

## **The capitalist conquest of democracy**

by **Ben Thacker-Gwaltney**

Capitalism has invaded our system of democracy. Book after book has come out recently describing how the values of our market-based economy have spread into other aspects of our lives. Most of the discussion can be traced to a philosophical tradition that goes back for centuries.

Bear with me while we go back in time for a moment. I promise, three paragraphs and we'll be done with the philosophers.

The ancient Greek philosopher Aristotle wrote of three types of knowledge. The first type, theory, is knowledge that pertains to the nature of the universe and those things that are unchangeable and eternal. Theoretical knowledge is valuable for its own sake, with no practical application necessary. A modern example would be theology, the contemplation of the divine. Thus, the two words, theology and theory, have the same root, theos, or God.

The second type of knowledge is politics, by which Aristotle meant the creation of a society made of virtuous citizens capable of leading a good and just life together. This involves thought of ethics and morality, of "values" — a word much used in American politics today. How can we create a society that educates its members so that they are people of good character? Hard and fast rules do not apply here; human life is enormously complex, and wisdom is required to look at the current situation and figure out the right and moral thing to do in response. This knowledge is practical, a word directly derived from the Greek word praxis.

Finally, the third type of knowledge is productive in nature, describing the knowledge necessary to produce useful or beautiful objects. Artisans and crafters need this sort of knowledge for making things. It comes from the Greek word techne, technical knowledge, or skill. In the modern world, this type of knowledge has become the domain of experts, administrators and bureaucrats who have special training not available to the general public. Their job is done without reference to particular morality outside of their own professional ethics. They attempt to do their job from an objective, value-free point of view that cares mainly about technical efficiency as an ultimate goal.

What does this have to do with understanding the economy and why capitalism has over-run our democracy?

Let's look at an example. City Council is meeting to discuss the zoning approval of a new housing development. The local housing authority recently tore down a large public housing complex, and then they sold the land to Mr. Deep Pockets who plans to build upscale condominiums and high-end houses. City Council does a straight cost/benefit analysis to determine their response. 1) We tore down low-income housing and dispersed poor people who were a drain on city services. Our city budget is strapped for cash, so we are glad that some of them left the city altogether and the others are spread out across other neighborhoods. 2) Mr. Deep Pockets is going to build houses for wealthy people who will pay a lot more in property taxes and spend money in the businesses in our city, all of which increases our tax revenue. The city comes out way ahead.

This argument is an application of technical knowledge. The City Council asked themselves, "How can we make a city which functions efficiently?" With the goal of a more profitable and efficient city, the council votes in favor of the zoning change and the new houses are built. Absent from the decision was any real consideration of the city's obligation toward its low-income citizens, any notion of the response demanded

of a council member of virtuous character or, much less, what decision would help make the city into a good and just community.

Here is another example. The Virginia General Assembly considers legislation every year which would prohibit any local government from passing a living wage ordinance and erase any that are already in effect. On one side of the argument the business community argues that local government, like private business, must be run as efficiently as possible in order to keep taxes low. The market's prevailing wage should set the amount that local governments pay to each of their employees.

On the other side, unions, faith communities and civic organizations argue that a good and just society ensures that all of its citizens work in jobs that pay an amount sufficient to maintain a decent quality of life. A politician whose character was built on the virtues of mercy, compassion and justice would instantly recognize the validity of the argument. Instead, such concerns are dismissed as idealistic. We are forced to argue our case using technical knowledge: better wages mean lower costs for business and government because workers perform their jobs better and employee turnover costs are dramatically reduced. In other words, living wages boost efficiency.

In the end, the competition of our capitalist economy rewards only one goal: efficient production. Other values can be its servant, but never its master. Community institutions that refuse to bow down at its altar are ultimately punished. Businesses fail, organizations dissolve, local governments go bankrupt.

Political knowledge has nearly lost its struggle with technical knowledge. The servant has become the master. Neither liberals nor conservatives argue this point. Progressives are often unwilling to recognize the problem because so many have been absorbed into the professional class, and conservatives possess the very technical knowledge that now rules the world.

And most ironically, the right-wing embraces the rule of the free market while simultaneously demanding good character from its leaders. The result is so much public speech about morality and family values coupled with public decisions that seem to disregard those values beyond a few token issues. The right-wing daily increases the power of the very thinking that destroys that which they value most.

What is demanded of us now is true citizenship. We organize to demand leaders of good character. And good character means they put our capitalist economy to the service of human well-being, rather than enslaving humans to economic efficiency.

## **With taxes, what you believe in is what you get**

At least three distinct sets of economic beliefs have provided the foundation to this year's budget battles in Virginia's General Assembly. There are the Senate and the Governor, the anti-taxers in the House, and finally, a coalition of community, church and labor organizations called Virginians For Tax Reform. Each presented a different tax proposal. What we get when all is said and done may be some mix of the three.

### **Senate/Governor**

We can trace the roots of the Senate/Governor proposal back to the economic theory which dominated the period from the Great Depression up to the Reagan Revolution of the early 1980's, that of John Maynard Keynes. At its heart, Keynesian economics believes that private markets are inherently unstable, moving through extreme periods of boom and bust. The role of government is to curb these excesses by regulating the powerful drive of private business toward profit at any cost, as well as cushioning the effects of economic inequality by providing a social safety net for the poor. Government and business are in a partnership where business is the engine and government is the driver, keeping the train on the tracks and moving forward.

To accomplish that, government has certain public duties — many have to do with the infrastructure that allows business to continue functioning. Education, transportation, public safety, health and welfare all fall under the proper role of government. To accomplish these duties, government needs money, which it gets by raising revenue from all citizens on a more or less equal basis.

Governor Mark Warner and Senator John Chichester each recognized that the core obligations of Virginia state government would need to be cut this year unless some new money was raised. In addition, each of them wanted to provide some degree of tax relief to working families; the Senator fixes the “cliff effect” in the current low-income tax credit and both of them raise the personal exemption and standard deduction to help cut some poverty-level income from the tax base.

