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Rethinking Combined Reporting, the Worst Idea of the Year, and Unicorns in Kentucky

by David Brunori

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For many years I believed that to make the corporate income tax work, states had to adopt combined reporting. I believed that separate accounting regimes left too many planning opportunities. Yes, I also thought that the corporate tax should be repealed. But, I thought if the corporate tax were to survive combined reporting was a necessity, especially given all the other problems with the tax.

I no longer believe combined reporting is a remedy for fixing the corporate income tax. In part, I do not believe there is a remedy; the corporate tax is unfixable. It should be repealed not mended. And, it turns out combined reporting doesn't actually do much to strengthen the tax. My students and I have been studying the revenue effects of combined reporting. Does it lead to more money? The answer is: not really.

Our preliminary findings show that the adoption of combined reporting does not raise as much revenue as proponents projected. Indeed, in many states, corporate tax revenue declined after the adoption of combined reporting. There are of course many factors that affect tax collections, including rate and apportionment changes as well as the overall economy. But our research suggests that combined reporting has hardly been the savior of the corporate income tax.

We looked at six states that recently adopted combined reporting: Massachusetts (2009), New Mexico (2014), New York (2007), Rhode Island (2014), West Virginia (2009), and Wisconsin (2009). Of these states, only New York met or exceeded corporate tax revenue projections in the years after adoption. The other five states did not raise as much revenue as proponents predicted. Worse, net corporate

income tax revenue actually fell in the year after adoption. Three of these states adopted combined reporting in the early years of the Great Recession. But Rhode Island basically broke even and New Mexico lost corporate tax revenue after adoption in the midst of a growing economy. The following chart illustrates the issue: **Recently adopted combined reporting** . The projected change figures are based on legislative estimates. The actual change figures are from U.S. Census data. I will send anyone who writes to me the underlying data and citations.

Opponents may quibble with the numbers as timing and external events may change outcomes. But it is clear that combined reporting has proven to be no panacea. Indeed, corporate income tax growth has been better in non-combined reporting states as shown in the following chart: **Percent Change in Corporate Income Tax Revenue from 2013-2015** .

Combined reporting is not raising as much revenue as opponents thought. But there is another problem with combined reporting. Combined reporting can only be used by related parties in a unitary business. The problems with ascertaining unitary versus non-unitary business are legendary. There are factors and indicators. But there are no real rules. And that means the states have a lot of discretion in determining what constitutes a unitary business. Not surprisingly they will err on the side of unitary when it favors the state. Of course, the lack of meaningful rules gives taxpayers plenty of room to argue as well. And that means there are administrative and compliance costs of adopting combined reporting. States should not minimize the administrative burdens.

States do not raise nearly as much revenue as they thought they would from combined reporting. But adoption sends a decidedly business unfriendly message. Right now Alabama is considering a combined reporting bill (SB 67). New Mexico and Pennsylvania may consider combined reporting this year. For the first time in my life, I would advise those states not to go the combined reporting route.

Worst idea of the year. It's early. But West Virginia Governor Jim Justice (D) might have the worst idea of the year locked up. The Governor is proposing to adopt a commercial activity tax. Yes, he is proposing a gross receipts tax. Every public finance expert who has ever studied a gross receipts tax has said it was a terrible way to raise revenue. In fact, many economists and scholars have called gross receipts the absolute worst way to raise revenue.

Someone should have told the Governor that gross receipts taxes are regressive. Indeed, it is odd that a professed liberal would be championing something so unfair to the poor. Someone should have told the Governor that gross receipts taxes are hidden taxes. Businesses pay them and pass the tax cost to their customers in the form of higher prices. The tax price is passed down surreptitiously until someone at the end of the chain actually pays it. That is an awfully cynical way to pay for government. It is also most unfair. Someone should have told the Governor about the problem of pyramiding. Taxes are imposed on the value of the tax as they are passed down the supply chain. But if the Governor can't get his head around regressivity, pyramiding is probably out of reach.

The gross receipts tax is terrible in Ohio, Nevada and everywhere else that has implemented it. It will be

equally as bad in West Virginia.

Cheers to Oklahoma Governor Mary Fallin. Oklahoma Governor Mary Fallin (R) has offered up some terrific tax ideas as part of her budget proposal. Fallin is calling for a complete repeal of the corporate income tax. The corporate income tax does not work. It does not raise much money, about $388 million in Oklahoma. There is increasing evidence that the tax falls heavily on labor in the form of lower wages. The tax does nothing but spur the proliferation of incentives. And, as I have been saying for nearly two decades, it is not worth it. Fallin has a Republican legislature. Oklahomans should hope the lawmakers follow her lead.

Fallin also called for broadening the sales tax base while lowering rates. She did not provide details. But base broadening and rate lowering are the hallmark of good tax policy. It's not so easy as everyone knows, especially the broadening part. Fallin should be applauded for trying.

Fallin is calling for higher cigarette and gas taxes. Excise taxes are terrible ways to raise general fund revenue. We should pay for government with broad based taxes; everyone should have the oar in the water. And, some conservatives are noting that Fallin wants to dramatically increase spending. Still, repealing the corporate tax and fixing the sales taxes are very good ideas.

And cheers to Texas Governor Abbott. Texas Governor Greg Abbott is calling for the repeal of the corporate franchise tax. A saner proposal has never been uttered. The Texas franchise tax is one of the worst concoctions in American public finance, ranking up there with the Michigan single business tax (SBT)/Michigan business tax (MBT) and every gross receipts tax. It is badly designed. As a result, it creates untold inefficiencies in both administration and compliance. It's simply a bad tax. There is legislation proposed that will repeal the tax. Lawmakers should pass it.

An honest politician. Some folks think honest politicians are as rare as unicorns. Maybe we found one in Kentucky Governor Matt Bevin (R). Bevin has forcefully called for tax reform. Specifically, he singled out the need to reform incentives and to make the tax laws more business friendly. Bevin has not provided details. Observers believe that reform may include single sales factor, market based sourcing, and steep reductions in both personal and corporate rates. And, it is almost certain that reform will include broadening the sales tax base to raise revenue. In his State of the Commonwealth address, Bevin warned that his reforms will mean some people are going to pay more. Apparently, Bevin has been telling folks around the state that tax reform will mean there will be losers. Yet, he is determined to change the system. He is giving the myriad of people who might pay more a head's up. I think we need more politicians like Governor Bevin.

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