

Tax Watch

Winter 2009



Recession Blues: Can Reforming Business Taxes Boost the Economy?

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With the American economy slowing, lawmakers are scrambling for ways to restore confidence and boost markets. But one obvious way to improve economic performance is mostly being overlooked—reforming America's complex and punitive business taxes.

Throughout the states there are big differences in the “business friendliness” of tax codes. Some states tax companies lightly and simply—allowing them to focus on profits rather than tax forms—while others swamp companies with high rates and labyrinthine rules that risk deepening the already severe economic downturn.

“With the U.S. economy officially in recession, now's the time to reexamine America's business taxes,” said Scott A. Hodge, President of the Tax Foundation.

Which state taxes are best and worst for business? The answer comes from the Tax Foundation's 2009 *State Business Tax Climate Index*. The *Index* ranks how business friendly the 50 state tax systems are, providing a roadmap for lawmakers who want to keep their taxes competitive during uncertain economic times.

According to this year's ranking, Wyoming boasts the nation's simplest and best-designed business tax system. They're followed closely by the high-quality tax systems in South Dakota, Nevada, Alaska and Florida. In contrast, the nation's most poorly designed business

tax system is found in New Jersey, followed by New York, California, Ohio and Rhode Island.

Tax Reform as Stimulus Package

According to the study, lawmakers who ignore the impact of business taxes on their state's economy do so at their own peril.

“Studies have shown for decades that companies flee areas where they face competitive disadvantages,” said Tax Foundation economist Joshua Barro, author of the new study. “In a slowing economy, heavy taxes and regulations are an especially harmful disadvantage. States with good tax systems are best positioned to weather the economic slowdown and preserve their employment base.”

The Tax Foundation's *Index* ranks states based on taxes that matter most to business investment: corporate taxes,



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Message from the President: Pro-Growth Opportunity in a Time of Crisis



Since its founding during the height of the Great Depression in 1937, the Tax Foundation has carried the banner for principled, pro-growth tax policy through some of the most challenging times in American history.

During World War II we challenged the wisdom of higher taxes and barnstormed the country pressing for greater economy in government to finance the war effort. In the 1960s our research provided the intellectual basis for the Kennedy tax cut. And in the 1990s we fought against both the Clinton and H.W. Bush administration's tax hikes.

In 2009, however, we face perhaps our greatest challenge in decades. By all accounts, President Barack Obama and the new Congressional majority will usher in some of the most profound changes in tax and spending policy since Ronald Reagan in 1981. Obama campaigned on a platform of raising taxes on high-income Americans to cut taxes for the "middle-class" and boost spending on a host of new programs. To paraphrase President Obama, he has promised to "spread the wealth around."

Compounding these vast philosophical changes, Washington is about to be hit by the perfect storm of the sunset of the 2001 and 2003 tax cuts, the growing Alternative Minimum Tax, and the need for entitlement reform. In these perilous times, it is critically important that taxpayers are aware of the facts about these sweeping policy changes.

To meet these challenges, the Tax Foundation will be sharpening our focus in 2009. At the federal level, we will be launching a major new project to build the tools necessary to measure the income redistribution that results from the Obama administration's new tax and spending policies. We believe this project will be a "game-changer" in Washington, and will help shift the terms of the tax policy debate in a more pro-growth direction.

At the state level, the current economic downturn and shocks to the financial system have caused many states to announce budget troubles in 2009. Most will be looking for new revenue sources to close budget gaps. These pressures are likely to accelerate the disturbing trends we've been fighting in recent years: "tax exporting" through rental car and tourism taxes, taxing out-of-state business income, and raising fees and charges as a way of enacting stealth tax increases.

To maximize our impact on these state-level debates, the Tax Foundation has designed a multi-pronged strategy for 2009 including new research, outreach to lawmakers, coordination with state policy groups, public education, and new media marketing.

At our founding in 1937, the Tax Foundation stood alone as a defender of pro-growth tax policy. Today there are a number of Washington policy groups. But the Tax Foundation remains as the only organization focused on principled, unbiased analysis of tax policy at all levels of government—federal, state and local.

As we face America's coming fiscal challenges, we remain grateful for your financial support and look forward to another year of educating American taxpayers about the size and impact of government on their lives.


Sincerely,

Scott A. Hodge

Small Business Tax Hike May Be on the Way

President Obama's campaign promise to restore the higher, Clinton-era tax rates on the top two brackets could raise taxes on 55 percent of small business income in America, according to a new Tax Foundation study.

