

How Closely Do Business Taxes Conform to the Benefits Principle?



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Context

- ❑ GRT's have emerged from the dead. Ohio, Texas have recently adopted GRTs and Illinois had major GRT proposal. Why the sudden popularity?
- ❑ Larger issue—the growing difficulty of taxing business. Traditional structures fail to capture revenue from new business forms such as LLPs and and S corps.
- ❑ Philosophical issue—how should we tax business? What tax principles should guide the discussion?

What should guide business taxation?

- ❑ Benefits principle would seem to be best candidate (Oakland and Testa).
- ❑ Businesses should pay based on the benefits they receive for public services (or for their social costs). (User charges preferable)
- ❑ Can you really tax business rents or export the burden? If not, over-taxing business leads to poor public choices...may over-consume government services since voters don't think they are paying for them
- ❑ Salutory effects on current development policy?
- ❑ Current evidence suggests state and local business taxation is significantly too high

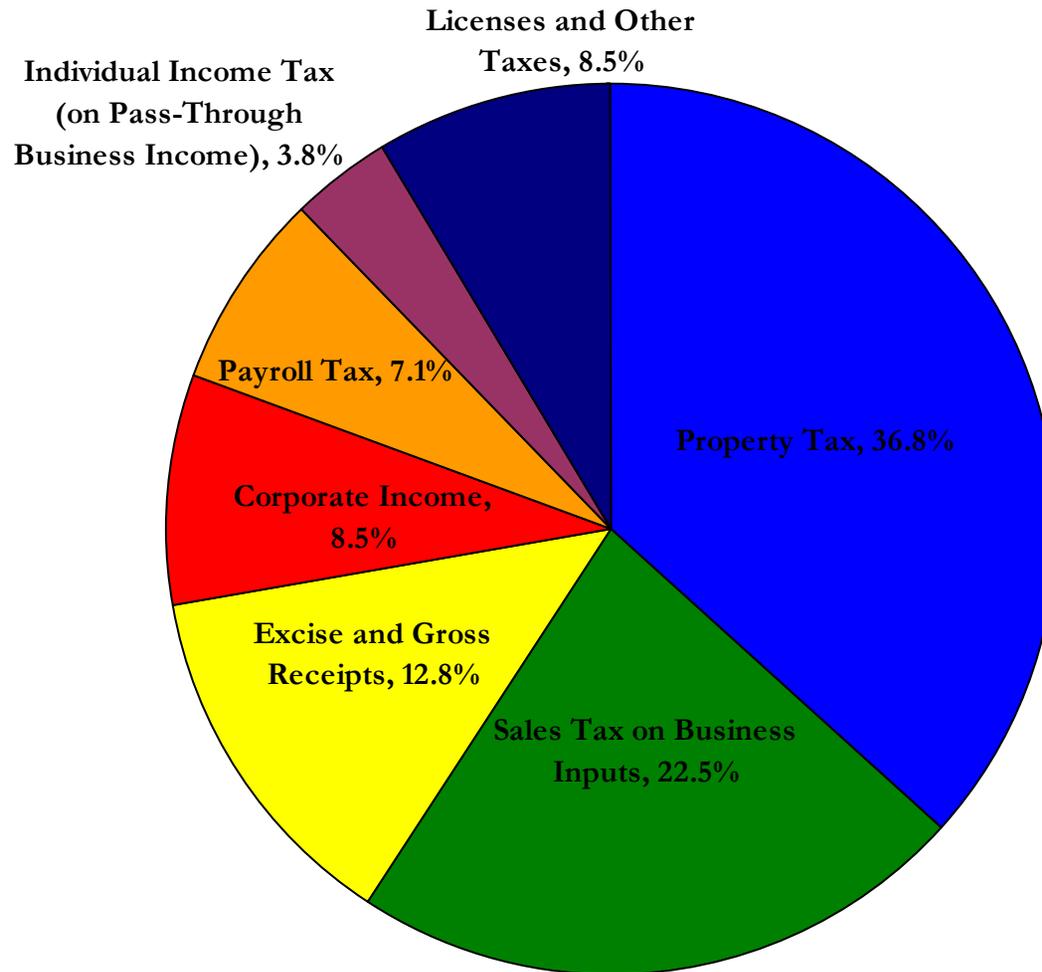
State & local business taxes in the United States, 2005

