High Costs, Dubious Benefits
The Fiscal Impact of Tax Cuts in SB 680 and SB 465

Ted Boettner

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About Us

The West Virginia Center on Budget and Policy is a policy research organization that is nonpartisan, nonprofit, and statewide. It focuses on how policy decisions affect all West Virginians, especially low- and moderate-income families.
Key Findings:

• Within a decade, the additional corporate tax cuts that will result from the enactment of SB 680 and SB 465 are likely to undermine the state’s ability to provide quality public services, require substantial tax increases, or result in a sharp drawing down of the state’s financial services.

• Already-enacted cuts in the business franchise and corporate net income tax rates, partially offset with revenue from the adoption of combined reporting, are estimated to cost the state $626 million between FY 2007 and FY 2017.

• If SB 465 and SB 680 are adopted this will add an additional $531 million in lost revenue over eleven fiscal years, bringing the cumulative cost of the business tax cuts alone to $1.2 billion.

• The state’s official long-term forecast (available through FY 2013) foresees combined General Fund/Lottery Funds deficit in each of the four years from FY 2010 through FY 2013 totaling $317 million. These deficit estimates only take into account part of the revenue loss from SB 680; if a Senate-adopted amendment to SB 680 that accelerates its proposed corporate income tax cut is ultimately enacted into law, this cumulative deficit is likely to grow by an additional $97 million during these four years.

• As of December 31, 2007, the state’s Rainy Day and other reserve funds stood at approximately $682 million. If the state chose to close FY 2010-2013 budget gaps totaling approximately $414 million by drawing down these reserves rather than increasing other taxes or cutting services, the funds would be more than 60 percent depleted. Of course, the corporate income tax cuts from SB 680 extend beyond FY 2013, and the cuts in the business franchise tax proposed in SB 465 do not even begin to take effect until FY 2014.

• Moreover, the business tax cuts enacted last year and the new ones proposed in SB 680 and SB 465 by no means encompass all the tax changes that have recently been enacted or are under consideration. From FY 2007 to FY 2017, the estimated cumulative cost of all tax cuts and changes that have been enacted over the last two years, plus those proposed in SB 680 and SB 465, plus several other tax changes under serious consideration, is almost $1.9 billion. Again, this is far in excess of the state’s reserves. Thus, the enactment of SB 680 and SB 465 will sharply increase the likelihood that the state will need to significantly cut services or increase other taxes to balance its budget within the next decade.

• Nor is there any realistic prospect that the business tax cuts will “pay for themselves” through increased economic growth. Two recent studies conducted by the states of Oregon and California concluded that if corporate taxes were cut by $100 those states could expect to recoup on average no more than $16-18 as a result of increased economic activity. Even this modest feedback effect depended on the assumption that no offsetting cuts in spending were required – an unrealistic on in light of state balance-budget requirements.
• State and local taxes make business profitability possible by financing quality infrastructure (e.g., roads and bridges) and services (e.g., crime protection, education) that businesses need and that attract them to particular states. Thus, cuts in state services that might occur as the result of unaffordable tax cuts could harm the state’s future economic vitality.

• The vast majority of the tax savings resulting from cuts to the corporate income and franchise tax are likely to flow to out-of-state owners of corporations, partnerships, and limited liability companies and make the overall West Virginia tax system more regressive.

Definition of Terms:

The Business Franchise Tax applies to the net equity of a business for the privilege of conducting business in West Virginia. It applies to partnerships, limited liability companies and most corporations.

The Corporate Net Income Tax is a tax on the annual net profits of incorporated entities doing business in West Virginia. It applies only to C corporations, not S corporations.

The Rainy Day Fund sets aside surplus revenue during periods of economic growth for use in times of budget shortfalls.

