



Finance & Tax Council

Wednesday, November 4, 2009

1:00 PM

404 HOB

Action Packet

**Larry Cretul
Speaker**

**Ellyn Setnor Bogdanoff
Chair**

COUNCIL MEETING REPORT

Finance & Tax Council

11/4/2009 1:00:00PM

Location: 404 HOB

Summary: No Bills Considered

Committee meeting was reported out: Wednesday, November 04, 2009 3:57:55PM

COUNCIL MEETING REPORT

Finance & Tax Council

11/4/2009 1:00:00PM

Location: 404 HOB

Attendance:

	<i>Present</i>	<i>Absent</i>	<i>Excused</i>
Ellyn Setnor Bogdanoff (Chair)	X		
Joseph Abruzzo	X		
Gary Aubuchon	X		
Chris Dorworth	X		
Keith Fitzgerald	X		
Erik Fresen	X		
Doug Holder			X
Kurt Kelly	X		
H. Marlene O'Toole	X		
Ron Schultz	X		
Michael Scionti	X		
William Snyder	X		
Perry Thurston	X		
John Tobia	X		
James Waldman	X		
Michael Weinstein	X		
Totals:	15	0	1

Committee meeting was reported out: Wednesday, November 04, 2009 3:57:55PM

COUNCIL MEETING REPORT

Finance & Tax Council

11/4/2009 1:00:00PM

Location: 404 HOB

Other Business Appearance:

Single Sales Factor

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Committee meeting was reported out: Wednesday, November 04, 2009 3:57:55PM

BRIEFINGS



March 2009

*Center for Competitive Florida
Florida Council of Economic Advisors at Florida TaxWatch*

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Transforming Florida's Corporate Income Tax to Encourage Capital Formation and Job Creation

"If all regions act simultaneously, however, there are very clear winners and losers, and the competitive economic development landscape is markedly reshaped. In essence, the apportionment game is a prisoner's dilemma: regardless of the strategies of other states, each state's best economic development strategy is single factor sales."

Edmiston, 2002

I. Executive Summary

In the midst of the most severe economic downturn in decades, Florida must seize the opportunity to implement structural policy changes that will contribute to its long-run economic vitality. The single sales factor (SSF) apportionment formula is just such a change.

Each state allocates a corporation's net income to the state for tax purposes using apportionment formula. Florida's current apportionment formula considers three factors: Sales (50%) property (25%), and payroll (25%). Florida should adopt a corporate income tax (CIT) based on a one-hundred percent sales factor apportionment formula in order to bolster the state's competitiveness and spur long-term economic growth. Florida currently faces a rising competitive *disadvantage* compared to an expanding number of states that have adopted the single sales factor apportionment formula corporate income tax (SSF-CIT) in recent years – including states with which it most directly competes. Moreover, economic theory and empirical research increasingly point toward considerable gains in job formation, capital investment, and long-term economic growth from CIT apportionment formulas that place greater weight on sales and less or no weight on property (capital) or payroll (jobs) in the state. Revenues are likely to increase over time due to the boost to long-term economic growth and the significant incentive to locate or expand a corporation's property and payroll (jobs) inside Florida

The recommendation that Florida adopt a SSF-CIT recognizes that such a tax base may not necessarily be optimal when evaluated on a nationwide basis. Several decades ago states imposing a CIT – except Iowa – followed the Uniform Division of Income for Tax Purposes (UDITPA) guidelines. However, this uniformity unraveled over the years as states either sought additional revenues or competitive advantages by altering their apportionment formulas. The recent trend by states to adopt a SSF apportionment formula is, once again, encouraging

uniformity – but in a beggar-thy-neighbor policy sense. CIT policies may be entirely rational from the perspective of individual states, but not on a nationwide basis.

II. Background: Historical Underpinnings

States have imposed a variety of excise, property, and franchise taxes on businesses since the nation's founding. The roots of the modern CIT among the states can be traced to the Progressive era in the early twentieth century – a period which also witnessed the rise of the federal personal income tax and a number of state personal income taxes. Progressive political leaders dominated many state legislatures during this period, and a tax on corporations aligned naturally with their jaundiced views of corporations.

Brunori and Cordes (2005) report the first state to impose a CIT was Wisconsin in 1911. By 1940 thirty-nine other states had adopted one.

They further state:

Like other levies, the state corporate income tax was developed for a *far different economy* (italics added). The tax was designed at a time when most corporations manufactured tangible personal property. It was also designed to function in an environment in which interstate tax competition was not nearly as intense as it is today. *Although that economy no longer dominates, the tax has largely remained the same* [italics added].

A CIT did not exist in Florida until 1972. In response to a November, 1971 constitutional amendment authorizing the imposition of a state CIT at five percent beginning in that fiscal year, the Legislature enacted Chapters 220 and 221, *F.S.*, which created the statutory framework for Florida's CIT.¹

By enacting a CIT, the Legislature looked to the federal tax code as the basis for taxing corporate income in Florida. Importantly, the Legislature decided not to automatically adopt future changes to the federal tax code for the Florida version of the CIT. Annual adoption to changes in the federal Internal Revenue Code generally has been the practice in Florida since 1972, with the exception of 1981 and 2008.

The Florida Legislature has amended the CIT on eighteen occasions – including special sessions – since its enactment thirty-seven years ago. Undoubtedly the most sweeping and controversial change occurred in 1983, when the Legislature substantially altered the CIT base by:

1. Adopting a worldwide, unitary combination for determining taxable income;
2. Enacting a throwback rule for sales to affiliates whose earnings were not subject to the tax;²
3. Repealing the exemption on income from foreign sales and foreign source dividends;
4. Differentiating between business and non-business income for tax purposes.

¹ The following is adapted from the *Florida Tax Handbook, 2008 edition*, pages 50 – 52.

² Throwback rule was designed to prevent so-called “nowhere income” – income that no state subjects to tax.

A December 1984 *Special Session* of the Legislature repealed the domestic and worldwide unitary income combination, as well as the throwback rule and the taxation of foreign source dividends. At the same time, the CIT rate was increased to its present level of five and one-half percent. The overwhelming majority of legislative changes since then have emphasized a variety of exemptions and tax credits focused on community and capital investments.

