Policy Option 10

REFORMING REVENUE SYSTEMS AND CLOSING TAX LOOPHOLES

The ultimate policy option is to reform revenue systems and close tax loopholes. The ability of state and local governments to adequately fund public services that citizens need depends on governments' economic capacity as measured by GDP or personal income. The amount of revenue that state and local governments need to fund services depends on how their revenue systems are structured and how many tax loopholes they countenance. To best utilize their economic capacity, the revenue system and economy must be in sync. Unfortunately, that is not the case.

Tax reform is not something trustees and administrators of public pensions do on a day-to-day basis. But many pension plans have government relations representatives and other advocates who can lobby policy makers to protect and preserve public pensions. It is important to understand what's going on in this area.

Tax reforms. During the past several decades, intentionally or unintentionally, state and local governments have made their revenue system more regressive by cutting progressive and stable taxes such as income and property tax and by filling the resulting revenue shortfalls with risky and regressive revenue schemes such as casinos, lotteries, and excise taxes. Furthermore, state and local revenue systems are laden with tax loopholes and economic development subsidies. If this trend continues, state and local governments won't be able to maintain funding for the current level of vital public services, let alone fund pensions adequately.

A good tax system should be in sync with the economy. Taxes shouldn't be too high. They shouldn't be too low. They should be broad based and progressive. A good tax system should provide stability during bad economic times and keep pace with the economy in good economic times. Currently state and local tax systems are regressive and inequitable. They are out of sync with the economy. When the economy grows, tax revenues lag. When it slows, revenue shortfalls exacerbate.

To assist pension fund stewards and advocates, NCPERS has recently published a practical guide to raising needed revenues and closing loopholes.[21] Advocates of public pensions usually go to the budget committee hearings room where everyone is fighting for a share of the pie, whereas the revenue committee hearings room is full of lobbyists from chambers of commerce and corporate lobbyists trying to reduce the size of the pie and seeking tax subsidies and tax loopholes.

21 www.ncpers.org/files/Tax%20Loopholes%20Final.pdf.

As advocates of public pensions, we need to monitor the revenue side of the equation as well. The NCPERS guide outlines a simple way, apart from being in the right room at the legislature to protect the revenues currently available to pension systems, to tell if a given state and local tax system are well conceived.

What are the hallmarks of a good, fair, and effective tax system? One way to determine a good tax system is to look at its elasticity. Elasticity measures whether revenues are in sync with the economy. An elasticity of 1 means the revenue system is in sync with the economy. For example, if the economy grows by 1 percent, revenues grow by 1 percent. On the contrary, an elasticity of less than 1, say 0.8, means that if the economy grows by 1 percent, revenues grow by 0.8 percent. When the economy grows, the need for public services and hence revenues grows. But an elasticity of less than 1 means that we'll never have enough revenues to maintain the current level of public services. Ideally, elasticity should be more than 1 so that during good economic times an adequate rainy day fund can be built to weather economic downturns.

A simple way to measure the elasticity of a tax system is provided below, and it also may be found on page 8 of the NCPERS guide. If 40 percent of state and local revenues come from income tax, 40 percent from sales tax, and 20 percent from all other sources, the elasticity of the revenue system is 1.14. On the contrary, if 80 percent come from sales taxes and 20 percent from all other taxes, the elasticity is 0.74. The elasticity of 0.74 means that if the economy grows by 1.00 percent, revenues grow by 0.74 percent. In other words, revenues are coming up 26.00 percent short. This can add up year after year to a point where state and local governments cannot adequately fund public services that citizens need.

Information about what percentage of revenues comes from which source is usually available from state revenue departments as well as from various public sources such as the Census of State and Local Government Finance.[22] Stakeholders can simply assess any state or local tax legislative proposal by asking how it would affect the tax system's overall elasticity.

Tax loopholes. Tax loopholes are provisions in the tax law that allow multinationals or multistate corporations to avoid taxes. More plainly, corporations may be following the letter of the law when they avoid taxes through loopholes, but they are not meeting their responsibility to pay their share of the public services that they use. Most people believe that corporations should pay their fair share because they are doing business in a given jurisdiction and using public services like police, fire, roads, and schools. For

Table 3

How the composition of taxes effects General Fund elasticity

	IF: 40%, 40%, 20%			IF: 20%, 60%, 20%			IF: 0%, 80%, 20%		
	a	b	a x b	a	b	a x b	a	b	a x b
	Tax Share	Tax Elasticity	General Fund	Tax Share	Tax Elasticity	General Fund	Tax Share	Tax Elasticity	General Fund
Personal Income	40%	1.8	0.72	20%	1.8	0.36	0%	1.8	0.00
General Sales	40%	0.8	0.32	60%	0.8	0.48	80%	0.8	0.64
Other	20%	0.5	0.10	20%	0.5	0.10	20%	0.5	0.10
TOTAL ELASTICITY			**1.14**			**0.94**			**0.74**

22 www.census.gov/programs-surveys/gov-finances/data/datasets.html.

example, General Electric paid no taxes from 2008 to 2015 (despite large US profits) yet used public infrastructure and other public services such as public safety services.[23] This is unfair to small businesses who pay their fair share of taxes.