During the 2008 presidential campaign, Obama promised to increase the top two federal individual income tax rates from 33 and 35 percent to 36 and 39.6 percent, respectively. Since most small business income is reported on the personal income tax returns of owners in those brackets, thousands of companies could face tax hikes from the proposal.



"Small businesses are an important source of innovation and risk-taking, creating between 60 and 80 percent of new jobs and employing over half the labor force," said Dr. Robert Carroll, author of the study and Tax Foundation Vice President for Economic Policy. "High income tax rates reduce the investment spending of entrepreneurs and the likelihood that they

invest at all, discouraging the growth and expansion of small businesses."

\$30 Billion Tax Increase

The study analyzed how this tax increase might affect entrepreneurial activity in the economy. Top individual income tax rates are particularly important to companies. Among tax returns subject to the top two tax rates, most receive some form of small business income.

According to the study, 1.3 million tax returns would pay an extra \$30 billion in taxes under Obama's plan to raise the top two tax rates. Using various definitions of "small business," the study calculated the percentage of the tax hike that would fall on small companies.

Under the broadest definition, nearly 80 percent of taxpayers affected by the top two tax rates report at least some income or loss from a flow-through business. By that definition, 51 percent of small business income would see a tax increase totaling \$15.4 billion.

Under a more narrow definition of business income, 65 percent of taxpayers in the top two brackets report positive business income, and 55 percent of small business income would see a tax increase totaling \$16.4 billion.

"Under these alternative definitions, the fraction of taxpayers in the top two brackets with business income varies from 36 percent to 77 percent," said Carroll. "However, roughly one-half of the \$30.1 billion in higher taxes is attributed to business income regardless of the definition."

There is abundant research showing that high tax rates affect flow-through businesses and entrepreneurs in a number of damaging ways.

Previous studies by the Tax Foundation's Dr. Carroll have found that taxes slow the rate at which entrepreneurs expand operations and discourage hiring and investment. In one study, raising the marginal tax rate by five percentage points was found to reduce the percentage of entrepreneurs who invested by 10.4 percent and lowered their average investment by 9.9 percent.

"The entrepreneurial sector in the United States is proportionately larger than in the private sector economies of its major trading partners," said Carroll. "The Obama administration should be wary of discouraging small business formation as they make changes to the federal tax code in coming years."

Read the full study, "The Effect of the Presidential Candidates' Tax Plans on Flow-Through Businesses," at www.taxfoundation.org/publications/show/23824.html.

"Roughly half of small business income could see a tax increase of \$16.4 billion."

Tax Fact:

Highest state-local income taxes per household: New York, \$5,462 per year.

Lowest: Tennessee, \$82.

America's Highest Property Taxes: New Jersey and New York



According to a new Tax Foundation study, residents of New York and New Jersey bear the heaviest property tax burdens in America.

Using newly released Census Bureau data, the study analyzed property tax burdens in all 788 high-population counties in the nation, comparing the results to home values and household incomes. The findings reveal dramatic differences in property tax burdens throughout the nation.

The top ten highest-tax counties in America all fall in New York and New Jersey. Westchester County in New York tops the list with an average annual tax bill of \$8,422. It's followed closely by New Jersey's Hunterdon County (\$8,224), New York's Nassau County (\$8,153), and New Jersey's Bergen and Somerset Counties (\$7,797 and \$7,597).

Homeowner's Burden

So what explains the high tax burdens? According to the study, areas with the highest incomes, highest real estate prices, and

highest government spending typically bear the heaviest tax burdens.

"New York and New Jersey have very high per capita incomes," said Tax Foundation economist Gerald Prante. "Because high-income areas also tend to have high home prices, the largest property tax bills are usually found in the nation's most affluent areas."

The study notes public school spending is an additional factor affecting property tax burdens. Roughly half of all property taxes in America go to fund public schools, making differences in school spending an important long-run driver of tax burdens.

In contrast, America's lowest property tax burdens are found in Apache County, Arizona. Residents there pay an average of just \$133 per year. It's followed by four counties located in Louisiana: St. Landry Parish (\$139), Iberia Parish (\$144), Rapides Parish (\$146) and Lafourche Parish (\$148).

The 2007 rankings show some shuffling from the previous year. In 2006, Hunterdon County was ranked highest, followed by Nassau County and then Westchester County. In order to make the leap up to first place this year, Westchester County's median property tax payment increased by a whopping \$796.

Some analysts have predicted that the recent declines in home prices could lead to budget crises for local governments that rely heavily on property tax revenue.

"If property values continue falling, there will likely be a combination of three policies taken by local school districts," said Prante. "They may raise property tax rates to replace the revenue, cut government spending, or simply ask for more financial assistance from state and federal governments."