	Total (\$ billions)	Percent of business	Percent of total state-local taxes
Property Tax	\$182.8	36.7	16.0
Sales Tax on Business Inputs	\$111.7	22.5	9.8
Excise and Gross Receipts	\$63.7	12.8	5.6
Corporate Income	\$42.1	8.5	3.7
Unemployment Insurance Tax	\$35.5	7.1	3.1
Individual Income Tax (on Pass-Through Business Income)	\$19.1	3.8	1.7
Licenses and Other Taxes	\$42.5	8.5	3.7
Total Business Taxes	\$497.4	100.0	43.6
Total Taxes	\$1140.6	--	--

Source: Ernst & Young

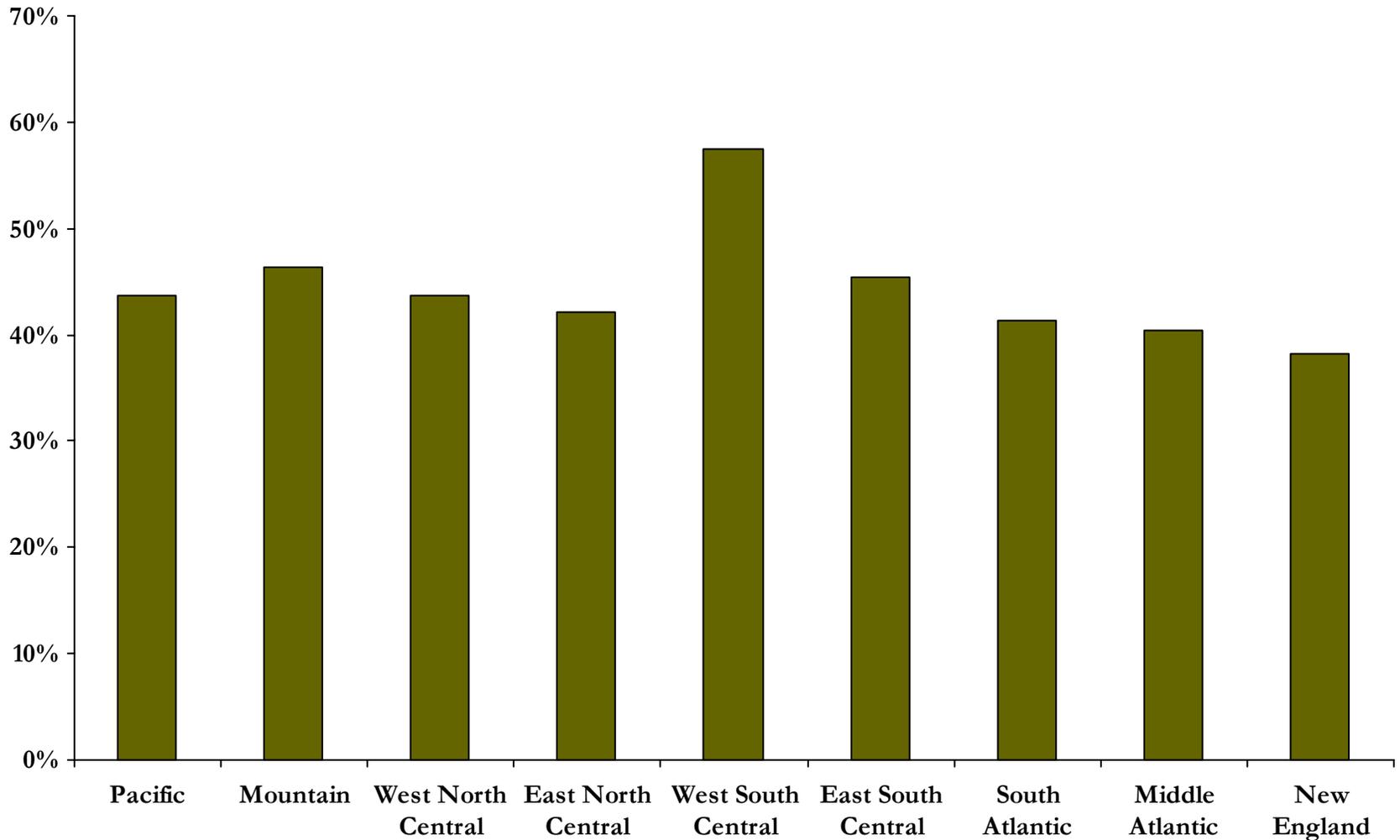
- **Business taxes fall heavily on capital returns and investment**

