TESTIMONY

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CORPORATE AND PASS-THROUGH INCOME TAXATION:

TIME FOR REFORM

By Patrick Ishmael

Testimony Before The Missouri House Ways and Means Committee

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To the Honorable Members of This Committee:

Ladies and gentlemen, thank you for the opportunity to testify today. My name is Patrick Ishmael, a policy analyst for the Show-Me Institute, a nonprofit, nonpartisan Missouri-based think tank that supports free-market solutions for state policy. The ideas presented here are my own. This testimony is intended to provide a framework for understanding how tax structure fits into the economic development landscape in theory and in practice, with a particular focus on Missouri's corporate income tax and the tax on pass-through income.

Where We Stand Now

Missouri has not been doing well economically. For the past decade, the state has fallen behind its sister states in economic growth. As noted in our paper "Cutting the Ties That Bind: End Missouri's Corporate Income Tax," Missouri's economic performance places it in the bottom tier nationally.[1]

From 1997 to 2011, Missouri continued to slip behind the rest of the country in economic growth. If Missouri had managed to just keep pace with the rest of the country, its total output would have been $285 billion higher over that time. This trend must change.

Table 1: Real GDP

Area	1997 Index	2011 Index
Oregon	100	136.81
North Dakota	100	132.86
Idaho	100	124.86
Arizona	100	120.69
Utah	100	118.39
South Dakota	100	115.84
Nevada	100	114.98
Texas	100	114.64
Wyoming	100	112.85
Colorado	100	111.97
Virginia	100	109.71
California	100	109.63
North Carolina	100	107.24
Maryland	100	106.63
New Hampshire	100	106.02
Washington	100	104.46
Florida	100	103.98
District of Columbia	100	103.93
Massachusetts	100	103.12
Delaware	100	102.73
Minnesota	100	102.27
United States	100	100
Montana	100	99.95
Iowa	100	99.90
Vermont	100	99.81
New Mexico	100	99.55
Oklahoma	100	99.53
New York	100	99.51
Nebraska	100	99.38
Georgia	100	97.87
Tennessee	100	96.73
Arkansas	100	96.15
Kansas	100	96.06
Rhode Island	100	95.20
Louisiana	100	93.52
Wisconsin	100	92.86
Connecticut	100	92.31
Alabama	100	92.24
South Carolina	100	91.73
Indiana	100	91.36
Maine	100	90.53
Pennsylvania	100	90.26
Alaska	100	90.23
Hawaii	100	90.08
New Jersey	100	89.84
Illinois	100	89.68
Mississippi	100	88.75
West Virginia	100	88.48
Kentucky	100	85.75
Missouri	100	85.52
Ohio	100	79.34
Michigan	100	73.99

Table 2: Real GDP Per Capita

Area	1997 Index	2011 Index
North Dakota	100	144.49
Oregon	100	133.26
South Dakota	100	119.66
Massachusetts	100	111.36
Wyoming	100	111.25
Idaho	100	110.61
District of Columbia	100	109.59
New Hampshire	100	109.45
New York	100	109.00
Vermont	100	108.72
California	100	108.09
Maryland	100	107.93
Iowa	100	107.79
Rhode Island	100	106.35
Virginia	100	105.72
Minnesota	100	104.25
Nebraska	100	104.18
Louisiana	100	103.40
Montana	100	101.92
Utah	100	101.90
Oklahoma	100	101.23
Kansas	100	100.90
Texas	100	100.61
Arizona	100	100.53
Colorado	100	100.28
United States	100	100
Washington	100	99.24
West Virginia	100	99.20
Pennsylvania	100	98.92
Connecticut	100	98.21
Maine	100	97.89
Wisconsin	100	97.59
Arkansas	100	97.55
North Carolina	100	97.13
Illinois	100	97.01
New Mexico	100	96.85
Delaware	100	96.39
Alabama	100	95.98
New Jersey	100	95.92
Indiana	100	95.43
Florida	100	94.78
Tennessee	100	94.64
Mississippi	100	94.60
Hawaii	100	91.19
Missouri	100	88.90
Kentucky	100	88.80
Ohio	100	88.40
Alaska	100	87.64
Georgia	100	87.61
South Carolina	100	86.53
Nevada	100	85.16
Michigan	100	84.28

Table 3: Non-Farm Employment

Area	1997 Index	2011 Index
North Dakota	100	119.97
Wyoming	100	118.83
Nevada	100	117.06
Texas	100	114.15
Utah	100	114.11
Alaska	100	113.82
D.C.	100	112.63
Idaho	100	111.98
Arizona	100	111.53
South Dakota	100	107.88
Montana	100	107.19
Virginia	100	106.64
Florida	100	106.25
Hawaii	100	105.82
Colorado	100	105.43
New Mexico	100	105.13
Maryland	100	105.07
Oklahoma	100	104.73
Washington	100	103.92
Nebraska	100	102.85
New Hampshire	100	101.86
New York	100	100.52
West Virginia	100	100.26
Vermont	100	100.19
California	100	100.11
United States	100	100
North Carolina	100	99.85
Georgia	100	99.64
Minnesota	100	99.45
Delaware	100	99.36
Maine	100	99.00
South Carolina	100	98.94
Pennsylvania	100	98.35
Kentucky	100	98.16
Oregon	100	98.00
Arkansas	100	97.89
Iowa	100	97.78
Kansas	100	97.49
New Jersey	100	96.80
Louisiana	100	96.61
Tennessee	100	96.37
Massachusetts	100	95.84
Wisconsin	100	95.06
Rhode Island	100	94.74
Connecticut	100	94.01
Alabama	100	93.39
Indiana	100	93.10
Missouri	100	92.95
Illinois	100	91.54
Mississippi	100	91.02
Ohio	100	88.16
Michigan	100	83.36