III. The Current Corporate Tax System in Florida

Tax Rate

As noted previously, the CIT rate in Florida is currently 5.50 percent. This rate has remained unchanged since 1984. The State of Florida Constitution requires a three-fifths supermajority vote of the membership of both the Senate and the House to increase the tax rate.

Tax Base³

Federal taxable income, based on the federal income tax code and modified by certain adjustments, is used in Florida to determine adjusted federal income subject to the 5.5 percent rate. These adjustments include a \$5,000 exemption.

Adjusted federal income is apportioned to arrive at Florida taxable income using a three-factor, weighted-average formula. This formula has been in place since the inception of the tax. All business income is apportioned. Non-business income is allocated to a single tax jurisdiction – generally the state of commercial domicile. The apportionment factors and their respective weights are:

1. Sales with a 50 percent weight;
2. Property with a 25 percent weight; and
3. Payroll/Labor with a 25 percent weight.

The apportionment formula is illustrated in equation 1 below:

$$(1) T = R [(W_S \times \frac{S_F}{S_{US}}) + (W_P \times \frac{P_F}{P_{US}}) + (W_L \times \frac{L_F}{L_{US}})] \times FTI$$

T	= Florida corporate tax liability.
R	= Florida corporate tax rate, currently 5.50%.
W _S	= Weight applied to sales; currently 50%.
W _P	= Weight applied to property; currently 25%.
W _L	= Weight applied to payroll/labor; currently 25%.
S _F	= Sales sourced to Florida.
P _F	= Property sourced to Florida.
L _F	= Payroll/Labor sourced to Florida.
S _{US} , P _{US} , L _{US}	= A corporation's total U.S. Sales, Property and Payroll/Labor.
FTI	= A corporation's adjusted Florida taxable income.

²See *Florida Tax Handbook, 2008 edition*, page 50 and Florida Department of Revenue, *Florida's Corporate Income Tax* for more detail.

IV. Principles of Taxation

At least since the time of Adam Smith, economists have debated the issue of how to properly tax individuals, households, and businesses.⁴ Consensus seems to exist on the following principles in relation to state taxation of corporations:

1) Economic Neutrality

Neutrality simply means that corporate behaviors and decisions will not be affected by state CITs. In other words state CITs will not result in either beneficial or adverse unintended consequences. As McLure (2005) points out, it is impossible to eliminate all non-neutral elements of all taxes. State CITs (as well as other taxes) will therefore affect a state's competitiveness by affecting such things as corporate expansion and location decisions. In an increasingly open, global economy this is especially the case. Florida may face a growing threat to its competitiveness from states that have implemented SSFCITs – as corporations find capital investment and job creation more attractive in these states.

2) Benefits Based Taxation

Corporations should be taxed based on the benefits they receive from publicly provided goods and services such as transportation, public safety, water and sewer, education, etc. in order to avoid subsidies to and from the rest of the community and to properly align the cost of public goods provision. A number of researchers (McLure 2005, Fox, Luna, and Murray, 2004) have persuasively argued that corporate profits are a poor proxy for benefits and benefit-based taxes should apply to all businesses and not just corporations. Oakland and Testa (2000) estimated for a sample of Midwestern states that, in 1995, Minnesota's taxes on business were some 129 percent higher than would be appropriate under the benefit principle. In light of the challenges associated with implementing benefits-based taxation of corporations, the "ability to pay" principle has been widely introduced.

3) Design the Corporate Income Tax Based on the Goal(s) for the Tax System

This principle is a corollary to the previous two. It simply recognizes that the state CIT should be viewed as part of the state's overall system of taxation, that it should not work at cross-purposes with other components of the overall tax system, and that there should be specific goals for each component of the tax system.

The goal of the corporate income tax in Florida appears to basically be an additional source of general revenue. In 1971, when then-Governor Rueben Askew championed passage of the corporate income tax constitutional amendment, he often compared similar merchandise (mini-skirts) sold at major retailers at the same price in Georgia, which had a corporate income tax, and Florida, which did not. Governor Askew suggested that the same national corporation was making a greater profit off the Florida customers since they were not paying the tax it paid in many other states, especially neighboring Georgia.

⁴ See Musgrave (1959), which is now a classic in the field, or Myles (1995) for a more recent treatment of the issue.

4) Fairness

A fair tax exhibits horizontal equity, where equals are treated equally, and vertical equity, via socially acceptable differences in treatment of those who are not equal. Vertical equity is taken to imply that taxes are mildly progressive and standard theory assigns this responsibility to the federal level.

Fairness is determined by who ultimately bears the burden of the state CIT. Determining the incidence of Florida's CIT is extremely difficult. The notion – widely held in some quarters – that Florida can export the CIT to other states – as the corporation's owners/shareholders are largely non-residents – may be a serious oversimplification. Tax exporting may shift the burden out-of-state only for those industries where Florida has clear dominance. The increasingly national and international nature of competition in almost all industries limits such dominance.

As a basic economic precept, corporate income taxes, like all other corporate expenses, can only be borne by customers, employees/managers, suppliers, and shareholders. The degree to which these corporate income taxes are borne by each group depends on market conditions and the intensity of competition and in an extreme economic recession, less costs and taxes can be readily passed on to customers, so employees, suppliers, and shareholders feel the burden if the corporation cannot avoid such costs.

5) Transparency and Low Compliance Costs

Corporations, in particular, and taxpayers, in general, should understand the 'tax prices' they are paying with the CIT. Taxing business inputs such as property and labor make the tax system less transparent. These taxes, about \$2.4 billion, or close to 7 percent of Florida total tax revenue in 2007, are largely hidden making this part of the cost of government difficult to discern. Moreover, the burdens of these hidden taxes are far from transparent and may be borne by Florida workers.

In a related vein, low compliance cost should be a feature of the CIT. This is far from the case. For example, Gupta and Mills (2003) find that, as a percentage of revenue, the compliance costs associated with the state CIT are roughly twice those of compliance with the federal CIT.

6) Predictability/Stability of Changes

The more predictable policy changes to the corporate income tax system are, the lower the costs corporations and citizens face in adjusting to them. After ten years of relative policy stability, the sweeping, somewhat unpredictable changes of 1983 – and the state's, and the international community of nations', adverse reactions to them – are a classic example of the absence of predictability. Fortunately, since 1984 Florida's CIT system has exhibited more policy predictability. But, as discussed later, the revenues generated by the CIT show substantial year-to-year volatility.

