Tax Revenues Better in 2013, Will Continue Improving in 2014

By William F. Fox

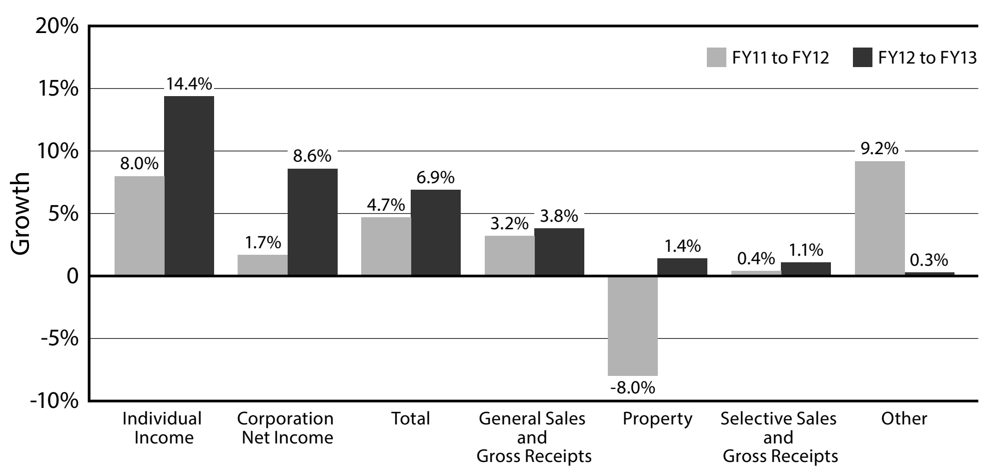
Inflation-adjusted gross domestic product grew 1.9 percent in the United States during 2013, which is somewhat lower than long-term expectations for economic growth. Employment rose a relatively healthy 1.6 percent, but nearly 1.2 million fewer people have a job than before the recession. Most analysts expect better GDP growth during 2014 and anticipate employment will finally rise above the pre-recession peak sometime during the second half of 2014.

Economic growth will improve because the short-term drag caused by sequestration and the debt ceiling debate has played through the economy, improvements in household balance sheets are allowing solid consumer spending increases, business investment is rising with better business equipment purchases and housing construction is healthier in many regions.

Tax Revenue Growth Accelerated

Economic growth and tax revenue growth are strongly correlated, but they have fairly different patterns since tax revenues also depend on factors such as the tax structure chosen and the type of economic growth taking place. Tax revenues grew much better in 2013 than in 2012 (see Figure A), though the reverse took place for GDP.[1] State tax revenues rose 6.9 percent in 2013 after increasing only 4.7 percent in 2012. Most taxes increased at a higher rate in 2013, but the individual income tax, which expanded at an extraordinarily fast 14.4 percent rate, accounted for much of the acceleration.

Figure A: State Tax Revenue Growth, U.S.



Sources: U.S. Census Bureau, Annual State Tax Collections (FY11–FY12); Quarterly State Tax Collections (FY12–FY13).

As a result, the personal income tax collected 38.6 percent of total tax revenues, continuing the long-term trend for its revenue share to expand. For example, the personal income tax collected 35.7 percent of revenues in 2008 and 32 percent in 1991.

Sales taxes grew modestly better than in 2012, but still rose less than 4 percent. Sales tax growth rates have remained below normal expectations for a recovery, likely because of lower inflation, modest consumer spending increases and robust e-commerce transactions for which vendors are less likely to collect the tax. Sales taxes have fallen from 33.6 percent of total taxes in 2003 to about 30.8 percent in 2013 mostly because personal income taxes have risen so rapidly. Selective sales taxes, which include alcohol, tobacco and motor vehicle taxes, rose only slightly in 2013 because these taxes are frequently levied on units of sales and not value. Selective sales taxes collect a slightly larger share of revenues than in 2008, but this is heavily attributable to rate increases. For example, states have increased cigarette tax rates at least 24 times, mostly in different states, since 2009.[2]