Background on Recent Tax Cuts:

Business Franchise Tax (BFT): During the November 2006 Special Legislative Session on tax modernization the business franchise tax was lowered from .70 percent to .55 percent, effective January 1, 2007. This decision resulted in an estimated annual loss of $25.7 million to the General Revenue Fund in the current 2008 Fiscal Year. During the 2007 Legislative Session, SB 749 reduced the rate by an additional .35 percent. Under current law, the rate will decrease from .55 percent to .20 percent by January 2013. These two reductions are estimated to cost the General Revenue Fund about $116 million per year upon full implementation in FY 2015.

Combined Reporting: SB 749 also included a provision making West Virginia a “combined reporting” state in 2009. Combined reporting is a method of taxation that closes corporate tax loopholes that large multi-state companies have exploited to avoid paying in-state corporate income taxes. Combined reporting is expected to begin generating revenue in FY 2011, yielding $32.7 million in revenue per year upon full implementation.

Corporate Net Income Tax (CNIT): The corporate net income tax rate was lowered on January 1, 2007 from 9.0 percent to 8.75 percent, also as a result of the November 2006 Special Legislative Session. The estimated fiscal impact of this reduction is $5-6 million in lost revenue per year over the next nine fiscal years.

Table 1 below illustrates that under current law the tax reductions in the business franchise and corporate net income tax, partially offset with the revenue increases resulting from the adoption of combined reporting, total $626 million between FY 2007 and FY 2017. The estimated cost from these tax reductions is $89 million per year upon full implementation.
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Table 1: Fiscal Impact of BFT, CNIT, and Combined Reporting Changes on General Revenue Fund Under Current Law

(Expressed in $ Millions)

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Source: West Virginia State Tax Department


SB 680, as amended, slightly modifies the combined reporting requirements set to go into effect in 2009 and proposes to reduce the corporate net income tax rate to 8 percent in 2009, 7.5 percent in 2010, 7 percent in 2011 and 6.5 percent in 2012. The further reduction in the corporate net income tax rate will result in an estimated additional $71 million revenue loss upon full impact. As Table 2 indicates, the cumulative impact of reducing the corporate income tax rate from its current 8.75 percent to 6.5 percent is $431 million from FY 2010 to FY 2017. Approximately $118 million of this amount results from an acceleration of the corporate rate cuts contained in the original version of the bill.

Table 2: Additional Fiscal Impact of SB 465 & SB 680

(Expressed in $ Millions)

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Source: West Virginia State Tax Department

SB 465 continues phasing down the business franchise tax rate from .20 percent in 2013 to 0.10 percent in 2014 and zero percent in 2015. Eliminating the business franchise tax will result in an additional $100 million loss of revenue to the General Revenue Fund from FY 2014 to FY 2017 and $50 million per year when fully implemented.
Figure 1 above illustrates how adopting SB 680 and SB 465 significantly deepens the amount of revenue loss to the General Revenue Fund resulting from already-enacted corporate tax cuts. The General Revenue Fund loses an additional $121 million in revenue per year upon full implementation if both bills are enacted. From FY 2007 to FY 2017, the General Revenue Fund will lose an estimated $531 million if SB 680 and SB 465 are enacted. The total estimated cumulative fiscal impact of these business tax reductions and those already enacted under current law from FY 2007 to FY 2017 is just under $1.2 billion.

In considering these further business tax reductions, policy makers should consider the long-term budget implications; the effectiveness of tax cuts in spurring economic development, and the distributional impact on the state tax system.

**Long-term Fiscal Impact of Tax Cuts**

Due to a projection of weaker state revenue growth, making additional business tax cuts could further damage the state’s ability to provide quality services. The West Virginia Department of Revenue estimates that state revenue growth will decline between FY 2008-2010 from 9 percent per year to 3 percent per year -- or less.¹ This is due to a projected leveling-off or decrease in severance tax revenues and a reduction in lottery

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receipts. The General Revenue Fund growth rate for 2010- FY 2013 is estimated at 3.5 percent per year on average.2

According to the Governor’s FY 2009 Executive Budget, the state already is projected to run budget deficits for the General Revenue Fund and Lottery Funds in each fiscal year from FY 2010 through FY 2013; the projected deficit in the latter year stands at $140 million. For the four-year period, the deficits total $317 million. This figure takes into account the original version of the proposed corporate income tax rate cuts in SB 680. However, an amendment adopted by the Senate accelerated those rate cuts, at an additional cost of $97 million during those four years. Of course, the business franchise tax and corporate income tax rate cuts in SB 465 and SB 680 are permanent and thus would make the annual budget deficit even larger after FY 2013 — further straining the state’s ability to provide state services.