With the possible exception of Principle 6, it is difficult to conclude that Florida's CIT meets the standards of either an efficient or fair tax. Arguably, the same conclusion could likely be reached for the other forty-six states that impose a CIT. Florida, however, should take little solace from this result.

V. The Corporate Income Tax Is Not Disappearing in Florida

Several researchers (Wilson, 2006; Edmiston, 2005; Brunori and Cordes, 2005) have observed that, since about 1980, state CITs on a national basis have become an increasingly smaller share of total state tax revenues. For example, Edmiston (2005) reports that state corporate tax revenues comprised 9.40 percent of total state tax revenues in 1981, but made up only 5.0 percent by 2002. Some commentators have even referred to this noticeable national downtrend as the "disappearance" of the state CIT. While disappearance may be an overstatement, it is unlikely that the percentage of revenues raised from the CIT will trend upwards in the future.

The national causes of the sharp downtrend have not been completely identified, although several factors have been uncovered – at least on a preliminary basis. They are as follows:

- Tax planning; especially apportionment factor management in response to changes in apportionment factors and changes in corporate form (Edmiston, 2005).
- Increases in state corporate tax credits and tax credit rates (Wilson, 2006).
- Changes in industrial structure resulting in lower corporate tax revenues (Edmiston, 2005).

The declining importance of the state CIT may be one factor behind state lawmakers' drive to increasingly view it less as a revenue source and more as an economic development tool.

The trends in Florida's CIT exhibit some similarities to the national trend, but also some important differences – especially over roughly the last fifteen years. Table 1 illustrates the CIT's average contribution to Florida's total tax revenues by decade grouping from 1972 to 2007. As can be seen in Table 1, the average contribution peaked in the decade of the 1980s; though with two economic recessions since 1999, we cannot conclude that an accelerating downtrend exists at present.

Table 1
Florida Corporate Income Tax Revenue as Percent of Total Tax Revenues, Average by Decade Grouping

<u>Time Period</u>	<u>Corporate Income Tax/ Total Tax Revenue</u>
1973 – 1979	5.26%
1980 – 1989	6.25%
1990 – 1999	5.17%
2000 – 2007	4.83%

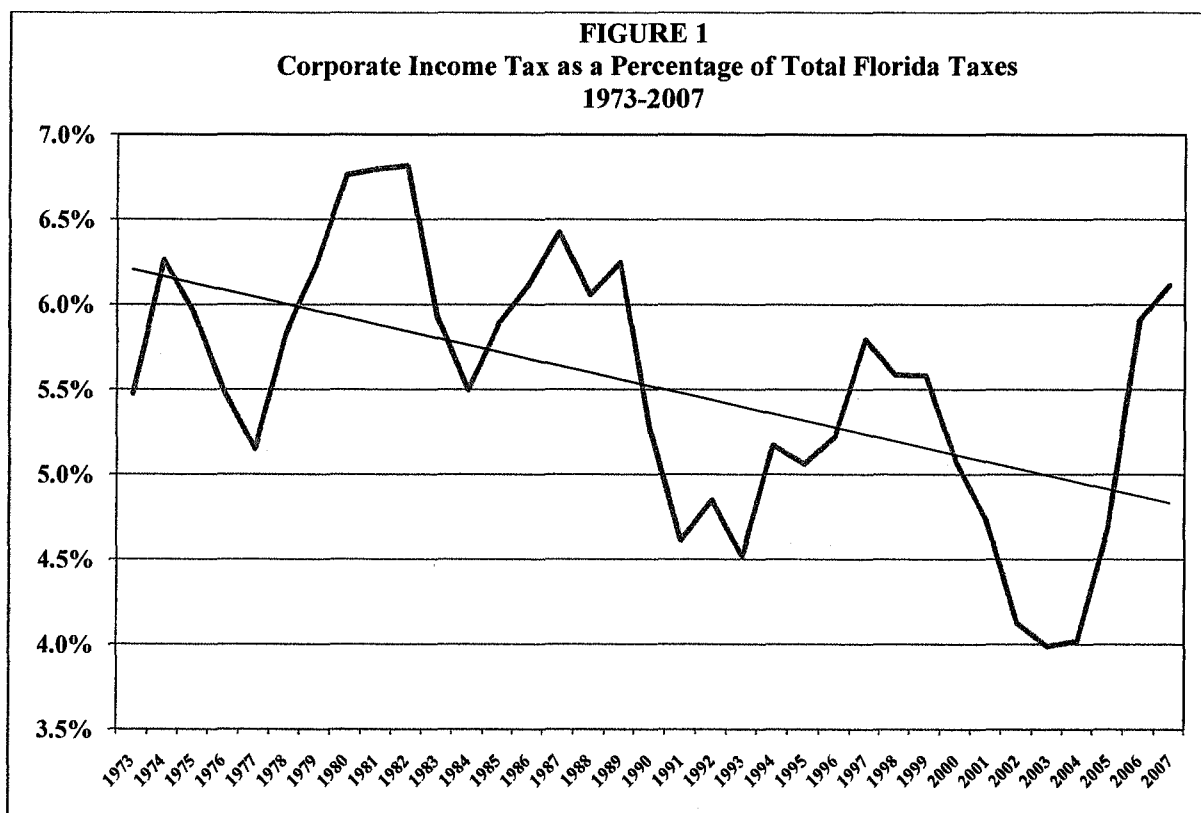
Source: Florida Office of Economic & Demographic Research and Florida TaxWatch.

Figure 1 charts Florida CIT revenues as a percent of total state tax revenues from 1973 to 2007. Three features of the CIT stand out. First, growth in the CIT is highly sensitive to state economic growth. CIT payments rise rapidly during economic upswings and fall sharply during

economic slowdowns and recessions.⁵ Our estimates suggest a 1 percent change in Florida's nominal GDP causes a 1.94 percent change in current dollar corporate tax revenues.

The second feature encompasses two time periods when the contribution of CITs dropped sharply owing other than to general economic conditions. From 1987 to 1993 – the first period of note – CITs as a percent of total tax revenues fell from 6.4 percent to 4.5 percent. The 1987 Legislature provided for the piggybacking of the Florida Income Tax Code with the Federal Tax Reform Act of 1986, which likely contributed to the eroding contribution of the CIT. Then, from 1997 to 2004, the contribution of the state CIT declined from 5.8 percent to 4.0 percent of total tax revenues. The 1997 and 1998 Legislatures enacted a sizable number of changes to the Florida CIT, which generally expanded exemptions and tax credits.

