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**TESTIMONY OF JEFF McLYNCH
INSTITUTE ON TAXATION AND ECONOMIC POLICY
BEFORE THE MASSACHUSETTS GENERAL COURT
JOINT COMMITTEE ON REVENUE
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Chairwoman Creem, Chairman Binienda, thank you for the opportunity to testify before you this morning. My name is Jeff McLynch and I am the Northeast Regional Director of the Institute on Taxation and Economic Policy (or ITEP). Founded in 1980, ITEP is a non-profit, non-partisan research organization, based in Washington, DC, that focuses on federal and state tax policy issues with an emphasis on tax fairness and adequacy.

Over the past few months, a strong consensus appears to have developed here in Massachusetts, a consensus that the Commonwealth should put a stop to tax avoidance by large and profitable businesses and adopt a new approach to its corporate excise tax – a method of taxation commonly referred to as combined reporting. I want to commend the Governor, the Legislative leadership, and the members of this Committee for the contributions that they have made in building that consensus. Combined reporting is easily one of the most important steps the Commonwealth could take to improve the overall fairness of its tax system and to ensure that its tax system produces an adequate stream of revenue over time.

There appears to be far less agreement, however, on one equally important issue – the purposes to which the revenue generated by combined reporting and other tax reforms ought to be devoted. Governor Patrick, in a bill before the Committee today, has proposed lowering the corporate excise tax rate to 8.3 percent, while Speaker DiMasi has recommended dropping it still further – to 7 percent. I would argue instead that the Commonwealth should institute critical reforms such as combined reporting and check-the-box conformity, but that it should maintain the corporate excise tax rate at its present level of 9.5 percent, as both fiscal and economic considerations dictate against such a change.

In the time I have remaining, I'd like to explain in a little more depth why combined reporting is so essential to the long-term health of Massachusetts' corporate excise tax and why the Commonwealth should refrain from reducing its corporate excise tax rate.

## "Zero-Tax Corporations" and the Need for Combined Reporting

The reason we are here today to discuss corporate tax reform – and the reason that similar deliberations have taken place across the country – is quite simple. The U.S. corporate income tax is in decline. At both the federal and state level, governments now collect far less in corporate income taxes, as a share of the economy, than they did several decades ago. Data compiled by the Tax Policy Center show that federal corporate income taxes equaled 1.6 percent of Gross Domestic Product (GDP) in federal fiscal year 2004, above its nadir of 1.1 percent in 1983, but still well below the levels that obtained for much of the last few decades. As you are no doubt aware, Massachusetts' corporate excise tax collections have mirrored this nationwide decline.

This decline is troublesome for two reasons. First, it appears to be at least partially the result of tax avoidance strategies by corporations rather than the conscious design of federal and state policymakers. Second, a decline in the corporate income taxes paid by the biggest, most profitable companies inevitably means either, one, that taxes paid by smaller businesses and by individuals must make up a bigger share of the tax pie or, two, that the vital public services funded, in part, by corporate taxes will suffer.

There is a substantial body of evidence that corporate tax avoidance is real and widespread. For instance, an analysis of the public filings of 252 of the largest and most profitable corporations in America jointly released by ITEP and Citizens for Tax Justice in February 2005 found that 71 of these corporations – more than a quarter of the total – managed to pay zero state corporate income taxes in at least one year between 2001 and 2003. Among these "zero tax" corporations was Boston Scientific, which, despite profits of $266 million in 2001 and $373 million in 2002, paid nothing in state corporate income taxes in either of those years. Similarly, Massachusetts-based Reebok earned $58 million in total profits between 2001 and 2003, yet, overall, owed nothing in state corporate income taxes over that span.

More recent research suggests that, despite the incremental efforts of states like Massachusetts to shore up their corporate income taxes, profitable companies still do not pay their fair share in taxes. Last year, Citizens for Tax Justice and the Change to Win coalition found that Wal-Mart, the country's largest employer and the world's largest retailer, may have avoided roughly $2.3 *billion* in state income taxes between 1999 and 2005. Over that time frame, Wal-Mart reported $77.4 billion in pretax profits, but ultimately paid only $2.4 billion in state income taxes, close to half the amount it would have paid had it paid its state income taxes at statutory tax rates for the same period.

Tax avoidance on this scale naturally leads to a host of questions, perhaps the most important of which is: how do they do it? One of the main ways in which Wal-Mart has been able to avoid contributing fairly to the public services that we all count on each day is to use accounting techniques to shift income from state to state to reduce its tax liabilities. A prime example of these accounting techniques is what is known as the “captive REIT” strategy. (REIT is short for Real Estate Investment Trust, an entity that is typically used by smaller investors to minimize risk when investing in real estate.) As a February 1, 2007 article in the *Wall Street Journal* revealed, Wal-Mart Stores used this one stratagem to avoid upwards of $350 million in state corporate income taxes between 1998 and 2001. Like the inflated royalty payments and the passive investment companies large corporations create to receive them, “captive REITs” essentially allow corporations to pay rent to themselves – and then to deduct that rent as a business expense – without that rent ever leaving the companies’ ledgers.

States seeking to nullify the income-shifting strategies employed by Wal-Mart and other corporations have two options. They can close down these loopholes one at a time – as Massachusetts and a few other states have done in response to passive investment companies – by enacting legislation that explicitly prevents their use – or they can adopt a comprehensive solution known as combined reporting.

