ECONOMIC DEVELOPMENT STRATEGIES, INFORMATION BRIEF 5

Using the Tax Structure for State Economic Development

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May 2016

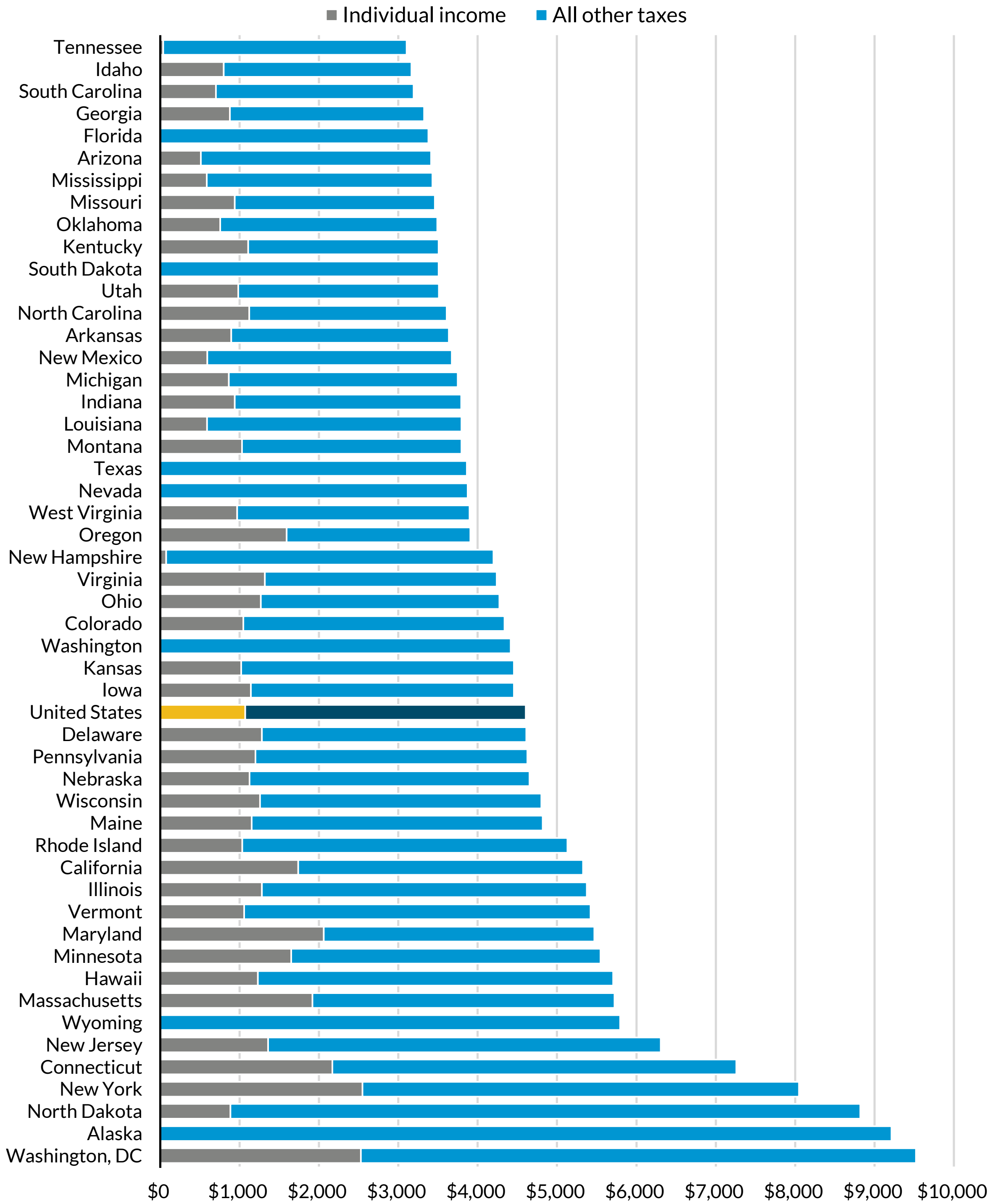
Every state uses a different combination of taxes to fund government services. Some rely more heavily on income taxes, and others see the most revenue from consumption taxes, such as general sales taxes or excise taxes on select goods. Reports that rank states by how "business friendly" they are often use tax composition as the primary—and sometimes only—criteria, implicitly suggesting there is a single best tax structure to attract businesses and strengthen economies.