The third feature of Figure 1 is the downward sloping trend line depicted on the graph. It indicates that corporate taxes, relative to total taxes, are shrinking at a rate of roughly one-half of one percent per year. However, the episodes noted above may be exaggerating the downtrend.



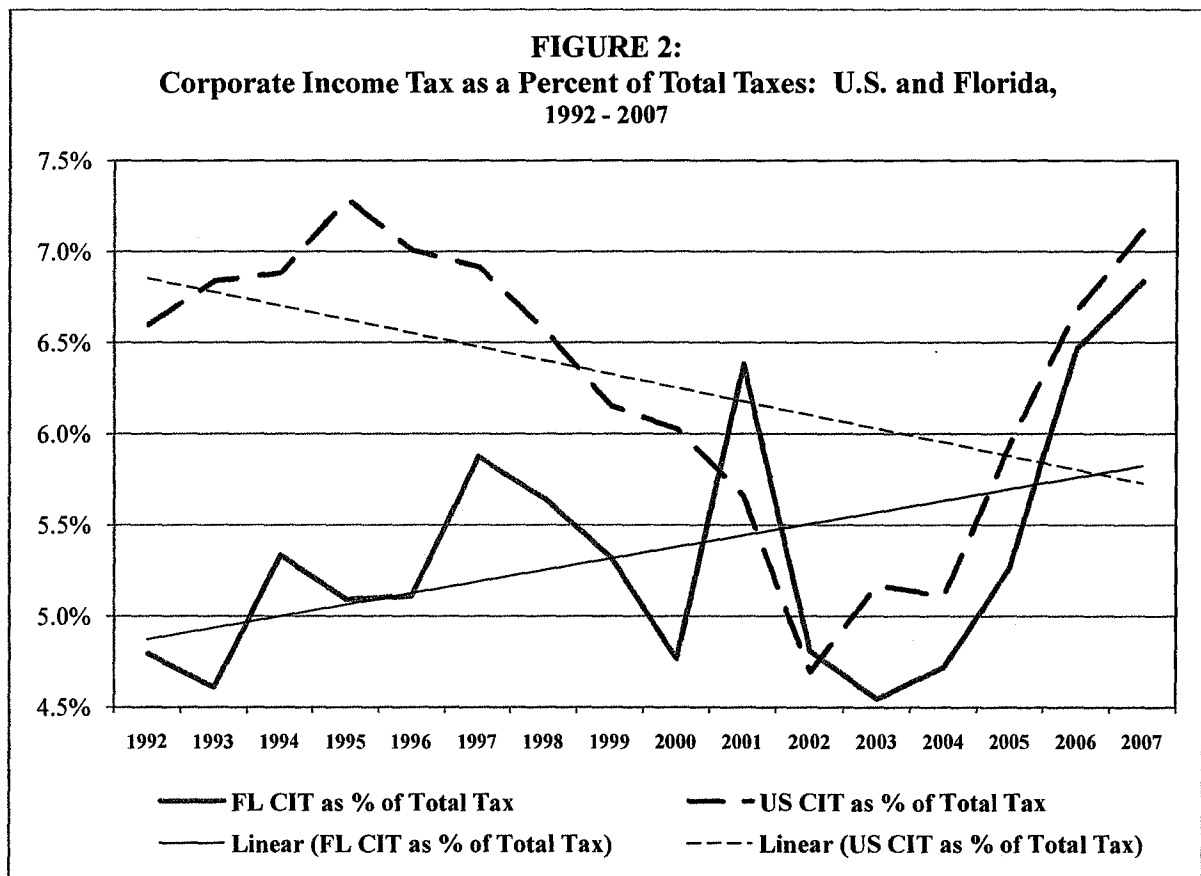
Source: Florida Office of Economic & Demographic Research and Florida TaxWatch.

⁵ A simple linear regression of the form, % Change NCIT = a + b*% Change NGDP + U with annual data from 1973 to 2007 gives the following estimates: % Change NCIT = -.07 + 1.94*% Change NGDP. R² = .53; F = 12.30 with t-statistics in parentheses. (-1.41) (3.50)

Using current or nominal dollar values for CIT and GDP rather than real or inflation-adjusted ones may bias the estimates downward owing to the disinflationary trend during much of the sample period.

Figure 2 presents CIT data relative to total taxes for Florida and the U.S. states which impose such a tax from 1992 to 2007. Focusing on the last fifteen, rather than thirty-five, years may provide greater insights on underlying changes.

A pronounced downtrend from 1995 to 2002 is apparent in the U.S. data when corporate taxes slipped from 7.3 percent to 4.7 percent of total state tax revenues. In contrast, Florida corporate taxes showed no discernable trend during this period although they did display considerable year-to-year variability. In 2002 and 2003, respectively, U.S. and Florida corporate taxes started to rapidly rise. However, as the trend lines indicate, over the last fifteen years corporate taxes relative to total taxes have trended *down* in the U.S. and *up* in Florida.



Source: U.S. Census Bureau, Governments Division: State Government Tax Collections

Table 2 compares the annual average growth rates of CIT revenues in Florida and the U.S. from 1992 to 2007. To provide perspective the annual average growth rates of total tax revenues and nominal GDP are also presented. As can be seen in Table 2, total tax revenues in Florida – as well as the U.S. – have, on average, grown roughly in line with the respective economies. Total tax revenues in Florida have expanded by an average of 6.30 percent per year compared to an average 6.60 percent per year increase in nominal GDP. However, the differences in the growth rates between corporate tax revenues and nominal GDP – as well as total tax revenues – are striking. In Florida, corporate tax revenues have grown by an average of 50 percent more per

year than the overall economy, and by an average of 57 percent more than total tax revenues. If nothing else, these data clearly indicate a rising burden of corporate taxes in Florida.⁶

Table 2
Corporate Income Tax Revenues in Florida and the U.S.: Average Annual Growth Rates 1992 – 2007

<u>Measure</u>	<u>Florida</u>	<u>United States</u>
Nominal GDP	6.60%	5.30%
Total Tax Revenues	6.30%	5.70%
Corporate Income Tax Revenues	9.90%	6.70%

Sources: U.S. Census Bureau, Governments Division: State Government Tax Collections. U.S. Department of Commerce, Bureau of Economic Analysis.