It is also important to recognize that in addition to the business tax cuts that have been enacted over the last two years and the ones being proposed this year, the state has cut other taxes that will have an adverse impact on revenues over the course of the next decade. (See the Appendix for more detail.) These additional tax cuts include a reduction in the food tax rate from 5 percent to 3 percent, and other lesser tax cuts. Moreover, additional tax cuts are under consideration — for example, enacting a three-year suspension of the timber severance tax.

Figure 2 above illustrates the estimated revenue loss to the General Revenue Fund of all tax cuts and tax changes that have been enacted over the last two years, those being proposed in SB 465 and SB 680, and those under serious consideration. (A few loophole-closing measures that will gain revenue are also incor-

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2 State of West Virginia Executive Budget FY 2009, Volume I Budget Report pp.44

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From FY 2007 through FY 2017, the estimated cumulative revenue loss will be almost $1.9 billion and almost $240 million in the final year of the forecast.

If revenues fall short due to tax cuts and/or weaker-than-expected revenue growth, the state has three choices. It can cut services, raise taxes or turn to its Rainy Day Fund (also called Revenue Shortfall Reserve Fund) to close the budget gap.

The state has four separate long-term reserve funds that can potentially be tapped when current-year revenues are insufficient to fund current-year services. As of December 31, 2007, the balance in the Rainy Day Fund was about $290.5 million. The state also has a Rainy Day Fund–Part B that can only be used when all the monies from the Rainy Day Fund have been spent. Rainy Day Fund – Part B has a total of $285.2 million. Two other major reserve funds, the Income Tax Refund Reserve Fund and the Tax Reduction and Federal Funding Increased Compliance (TRAFFIC), contain $105.7 million. The combined total of all four stabilization accounts stood at $681.4 million as of 12/31/07.

Figure 3: General Revenue Fund and Rainy Day Fund(s) Balance (FY 2007- FY 2017)

![Figure 3: General Revenue Fund and Rainy Day Fund(s) Balance (FY 2007- FY 2017)](image)

Source: West Virginia Department of Revenue and State of West Virginia Executive Budget FY 2009

Figure 3 above compares the estimated accumulated balance of the Rainy Day Funds and the projected reductions in General Revenue Fund receipts that would result from the combination of previously-enacted tax cuts, the adoption of SB 465 and SB 680, and the approval of a number of smaller tax cuts that currently are under consideration. The latter include, for example, accepting the negative impact on West Virginia revenues of the state’s conformity to corporate income tax cuts contained in the recently-enacted federal stimulus bill.

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\(^3\) State of West Virginia FY09 Executive Budget, pp. 50-52.

cover the cost of the tax cuts. The net balance in the Rainy Day Funds is $681 million and the tax cuts total almost $1.9 billion, which is a difference of over $1.2 billion. This will most likely mean that if these tax cuts are enacted, they will have to be offset either by cuts in government services or additional tax increases at some point in the next 10 years.