Another factor driving both the Governor and the Senate is the danger to Virginia's AAA bond rating that instability in recent budgets have caused. Over the summer Virginia was put on the bond agencies' “watch list” for possible downgrading. Losing the AAA bond rating could greatly increase the cost of government.

### **Anti-tax House Republicans**

The poster child for supply-side economics, Milton Friedman, can serve as the economic theorist at the heart of the House Republican tax proposal. Friedman is a proponent of free market capitalism, where the market is left to set its own rules without interference from government regulation. Taxation is the worst form of interference, since it sucks out resources which otherwise would have been used for economic growth. Taxing individual consumers is bad, but taxing business in such a way that you skew the playing field is even worse.

Thus, there is the “No Tax Hike Ever” pledge. Under this theory, taxes are always a bad thing, even if it means the government has to cut services it shouldn't have been providing anyway. Why? Because they believe the ruthlessness of the market means it will always be more efficient at whatever it does than the government. If the government drops a program and it was really needed, then some private business will take up the task and make money doing it.

After stonewalling on collecting any new revenue whatsoever, the House produced a bill that would eliminate sales tax exemptions for particular commercial and industrial uses. In effect, shipyards, airlines, taxicabs, printers, natural gas and oil companies, the Wallops Island spaceport and trucking companies would have to start paying sales taxes. They refused to call this a tax hike, since it was collecting taxes that

normally would have been paid without these special exemptions. This has an internal logic. If we have to have a sales tax, then it should apply to all individuals and businesses equally. Otherwise, the government is messing up the market's balance again.

## **Virginians For Tax Reform**

The third proposal came from a group of community, church and labor organizations which were less interested in a particular set of economic beliefs than in injecting basic human values into our state's tax policy. As the author William Greider puts it in his recent book, *The Soul of Capitalism*, the values of capitalist accumulation and efficiency are threatening to overwhelm the values of human caring and community. These values include demands such as: We must be fair with one another. We must take care of one another. We must seek the best life possible for all members of our community, not just an elite few.

From these values come the three demands of the coalition to reform our state tax system so that it is fairer, adequate to fund the functions of state government and best suited to raise revenue in the current economy. Fundamental to the demand for fairness is the realization that our tax system takes 10 percent of the income of the poorest Virginians and only 6.9 percent of the richest. Our tax system redistributes wealth upwards. At a minimum, human fairness demands that we all pay an equal share of our income to help fund public projects. Also, people below the poverty line should pay little tax at all, since as a society we want their income to increase so that they can provide for the basic needs of their families. Taking more of what little they have is counter-productive.

Second, the coalition sees that state government has an essential role in maintaining the quality of life for its citizens. Without adequate revenue, it cannot do its job. Happily, by meeting the third goal of modernizing the tax system, Virginia can also raise this extra revenue.

By demanding that basic human values take precedence over economic growth at all costs, the community coalition believes that economics should always serve the well-being of human beings rather than vice versa.

## **And with some legislators, what you give is what you get**

*Quid pro quo* awards should go this year to Senators Thomas Norment and Walter Stosch, who each accepted large campaign donations from corporate PACs and then sponsored legislation which would directly benefit those corporations.

Senator Norment comes in first place. The ironically-named Verizon Good Government Club made a \$14,000 donation to him in this last campaign cycle, nearly double what it gave any other legislator (Sen. Richard Saslaw, the Senate Minority Leader, received \$7,750.) Sen. Norment turned around and sponsored a bill, apparently written by Verizon.

The Senator also accepted a donation of \$11,551 from Dominion PAC, the lobbying arm of Dominion Power Company. This time, his donation was on par with other heavy hitters like House Majority Leader Del. Morgan Griffith, and less than what Dominion gave to Del. Frank Hall (House Minority Leader), Sen. Saslaw, and Sen. Ken Stolle. Nevertheless, Sen. Norment patroned a bill on electric utility restructuring which extends the period of capped rates as Virginia moves toward electric deregulation. The bill short-circuited the argument that some legislators are making that Virginia should entirely re-think the idea of deregulation, considering the chaos it caused in California.

And finally, Senator Stosch sponsored a bill for Phillip Morris, Inc. after accepting a \$7,300 donation from Altria, its parent company (Norment appears again with the second highest Altria donation at \$4,000.) The bill would have provided a corporate income tax credit based on the number of cigarettes that the business manufactures and exports to a foreign country. Ironically, Phillip Morris only employs 6,800 Virginians

while Northrop Grumman, owners of Newport News Shipbuilding, employs 18,000. So we cut the tax break for shipyards and add a new one for making cigarettes.

## **Subsidizing the destruction of the commons**

For decades, major polluters have been claiming that they can't afford to clean up the results of their actions without laying-off workers: "jobs vs. environment" is the common phrase.

Naturally, such talk can make workers feel insecure and resentful of community activists. So for decades the "jobs vs. environment" argument has served to divide workers from many of their best natural allies — activists concerned about quality of life in their communities, including the natural environment and jobs. All too often, the "jobs vs. environment" argument has allowed the polluters to divide and then conquer whole communities, even whole states.

Recent economic research shows that the "jobs vs. environment" argument doesn't hold water. Communities and states that fail to protect their environment don't do well. They tend to have stagnant economies (low rates of job growth) and low average incomes, unfair taxes and high prices for energy for the average person. They also tend to have huge gaps between the rich and everyone else and mediocre public health — partly related to pollution, partly related to the huge inequalities in income. And finally, they have low participation in elections.

States that enact strong environmental protections tend to create good jobs, spread the wealth around more fairly, and have better public health, fairer taxes and greater democratic participation. In sum, numerous studies now show that good jobs, a clean environment and a better quality of life all go hand in hand. From the community's perspective, pollution does not pay.

For example, studying Los Angeles County, California, sociologist Manuel Pastor, Jr. has shown that the most dangerously polluted areas of the county have the highest proportion of minority residents and the lowest rate of job growth. Thus it is apparent that jobs do not necessarily increase when the environment is allowed to deteriorate.

"Instead, it looks like environmental degradation and economic weakness go hand in hand," Dr. Pastor said.

In a series of studies over a decade's time, Professor Paul Templet has analyzed all 50 states and found that states with lax environmental enforcement are the poorest states in the union. Dr. Templet served as Secretary of the Louisiana Department of Environmental Quality from 1988 to 1992 and is now professor of environmental studies at Louisiana State University.