Composition of business taxes U.S. 2005

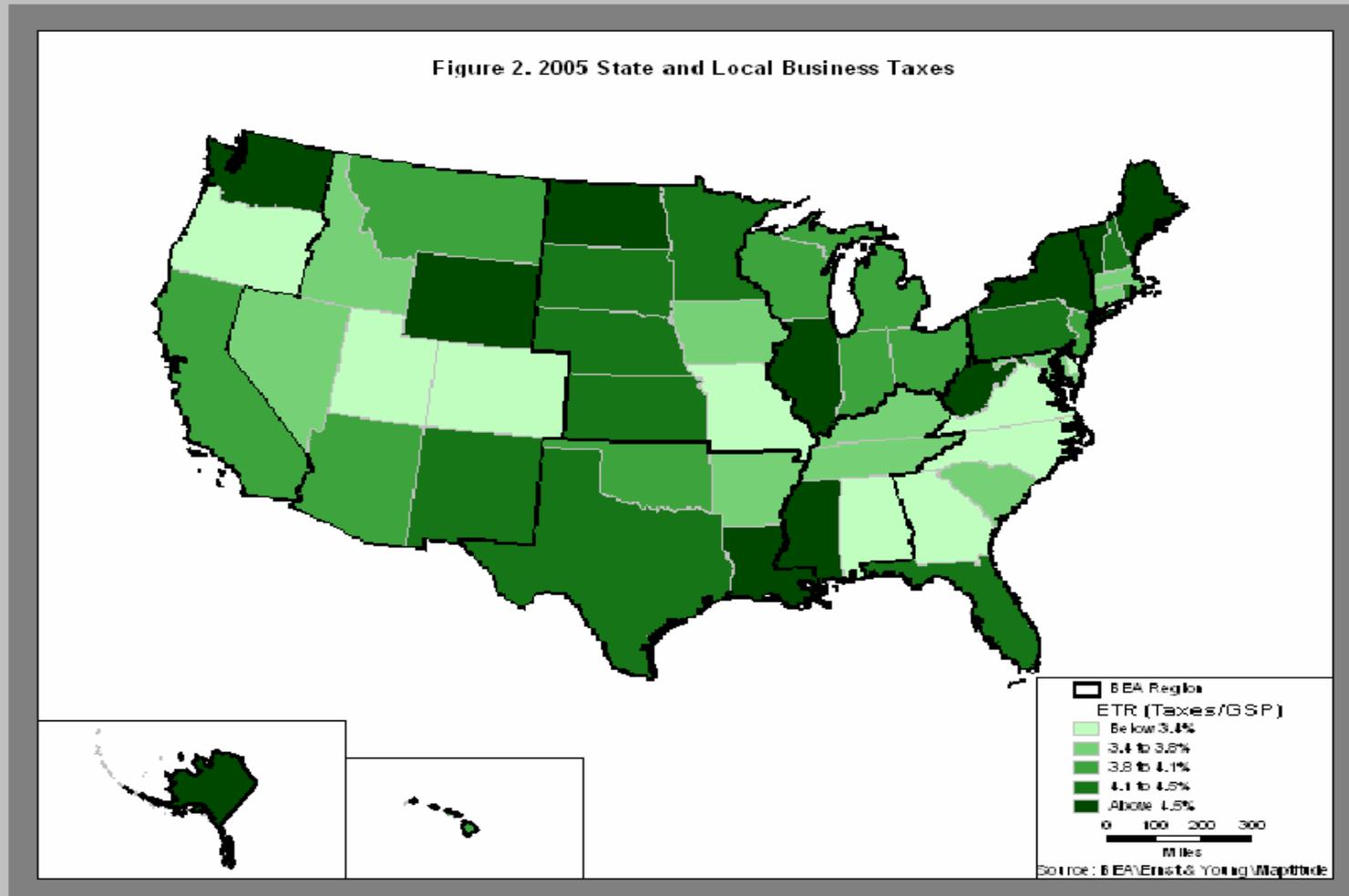


Business Share of Total Taxes

BEA Regions 2005



Estimated tax rates for a hypothetical single tax on economic activity (S/L Business taxes/GSP)



Crude estimates of benefit principle in business taxation and state-local expenditure

- ❑ How much does state-local government currently spend on unpriced inputs to production?
- ❑ How do these expenditures compare to current business taxation?