A 2007 Tax Foundation study found that between 1982 and 2004, property taxes nationwide rose from \$704 per person to \$1,089 per person in 2004 inflation-adjusted dollars. This increase has prompted many heated debates and proposals for property tax limitations in state capitals.

"For better or worse, public opinion polls consistently find property taxes are among the most hated of all taxes," said Prante.

A 2006 Tax Foundation survey revealed 39 percent of U.S. adults said property taxes were the "least fair" state and local tax, compared to just 20 percent who said income taxes and 18 percent who named sales taxes.

"Although falling home prices are likely to ease tax bills, taxpayers' distaste for property taxes is likely to persist," said Prante.

Read the full study, "New Census Data on Property Taxes on Homeowners," at www.taxfoundation.org/research/show/23648.html.

"Surveys find property taxes are among the most disliked of all taxes."

Tax Fact:

Highest average property taxes: Westchester County, New York, \$8,422 per year.

Lowest: Apache County, Arizona, \$133.

KPMG Study Warns of High U.S. Corporate Taxes

"The U.S. corporate tax rate is now higher than all other global regions."

The famous accounting firm KPMG released its latest annual survey of corporate tax rates around the world, and its findings are bad news for America's global tax competitiveness.

The new study shows the U.S. corporate income tax rate is higher than all other global regions—14 percentage points higher than the global average and nearly 17 percentage points higher than the average among European Union nations.

According to Scott A. Hodge, President of the Tax Foundation, the new study illustrates how America's stagnant business tax system is becoming more harmful to the nation's economic competitiveness with each passing year.

"Of the 106 countries surveyed, only the United Arab Emirates, Kuwait, and Japan impose a higher corporate tax rate than the combined rate of 40 percent in the U.S.," said Hodge. The United Arab Emirates and Kuwait each have a staggering tax rate of 55 percent; Japan's rate is 40.69 percent.

"What this says about America's tax competitiveness is not good," said Hodge. According to the KPMG report, 23 countries cut their corporate tax rates in 2008, and no nation raised rates.

A typical example of corporate tax cutting comes from Sweden. The nation recently announced a series of proposals to improve its business climate, including a plan to cut its corporate tax rate from 28 percent to 26.3 percent. According to one media report, "Since coming to power in the autumn of 2006, the Swedish government has launched a series

of measures aimed at inciting Swedes to return to the job market instead of living off of state subsidies."

America Falling Behind

According to the study the global average corporate tax rate is 23.2 percent in the European Union, 26.6 percent in Latin America, and 28.4 percent in the Asia Pacific region.

Twenty-three countries cut their corporate tax rates in 2008 alone, including Canada, China, Columbia, the Czech Republic, Denmark, Germany, Hong Kong, Israel, Italy, Malaysia, New Zealand, Singapore, South Africa, Spain, Switzerland, and the United Kingdom.

In contrast, the U.S. corporate tax rate has remained unchanged since 1994.

The KPMG survey comes on the heels of the Tax Foundation's *CompeteUSA* project, a campaign to raise public awareness of America's high business taxes and how our business tax system is affecting our competitiveness, wages and living standards.

Recent OECD studies show U.S. corporate income taxes are 50 percent higher than the average among our counterparts in the industrialized world, and that corporate taxes are the single most harmful tax to GDP growth—even more harmful than personal income taxes or consumption taxes.

In 2008, the Tax Foundation released an analysis showing that the U.S. federal corporate income tax quietly taps family pocketbooks for nearly \$370 billion per year in the form of higher prices, lower wages and poorer return on investment.

"If even notoriously high-tax Sweden recognizes that taxes matter to a country's business climate and work incentives, when will the political class in Washington take action?" said Hodge.

Read the full study, "KPMG Study Finds U.S. Corporate Tax Rate Higher Than Every Global Region," at www.taxfoundation.org/publications/show/23621.html.



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*"In a slowing
economy,
reforming
business taxes
is more
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than ever."*

individual income taxes, sales taxes, unemployment taxes and property taxes. States are scored on the business-friendliness of each tax, and the scores are then weighted to reflect the relative importance of the tax to companies.

"When states enact tax reforms, they do not do so in a vacuum," said Barro. "Every tax change affects a state's competitive position relative to its neighbors, region, and even globally. Today more than ever, entrepreneurial states can seize opportunities to lure ailing businesses from high-tax states."

There are many examples of companies fleeing high-tax states. The study notes the example of the ongoing competition between high-tax California and low-tax Arizona. For example, in 2005 Intel chose Arizona as the location for a new multi-billion dollar chip making facility, citing California's burdensome corporate income tax.