Corporations that dump pollutants into air, water or soil are using nature, a public resource, as a free toilet. But of course nature's toilet — which economists prefer to call a "sink resource" — isn't really free. Someone besides the polluter eventually pays — for abandonment of a resource such as shellfish beds, for cleanup or for harm to health from asthma, cancer and so on.

Economists like to say that such polluters have "externalized their costs" by dumping their poisons into public spaces, forcing the public to bear the costs. In essence, the poisoners have received a public subsidy in the form of a free toilet.

In the same way, a timber company is receiving a subsidy when it logs a forest without paying the attendant costs of soil erosion, stream siltation, loss of flood control that the forest provided by storing water and other environmental damage.

These "pollution subsidies" increase a firm's profits while imposing costs on those who are affected, ranging from immediate neighbors to all taxpayers. Thus pollution moves large sums of money from the pockets of its victims into the pockets of its perpetrators.

Viewed by an economist, those who pollute without paying the full costs are depreciating a “public trust resource” that belongs to society at large. They are appropriating a resource that belongs to everyone, without paying compensation. Normally when a public servant embezzles or steals financial capital from the public, society imposes penalties including disgrace, monetary fines and possibly imprisonment. But when polluters appropriate and degrade public-trust resources, such as water and air, they often get away scot-free.

Many states provide a second kind of subsidy to corporations – energy subsidies. In the U.S., the average residential consumer pays about twice as much per unit of energy as an industrial firm pays. This represents a subsidy by individual ratepayers to the big consumers of energy.

Economists say that some disparity in price can be justified because the cost of delivering large quantities of energy to one end-user is lower than the cost of delivering the same amount of energy to many end-users. However, some states are clearly favoring large users at the expense of small users, thus taking money from individuals and putting it into the pockets of corporations.

In Louisiana and Alaska, for example, individual consumers pay four times as much per unit of energy as industrial users pay.

As Templet observes, “The energy subsidy... reduces the cost of obtaining a natural resource. There is no particular reason that industry should enjoy drastically cheaper energy than the public does.... The huge price differences in certain states reflect political power. Eliminating the energy subsidy would return the appropriated natural assets to citizens in the form of reduced pollution and more equitable prices. It would also promote more efficient use of energy and enhance public health. Citizens could spend less on energy, and more on education or other needs.”

A third kind of subsidy occurs through taxation. In general, income taxes and property taxes take a larger proportion of wealth from the rich than from the poor. Such taxes are labeled “progressive.”

On the other hand, sales taxes tend to have the opposite effect and are thus labeled “regressive.” Sales taxes are regressive because they take a fixed share of whatever is consumed and those with low- and moderate-incomes tend to spend a greater portion of their income on consumption, compared to the rich. A poor person and a rich person will pay the same amount of sales tax on the purchase of a hot water heater, but the cost of a hot water heater is a much larger proportion of a poor person’s income than of a rich person’s income, so the sales tax is regressive — it stings the poor worse than it stings the rich. A state that relies on regressive taxes more than progressive taxes is providing a subsidy to those with high incomes and large property holdings, a subsidy paid by those with low incomes and few property holdings. It is a way of picking the pockets of the poor and handing the proceeds to the rich. Thus a sales tax is like Robin Hood in reverse.

Templet has shown that all three kinds of subsidies — pollution, energy and tax — are associated with poor environmental performance.

Templet examined all 50 states in terms of a Green Policy Index (developed by the Institute for Southern Studies), which took into account 77 indicators of effective environmental policies. Templet also examined all 50 states in terms of a Green Conditions Index, which is based on 179 measures of environmental quality.

Templet found that states that provide the largest subsidies to polluters, energy hogs, and the rich are the same states that have the weakest environmental protection policies and the most degraded environments. The 25 states providing more total subsidies than the national average are (in order of biggest subsidies to the smallest): Louisiana, Utah, Florida, Tennessee, Mississippi, Alabama, Washington, Nevada, Texas, Arizona, New Mexico, Oklahoma, Hawaii, West Virginia, Arkansas, South Carolina, North Dakota, Indiana, South Dakota, Virginia, Kansas, Missouri, North Carolina, Alaska and Georgia.

Templet also examined the relationship between the three kinds of subsidies and various measures of economic well-being. He found that the pollution subsidy is a good predictor of poor economic performance as measured by poverty, income inequalities (the gap between high and low incomes), unemployment and low average personal income.

In other words, as firms are allowed to externalize more of their costs, poverty increases, the gap between rich and poor increases and average income declines.

As Templet notes, “This suggests that spending to control pollution constitutes a progressive policy in terms of income distribution.”

The benefits may be more than just economic, since it is the poor, and often minorities, who are most likely to live near polluting facilities and who therefore bear the burden of health damage as well.

Templet found that large energy subsidies are, likewise, correlated with poverty, unemployment, income inequalities and low personal incomes. The tax subsidy is also correlated with increased poverty, greater inequalities in income and lower average incomes.

Templet examined the pollution subsidy in relation to economic growth and found a negative correlation: as firms dump more pollution and thus externalize more costs, their states forego jobs. Pollution retards economic growth.

Templet also wondered whether corporate profits increased in those states where subsidies were highest. Data on corporate profits were not available, but he found a surrogate measure – value added in manufacturing — that allowed him to test whether profits increased as subsidies rose. They did.

If firms invested these increased profits within the state, then they might contribute to public welfare through increased employment and income. Unfortunately, Templet found that most of the profits go to shareholders and managers, most of who live in other states and even other countries.

As value added per job increases, a greater proportion of gross state product leaves the state, Templet found.

“In general,” he said, “profits tend to leak from high-subsidy, low-income states to low-subsidy, high-income states, fueling inter-state inequality.”

Leakage of profits from high-subsidy states to low-subsidy states is a major source of income inequalities between states. It drains income from states that consume the most resources and generate the most pollution. As income leaks from a state, we see a rise in unemployment, poverty and pollution. Leakage goes somewhere. In general, it goes to the states where the owners live. Indeed, a number of the richer states actually import income — their total income exceeds their gross state product.