But the effect of state taxes on business decisions is far more complex than just the composition of taxes. The effect of a state's tax structure on economic development includes not just the mix of taxes but specific features of those taxes as well. It also depends on the overall tax burden from the combination of different taxes levied. New Hampshire and Alaska are two of nine states without a broad-based individual income tax and two of five states without a general sales tax.[1] Rankings based only on tax structure, which usually give high marks to states without an income tax, would be favorable to New Hampshire despite its high property taxes and resultant higher than average state and local per capita tax burden (figure 1).

Moreover, as Cline, Phillips, and Neubig (2011) point out, a state's reliance on a particular tax can benefit certain businesses more than others. For example, property taxes are more burdensome to a capital-intensive company than a labor-intensive company. This disparate effect within the state, not the overall ranking, is what creates incentives for states to modify their tax structure for economic development purposes.

FIGURE 1

Per Capita State and Local Tax Revenue, by Type of Tax, 2013



Source: "State and Local Finance Data Query System," Urban-Brookings Tax Policy Center, accessed May 20, 2016, http://slfdqs.taxpolicycenter.org.

But there are risks in attempting to target tax benefits. Modifications often lead to narrower tax bases to minimize liability, often for particular industries. Because they are available to any taxpayer who fits the criteria, they are often not flexible enough for specific economic development efforts. Plus, structural incentives and modifications to a state's tax structure for economic development purposes can distort business decisions. Businesses may choose to organize in a particular way (such as a partnership or a limited liability company) simply to take advantage of a tax exemption or other preference.

A state's tax structure touches all taxpayers, not just businesses. Unlike tax incentives for economic development, which typically target an explicit purpose, composition changes affect all businesses and residents in the state. Pushing down one tax may push up another or lower funds for government services, both of which may harm economic development. Moreover, a state's tax structure often reflects historical more than contemporary policy decisions; making major reform difficult but necessary.

This brief examines state actions to affect economic development across four major types of state and local taxes: personal income taxes, corporate income taxes, sales and use taxes, and property taxes. Tax reform policies aimed at simplicity, equity, or increased revenue are not discussed here.

Personal Income Tax

Some state business climate comparison studies typically rank states without income taxes higher than states with income taxes (Keating 2016; Walczak et al. 2015). In recent years, there have been calls to reduce or repeal personal income taxes, and many states are listening. Since 2000, 20 states have reduced their top rates (table 1),[2] often to protect the competitive position of the state. When Oklahoma Governor Mary Fallin signed a 2014 bill cutting the top tax rate, she claimed, "If Oklahoma wants to attract and retain good jobs—rather than losing them to neighboring states—we must improve our tax climate."[3] Gale, Krupkin, and Rueben (2015) remind us, however, that there is little evidence that income tax cuts lead to economic growth.

TABLE 1

Reductions in Personal Income Top Tax Rate, 2000–16

	Top Personal Income Tax Rate		
	2000	2016	Year of tax reduction
Arizona	5.040	4.540	2006
Arkansas	7.000	6.000	2015
Colorado	5.000	4.630	2000
Hawaii	8.750	8.250	2016
Idaho	8.200	7.400	2012
Indiana	3.400	3.300	2015
Kansas	6.450	4.600	2012
Maine	8.500	7.150	2011
Massachusetts	5.950	5.100	2016
Michigan	4.400	4.250	2013
Montana	11.000	6.900	2003
New Mexico	8.200	4.900	2009
North Carolina	7.750	5.750	2013
North Dakota	5.540	2.900	2010
Ohio	7.228	4.997	2005
Oklahoma	6.750	5.000	2014
Rhode Island	10.490	5.990	2010
Utah	7.000	5.000	2007
Vermont	9.900	8.950	2010
Washington, DC	9.500	8.750	2016

Sources: "Individual State Income Tax Rates 2000–2015," Urban-Brookings Tax Policy Center, February 16, 2015, http://www.taxpolicycenter.org/statistics/individual-state-income-tax-rates-2000-2015.

States also use policies other than rate cuts to alter their income tax structure. Some states carve out certain types of investment income for tax exemption or preferential rates in hopes of encouraging greater investment.