VI. The Drive to the Single Sales Factor

The landmark *Moorman Manufacturing* ruling by the U.S. Supreme Court – which upheld the Constitutional validity of Iowa's SSF apportionment formula and thus refused to sanction the equally weighted three-factor formula – served as the clarion call for state legislatures to actively pursue economic development and revenue strategies via changes to factor apportionment formula.⁷ In the thirty-one years since the *Moorman* ruling, a clear trend has emerged – gradual at first, but now accelerating towards the SSF in state apportionment formulas.

The 1980s witnessed most states – roughly thirty of forty-four – adhering to the equally-weighted, three factor formula; though about ten states shifted to a double or fifty percent weight on sales in this decade. The 1990s saw an intensification of the trend to a double-weighted sales apportionment formula. About twenty-five states had shifted to the double-weighted formula by the end of 1999 and five had moved to the SSF formula. Eighteen states have increased the weighting of the sales factor since the year 2000 – including seven that have adopted some form of the SSF with an eighth state seemingly on the verge of doing so. In the last twelve months:

- Colorado adopted the SSF in May, 2008 to be fully implemented beginning in January, 2009.
- California adopted an elective SSF on February 23, 2009 to be effective beginning on January 1, 2011.
- The Virginia General Assembly, without dissenting votes in either the House or Senate chambers, voted on February 23 and 24, 2009, respectively, to adopt an elective SSF to be effective on July 1, 2010 and fully implemented in 2013.

⁶ Other researchers have also noted the rising burden of business taxation in Florida. See, for example, R. Cline, T. Neubig, A. Phillips, "Total State and Local Business Taxes: 50 State Estimates for Fiscal Year 2006." Council on State Taxation and Ernst and Young, February, 2007. S. Morrell, "Business Taxation in Florida: A Growing Threat to Competitiveness?" *Economic Commentary*, Center for Competitive Florida at Florida TaxWatch, #18, April/May, 2007.

⁷ *Moorman Manufacturing Company v. Blair* (437 US 267, 1978).

Table 3 summarizes, as of March 2, 2009, the fast-changing landscape of CIT apportionment formulas.

Table 3
State Corporate Income Tax Apportionment Formulas
As of March 2, 2009

The Following 5 States Do Not Have a Corporate Income Tax

Nevada
South Dakota
Washington
Wyoming
Texas employs a 1% franchise tax apportioned by sales

The Following 11 States Have a Mandatory Single Sales Factor

Colorado
Georgia
Illinois
Iowa
Louisiana
Maine
Michigan
Nebraska
New York
Oregon
Wisconsin

The Following 2 States Are Phasing-In a Mandatory Single Sales Factor

Indiana complete phase – in 2011
Minnesota complete phase – in 2013

The Following 6 States Have an Elective Single Sales Factor

Connecticut election between single sales factor and double-weighted sales factor
Maryland election between single sales factor and double-weighted sales factor
South Carolina election between single sales factor and double-weighted sales factor
California election between single sales factor and double-weighted sales factor,
beginning in 2011
Missouri election between single sales factor and equally weighted three factors

The Following 3 States Have a Greater Than 50 Percent Weight on the Sales Factor

Arizona sales weighted 75%; property and payroll each weighted 12.50%
Ohio sales weighted 60%; property and payroll each weighted 20.00%
Pennsylvania sales weighted 70%; property and payroll each weighted 15.00%

The Following 12 States Have a Double Weighted Sales Factor

Arkansas
Florida
Idaho
Kentucky

Massachusetts	certain manufacturing, defense contractors, and mutual fund firms must use single sales factor only
New Hampshire	
New Jersey	
North Carolina	
Tennessee	
Vermont	
Virginia	state legislature has voted to adopt elective single sales factor
West Virginia	

The Following 2 States Can Choose Either a Double Weighted Sales Factor or an Equally Weighted Three Factor

New Mexico
Utah

The Following 10 States and the District of Columbia Have an Equally Weighted Three Factor

Alabama
Alaska
Delaware
Hawaii
Kansas
Mississippi
Montana
North Dakota
Oklahoma
Rhode Island

Source: Federation of Tax Administrators and Florida TaxWatch

VII. Conceptual Foundations of a Single Sales Factor

Florida faces two powerful incentives to adopt a SSF apportionment formula. The first is the boost to the state's long-term economic growth. The second incentive is to ward off competitive disadvantage as other states implement a SSF apportionment formula.

The Stimulus to Economic Growth

McLure (1980) was the first to recognize that, when tax rates vary across states, a formula apportioned CIT is equivalent to *four* separate firm-specific taxes. These are:

1. A nation-wide profit tax rate, and;
Three state specific excise taxes (or subsidies) - one each on
2. Sales,
3. Property, and
4. Payroll

As discussed later, the economic development effects of these taxes on such things as firm location, expansion, capital investment, job creation, and tax payments are not necessarily either easy or straightforward to determine.

To illustrate the potential complexities, consider the case where: (a) all states impose a corporate income tax; (b) all states completely piggyback the Federal income tax code; (c) all states tax at the same rate; and (d) all states use the same factor apportionment formula with the same weights. In this hypothetical environment, the economic development effects of the three excise-corporate taxes will completely disappear as the taxes would not provide any one state either a competitive advantage or disadvantage compared to any other state. In other words, the three excise-corporate taxes on sales, property, and payroll would be completely neutral and the state CIT would simply resemble a corporate tax levied at the national level.⁸

The information in Table 3 demonstrates that the above situation is a far cry from today's reality. Factor apportionment formula(s) and the weight(s) assigned to the factor(s) vary widely across states – though, as previously noted, a convergence to the SSF may be in progress. There is a burden/incidence associated with the excise-corporate taxes on sales, property, and payroll as a result. Corporations will engage in a variety of factor apportionment management schemes – including those which may directly or indirectly either stimulate or retard capital investment, job creation, and economic growth in states. For Florida at present, in light of the drive to the SSF among states with which it directly competes such as Georgia, South Carolina, Illinois, and possibly Virginia, incremental economic growth is clearly being disadvantaged.