“The situation is analogous to colonialism in which the mother country draws resources and other wealth from the colony, proffering little compensation in return. In this respect, the United States displays a kind of internal colonialism,” Templet says.

In addition to environmental degradation and economic decline, subsidies also damage our democratic ideals. By examining all 50 states, Templet found that, as subsidies increase for polluters, energy hogs, and the rich, political participation declines — fewer people bother to go to the polls at election time. States with above-average total subsidies have a voter participation rate that is 15 percent below the U.S. average.



Based on his personal experience as a cabinet official in Louisiana state government, Templet believes that subsidies damage democracy because polluters and the rich use their extra profits to buy political favors to further increase their own power.

He says, “Citizens in high-subsidy states may well feel disenfranchised, perceiving that their elected representatives cater to special interests. They may doubt that voting will change anything. Yet low [voter] participation itself contributes to the further concentration of power. In my experience as a cabinet official in Louisiana’s state government, I found that the quality of public leadership declines as special interests increase their sway. Even federally funded programs tend to languish. State agencies become less responsive to citizens, who in turn withdraw from the political process. The state becomes a less attractive place to live and do business. The end result is institutional failure, the erosion of democracy and the loss of social capital.”

Templet shows that all three subsidies — pollution, energy and tax — foster inequality in at least three ways: First, subsidies diminish productivity, disposable income, health and quality of life for those who bear the costs. Second, subsidies enhance the political power of those who are subsidized, allowing them to manipulate markets and the political process to further their own interests. Third, subsidies deprive governments of revenues that they could have used for education, health care and other programs that serve citizens.

In sum, Templet describes a vicious circle. By discharging poisons into air, water, and soil, corporations take — without compensation — the public’s clean environment and the public’s health. In so doing, the polluters capture subsidies, for which the public pays the price. Thus the poisoners increase their profits. With their ill-gotten gains, the polluters then purchase favors from public officials, who in turn pass weak laws that allow the poisoners to continue using the environment as a free toilet. These policies make the state less attractive to other firms, so the diversity of the economy declines.

“Communities may be left with a ‘company town’ syndrome. They grow poorer, more polluted, more subject to boom-and-bust cycles, and more dependent on the industries that are reaping the benefits. As concentrated wealth fosters concentrated power, public policy embraces subsidies even more. The result is a spiral of public and ultimately private decline. Although corporations can eventually pick up and go elsewhere, the public as a whole cannot,” Templet notes.

The public sees what is going on but believes it cannot affect the outcome of this corrupt game, and so drops out, refusing to participate in elections or other forms of democratic engagement. This leads to the further decline of public-trust resources and a downward spiral of social, economic and environmental decay.

What can be done? The short answer is that we could improve public health and well-being, and enhance environmental quality, first by reducing or eliminating subsidies for corporate polluters, energy hogs and the rich and by taking back control of “the commons” to put citizens in control of our public-trust resources, the environment. It is time we denied special interests the right to “privatize” our air and water without full compensation to their rightful owners: the public.

One way to tackle these problems would be by reviving and revitalizing the ancient “public trust doctrine” — the legal doctrine that says state governments have an affirmative duty to protect our common-heritage resources, such as water and air, for generations unborn. States have an affirmative duty to prevent private parties from “taking” or degrading our common-heritage resources. Like the “precautionary principle,” the “public trust doctrine” is a powerful new tool for community protection that can be learned, articulated, expanded and advanced by grassroots activists.

**The preceding is based on an article from RACHEL’S ENVIRONMENT & HEALTH NEWS, a service of the Environmental Research Foundation, [www.rachel.org](http://www.rachel.org).**

## **Closing three corporate income tax loopholes would generate \$92 million in new revenue**

### **Large corporations are not paying their way in Virginia's tax system.**

According to census data, in 1979 the corporate income tax accounted for 7.7 percent of total state revenue in Virginia. By 1989 that share had shrunk to 5.2 percent, and data from 2000 — a year of healthy corporate profits before the current recession hit — shows a further drop to 4.5 percent.

That means that the share of tax revenue from other sources has taken up the slack. As individuals, all of us are paying more than we should in sales tax, personal income tax and user fees in order to make up for the shrinking contribution of business to the common good.

But the Virginia corporate income tax rate has remained steady at 6 percent of profits for many years. What accounts for the decline in tax revenue?

Special exemptions and other tax breaks have caused corporations' fair share of the decline, but corporations have also become more adept at avoiding taxes through loopholes and dodges. In fact, a large consulting industry has developed which focuses solely on helping corporations escape paying taxes. Small businesses rarely have the money or volume to take advantage of these loopholes, so these tax dodges go primarily to multi-state corporations.

Three changes to Virginia's corporate tax law would raise approximately \$92 million in new revenue, take effect relatively quickly, and require only minor adjustments to the current system. Also, all three of these changes would bring in revenue from corporate profits that are currently escaping taxation altogether.

### **Institute a throwback rule**

The first change involves corporations that produce and sell products in more than one state. Their profits are usually divided, or apportioned, between the various states to be taxed. The problem is there is a federal law that says that the corporate presence — via sales or manufacturing — in a state must reach a certain level before the corporation can be subject to taxes there. As a result, the fair share of corporate profits apportioned to many states where the corporations only sell products becomes “nowhere income,” untaxed by any state.

The Throwback Rule corrects this loophole. The corporation's home state would get to tax the “nowhere income.”

“The throwback rule effectively allows a state in which a corporation produces its wares to tax the profit on any sales made by the corporation into states in which the corporation has insufficient presence to be subjected to a tax on its profit from those sales,” said Michael Mazerov of the Center on Budget and Policy Priorities.

Virginia does not have a throwback rule. As a result, as much as 50 percent of the profit of a resident corporation can go untaxed.

The throwback rule could be put in place by a simple, one sentence addition to state code: “Sales of tangible personal property are in this State if the property is shipped from an office, store, warehouse, factory, or other place of storage in this State and the taxpayer is not taxable in the State of the purchaser.”