- **Capital gains**. Of the 43 states (and Washington, DC) that tax personal income, 30 have some preference for the treatment of capital gains and 7 have a broad exclusion for capital gains income, ranging from 30 percent in Arizona to 50 percent in New Mexico. Some states (Alabama, New Jersey, and Pennsylvania) do not cap deductible capital losses at the federal limit of $3,000 (see table 2). As in many other states, when New Mexico passed its capital gains exclusion, economic development was the reason. Governor Bill Richardson said at the time, "Make no mistake, the point of cutting the personal income tax and the capital gains tax is to send an unmistakable message to business leaders, here in this state and across the nation, that...New Mexico is open for business."[4]

  An argument for preferential rates for capital gains is that lower taxes reduce the cost of capital and increase the after-tax return on investment, but the effect of capital gains taxes on economic growth is highly uncertain (Burman 1999). At the state level, general capital gains preferences are unlikely to generate additional *in-state* investment because about 80 percent of capital gains income comes from equity investments either directly in publicly traded corporations or through mutual funds. As a result, the effect of any tax savings is dispersed nationally.

Several states target capital gains preferences to in-state assets. For example, most agricultural states have preferences for capital gains from the sale of agricultural property. States also have small-business capital-gain exemptions; Idaho allows a 60 percent capital gains exemption for realized gains from the sale of Idaho assets related to revenue-generating activity.[5] Montana similarly excludes gains from qualified small businesses while allowing a credit for a portion of other long term capital gains.

- **Business income**. Most US businesses are not subject to corporate income taxes; rather, profits flow through to owners and are taxed under the personal income tax as sole proprietors or partnerships.[6] Two states with personal income taxes (Kansas and Ohio) recently exempted noncorporate business income to encourage economic growth. Although data for Ohio is not yet available, there is little proof this policy improved the economies of either state. In Kansas, evidence suggests the opposite, and that many existing taxpayers recharacterized income to qualify for the exemption. Thus, no new business was created but revenue was lost.

Corporate Income Tax

The corporate income tax provides only about 5 percent of total state tax revenues and is mostly paid by large corporations operating in multiple states. State business tax rankings often consider top corporate tax rates and other features of the corporate income tax when determining how "business friendly" a state is. There is mixed evidence about the effects of cutting corporate tax rates to spur economic growth,[7] yet they remain a salient metric in state rankings. There are other corporate tax policy changes beyond lowering tax rates that states have adopted:

- **Single sales factor**. Until the late 1990s, states used the Uniform Division of Income for Tax Purposes Act standard three-factor apportionment formula for taxing multistate corporations. That formula gives equal weight to a corporation's share of payroll, property, and sales in a state when determining the share of profits taxable by the state.[8] However, states have recently adjusted the formula to give more weight to in-state sales. This reduces the taxable income for in-state exporters, usually manufacturers, and increases taxable income for companies with nexus that sell into the state.

- **Net operating loss.** The treatment of net operating losses has become a bargaining chip as states confront multistate corporations with far-flung operations. The federal government allows businesses to carry back losses for two years or carry them forward for 20 years to offset prior- or future-year tax liability. Most states conform to federal practice, but there have been recent changes in the number of carryback or carryforward years. To help states balance their budgets, carryback provisions were repealed. More recently, states have opted to extend the length of carryforward provisions for economic development reasons (Francis 2016). New Mexico recently changed its carryforward provision from 5 years to 20, in line with federal practice, citing interstate competition as the impetus.[9]

- **Combined reporting.** The debate over requiring multistate corporations to combine their related entities when determining income, known as mandatory combined reporting, has been as much about economic impact as accounting.[10] The Maryland Business Climate and Economic Development Commission (Bennett and Bishop 2016) explicitly stated that the rule is not business friendly despite citing it as one of the reforms states can use to combat aggressive tax planning. National business organizations cite the requirement as anticompetitive from an economic development perspective (Cline 2008). Other groups contend that tax planning by multistate corporations ultimately raises taxes for everyone in the state (Mazerov 2009).

Sales and Use Tax

Most policy choices surrounding sales tax involve specific incentives, such as exemptions for particular purchases and certain industries, rather than structural choices (Francis 2016). However, shifts in consumer purchases from tangible goods to services and from brick-and-mortar retailers to online commerce have pushed states to rethink how they tax transactions. The economic literature supports a broad tax base that includes as many transactions as possible without taxing business inputs (Brunori 2005; Fox 2012). Any expansion of the base, however, will necessarily expand tax to previously untaxed transactions.

- **Nexus.** The Internet has disrupted business fundamentally and created new complications for state sales-tax collectors. With significant amounts of transactions now occurring online, states have sought to broaden their authority over retailers by relaxing the physical presence standard determining nexus. The debate on this issue centers on revenue stability, but with major retailers like Amazon threatening retaliation (e.g., moving factories and jobs if their transactions are taxed but other online commerce is not), economic development concerns exist as well.