A recent report by the Center on Budget and Policy Priorities found that states that cut taxes the most during the boom years of the late 1990s experienced far greater fiscal hardship during the 2001 recession and the following years. The report concluded that states that had the highest tax cuts experienced lower reserve funds and larger deficits and ended up having to raise taxes the most in order to maintain public services at a level that would be competitive with other states.5

State Business Tax Cuts Have Small Effect on Economic Development

In a recent review of tax studies, Dr. Robert Lynch, an associate professor and chairman of the Department of Economics at Washington College, finds that “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.”6

According to IRS figures, state and local taxes paid by corporations account for no more than 4-5 percent of business costs. This makes clear that state and local taxes are a relatively small burden on businesses and reduce profit rates by comparatively small amounts. Such taxes are simply too small a cost to have much influence on location decisions and pale in comparison to the cost of labor, energy, and transportation. Moreover, higher state and local taxes are often associated with better quality infrastructure (e.g., roads and bridges) and services (e.g., crime protection, education), that businesses need and that attract them to particular states. A relatively recent study based on a particularly rigorous method of calculating differences among states in overall business taxes concluded: “Our results suggest that state and local taxes, when properly measured, do not appear to have played a statistically significant role in the locational decisions for business investment. .”7

The most important factors affecting business investment and location are not a state’s tax rates, but a variety of factors that include the availability and cost of skilled workers, transportation, health services, good schools, communication infrastructure, and utilities.

According to a 2007 study conducted by Area Development Magazine, highway accessibility, availability of skilled labor, and availability and costs of energy rank in the top three site selection factors while corporate tax rates, state and local incentives, and tax exemptions rank 7th, 8th, and 10th respectively.8

Professor Lynch finds the economic development justification for business tax cuts to have the following three flaws: “State and local taxes are a relatively small burden on businesses and reduce profit rates by comparatively small amounts. After-tax rates of profits within industries do not vary significantly by state. Taxes are not just burdens but also provide the financial support for public services that reduce costs for businesses.”

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5 “Tax Cuts and Consequences: The States That Cut Taxes the Most During the 1990s Have Suffered Lately,” Center on Budget and Policy Priorities, January 12, 2005
The owners of businesses benefit from state programs and activities that make possible or facilitate the operation of the business. These services include public education (which helps provide the business with a productive workforce), the maintenance of a legal and regulatory system that enforces business contracts and discourages commercial fraud, and the provision of public transportation networks that enable businesses to obtain inputs and get their products to market.

The case for business tax cuts is further diminished by the fact that West Virginia state tax liability for the manufacturing industry is already competitive. According to the West Virginia State Tax Department, “the West Virginia State tax burden for the manufacturing sector is generally competitive with surrounding states because of the 50% tax break offered by the Manufacturing Investment Tax Credit.”

Rather than cutting taxes to promote business investment, West Virginia could invest in its people and infrastructure and build on its comparative advantages. These strengths include the lowest industrial electricity costs in the nation, according to the U. S. Department of Energy. A recent study by Global Insight concludes that the cost of doing business in West Virginia is 14 percent below the U.S. average.

**New Tax Cuts Won’t Pay for Themselves**

Because state and local tax cuts for businesses only have a relatively small impact on stimulating additional investment by existing businesses and attracting new ones to a state, such tax cuts cannot and do not “pay for themselves.” The revenue generated by taxing the wages of a few new employees or the profits of a few new businesses attracted to a state simply cannot compensate for the revenue forgone by giving a tax cut to every existing business in the state – including those whose sales and employment may be flat or even declining. No mainstream economist of any political persuasion would likely argue to the contrary, and the economic models used to forecast the impacts of state business tax cuts make the same assumption.

For a number of years, for example, California was required to use so-called “dynamic” revenue estimating techniques to evaluate the economic impact of tax cuts and tax increases. A recent review of that experience by the director of economics and taxation with the state’s Legislative Analyst’s Office concluded: “There is no evidence from the [dynamic analysis] model that tax rate reductions can pay for themselves, as some parties have in the past claimed.” With respect to corporate income tax changes, for example, the state found roughly an 18 percent feedback effect; that is, a $100 million cut in corporate taxes would, over a number of years, stimulate corporate activity sufficient to generate $18 million in offsetting revenue — for a net revenue loss of $82 million.

In Oregon, a dynamic revenue model created by the Oregon Legislative Revenue Office and Oregon State University found similar, if somewhat smaller, effects. It concluded that a reduction in the corporate income tax of $100 million would have some positive feedback, however, the feedback amounted to less than 16 percent for a net loss of $84 million. The model found even smaller feedback effect from a reduction in business property taxes.