Edmiston (2002) provides a theoretical framework for analyzing the economic effects of a SSF. He does this in the context of states acting strategically – that is, seeking an economic development advantage via adopting a SSF, as well as for the case when states act simultaneously to adopt a SSF. These cases are apt descriptions of the situations many states – including Florida – face today.

In this regard, consider a multistate firm producing and selling a good in several states, where each state employs an equally-weighted, three factor apportionment formula. The firm faces four tax rates as noted above. These are:

- A nation-wide tax rate on *profits/net income*

This tax rate is the weighted average state CIT rate across all the states where the firm does business (has nexus). That is, the weight for each state is multiplied by the tax rate for that state. Each state's weight is the percentage of profits apportioned to that state.

- A state tax (or subsidy) rate on *sales, property and payroll*

The tax rate on sales, for example, is the product of two factors. First, the firm's profit margins on sales in a specific state. The second factor is the difference between the factor weighted tax rate on sales in that state and the average factor weighted tax rate on sales in all states where the firm does business. The tax rates on property and payroll are determined in a similar fashion.

When the above tax rates on sales, property, and payroll are greater than (less than) the nation-wide tax rate on the firm's profits, it faces what are in essence excise-corporate taxes (subsidies) on the factors. It is these excise-corporate taxes, or subsidies, that

⁸ In an open, global economic environment where firms, labor and capital are mobile this may not be the case and the three excise taxes may have a burden or incidence.

discourage and encourage firms, respectively, to relocate, expand, make capital investments, and create jobs.

What happens when a state such as Florida increases its sales factor weight to 100 percent and lowers the property and payroll factor weights to zero? The answer depends on the changes in the four tax rates. In the first instance it is revealing to examine the change in each tax rate in isolation of the others. The results are as follows:

- Change in the tax rate on Florida profits: Winners and Losers.

The change in the tax rate on profits will critically depend on the relative size of the firm's total/nationwide sales, property, and payroll located in Florida. Firms with a large (small) share of total sales in Florida compared to the Florida shares of property and payroll will see an increase (decrease) in the tax rate on Florida profits.

This result has led to the general view that corporations with substantial capital investments and work forces in Florida who sell most of their products out-of-state will enjoy lower tax rates on their Florida profits. Such corporations have been labeled "production intensive." In contrast, those corporations with relatively small capital investments and work forces in Florida who sell most of their products in Florida will face higher tax rates on Florida profits. Such corporations have been labeled "market intensive." The burden of the profit taxes will be shifted to these out-of-state corporations. Firms with substantial capital investments in Florida who sell most of their products in Florida are not likely to see any change in their tax rate on Florida profits.

- Change in the excise-corporate tax rate on Florida sales.

Increasing the sales factor weight to 100 percent will raise the effective excise-corporate tax rate on Florida sales. Whether or not this will discourage sales in Florida will depend on how much of the higher excise-corporate tax on sales can be shifted to consumers and the response of consumers to higher prices.

- Change in the excise-corporate tax rate on Florida property and payroll.

Lowering the factor weights on property and payroll eliminates these excise-corporate taxes. By doing so, capital investment and job creation in Florida are unambiguously encouraged.

- Overall Effects

A 100 percent sales factor (SSF) weighting will encourage all firms, both production and market intensive, to produce more in Florida. Even for market intensive firms, tax liabilities will be reduced by shifting production to Florida.⁹

⁹ The above discussion follows Edmiston's (2002) assumption that sales are situated at destination rather than origin. He demonstrates, pages 243-244, that when sales are situated at origin then for such firms productive activities may either fall or increase only slightly in response to a 100 percent sales factor weighting. In the former case the 100 percent sales factor weighting essentially becomes an origin-based gross receipts tax.

Immunizing Against Competitive Disadvantage: The Prisoner's Dilemma

The capital investment and employment benefits one state achieves from moving to a SSF apportionment formula may come at the expense of states that do not make the change. Once one state initiates a SSF change all other states gain from doing so – even if the state would have been better off if all states had maintained a different apportionment formula such as an equally weighted three factor formula.

The apportionment game thus becomes a prisoner's dilemma as shown by Edmiston (1999).¹⁰ Each state's best economic development strategy is a SSF scheme, regardless of the strategy of other states. An equilibrium-dominant strategy exists where the SSF becomes universal.

VIII. Empirical Estimates of the Gains from a Single Sales Factor

Researchers have been measuring the effects on economic activity of moving to a heavier sales factor weight (and reducing the weights on property and payroll) for several years. Different time periods, states, data bases, and empirical techniques have been employed.

The early flurry of research dating from the 1990s found scant economic impacts from shifting apportionment factor weights to the sales factor.¹¹ However, more recent research has consistently and unambiguously found positive economic effects – often of substantial magnitudes – from increasing the sales factor weight. Tables 4 and 5 below summarize some of the key findings from this research.

Table 4

Empirical Estimates of the Gains from Increasing the Sales Factor Weight

<u>Researcher</u>	<u>Research Issue</u>	<u>Results</u>
Klassen & Shackleford (1998)	Apportionment Management	Evidence of widespread apportionment management.
Goolsbee & Maydew (2000)	Manufacturing Jobs	Double weighting sales increases jobs by 1.1%
Gupta & Hofmann (2003)	Capital Investment	Reducing property burden increases capital investment by 0.05% to 0.35%
Edmiston (2006)	Jobs, Capital Investment, Sales	Double weighting sales increases jobs by 2.00%, capital investment by 2.10%, reduces corporate in-state sales by 6.50%

The above research – focused primarily on shifts from an equally-weighted, three factor apportionment formulas to double-weighted sales ones – indicates job gains on the order of 1 percent to 2 percent and capital investment expenditure increases of more than 2.00 percent. These are sizable increases.

¹⁰ A prisoner's dilemma is a situation in which agents act strategically, responding to what they think their competitor will do. If the agents do not cooperate, then each agent will end up worse off than if cooperation occurred.

¹¹ See, for example, the research summary in Edmiston (2006).

Edmiston's 2002 research focused exclusively on a shift from an equally-weighted, three factor apportionment schemes to a SSF. Moreover, the design and scope of his model makes his empirical estimates deserving of special attention.