- **Machinery and equipment exemptions.** Many states exempt machinery and equipment purchases from sales and use taxes to minimize economic distortions from taxing business inputs. Some states, such as Alabama and Mississippi, may tax those purchases but at a preferential tax rate. Others use the exemption as an economic development tool, exempting machinery and equipment for new or expanding facilities but not for routine replacement.

- **Base expansion.** Efforts to expand the tax base, even when combined with a lower rate, have been met with fierce opposition, usually couched in the negative economic development terms. When Washington, DC, proposed expanding the sales tax base to include services like fitness facilities (fitness equipment was already taxable), local yoga studios and gyms claimed the industry would be decimated if their transactions were subject to tax.

Property Tax

Property taxes make up the largest share of state and local taxes on business (Phillips et al. 2015). Although primarily a local tax, states sometimes use the structure of the tax as an economic development tool, particularly for the personal property tax. Recently, some states have repealed their tangible personal property tax (e.g., equipment). Ohio had an exemption but phased it out over several years, and a measure to expand the amount that businesses can exempt was on the ballot in Florida in 2012 but failed to pass.[11] And many states with personal property taxes exempt specific property for manufacturing.

Another way states use the property tax structure as an incentive for economic development is through valuation methods. Iowa reduced valuation of agricultural, commercial, and industrial property to 90 percent of fair market value (LSA 2013). Neighbor state Nebraska has a cap on valuation, similar to most states' residential caps, for agricultural property assessment. Unlike credits or abatements, these policies apply to all qualified property and are ill-suited for specific economic development goals.

Conclusion

Despite the widespread use of state tax structures to assess business climate, it is difficult to establish a direct link between a particular tax structure and positive economic outcomes, such as increased investment or employment. More important elements are the particular features of each tax—exemptions, deductions, credits, and tax rates—and how each affects the specific businesses within a state.

One challenge often cited by authors of tax expenditure reports is determining what policies deviate from the *normal* tax structure. Unlike credits and exemptions, modifications to the structure of the tax are much more difficult to assess because of the subjective description of *normal*. Here we have highlighted some deviations from typical tax structures where the explicit goal was economic development. But modifying the tax structure for economic development purposes runs contrary to standard tax policy principles like simplicity, transparency, adequacy, and equity. A well-balanced and broadly applied tax system ensures that states can generate sufficient revenue and provide services to their residents. Income, sales, and property taxes respond differently to economic cycles and strength in one can offset weakness in another.

TABLE 2

State Personal Income Tax Treatment of Capital Gains and Losses, 2016

	In-state focus?	Policy
Alabama		Conforms to federal practices, except all gains are taxable and all losses deductible in year incurred.
Arizona		Exclusion of 25 percent.
Arkansas		Exclusion of 45 percent of net long-term capital gains. Capital gains in excess of $10 million exempt.
Colorado	Yes	Capital gains from certain Colorado sources are exempt if held for specified periods.
Connecticut	Yes	Gains or losses from the sale of Connecticut state and local bonds are subtracted or added back.
Hawaii		Maximum tax on long-term capital gains of 7.25 percent (preferential).
Idaho	Yes	60 percent exclusion for long-term gains from the sale of certain real and tangible Idaho property.
Iowa	Yes	100 percent exclusion for capital gains on qualified business assets.
Kentucky	Yes	Gains on Kentucky Turnpike bonds and property taken by eminent domain are exempt.
Maine	Yes	Earnings from fishing operations contributed to a capital conservation fund and income from the Northern Maine Transmission Corporation are exempt.
Massachusetts		All short-term capital gains (net of capital losses) and long-term capital gains from collectibles and pre-1996 installment sales (less certain excess deductions from a trade or business and 50 percent of long-term capital gains from collectibles and pre-1996 installment sales) are taxed at 12 percent. Other long-term capital gains are taxed as normal income.
Michigan		Persons age 65 or over may deduct up to $11,104 (2015) per person in interest, dividends, and capital gains. Amount is indexed for inflation.
Minnesota	Yes	Conforms to federal practices, except sales of Minnesota farm property are exempt if insolvent at time of sale.
Missouri		25 percent exclusion for certain sales of low-income housing.
Montana	Partial	40 percent exclusion for installment sales entered into before 1987. Gains from certain small-business investment companies are exempt. Tax credit for 2 percent of net capital gains.
Nebraska	Yes	Special dividends and capital gains on stocks owned by employees of qualified corporations.
New Hampshire	No	Only interest and dividends are taxed.
New Jersey	Yes	Conforms to federal practices, except capital gains from New Jersey obligations are exempt and capital losses may not be deducted from ordinary income.
New Mexico		May deduct the greater of 50 percent or $1,000 of federally taxable gains.
New York	Yes	Gains from investments in new businesses subtracted from income.
North Carolina	Yes	Conforms to federal practices, plus exemption for gains from certain North Carolina obligations issued before July 1, 1995.
North Dakota		Exclusion of 40 percent.
Ohio	Yes	Conforms to federal practices, except losses from the disposition of Ohio public obligations and income from an Electing Small Business Trust are added back; gains from Ohio public obligations and losses from an Electing Small Business Trust are deducted.
Oklahoma	Yes	Deductions for gains from certain Oklahoma property and stock. 50 percent exclusion for sales of historic battle site property to the state.
Pennsylvania		All gains are taxable and all losses deductible in year incurred, with certain limitations if married and filing jointly.
South Carolina		44 percent exclusion for long-term (more than one year) gains.
Tennessee		Exempt, with the exception of capital gains from the sale of mutual funds.
Utah	Yes	Deduction for certain gains used to purchase qualifying stock in a Utah small business corporation.
Vermont	Partial	40 percent exclusion for net capital gains and 60 percent deferral for gains invested in eligible angel ventures.
Virginia	Yes	Exclusion for gains on land sales for open-space use.
Wisconsin	Partial	60 percent exclusion for assets held more than one year; deduction for net capital losses limited to $500. Gains from qualified small business stock and family business sales are excluded.