### **Block the passive investment company (PIC) loophole**

Large corporations often open subsidiary corporations — ones that they own but that have a separate incorporation — in states like Delaware and Nevada that do not tax royalties, interest and other intangible income. These corporations are often called “passive investment companies.” The parent corporations then give ownership of their trademarks and patents to these PICs.

Each time the parent corporation uses the trademark, they must pay a royalty to the PIC, their own subsidiary. In this way, they can shift large chunks of their profit to the PIC’s state, where it is not taxed. Then the PIC loans its shadow profits back to the parent company, which can make a further tax deduction based on interest on the loan.

Isn’t that clever? Massive amounts of corporate income escape taxation by flowing through this loophole. A few examples have emerged from lawsuits brought by states against particular corporations.

- Toys R’ Us paid royalties on their Geoffrey character trademark to their Delaware PIC in the amount of \$55 million in 1990 alone.
- The Limited/Victoria’s Secret/Lane Bryant/Express clothing retailer paid \$949 million to their Delaware PIC between 1992 and 1994.

In June of this year, the Maryland State Court of Appeals ruled that companies doing business in Maryland couldn’t take advantage of this loophole by sending their profits to Delaware subsidiaries. Hopefully, other states will take advantage of this legal precedent to reclaim tax dollars due to them.

“The average homeowner can’t just take out a post office box in Delaware to cheat on their state taxes, but we’ve allowed every corporation to do that for years,” Tom Hucker, director of the grassroots group Progressive Maryland, said.

A few figures will help show the extent of the problem. Approximately 6,000 PICs had been incorporated in Delaware alone by the end of 1998 and new ones were arriving at around 600-800 per year. On the 13th floor of a single, high-rise building in Wilmington, Delaware, over 500 corporations have an “office.” Corporations which have been hit with lawsuits by states for using PICs include Dress Barn, Gap, Kohl’s, Tyson Foods, Radio Shack, Burger King, Kmart and many more.

Two solutions, one short-term and one more comprehensive, could be adopted by the 22 states — including Virginia — with no laws limiting the loophole.

First, like seven other states including Alabama and North Carolina, they could simply deny deductions on royalties and other interest paid to related corporations.

Second, like 16 other states, they could demand “combined reporting” from corporations. This would require corporations to add together profits from the PIC and the corporation paying the royalty or interest for tax purposes. The advantage of combined reporting is that it also blocks other income-shifting schemes used by many corporations.

## **Within legal limits, tax all “non-business” corporate profits**

Remember back to the discussion of the Throwback Rule when we described how corporate profits get divided up between the states in which they operate? The Supreme Court has ruled that some kinds of profit fall outside those apportionments. Most states refer to those profits as “non-business income.” Instead, they are assigned to the state where the assets that generated them are managed, usually the corporation’s home state.

Most of this non-business income comes from the sales of property that are “irregular” or not part of the company’s regular transactions. For example, the sale of a factory and the equipment inside it are irregular occurrences and thus defined as non-business income.

But 13 states, including Virginia, have decided to treat all corporate profits as if they were regular business income. This blocks the loophole for all out-of-state corporations. Unfortunately, it creates a new loophole for companies headquartered within Virginia. Since it treats all profits as business income which should be apportioned to all the states in which the company operates, it cannot fully tax corporate profits which would legitimately be called non-business income and thus return entirely to Virginia to be taxed.

Here is an example. Say a fictitious corporation named T-G, Inc. sold a factory in Richmond for a \$100 million profit. That sale is an irregular transaction and thus non-business income, so Virginia is legally entitled to tax the entire \$100 million. Instead, Virginia treats it as if it was business income. If our apportionment calculation finds that 35 percent of the profit should be taxed here and 65 percent should be taxed elsewhere, then Virginia will only tax \$35 million of the profit. The other \$65 million becomes “nowhere income” for T-G, Inc. You can be sure that the owner, Mr. T-G, knows this and will take advantage of the tax dodge.

The solution is to change our tax law so that Virginia makes a distinction between business and non-business income and then to amend our tax definitions with the phrase, “‘Business income’ means all income which is apportionable under the Constitution of the United States.”

## **Won’t closing loopholes drive corporations to other states?**

This question always arises when the topic of corporate accountability comes up. And indeed, the answer is crucial if we want to make our state attractive for economic development.

Among many studies that have been done on this issue, most show that tax burden plays a relatively small role in corporate decisions to locate one place or another. Other factors such as the education of the potential labor-force, adequacy of the transportation network and basic quality of life play a far greater part.

For example, Robert Tannenwald of the Boston Federal Reserve Bank recently studied 22 states and the effect of state tax policy on economic development. He found no statistically meaningful connection between business tax burden and the location decisions of corporations. That being the case, closing these three loopholes in our corporate tax law should have little effect on Virginia’s economic development efforts.

Finally, Michael Mazerov’s study shows that states that closed the first two loopholes actually lead others in manufacturing job increases during the 1990’s. Of the top 12 states, all but three have both a throwback rule and combined reporting included in their tax law. Virginia ranks 31st on the list.

Much of the substance of this article comes from *“Closing Three Common Corporate Income Tax Loopholes Could Raise Additional Revenue for Many States,”* written by Michael Mazerov of the Center on Budget and Policy Priorities. Many thanks to him. You can find this and other articles on state fiscal policy at [www.cbpp.org/pubs/sfp.htm](http://www.cbpp.org/pubs/sfp.htm).