Methodology for estimating tax-funded expenditure

In estimating “business expenditures,” we would want to exclude those expenditures already funded by user fees and by the federal government.

Step 1: Deriving tax-funded expenditures



Step 2: Parsing expenditures to the household versus business sector

Result from step 1: Tax-funded state-local expenditures to be allocated to businesses and households, FY 2005

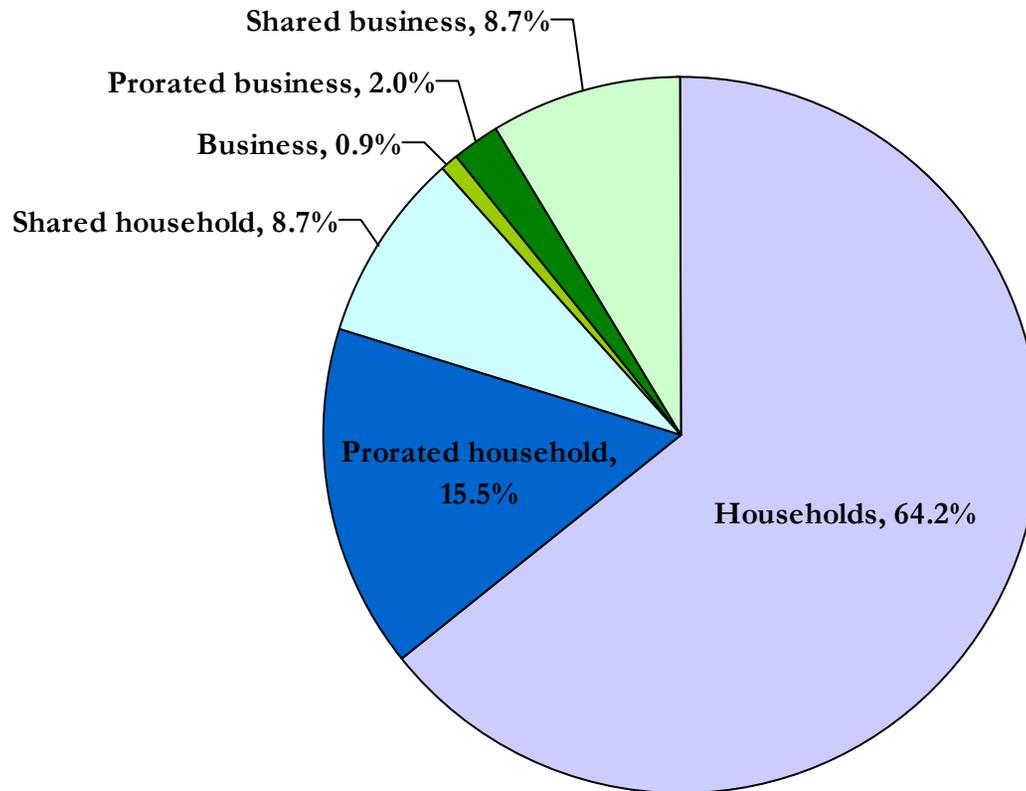
Spending category	Total (\$ millions)	Share of Total (percent)
Education	512,189	42.24
Libraries	7,078	0.58
Housing and community development	4,949	0.41
Natural resources (fish + forestry)	3,961	0.33
Natural resources n.e.c.	10,951	0.90
Parks and recreation	19,820	1.63
Sewage	3,220	0.27
Solid waste management	7,207	0.59
All other and unallocable	17,141	1.41
General interest on debt	76,823	6.34
Financial administration	32,808	2.71
General public buildings	10,300	0.85
Judicial	33,194	2.74
Other government administration (L+CS)	18,273	1.51
Corrections	57,764	4.76
Fire protection	23,445	1.93
Police	62,529	5.16
Protective inspection and regulation	11,824	0.98
Health	40,777	3.36
Hospital	23,728	1.96
Veteran services	1,349	0.11
Welfare	134,559	11.10
Air transportation	876	0.07
Highways	67,775	5.59
Parking	-196	-0.02
Water transport	493	0.04
Unemployment insurance	29,816	2.46
Total	1,212,652	100.00