What Policymakers Need To Understand About Taxes And Tax Structure

While not the sole determinant of a state (or country's) economic performance, a state's tax policy can and does affect its economic performance. Taxes affect the decisions that people make about spending and investing their money. In addition, tax rates affect where people work and employ their capital. The factors of production — the sources of income — are mobile. Once that is recognized, it is possible to better understand how tax rates affect economic growth.

Taxes on capital are viewed as among the most economically harmful.[3] People's savings fund projects all over the country — indeed, all over the world — because loans can cross political boundaries with electronic ease. Taxes on capital pose a problem for governments because capital is so movable. For a given return to a project, the after-tax return is highest wherever the tax rate is the lowest. Accordingly, if a company or a person wants to avoid being taxed on his or her income, typically all he or she would have to do is move the capital from the taxing jurisdiction.[4]

More to the point, there is evidence to suggest that the structure of taxes highly affects economic growth. In a study conducted for the Organisation for Economic Co-operation and Development, Jens Arnold assessed what the best and worst tax structures are for national growth.[5] He found that (emphasis added):

> [a] stronger reliance on income taxes seems to be associated with significantly lower levels of GDP per capita than the use of taxes on consumption and property. Within income taxes, those on corporate income seem to be associated with lower levels of GDP per capita than personal income taxes. In fact, **corporate income taxes appear to be the least attractive choice from the perspective of raising GDP per capita.**

Arnold's conclusions about income taxes are not isolated to trans-national circumstances, and Missouri would be well-served if policymakers took steps to eliminate similar taxes on capital at the statewide level.

What Other States Are Doing Consistent With These Conclusions

While Missouri contemplates its economic future, its neighbors are pro-actively taking steps aimed at promoting economic growth. In 2012, Nebraska passed a modest tax cut,[6] and further reductions of taxes in Nebraska appear likely.[7] Oklahoma plans to significantly reduce its income taxes with an eye toward phasing out its tax on individual income completely.[8] Farther to the south, Louisiana is still considering eliminating its corporate and individual income taxes.[9]

From 1997 to 2011, Missouri continued to slip behind the rest of the country in economic growth.

If Missouri policymakers want to pursue a Kansas-style reform, they will want to pursue a route that maximizes after-tax rates of return while ensuring that government service cuts, if any, would not overwhelm the new tax advantages.

Yet, Kansas' recent reforms may pose the most immediate threat to Missouri. In 2012, Kansas reduced its top individual income tax rate to 4.9 percent,[10] below Missouri's top rate of 6 percent. Perhaps more importantly, Kansas *completely eliminated* its tax on the non-wage income of businesses organized as limited liability companies, S-corporations, and sole proprietorships. Sometimes referred to as "pass-through entities," these companies are often small businesses whose incomes are taxed at the individual level rather than at the company level.

Kansas' tax move is a radical departure from what has grown into a sort of political and policy norm that treats taxes on business income as a central component to the budgets of American government. However, we know this about businesses and their capital: (1) business location decisions depend on after-tax rates of return, the level of valued government services (including infrastructure), and other business considerations; (2) Kansas has raised the after-tax rate of return for income that passes through businesses organized as LLCs, S-Corps, and the like; and (3) as it stands today, some Kansas state services will likely have to be cut to make up for the revenue lost, although the cut services may not necessarily constitute "valued" services for business location decision-making.

If Missouri policymakers want to pursue a Kansas-style reform, they will want to pursue a route that maximizes after-tax rates of return while ensuring that government service cuts, if any, would not overwhelm the new tax advantages.

Why Missouri Cannot Afford To Sit Idly By

The stakes could not be higher for Missouri. In a previous publication, Show-Me Institute economists Joseph Haslag and Michael Podgursky estimated that more than $3 billion worth of annual Missouri LLC income alone sits along Missouri's 11-county western border, and those businesses are probably paying attention to Kansas' recent tax reforms and considering the costs and benefits of moving across the border.[11] If the value of Kansas' tax cuts is larger than the value of services lost, then Missouri is at risk of losing millions, if not billions, of dollars in economic activity to its Jayhawk neighbors.

Moving Missouri Forward

We have written in the past about eliminating the corporate income tax strictly through the elimination of economic development tax credits. That paper showed that even if tax credit issuances were matched dollar-for-dollar with the lost corporate income tax revenue, there would *still* be tax credits remaining for some current tax credit programs. Alternatively, those tax credits could be used to eliminate or reduce other taxes — namely, the tax on pass-

through income.