## Virginia Organizing Project unveils tax reform plan

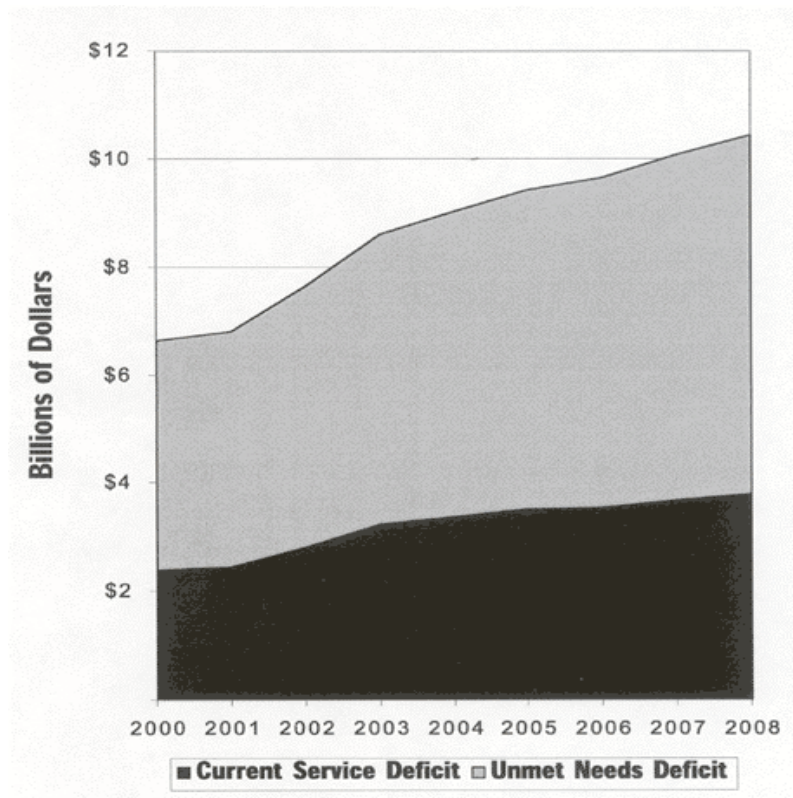
“It’s unfair, it’s inadequate and it’s obsolete,” said Jay Johnson, VOP Vice-Chairperson and a leader of the Hampton Roads VOP Chapter.

Johnson was describing the current tax system in Virginia. The final VOP plan for state tax reform is designed to address all three flaws.

“Everyone has already heard about the \$2 billion budget shortfall in Virginia this year and some around the state have already felt the sting of the \$858 million in cuts that Governor Warner announced in October 2002. The General Assembly will have to carve another \$1.25 billion out of the budget in their 2003 session, that is, unless someone comes to their senses and proposes a workable tax reform plan,” Johnson said.

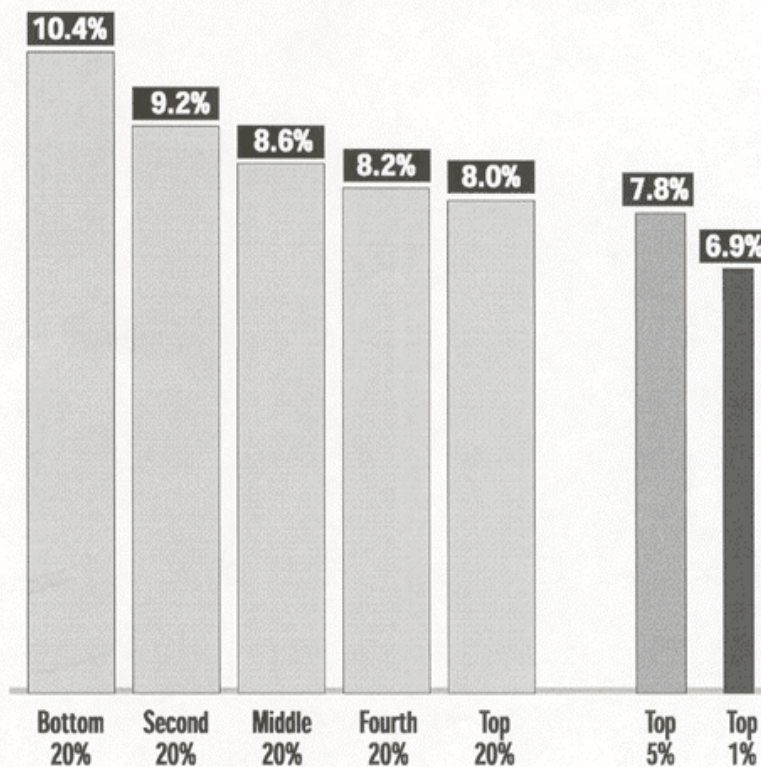
Not only is there a current shortfall, or “current service deficit,” there is also an abundance of long-term, unmet needs across the state. In a study produced for the business group called Virginia Forward, The Barent’s Group estimated these needs in the areas of transportation, Medicaid, K-12 education and higher education. They found that the deficit in unmet needs was double the current service deficit and growing.

### Unmet Needs and Current Service Deficit



Furthermore, basic problems in the structure of Virginia taxes cause lower-income families to feel the tax bite worse than higher-income families. In Virginia the bottom 20 percent in income pay 10.4 percent of their income in state taxes, while the highest 1 percent pays only 6.9 percent.

### Percent of Income Paid in State and Local Taxes in Virginia Middle and Low Income Virginia Families Have a Higher Tax Rate Than Wealthy Families



Source: Institute on Taxation and Economic Policy, July 5, 2000.

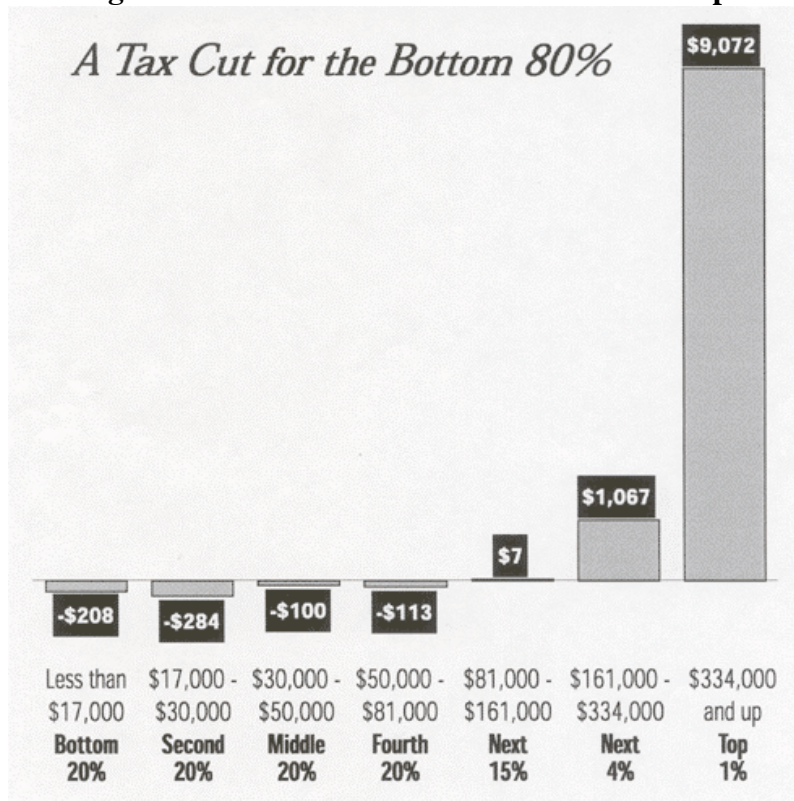
The VOP plan would reduce taxes on those in the lowest 40 percent in income and generate \$1.39 billion in new revenue to close the state's current budget gap. The plan accomplishes this without resorting to the drastic cuts in basic state services, such as mental health services, currently being discussed among state legislators.