Edmiston's purpose was to compare long-run economic equilibrium in environments with three-factor formulas (his benchmark) to those with a SSF. He developed an eight region, eight industry model of the U.S. economy and simulated the effects on each region moving independently and then each region moving simultaneously to a SSF formula.

Edmiston finds substantial, positive long-run economic development impacts from states independently adopting SSF formulas. In the short-run, the impacts were considerably smaller.¹² The magnitude of the impacts varies (understandably) with his assumptions for labor and firm location mobility. His 'base case' effects are reported in Table 5 below:

Table 5
Long-Run Economic Development Effects of Single Sales Factor Formula: Southeast Region

<u>Measure</u>	<u>Economic Impact</u>	
Capital Investment	Increases by 0.75%	
Employment	Increases by 0.66%	
Value of Output	Increases by 0.69%	
Corporate Tax Revenue	Decreases by 2.61%	
Other Tax Revenues	Increases by 0.63%	
Industry Effects	Capital Investment	Employment
Agriculture	0.75%	0.69%
Mining	0.00%	0.83%
Construction	0.61%	0.49%
Manufacturing	0.84%	0.77%
Transport/Communications/Utilities	1.17%	1.29%
Wholesale & Retail Trade	0.83%	0.83%
Finance/Insurance/Real Estate	0.80%	0.74%
Services	0.27%	0.22%

Source: Edmiston, 2002 Tables 3 and 4.

The fact that all of the employment, capital investment – except for mining – and value of output are positive is impressive and striking. While the results are for the Southeast Region and not Florida specifically, the inference is that Florida's economy would receive a sizable, permanent boost to its long-run economic growth from adopting a SSF formula.

¹² However, when all regions move simultaneously to a single sales factor the aggregate, long-run economic impacts for the Southeast region turn to slightly negative values. This presumably reflects the different industrial structure of the Southeast, with a lesser emphasis on manufacturing than regions such as New England and the Mideast. See Edmiston, Table 3 page 249.

IX. Conclusions

This report has clearly demonstrated that adopting the single sales factor apportionment formula for the corporate income tax will be a source of substantial economic growth for states. Increasing the sales tax weight to 100 percent will stimulate capital investment, job creation, corporate re-location, and retention. The combined effects of these factors will be to increase long-run economic growth.

The report also concludes that Florida should move to a SSF apportionment formula or face the very real risk of losing jobs, businesses, capital investment, and economic activity to states that have adopted it.

In adopting the SSF apportionment formula, a number of issues will need to be addressed. They include destination versus origin rules, nexus issues, and the so-called throwback rule. While important, these issues should not stop Florida from adopting the SSF apportionment formula.

In the midst of the most severe economic downturn in decades, Florida must seize the opportunity to implement structural policy changes that will contribute to its long-run economic vitality. The single sales factor apportionment formula is just such a change.

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Florida TaxWatch's research recommends productivity enhancements and explains the statewide impact of economic and tax and spend policies and practices on citizens and businesses. Florida TaxWatch has worked diligently and effectively to help state government shape responsible fiscal and public policy that adds value and benefit to taxpayers.

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The Single Sales Factor for Corporate Income Taxes

Is it Really a Good Deal for Florida?

Some representatives of the business community are urging the Florida Legislature to change the "apportionment formula" that is used to determine a multistate corporation's nationwide profit that is subject to Florida's corporate income tax. Instead of calculating Florida's corporate income tax on the portion of the multi-state corporation's sales, property and payroll (a three-factor formula) as a percentage of the total, they advocate for a substantial change that would base a corporation's tax on only the portion of sales in our state – a single sales factor. It is argued that this approach will stimulate job creation and investment by producing/manufacturing businesses. However, there is little evidence that would actually happen. Rather, the lost tax revenue that will result from changing the apportionment formula may impair the ability of Florida to provide vital and critical services needed.

Florida's current apportionment formula considers sales (50%), property (25%) and payroll (25%). Companies that have relatively large shares of their jobs and facilities in Florida, but primarily sell their products outside of Florida argue that Florida's current apportionment formula penalizes them for investing more capital in our state to expand their production facilities and increase jobs. Hence, corporate interests with a corporate model such as this would have a substantial tax decrease in Florida corporate income tax under a single sales factor for apportionment. In the extreme, a manufacturing company that produced its entire product in Florida but sold it all outside of Florida would pay no corporate income tax to Florida!

In contrast, companies with a relatively small share of property and payroll in Florida, but a significant share of their total sales in our state, would experience an increase in their corporate income tax. In other words, if Florida were to change to a single sales factor some corporations would receive tax cuts and others would experience a tax increase.

The three-factor formula recognizes that a state provides a range of services to a corporation's property and workers and provides a market for the products of the company, and therefore the corporate income tax levied against that company should consider all three factors.

Corporations benefit from a wide range of governmental services that specifically relate to the extent of property and payroll in a state. Under the single sales-only formula, only the portion

of the corporation's sales in the state are considered even if 90% of its employees and property are within the state. Therefore, a single sales factor apportionment formula is inconsistent with the fundamental principle behind the corporate income tax - that a corporation should pay taxes to a state as compensation for the benefits it receives from state services (environmental impact, police protection, transportation infrastructure, educated workforce, etc.) and the ability to market its products in the state. The change from a property-payroll-sales formula to a sales-only formula substantially reduces the corporate tax burden of businesses that arguably are benefiting the most from public services in a state and unfairly shifts the tax burden to out-of-state businesses (or in-state businesses that have a high sales factor) that benefit from state services to a lesser extent.

If all states adopted a single sales factor (SSF) apportionment approach there would be no competitive advantage to multistate corporations. However, with the current patchwork of apportionment formulae and different tax rates, an out-of-state corporation that would pay higher corporate taxes if Florida changes to a sales-only formula would have an incentive to remove all of its property and employees from our state to eliminate its tax liability. These companies would argue that a lack of physical presence means there is no "nexus" and therefore they cannot be taxed at all no matter how much of their product they sell in Florida. Therefore, switching to a single sales factor may cause some companies with significant sales outside of Florida to expand their operations in our state (as proponents argue) but it may also lead some companies to pull out of the state (unintended consequence) leading to both job gains and losses.