However, even the theoretical possibility of a modest positive impact on business investment from business tax cuts would be completely negated were the tax cuts matched with cuts in state spending of equal size. Removing purchasing power from the state’s economy by laying off state employees or cutting payments to
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Businesses that sell services to the state (such as providers of medical care) would lead to a negative “feedback loop” with respect to revenue.

The cost-effectiveness of business tax cuts is also significantly undermined by the fact that roughly one-third of the revenue that the state will forgo will immediately flow into the federal treasury rather than businesses’ coffers. This is because state and local taxes paid by businesses are deductible against the 35 percent federal corporate income tax. When such taxes are reduced, businesses’ deductions go down and their federal corporate income tax liability increases. For every dollar in corporate tax that West Virginia forgoes, 35 cents flows to the federal government and only 65 cents remains with the business.

Business Tax Reductions Benefit Out-of-State Stockholders

The vast majority of the benefit of cuts in corporate income and franchise tax rates is likely to flow to out-of-state owners of corporations, partnerships, and limited liability companies (LLCs). Because West Virginia is a relatively small state with a lower per capita income than the average state, the majority of stock in corporations benefiting from the tax cuts will most likely be owned by relatively affluent people who live outside West Virginia.

Partnerships and LLCs are subject to the corporate franchise tax but not the corporate income tax. Thus, the proposed complete elimination of the franchise tax over seven years will mean that any out-of-state owners of these types of businesses will not be subject to any direct tax on the business itself and can only be subject to personal income tax on their pro-rata share of the businesses’ profits. Enforcing personal income tax payments by non-resident owners of partnerships, LLCs, and other similar “passthrough”-type businesses has proven quite problematic for states, however.

While well-to-do and out-of-state stock-owners will receive the benefits, residents of West Virginia will either experience reduced services or pay higher taxes to compensate for the tax cuts. Because West Virginia’s taxes are already regressive – that is, they absorb a greater share of income for low-income taxpayers than for high-income taxpayers – any higher taxes enacted in the future to replace the revenue lost to business tax cuts are likely to be regressive as well.

Conclusion

Last year, significant reductions were made to the business franchise tax without replacing the revenue lost to the General Revenue Fund, and the same course of action is being pursued today. The additional cuts in business taxes embodied in SB 465 and SB 680 threaten to significantly undermine the ability of the state to provide quality public services. Some combination of a sharp drawing-down of the states reserves, reductions in state services, and increases in other taxes seems almost inevitable during the next decade.

In acting upon SB 465 and SB 680, it is important for policy makers to consider the fiscal implications not just on a short-term basis but also for the long term. It is in the “out” years that state policymakers will have to make difficult choices concerning whether to raise taxes or cut government services. In the end, policymakers should balance the short-term marginal effects of cutting taxes for businesses against the long-term benefits of investing in quality public structures.
## Appendix

### Projected Fiscal Impact From Changes and Proposed in General Revenues From 2007 - 2017*

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<td>Sales Tax Exemption Drug Purchases &amp; Providers</td>
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<td>Business Registration Tax</td>
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<td>Timber Severance Tax</td>
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<td>Non-Resident Withholding Tax Rate 6.5%</td>
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<td>Extend Non-Res. Withholding Tax to Captains-Real Estate</td>
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<td>Eliminate Pre-1997 Corporate Capital Gain Exclusion</td>
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<td>Conform to 95% Bonus Depreciation</td>
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<td>Total Cumulative Totals</td>
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**Total** | $-621.30 | $-130.20 | $-150.90 | $-216.10 | $-170.90 | $-201.00 | $-143.50 | $-173.40 | $-196.10 | $-222.10 | $-139.80 | $-1,077.20 |

*Data for some accounts were held constant between 2013 and 2017 due to the lack of available forecasting information.*

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**Source:** West Virginia Department of Revenue and State Tax Department