The first change proposed by the VOP plan would re-structure the personal income tax. It does this through several changes:

- Change tax brackets and rates. The VOP plan establishes a 5 percent tax bracket for those making up to \$35,000 per year. (This is a tax cut for those between \$17,000 and \$35,000 in income.) The rate would be 5.75 percent on income between \$35,000 and \$60,000, 6.5 percent on income between \$60,000 and \$100,000 and 7 percent on income over \$100,000 per year. This progressive income tax structure would replace the state's virtually flat current income tax, in which the top rate kicks in at \$17,000.
- Eliminate the age deduction for the higher income elderly.
- Raise the personal exemption to \$2,500 per person.
- Raise standard deductions to \$3,500 for a single person or \$7,000 for a married couple.
- Create a refundable Earned Income Tax Credit set at 20 percent of the federal credit.
- Create a \$100 per person sales tax credit to off-set the impact of sales taxes on those with lower incomes. The full credit could be claimed up to \$20,000 in income and it would phase out between \$20,000 and \$30,000.

The net effect of these income tax changes would be a \$10 million per year tax cut and increased fairness in the system. Additionally, the personal income tax would be cut for 80 percent of Virginia families.

## Changes in State Income Tax Under the VOP Proposal



Source: Institute on Taxation and Economic Policy, October 2002.  
Website: <http://www.ctj.org/itep/>

The second change proposed by the VOP plan impacts the state sales tax. While all sales taxes are regressive, Virginia's is worse than most because it taxes items used by low-income families, but not many of those used by higher income families. While the state charges sales tax on a loaf of bread, it doesn't charge the tax on the services of a lawyer or accountant or on tickets to a Brittany Spears concert.

To modernize the system and to make it more efficient, VOP would change the state sales tax to:

- Fully eliminate the sales tax on food.
- Expand the sales tax base by including services (excluding health care, insurance and utilities expenses).

The net effect of these changes in the sales tax is an increase of \$1.3 billion in revenue for the state, more than the remaining gap in the budget.

Finally, the third major change proposed by the VOP plan focuses on the corporate income tax. Because the costs of government should be shared by all the governed, VOP believes Virginia should:

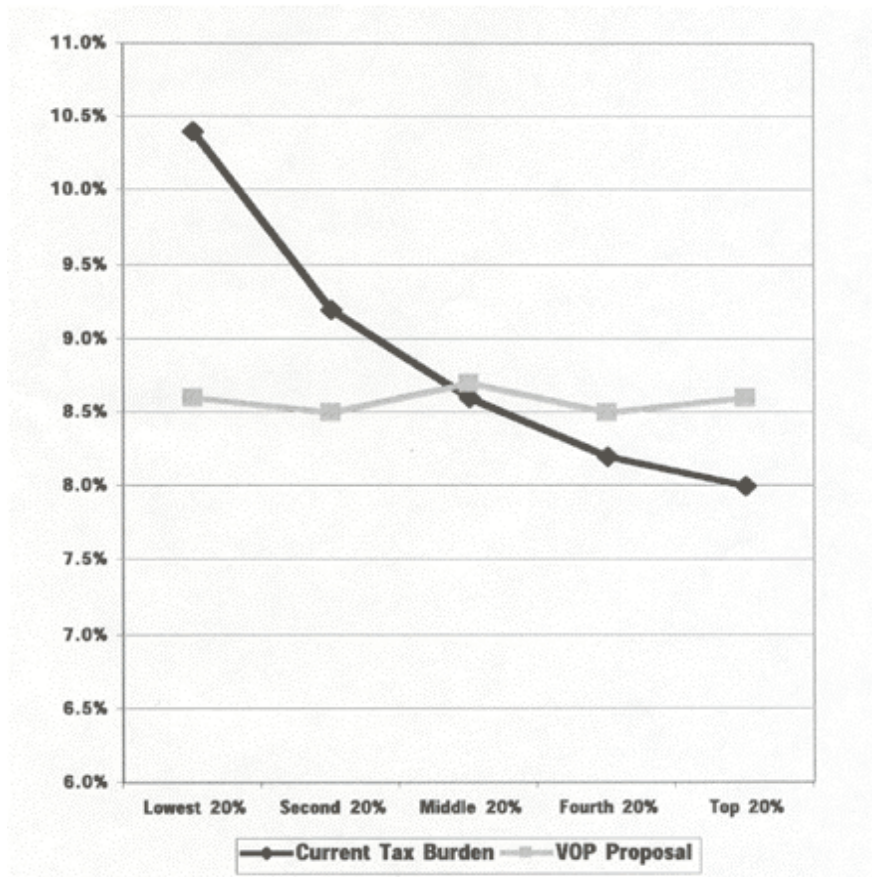
- Increase the corporate income tax from 6 percent to 8 percent.

The increase in the corporate income tax creates \$100 million in new revenue, while allowing the state to remain competitive with surrounding states.

Overall, the VOP plan creates a level tax burden of 8.5 percent for all citizens. This results in dramatic improvements to the fairness of the tax system when compared to the old tax burden.