The Center examined the relationship between job trends in the manufacturing sector and the nature of each state's apportionment formula. If the single sales factor formula is an incentive for job growth, it would be expected that those states with such a formula would lead the country in job growth in manufacturing. Table 1 illustrates that the only trend that exists is that there is no direct relationship. Of the 18 states with a single sales factor (either implemented or approved for implementation), nine are above and nine are below the median percentage of employment change in manufacturing for the period December 2001 to December 2007.ⁱ

Notwithstanding the benefits and costs associated with changing Florida's corporate income tax apportionment formula to attract manufacturers to Florida, it should be noted that in total, manufacturing is a declining sector of the national economy. Between 2001 and March 2009, manufacturing jobs in the U.S. have decreased from 16,441,000 to 12,310,000.ⁱⁱ Clearly, Florida and the nation's economic future are not in manufacturing.

It is also important to examine what happens to a state's corporate income tax revenue when it changes to a single sales factor. For example, the state of California enacted a Single Sales Factor tax apportionment during the 2009 Assembly session (effective tax year 2011). As noted in the California Senate bill analysis, the fiscal impact will exceed \$1.45 billion by FY 2012-13 (approximately 15% of the total corporate income tax revenues), "...with additional and

growing losses in subsequent years.”ⁱⁱⁱ Earlier research found that a similar trend in revenue reduction was probable in states adopting a single sales factor apportionment formula.^{iv}

These findings strongly suggest that changing Florida’s corporate income tax apportionment formula to a single sales factor would not be a good deal for our state. Harm from adoption of such a change would be even greater if the state did not first make other reforms to its corporate income tax policy. As further support for this admonition, the Senate Select Committee for Florida’s Economy Florida was advised by the Haas Center (its contractor for economic advice and recommendations) that any consideration of the single sales factor should also implement the following in order to avoid “jurisdiction shopping:”

- A broad and inclusive economic nexus standard to keep the taxable base broad;
- Combined reporting to reduce incentives to declare costs in one place and profits in another;
- Business level tax on LLC’s to avoid inequity between C corporations and LLC’s; and
- A throwback rule to capture “nowhere income.”^v

Florida already has one of the lowest corporate income tax rates in the country at 5.5%. As the Center already recommended (<http://www.fcfe.org/Documents/CloserLookTaxProposal.pdf>), we believe the best deal for Florida and its business partners is to make the corporate income tax fairer by closing corporate loopholes and eliminating the advantage certain businesses have due to a particular legal structure, and ultimately, reducing the corporate income tax rate to attract **all types of businesses** to Florida, not just manufacturers.

Table 1 - Selected State Corporate Income Tax (CIT) Characteristics

State	CIT Apportionment Formula Type	Maximum Corporate Income Tax Rate	Manufacturing Employment Change December 2001 - December 2007
Alabama	Equal 3F	6.50%	-6.7%
Alaska	Equal 3F	9.40%	13.3%
Arizona	>50% SF	6.97%	-5.8%
Arkansas	2xSF	6.50%	-15.0%
California	SSF (effective 2011)	8.84%	-14.0%
Colorado	Equal 3F or 2F	4.63%	-14.3%
Connecticut	SSF *	7.50%	-13.0%
Delaware	Equal 3F	8.70%	-10.4%
Florida	2xSF	5.50%	-11.2%
Georgia	SSF	6.00%	-12.1%
Hawaii	Equal 3F	6.40%	-5.0%

Idaho	2xSF	7.60%	-0.5%
Illinois	SSF	7.30%	-13.3%
Indiana	SSF (effective2011)	8.50%	-7.6%
Iowa	SSF	12.00%	-0.3%
Kansas	Equal 3F	4.00%	-2.4%
Kentucky	2xSF	6.00%	-11.0%
Louisiana	SSF *	8.00%	-3.1%
Maine	SSF	8.93%	-16.6%
Maryland	SSF *	8.30%	-19.0%
Massachusetts	SSF *	9.50%	-20.2%
Michigan	SSF	4.95%	n/a
Minnesota	SSF (effective2014)	9.80%	-7.4%
Mississippi	2xSF	5.00%	-12.4%
Missouri	SSF	6.25%	-11.1%
Montana	Equal 3F	6.75%	-1.4%
Nebraska	SSF	7.81%	-5.7%
Nevada	none	n/a	n/a
New Hampshire	2xSF	8.50%	-12.6%
New Jersey	2xSF	9.00%	-18.9%
New Mexico	Equal 3F or 2xSF	7.60%	-7.2%
New York	SSF	7.50%	-19.4%
North Carolina	2xSF	6.90%	-19.8%
North Dakota	Equal 3F	6.50%	9.3%
Ohio	>50% SF	8.50%	-15.8%
Oklahoma	Equal 3F	6.00%	-8.8%
Oregon	SSF	6.60%	-1.0%
Pennsylvania	>50% SF	9.99%	-17.2%
Rhode Island	Equal 3F *	9.00%	-23.1%
South Carolina	SSF *	5.00%	-17.0%
South Dakota	none	n/a	n/a
Tennessee	2xSF	6.50%	-13.9%
Texas	none	n/a	n/a
Utah	Equal 3F or 2xSF	5.00%	10.2%
Vermont	2xSF	8.50%	-17.8%
Virginia	2xSF	6.00%	-16.9%
Washington	none	n/a	n/a
West Virginia	2xSF	8.50%	-17.0%
Wisconsin	SSF	7.90%	-7.9%
Wyoming	none	n/a	n/a

* Includes variations to apportionment method

Source: "The "Single Sales Factor" Formula for State Corporate Taxes – A Boon to Economic Development or a Costly Giveaway", Michael Mazerov, Center for Budget and Policy Priorities, September 2005 as updated.

ⁱ "The "Single Sales Factor" Formula for State Corporate Taxes – A Boon to Economic Development or a Costly Giveaway", Michael Mazerov, Center for Budget and Policy Priorities, September 2005.

ⁱⁱ U.S. Bureau of Labor Statistics: <ftp://ftp.bls.gov/pub/supl/empsit.ceseeb1.txt>

ⁱⁱⁱ Bill analysis AB 15 X3 as amended February 14, 2009, the California Senate.

^{iv} The "Single Sales Factor" Formula for State Corporate Taxes – A Boon to Economic Development or a Costly Giveaway", Michael Mazerov, Center for Budget and Policy Priorities, September 2005.

^v Select Committee on Florida's Economy, Florida Senate, Meeting Packet, April 15, 2009.