Business Taxes

Corporate income taxes grew a robust 8.6 percent in 2013, much faster than in 2012. But the aggregate rebound in corporate tax revenues since the recession has been particularly slow. Lucy Dadayan and Don Boyd of the Rockefeller Institute of Government examined the bounce back in corporate income taxes after the last three recessions.[3] They found that it took less than three years from the beginning of the 1991 recession for inflation-adjusted revenues to recover and four years following the beginning of the 2001 recession. After more than five years, however, inflation-adjusted revenues are about 20 percent lower than at the start of the 2008–09 recession. Further, revenues were nearly 20 percent higher five years after the 1991 recession and were even stronger five years after the 2001 recession, highlighting the weak current recovery.

Recent data suggest the corporate tax recovery may be weakening further, at least in some areas. A number of states have seen corporate income tax revenues fall during the early part of the 2014 fiscal year. New Jersey, Oklahoma and Tennessee have seen significant slowdowns during the current year, and quarterly payments dropped sharply at mid-year in Iowa, Pennsylvania and Wisconsin, after revenues had grown better earlier in the year. But corporate tax growth rates are notoriously different across states at any point in time and the 2014 revenues to date are generally quarterly payments and not actual tax return data. So it is too early for much certainty about how the entire year will look.

Corporate income and franchise taxes together collect only 6.9 percent of total state tax revenues, although they generally attract political and media focus that far exceeds their importance as a revenue source. The modest revenue contribution from these taxes has generally been falling over time as they represented 7.7 percent of total collections in 2008. The key reason is the aggregate state corporate profits tax base has been declining relative to national corporate profits since shortly after the Tax Reform Act of 1986, so there has been trend erosion in the tax base. Among the likely explanations are:

1. State policy changes, such as altering the apportionment formula, that on net reduce taxable profits. Some policy changes likely raise the tax base and some, such as tax concessions, diminish the base;
2. Federal policy changes in cases where state tax structures are coupled with the federal tax base; and
3. Tax planning and other corporate strategies.[4]

Similar erosion has been taking place for the sales tax base, although the causes are different, but some of the diminished sales tax base has been offset with higher sales tax rates across the states. A parallel increase in corporate tax rates has not occurred, which has allowed revenues to fall more.

State Changes in Corporate Taxation

States have been transforming the ways they tax corporations, generally by reducing taxation of production and increasing taxation at the destination of transactions. Effectively, states are shifting away from taxation at the origin of business production and to the destination of business sales. The main goal has been to reduce the taxes implicit in the value of production in order to make in-state production more attractive in national and international markets. Other goals have included broadening the base to other forms of business, such as limited liability companies. Some states, such as Ohio and to a lesser extent Texas, have joined Delaware and Washington in taxing business through various versions of gross receipts taxes. Ohio's Commercial Activity Tax is a destination-oriented tax on gross sales to Ohio buyers. The tax broadens the set of taxpayers by applying to all business with receipts more than $1 million, regardless of their structure.

Most states—44 in all—have retained a corporate income tax structure based on the Federation of Tax Administrators' categorization.[5] Many states have expanded the destination component of their corporate income tax by increasing the weight on the sales factor in the apportionment formula and/or by situsing the sales of services on a destination basis. At least 18 states now apportion the corporate income tax on the basis of where the sales take place; only about 10 states rely on the traditional three factor formula—sales, payroll and property—and the other states are somewhere in between.[6] A 100 percent sales weighted formula—termed single factor sales apportionment—taxes corporations based on where they sell and not where they produce. Single factor sales apportionment effectively causes the corporate income tax to become a complicated sales tax—without exemptions—where the rate is a function of the corporation's national profitability and the state corporate income tax rate.