## Percent of Income Paid in State and Local Taxes in Virginia Under VOP Tax Reform Package

The Virginia Organizing Project Tax Package Would Close the Budget Gap and Make Virginia Taxes Fairer



Source: Institute on Taxation and Economic Policy  
Website: <http://www.ctj.org/itp/>

New revenue from the VOP plan covers much of the current budget shortfall. More importantly, the new structure prepares Virginia to capture new economic growth, much of which will come from the service industries.



## Whats on the Menu?

<i>Tax Package</i>	
Item	Value in millions of dollars (in FY 2003)
Reform the Personal Income Tax to Shift the Burden away from Low-income Families .....	-\$10
Increase the Corporate Income Tax .....	\$100
<u>Expand the Sales Tax Base .....</u>	<u>\$1,300</u>
TOTAL: \$1.39 billion	

Some Democratic and Republican state representatives propose that a cigarette tax hike can help Virginia. VOP does not oppose such a hike, but current bills would only raise about \$100 million, far short of the current shortfall. In addition, like all sales taxes, the cigarette tax is regressive, meaning it disproportionately hurts lower-income smokers. In the absence of fundamental, comprehensive tax reform that corrects the inherent flaws in the system, raising taxes on cigarettes or gasoline is a Band-aid approach to the problem, which attempts to balance the budget on the backs of lower and middle-income families.

Another current proposal reverses the car tax cut from 70 percent back to 47.5 percent. Again, VOP would not oppose such a reversal, especially since it could generate \$350 million in revenue. But the car tax cut represents spending in the Virginia budget, not revenue. Reversing the cut, in the absence of comprehensive tax reform, does not address the state's structural deficit.

One current proposal that VOP would oppose is the proposal to repeal Virginia's estate tax even faster than the federal repeal. VOP's analysis of Virginia's tax structure indicates that one of the major problems is that the people who would benefit from the estate tax repeal — the very wealthy — already enjoy too many tax breaks at the expense of the rest of the taxpayers.

The total effect of all the changes proposed by VOP would be a state tax system that is fairer, more modern and more capable of meeting the financial needs of the state.

## **Tax hikes vs. spending cuts in the VA General Assembly**

Virginia leaders should learn from Delaware Governor Ruth Ann Miner, who is proposing tax increases in her state for 2004.

Miner holds, “While I believe that we have cut costs and made government more efficient, I also believe that there are certain obligations government has and certain services the state provides that should not be eliminated. We cannot solve a \$300 million deficit completely through cuts without affecting children, the elderly, the poor, public safety and our state’s competitiveness.”

Governor Miner’s direction is opposite to that of the 2003 Virginia General Assembly. Senators and delegates ranging from Frank Ruff to Harry Purkey, from Ben Cline to Bill Bolling, all chimed in at some point with the party line: raising taxes during a recession is the most irresponsible thing we could do to the Virginia economy.

The legislators need to re-read their college Economics textbooks.

“Basic economic theory suggests that direct spending reductions will generate more adverse consequences for the economy in the short run than either a tax increase or a transfer program reduction,” say Peter Orszag and Joseph Stiglitz (who won a 2001 Nobel Prize in Economics) in an article for the Center on Budget and Policy Priorities titled, “Budget Cuts vs. Tax Increases at the State Level: Is One More Counter-Productive than the Other During a Recession?”

The argument is simple. By law, Virginia has to have a balanced budget, which means we cannot plan to spend more than we take in. That leaves us with two choices: raise taxes or cut public spending.

The anti-tax forces refuse to consider one of these options. They would never have us raise taxes for any reason. The problem is that their position hurts the Virginia economy worse than the alternative, keeping us locked in a recession for a longer period of time than necessary.

Raising taxes works better than cutting spending “because some of the tax increase would result in reduced saving rather than reduced consumption, say Orszag and Stiglitz. Consumption, or buying things, is the key to an economic turnaround. When anyone, including the state government, stops buying things it slows the recovery.

But a tax increase leaves less money in the pockets of individuals, which means they can buy less, yes? Indeed. The only difference is that individuals do two things with their money: spend it or save it. Saving money is fine, but it doesn’t speed up the economic recovery.

So with the money they are paying in higher taxes, individuals would have spent part of the money and saved part of the money. In contrast, spending cuts by the government are a dollar-for-dollar loss to our state economy.

What about the “transfer programs” referred to in the quote above? These are state programs like unemployment insurance, Social Security, and TANF benefits where the state passes money on to individuals rather than buying goods and services.

Are cuts in transfer programs also worse than tax hikes? It depends on who is receiving the money. Lower-income individuals tend to spend all or nearly all of their budget. Middle and upper-income individuals can afford to save more. Thus, transfer programs which give money to lower-income people are better for the economy than tax cuts, since more of it will be used for purchases and less will be saved.

Incredibly, this means that the kinds of spending cuts that might make sense in a recession are transfer programs that benefit higher-income people. Inversely, the tax cuts that make sense are those that benefit low-income people. They will likely spend those dollars right away, pumping the full amount right back into the economy for the purchase of necessities.

On this basis, we can evaluate the tax and budget decisions of the 2003 General Assembly.

Absolutely lowest on the list of effective economic stimuli is the cut in the estate tax. The benefit is delayed until 2005, so it does nothing to get us out of the current recession. It goes only to the extremely wealthy with estates worth over \$1 million, who save a lot of their money already. It reduces state revenue by over a hundred million dollars, forcing further spending cuts. Such a raw and ignorant money grab has not been seen in this state for years. Not only is it immoral, it is bad economics.

The only tax hikes were a few fee increases, particularly increased drivers license fees, DUI charges, saltwater fishing and other court charges. Tax hikes that make the most sense in a recession are those that fall upon higher-income individuals. These user-fee hikes fail the test.

Most harmful may be the massive budget cuts forced upon the state by the revenue shortfall. Weeding out inefficient spending is one thing; cutting core services is quite another. Cuts to higher education, public safety, transportation, public libraries and health programs will have an enormous economic effect, both in the short and long-term.

That leaves tax hikes, specifically directed at those most able to pay. It turns out that failing to raise taxes during a recession is the most irresponsible thing we could do to the Virginia economy.