Source: Census Bureau

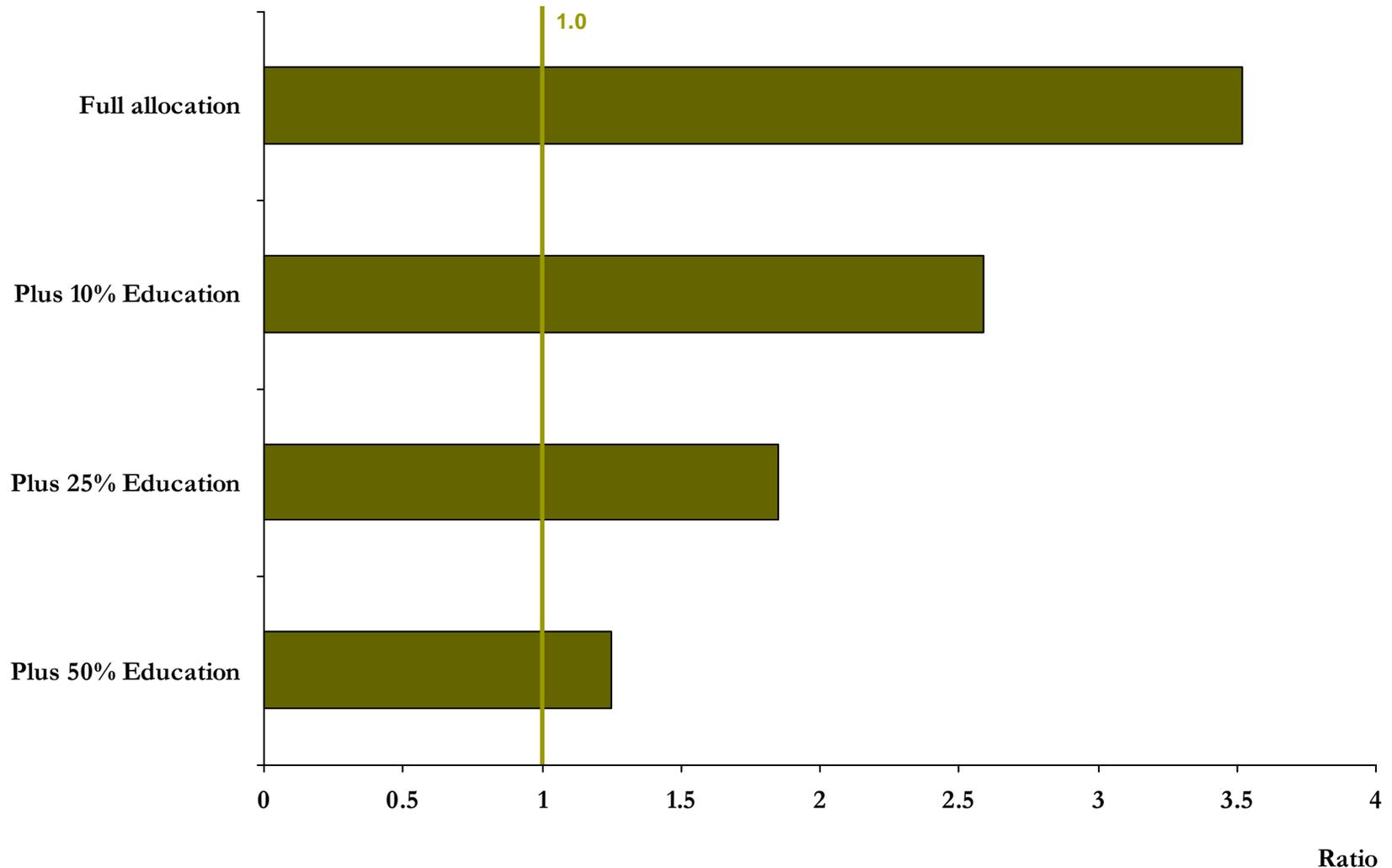
Step 2: Census Expenditure Categories as Allocated (Summary)