Just as tax cuts spur investment during recessions, tax hikes can have the opposite effect. For example, when Illinois' Governor Blagojevich proposed

a statewide gross receipts tax in 2006, the study notes that companies delayed hundreds of millions of dollars in capital investment until the tax was defeated in the legislature.

"Anecdotes like these reinforce what economists have been teaching since Adam Smith: taxes matter to business, and states with the most competitive tax systems always enjoy an advantage over neighboring states when courting jobs and investment," said Barro.

The goal of the Tax Foundation's *Index* is to focus lawmakers on long-term economic prosperity rather than short-term stimulus packages aimed at luring high-profile companies.

A notorious example of bad policy comes from Columbus, Ohio where lawmakers offered a five-year package of special tax breaks to lure a moving company in 2000. By 2004, the company failed to add the 100 jobs promised and had actually fired 98 employees, sending lawmakers scrambling to rescind the final year of tax breaks.

The lesson? Lawmakers should avoid picking winners and losers. Instead they should enact overall reform—simplifying, lowering rates, and cutting regulations.

How States Are Ranked

The Tax Foundation's *Index* is based on the idea that good business taxes shouldn't interfere with decisions in the marketplace—they should be what economists call "economically neutral."

"Good tax systems levy low rates and treat all taxpayers the same," said Barro. The more riddled a tax code is with politically-motivated preferences the more likely it is to interfere with good business decisions. Generally the *Index* rewards taxes that are simple, transparent and avoid double taxation. Using the *Index*, lawmakers can pinpoint sensible business tax reforms.

"In a slowing economy, business tax reform is more important than ever," said Barro. "Our goal is to guide lawmakers in the right direction."

Read the full study, "2009 State Business Tax Climate Index (Sixth Edition)," at www.taxfoundation.org/publications/show/22658.html.

New Book: The End of Prosperity

In the past quarter century Americans have enjoyed astonishing growth in wages and living standards. But according to one new book, that prosperity is slipping away as lawmakers in Washington abandon the pro-growth tax and spending policies that made it possible.

The End of Prosperity: How Higher Taxes Will Doom the Economy—If We Let It Happen presents a comprehensive overview of the case for pro-growth, free-market, and low-tax government policies. The book comes at a time when many lawmakers in Washington are turning against pro-market policies in the wake of the worldwide financial meltdown.

Authored by economists Arthur Laffer, Stephen Moore and Peter J. Tanous, the book explores topics ranging from the benefits of the Reagan tax cuts to the potential harm to small businesses if the estate tax is allowed to return in 2011.

"Our book is not meant to make a partisan case for one political party over the other," said the authors. "There are a lot of Democrats and Republicans who don't have their tray tables in the upright and locked position when it comes to understanding sound economics. The warning we give here is offered to both parties."

Read an excerpt from the book online at www.simonsays.com/content/book.cfm?pid=627851.

Media Impact Report

In the months leading up to the Presidential election this fall, Tax Foundation experts were cited throughout the popular media:

Television and Radio

Tax Foundation President Scott A. Hodge appeared on Fox News to talk about possible state-level tax increases as well as the future of federal income tax rates. Senior Economist Gerald Prante appeared on the Jim Bohannon Radio Show and was a frequent guest on Fox News, Fox Business News and CNN to fact-check the Presidential candidates on taxes. Staff Economist Joshua Barro hit the radio airwaves in nine different states to discuss the 2009 *State Business Tax Climate Index*. Finally, Tax Counsel Joseph

Henchman was featured on CNN and the Lars Larson Radio Show to discuss the impact of the financial crisis on city transit agencies.

Newspapers

Tax Foundation economists were cited in the *Wall Street Journal*, *New York Times*, *USA Today*, *Washington Times*, and *Boston Globe* on the Presidential candidates' tax proposals. Vice President for Economic Policy Robert Carroll, Ph.D., wrote an opinion piece in the *Wall Street Journal* on John McCain's healthcare tax credit plan. In all, the Tax Foundation had over 600 print media hits in 2008—many of which cited our latest study of state-local tax burdens and the 2009 *State Business Tax Climate Index*.

Learn more about the Tax Foundation's media impact at www.taxfoundation.org/press/.



Bringing Sound Tax Policy to the States

The Tax Foundation has taken its 2009 *State Business Tax Climate Index* on the road in recent months. Here's a summary of our recent work:

New Jersey: Tax Foundation economist Joshua Barro explained to state legislators why New Jersey is dead last in the 2009 rankings. Lawmakers subsequently passed one of the Tax Foundation's suggested reforms regarding carry-forward of business losses.