There are several types of tax loopholes, but most relevant to advocates of public pensions are those that allow companies to avoid tax responsibility at the state level. These include the throwback rule loophole, passive investment company (PIC) loophole, and nonbusiness income loophole.

Throwback rule loophole. Some companies cannot be taxed in every state because the level of business they are conducting in that state does not rise to the level that can be taxed. As a result, those companies sometimes assign income to the states where activity does not reach threshold levels, thus creating "nowhere" income. In other words, this income cannot be taxed by any state because it was reportedly earned in a state that has no taxing authority over that company. Enacting the throwback rule ensures that profits earned in a state in which a corporation may not be subjected to an income tax are taxed instead by the company's home state.

PIC loophole. Many major corporations have implemented a corporate income tax avoidance strategy that is based on transferring ownership of the corporation's trademarks and patents to a subsidiary corporation located in a state that does not tax royalties, interest, or similar types of intangible income. Such companies are called PICs. PICs can escape taxation by making payments to themselves. For example, the state corporation makes a royalty payment to the Delaware PIC, and because there is no state income tax in Delaware, that payment escapes taxation. The Delaware PIC then makes a payment back to the parent company and finally all the way back to the state corporation. These payments are for the sole purpose of avoiding tax, and all of these payments escape taxes through the PIC loophole.

Nonbusiness income loophole. The definition of "business income" has provided aggressive corporations with an enormous loophole they have used to deny many states their fair share of tax on billions of dollars' worth of corporate profits. Business income is traditionally defined as income that is generated from a company's core business and is generally taxed where it is earned. This definition excludes mergers and acquisitions as well as sales of divisions, equipment, and so forth. As one might imagine, an enormous amount of income is generated by these activities. This income is defined as nonbusiness income and is generally taxed where a business is located or in its headquarters' state. This definition becomes a loophole because most businesses are located in nontax states, like Delaware, or even overseas, making their nonbusiness income tax free. Expanding the definition of business income to capture certain types of nonbusiness income would close this loophole.

How to close these loopholes. There is a comprehensive way to nullify artificial income-shifting strategies used by corporations by passing mandatory "combined reporting" legislation. If a state mandates combined reporting, all related corporations that are operated as a single business enterprise, any part of which is being conducted in the state, are essentially treated as one taxpayer for deciding which state receives the tax. If all businesses are included in one enterprise, then all the income is subject to tax in a state rather than escaping the tax through income shifting to PICs in nontax states. Appendix A of the NCPERS tax study shows which loopholes each state has and what can be done to close them.[24]

23 Most of the information in this section is summarized from the NCPERS publication *Reforming Taxes and Closing Loopholes*, www.ncpers.org/files/Tax%20Loopholes%20Final.pdf. I recommend that stakeholders use the full publication for details.

24 www.ncpers.org/files/Tax%20Loopholes%20Final.pdf.

On a path to closing loopholes, the first step might be to find out who is not paying. Of course, revenue departments cannot disclose tax information about individual companies, but they can provide summary data. The NCPERS tax study includes a sample letter that can be used to request such data. A friendly legislator may be willing to sign such a letter. It has been used in several states, including Mississippi, Louisiana, and Alabama, to build momentum to close tax loopholes. The results have been dramatic. These results can get media attention as well as the attention of policy makers. For example, in Mississippi, of the 150 largest for-profit corporations, 103 (68 percent) paid zero taxes. The results are the same in other states where this approach has been used to date.

Economic development subsidies. In addition to closing loopholes, advocates and stewards of public pensions need to be cognizant of economic development subsidies. State and local governments give tax subsidies to businesses to locate in their jurisdictions in the hope that businesses will create jobs and local economies will grow. The outcomes of most of these arrangements have been economic disasters. State and local governments need to think twice before they engage in such risky ventures.

Advocates and stewards of public pensions need to be familiar with these subsidies and monitor them. Business subsidies are tax breaks, cash subsidies, and other benefits given by state and local governments to companies as incentives to open or expand new facilities. Subsidies take many forms, from tax abatements and tax credits to tax increment financing. The previously mentioned NCPERS study contains a complete list as of December 2019.[25]

Tax abatements reduce or eliminate the taxes a company pays to state and/or local governments. Commonly used abatements include property tax abatements, sales tax exemptions, and inventory tax abatements.

Tax credits reduce or eliminate state corporate income taxes by allowing a company to deduct a certain percentage of a specific kind of expense dollar for dollar from what it would normally owe.

Tax-increment financing uses the expected additional property tax collected on the increased property value of a new development (and in some places, the newly generated sales tax) to pay for infrastructure, land acquisition, or other costs of the development.

If subsidies cannot be prevented or ended, advocates of public pensions need to seek clawbacks in subsidy arrangements. A clawback means that if the company receiving state and local subsidies does not deliver on its promise to create a certain number and type of jobs, the company will pay back the cost of the subsidies. Pension advocates also should seek transparency and disclosure clauses as well as job standards in the subsidy arrangements.

How to find subsidies state by state. To see what kinds of subsidies are being given in a particular state, consult the Good Jobs First website, which tracks existing and emerging subsidies on a regular basis.[26]

25 www.ncpers.org/files/Tax%20Loopholes%20Final.pdf.

26 www.goodjobsfirst.org/subsidy-tracker.