Combined reporting requires a multi-state corporation to determine its apportionable income by adding together the profits of all its subsidiaries – without regard to their location – into one total. Since the income of subsidiaries in the various states is added together in one sum, there is no tax advantage to income shifting between these subsidiaries under a combined reporting regime. While anti-PIC legislation can close down one particular path to tax avoidance, combined reporting is a better, more comprehensive approach to loophole-closing because it simply removes the incentive to shift income from higher-tax to lower-tax jurisdictions.

Combined reporting is intuitively more fair than separate accounting – which Massachusetts now uses – because it ensures that a company’s tax liability should not change just because its organizational structure changes. It also creates a level playing field between smaller and larger companies. Small companies doing business only in Massachusetts are at a competitive disadvantage because they can’t use separate accounting to reduce their tax. This is simply because they have no business units in other states to which to shift their income. Large, multi-state corporations will find it easier to avoid tax using separate accounting because they do have business units in multiple states.

Of course, it is for these reasons that such a strong consensus about the need to move to combined reporting has developed in Massachusetts.

## Fiscal and Economic Considerations Dictate against Corporate Rate Cuts

As analyses by the Massachusetts Department of Revenue and its counterparts in other states make clear, corporate tax avoidance is so widespread that instituting combined reporting will ultimately yield a substantial amount of revenue. Given the consensus surrounding the adoption of combined reporting, the question that is now before this Committee is how such revenue ought to be used.

Some, including both the Governor and the Speaker of the House, argue that at least a portion of that revenue – if not all of it – ought to be dedicated to cutting the corporate excise tax rate. This is a false tradeoff. Simply because some corporations would pay higher taxes under combined reporting than they do now – as they would no longer derive any benefit from schemes designed to shift income out of Massachusetts – does not mean that all corporate excise taxpayers ought to pay taxes at a lower rate.

In my view, there are two tradeoffs that are far more salient to the debate over reducing the corporate income tax rate – one fiscal and one economic. Regarding the fiscal tradeoffs that would arise if the corporate income tax rate were lowered, the Massachusetts Budget and Policy Center, in examining the Governor's FY 2009 budget proposal, notes that the Commonwealth currently faces a budget deficit of $1.2 billion. Lowering the corporate income tax rate in this context means that the cuts in spending – or the withdrawals from the Stabilization Fund – necessary to address that deficit would have to be larger than they otherwise would be if the corporate income tax rate were to remain at 9.5 percent. These fiscal tradeoffs would have very real consequences – for fiscal stability, but more importantly, for the citizens of the Commonwealth that count on state government to help provide quality public services.

As for the economic tradeoffs that would occur, lowering the corporate income tax rate would not promote economic growth or attract businesses to Massachusetts, as some have asserted. Rather, doing so would make it more difficult for Massachusetts to pursue the sort of public investments that yield tangible economic benefits.

In brief, serious economic analyses of the relationship between corporate income taxes and economic development generally find little or no relationship between tax levels and economic outcomes. Studies that do purport to show such a relationship typically make simplifying assumptions that do not apply in the real world. For example, such studies will frequently estimate the negative impact of tax increases on a state's economy, but will not estimate the positive economic impact of increased state spending. In today's political climate, lawmakers raise taxes in order to fund services that improve the quality of life for individuals and businesses. Any analysis that does not attempt to quantify this positive effect is incomplete.

This basic finding of the economic literature really should come as no surprise. State and local taxes are a very small part of the costs that most businesses face. As Robert G. Lynch, the Chairman of the Department of Economics at Washington College found in his landmark study, *Rethinking Growth Strategies: How State and Local Taxes and Services Affect Economic Development*, "…after federal deductibility, all state and local taxes paid by businesses … accounted for only 0.8 percent of their costs."[1] State corporate income taxes, in turn, constitute only a fraction of the state and local taxes businesses pay.

As a result, the other costs that businesses incur are far more important in determining a state's business climate. Lynch's research leads him to include in this set of costs:

> the cost and quality of labor, the proximity to markets for output . . . access to quality transportation networks and infrastructure (e.g., roads, highways, airports, railroad systems, and sewer systems), quality-of-life factors (e.g., good schools, quality institutes of higher education, health services, recreational facilities, low crime, affordable housing, and good weather), and utility costs.[2]

Many of these costs can, in turn, be mitigated by state appropriations and other public policies, but only if states have the resources they require. Needless to say, lowering the corporate excise rate would help to put those resources in scarce supply.

## Conclusion

In sum, I again want to commend the Legislature and the Governor for continuing to take strides towards the adoption of combined reporting; such a reform is critical to creating a tax system that is more fair and more sustainable over the long run. However, using the revenue generated by combined reporting to reduce the corporate excise tax rate would be a step back, since, over the short-run, it would force larger than necessary spending cuts or Stabilization fund withdrawals to address the Commonwealth's budget deficit. Over the long-run, it would eat away at the resources the Commonwealth needs to make truly productive economic investments.

I thank you for the opportunity to provide you with this testimony and would be happy to answer any question you may have.

[1] Lynch, Robert G., *Rethinking Growth Strategies: How State and Local Taxes and Services Affect Economic Development*, Economic Policy Institute, March 2004, p. 4.
[2] *Ibid*., p. 6.