Rhode Island: Economist Josh Barro testified before the state's Tax Study Commission. Additionally, he and Tonya Barr, Manager of State Relations, met with the Ocean State Policy Research Institute to discuss Tax Foundation research.

Maryland: The Tax Foundation co-hosted a press conference with the Maryland Public Policy Institute in an effort to highlight Maryland's hostile business tax climate.

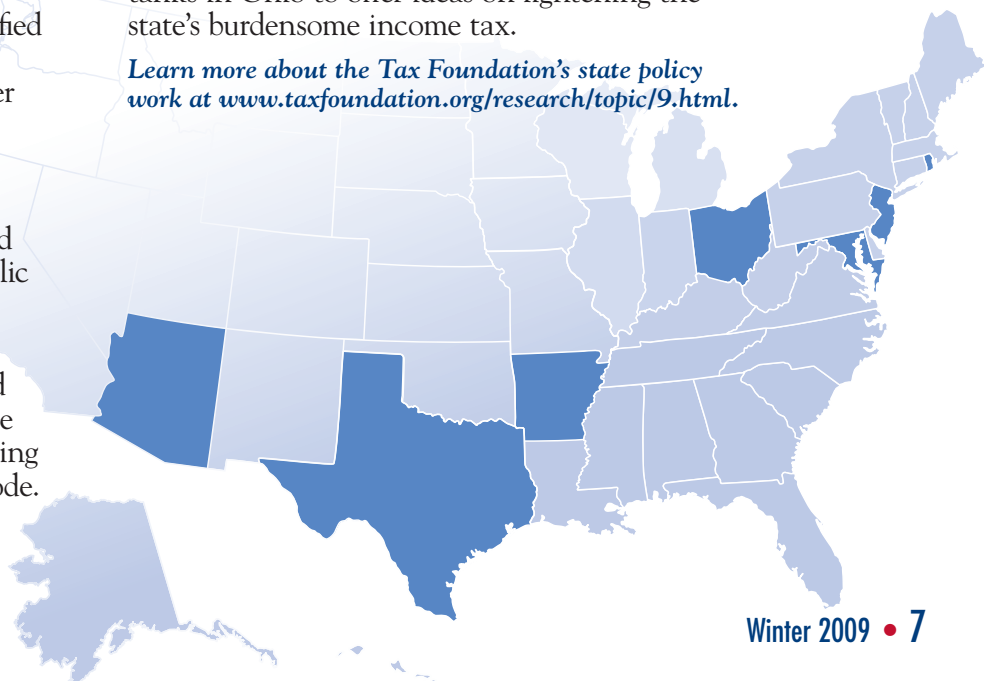
Arkansas: Economist Josh Barro testified in Little Rock, Arkansas before the House Committee on Revenue & Taxation, offering suggestions for improving the state's tax code.

Arizona: Arizona state lawmakers, accompanied by the Arizona Free Enterprise Club, visited the Tax Foundation to learn about sound tax policy in preparation for the next legislative session.

Texas: Legislative staffers in Texas asked Tax Foundation experts to give suggestions on ways to improve the state's business taxes.

Ohio: Economist Joshua Barro met with think tanks in Ohio to offer ideas on lightening the state's burdensome income tax.

Learn more about the Tax Foundation's state policy work at www.taxfoundation.org/research/topic/9.html.





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Help Support Sound Tax Policy



Since 1937 the Tax Foundation has monitored America's tax policies, and our research and educational efforts on the economic impact of government have stood the test of time. Our annual calculation of Tax Freedom Day® remains one of the most widely used tools for illustrating America's tax burden to media professionals, legislators, and—most importantly—taxpayers.

Our work would not be possible without the generosity of supporters like you. By making a tax-deductible investment in the Tax Foundation, you become a valuable partner in helping to assure that our research and publications continue to shape sound tax policy in America—for the good of future generations of taxpayers as well as our own.

Please use the enclosed envelope to send your contribution today, or visit our website at www.taxfoundation.org to make an online contribution. For more information about supporting the Tax Foundation, please contact Kim Jorns, Director of Development, at (202) 464-6200 or jorns@taxfoundation.org.

Congratulations

Congratulations to **Rep. Jim McCrery (R-LA)** and **Rep. Richard Neal (D-MA)**, winners of the Tax Foundation's 2008 Annual Distinguished Service Awards. The honorees were recognized for their commitment to sound tax policy at the Tax Foundation's 71st Annual Dinner on November 20, 2008 in Washington, D.C.