In a subsequent paper, we analyzed the economic benefits that Missouri might realize if it eliminates the tax on pass-through entities.[12] If the state prefers to eliminate the tax on pass-through entities instead of the corporate income tax, it can negate **some** of the lost revenue by eliminating economic development tax credit issuances.

While political considerations may favor such preferential taxing schemes, a more sound public policy would be to eliminate income taxes on all business forms, whether those businesses are organized as S-corporations, C-corporations, or otherwise. The Tax Foundation noted in its 2012 review of Kansas' tax reforms that Kansas lacked a sound economic basis to eliminate taxes only on businesses with pass-through income.[13] If Missouri links the elimination of the tax on pass-through entities with the elimination of the corporate income tax, it will be able to put forward a more consistent taxing environment for all kinds of businesses, and one that the academic literature better supports.

Tax reforms for pass-through entities and C-Corporations may appear daunting when taken separately, but taken together, the task is less so. By applying the savings achieved through tax credit reform toward a combined proposal to eliminate taxation on pass-through income and C-Corporations, the gap for achieving revenue neutrality while eliminating the taxes would be narrowed considerably — and considerably more defensible from the growth and policy viewpoints.

Conclusion

Intransigence on fundamental tax reform is not a viable option for Missouri, especially as other states start taking these tax structure lessons to heart and overhaul their tax systems. Missouri cannot afford to continue supporting an economic development status quo. Other states are reforming their taxes to promote growth. Will Missouri?

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NOTES

[1] Ishmael, Patrick, and Michael Rathbone. "Cutting The Ties That Bind: End Missouri's Corporate Income Tax." Show-Me Institute, Essay. October 2012. View online here: http://showmeinstitute.org/publications/essay/taxes/864-end-corp-income-tax.html.

[2] Haslag, Joseph, and Michael Podgursky. "Slip Sliding Away: The Weak Relative Growth of the Missouri Economy." Show-Me Institute. View online here: http://www.showmeinstitute.org/publications/essay/taxes/771-slip-sliding-away.html.

[3] Arnold, Jens. "Do Tax Structures Affect Aggregate Economic Growth? Empirical Evidence From a Panel of OECD Countries." Organisation for Economic Co-operation and Development, Economics Department Working Papers No. 643. Oct. 9, 2008. Also: McBride, William. "What is the evidence on taxes and growth?" Tax Foundation. View online here: http://taxfoundation.org/article/what-evidence-taxes-and-growth. December 18, 2012. Retrieved January 23, 2013.

[4] As with most general statements, there will be exceptions. Here, we would note that individuals are taxed by residence and corporations can be taxed by domicile, and that in practice, the ease of avoiding income taxes through the movement of capital will be affected by the facts of the given case. That clarification is a nuance, but a nuance that should probably be articulated for those unfamiliar with the area of tax policy.

[5] Arnold, Jens. "Do Tax Structures Affect Aggregate Economic Growth? Empirical Evidence From a Panel of OECD Countries." Organisation for Economic Co-operation and Development, Economics Department Working Papers No. 643. Oct. 9, 2008.

[6] O'Hanlon, Kevin. "Smaller tax-cut plan signed into law." *Lincoln Journal Star*. View online here: http://journalstar.com/news/unicameral/smaller-tax-cut-plan-signed-into-law/article_a08c7ff6-f4de-5b6e-9018-d57244a2d35d.html.

[7] "Nebraska governor proposes ending state income, corporate taxes." Associated Press. January 16, 2013. View online here: http://www.foxnews.com/politics/2013/01/16/nebraska-governor-proposes-ending-state-income-corporate-taxes/.

[8] Smoot, D.E. "HD 14 Dems frown on tax cuts." *Muskogee Phoenix*. View online here: http://muskogeephoenix.com/local/x946182782/HD14-Dems-frown-on-tax-cuts.

[9] Adelson, Jeff. "Gov. Bobby Jindal calls for elimination of all Louisiana income and corporate taxes." *The Times-Picayune*. January 10, 2013. View online here: http://www.nola.com/politics/index.ssf/2013/01/gov_bobby_jindal_calls_for_eli.html.

[10] Rothschild, Scott. "Brownback signs tax cuts, predicts boon; critics see budget buster." *Kansas City Kansan*. View online here: http://www.kckansan.com/2012/05/brownback-signs-tax-cuts-predicts-boon.html#.T8UqeIvDp5M.twitter.

[11] Haslag, Joseph, and Michael Podgursky. "More Bad News for Missouri Competiveness." Show-Me Institute. View online here: http://www.showmeinstitute.org/publications/commentary/taxes/809-more-bad-news.html.

[12] Ishmael, Patrick, and Michael Rathbone. "Pass-Through Taxation." Show-Me Institute. Working paper, to be released February 2013.

[13] Robyn, Mark. "Not in Kansas Anymore: Income Taxes on Pass-Through Businesses Eliminated." Tax Foundation, Fiscal Fact No. 302. May 2012.

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