Increasing weight on the sales factor is expected to reduce the tax on production for sales out of the state, but may not do so in all cases. The key distinction is that the tax on sales by firms with out-of-state customers can go down, but tax can be included in the selling firm's price when in-state firms purchase intermediate goods for use in production. For example, intermediate products purchased from another corporation will include the buying state's corporate tax regardless of where the seller is located, which could raise the cost for the buying firm. Thus, single factor sales weighting of the corporate income tax can raise the tax implicit in the cost of purchased intermediate goods while lowering the tax implicit in the purchasing firm's final sales to other states. The overall effect on the economy and the tax burden for firms are empirical issues, with the academic literature often finding that economic activity in a state is enhanced by single factor sales apportionment, though total tax revenues may not be increased.[7]

Most states have traditionally located the sales factor for goods on a destination basis as described above, which means the sale is counted in the formula in the state where the buyer is located and not where the seller is situated. For services, on the other hand, the sales factor has traditionally located transactions where "the greater cost of performance" or some related concept takes place. The result has been a focus on taxing services at their origin. At least 12 states have moved to destination situsing for services as well as goods, which expands the overall propensity to make the corporate income tax more like a sales tax on profitable corporations. Destination situsing of services is also generally associated with greater production in a state (see William Fox and Zhou Yang).

Conclusion

Corporate income taxation tells only a small part of the story associated with overall business taxes. Businesses are subject to a wide range of other taxes that must be considered to understand the overall tax burden on business. Most of these other taxes are not levied exclusively on business but are on general activity including businesses, such as the property tax on the owner of property or transactions taxes levied regardless the buyer. For a decade, Ernst & Young and the Council on State Taxation have undertaken annual studies on state and local government taxes incident on business.[8] They list property taxes on business property (more than one-third of business taxes) and general sales taxes (more than one-fifth of business taxes) as collecting much larger shares of business taxes than does the corporate income tax. Indeed, they estimate that the corporate income tax is only responsible for 7.6 percent of all taxes paid by business. Other taxes, such as unemployment insurance, corporate license and various excise taxes, are also among large taxes imposed on businesses.

The broader set of taxes that are initially incident on businesses has not been falling as evidenced by those imposed by state governments rising 5.8 percent in 2012. The Council on State Taxation study concluded that 45.2 percent of all state and local taxes are paid by business. By comparison, businesses were responsible for 41 percent of state and local taxes in the report for 2002.

The business share of taxes differs significantly by state. Resource rich states, such as Alaska, Louisiana, North Dakota, Texas and Wyoming raise more than 60 percent of tax revenues from business. At the other extreme, Connecticut and Maryland only generate about 30 percent of taxes from business, both owing to businesses paying a very low share of local taxes.

Notes

[1]Tax revenue growth rates are not strictly comparable across the two years, but the comparison should be qualitatively correct. Tax revenues for 2012 are taken from the annual tax series available from the Bureau of the Census, but must be gathered by aggregating information across four quarters that correspond to the fiscal year for most states (the third and fourth quarters of 2012 and the first

and second quarters of 2013). Some of the inconsistencies are that the quarterly data will generally be on a cash rather than accrual basis and there is some variation in the fiscal year across states.

[2] *http://taxadmin.org/fta/rate/cig_inc02.html*.

[3] Lucy Dadayan and Donald J. Boyd, "Growth in State Tax Revenues Softened in Third Quarter," Rockefeller Institute of Government, Dec. 19, 2013.

[4] See William F. Fox and LeAnn Luna, "State Corporate Tax Revenue Trends: Causes and Possible Solutions," *National Tax Journal* Vol. 55 (491–508), September 2002.

[5] See *http://taxadmin.org/fta/rate/corp_inc.pdf*.

[6] See *http://taxadmin.org/fta/rate/apport.pdf*.

[7] For example, see William Fox and Zhou Yang, "Destination Taxation: The Road to Economic Success?" University of Tennessee, March 2014.

[8] Ernst and Young and Council on State Taxation, "Total State and Local Business Taxes: State-by-State Estimates for Fiscal Year 2012," July 2013. The study defines business taxes as ones that are legally incident on business. Many taxes, such as tobacco, alcohol and sales taxes, are legally incident on household purchases and are not counted as business taxes, though businesses often remit the revenues on behalf of the households.

About the Author

William F. Fox is a Chancellor's Professor, the William B. Stokely Distinguished Professor of Business and the director of the Center for Business and Economic Research at the University of Tennessee. He has served as a consultant in more than 25 countries and 10 U.S. states on a wide range of public policy issues.