Source: Urban-Brookings Tax Policy Center analysis of state tax laws.

Notes

1. Alaska does not levy a state sales tax but allows its local governments to tax sales.
2. In the same period, 12 states increased their tax rates.
3. Oklahoma Governor's Office, "Gov. Fallin Signs Tax Cut Into Law," news release, April 28, 2014, https://www.ok.gov/triton/modules/newsroom/newsroom_article.php?id=223&article_id=14120.
4. Barry Massey. "Gov. Signs Tax-Cut Package," *Albuquerque Journal*, February 14, 2003, http://www.abqjournal.com/news/xgr/2003/apsign02-14-03.htm.
5. "Capital Gains," Idaho State Tax Commission, accessed May 12, 2016, https://tax.idaho.gov/i-1100.cfm.
6. Corporations pay more in corporate taxes, but there are more businesses that are sole proprietors and partnerships, which pay individual income tax on business earnings. In 2012, corporations made up 18 percent of business taxpayers but 82 percent of taxable income. See table 1, "Selected Financial Data on Businesses" at "SOI Tax Stats – Integrated Business Data," Internal Revenue Service, updated April 15, 2015, https://www.irs.gov/uac/soi-tax-stats-integrated-business-data.
7. Mazerov (2010) reports no gains from cutting corporate tax rates, while Ljungqvist and Smolyansky (2016) report no significant impact from cutting rates except during recessions but negative consequences from increasing rates.
8. See Francis (2013) for a detailed analysis of apportionment methods.
9. State of New Mexico Office of the Governor, "Governor Susana Martinez Acts on Legislation," news release, March 20, 2014, http://www.governor.state.nm.us/uploads/PressRelease/191a415014634aa89604e0b4790e4768/Governor_Susana_Martinez_Acts_on_Legislation_6.pdf.
10. See Fox and Luna (2010) for a complete discussion.
11. "Florida Tangible Personal Property Tax Exemption, Amendment 10 (2012)," Ballotpedia, accessed May 12, 2016, https://ballotpedia.org/Florida_Tangible_Personal_Property_Tax_Exemption,_Amendment_10_(2012).

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About the Economic Development Strategies Project

The Economic Development Strategies project is a three-year project to assemble comprehensive research on state economic development strategies. The scope of the project goes beyond tax structures discussed here to include tax incentives, workforce development, and best practices. This is the fifth of eight informational briefs that will frame the project.

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Acknowledgments

This brief was funded by the Laura and John Arnold Foundation. We are grateful to them and to all our funders, who make it possible for Urban to advance its mission.

The views expressed are those of the author and should not be attributed to the Urban Institute, its trustees, or its funders. Funders do not determine research findings or the insights and recommendations of Urban experts. Further information on the Urban Institute's funding principles is available at www.urban.org/support.

The author gratefully acknowledges comments from Richard Auxier, Kim Rueben, Frank Sammartino, and layout and editing from the Urban Institute communications team.

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