already declined as a share of net income by 43 percent between 1981 and 1999. By reducing corporate tax collections by $195 million in 2002-03 and substantially more in future years, AB 2560 would exacerbate the state's budget crisis and worsen the structural imbalance between revenues and expenditures that has been documented by the Legislative Analyst and others.

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[20] Goolsbee and Maydew, p. 142.
[21] Goolsbee and Maydew, p. 140.