Households	Business	Shared	Pro-rated
Education	Natural resources n.e.c.	Sewage	All other and unallocable
Libraries	Water transport	Solid waste management	General interest on debt
Housing and community development		Judicial	Financial administration
Parks and recreation		Fire protection	General public buildings
Natural resources (fish + forestry)		Protective inspection and regulation	Other government administration (legislative + central staff)
Health		Police	Corrections
Hospital		Air transportation	
Veteran services		Highways	
Welfare		Parking	
Unemployment insurance			

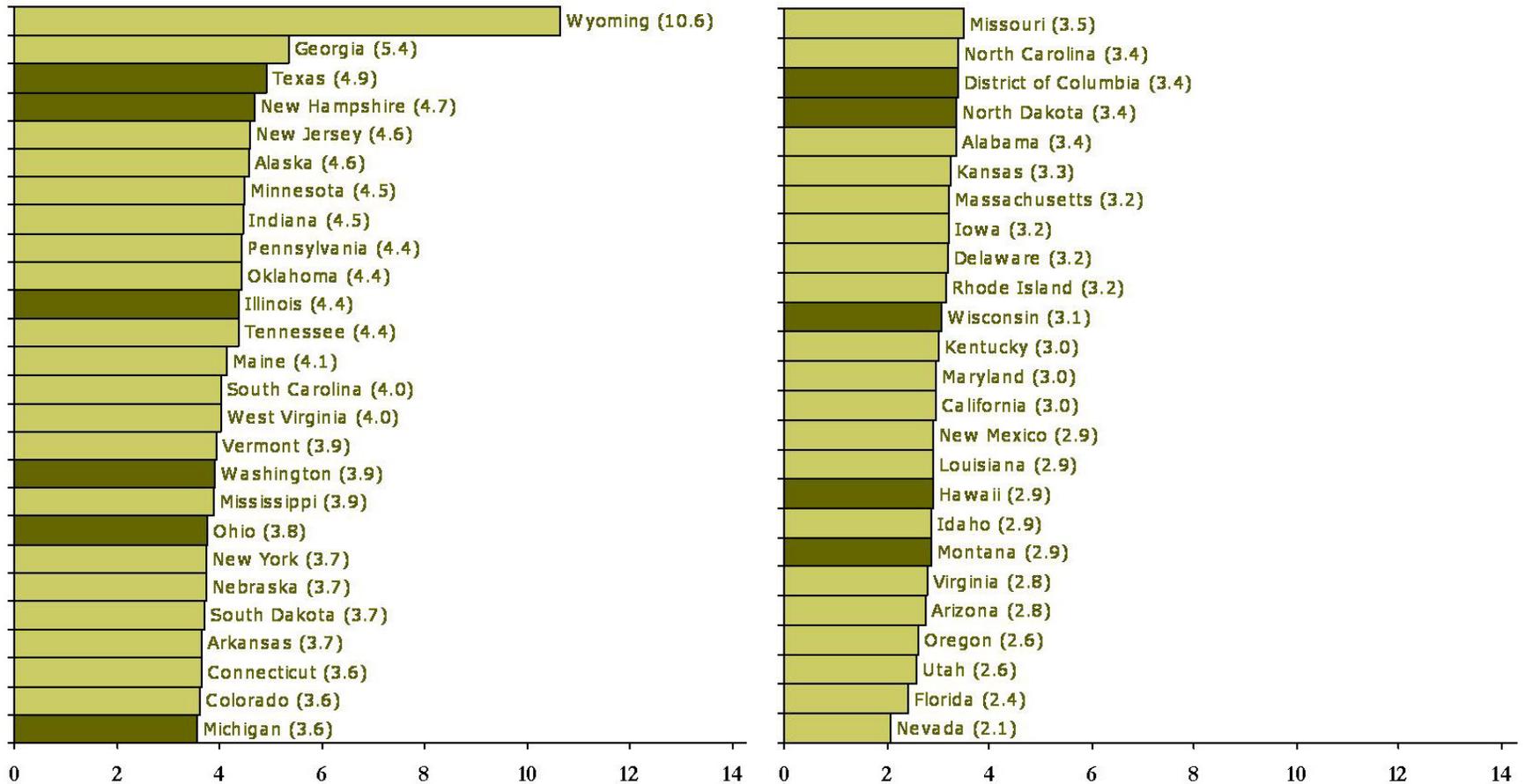
Distribution of state and local expenditures U.S. 2005



Result: Ratio of Business Taxes to Business Expenditures– U.S. Average

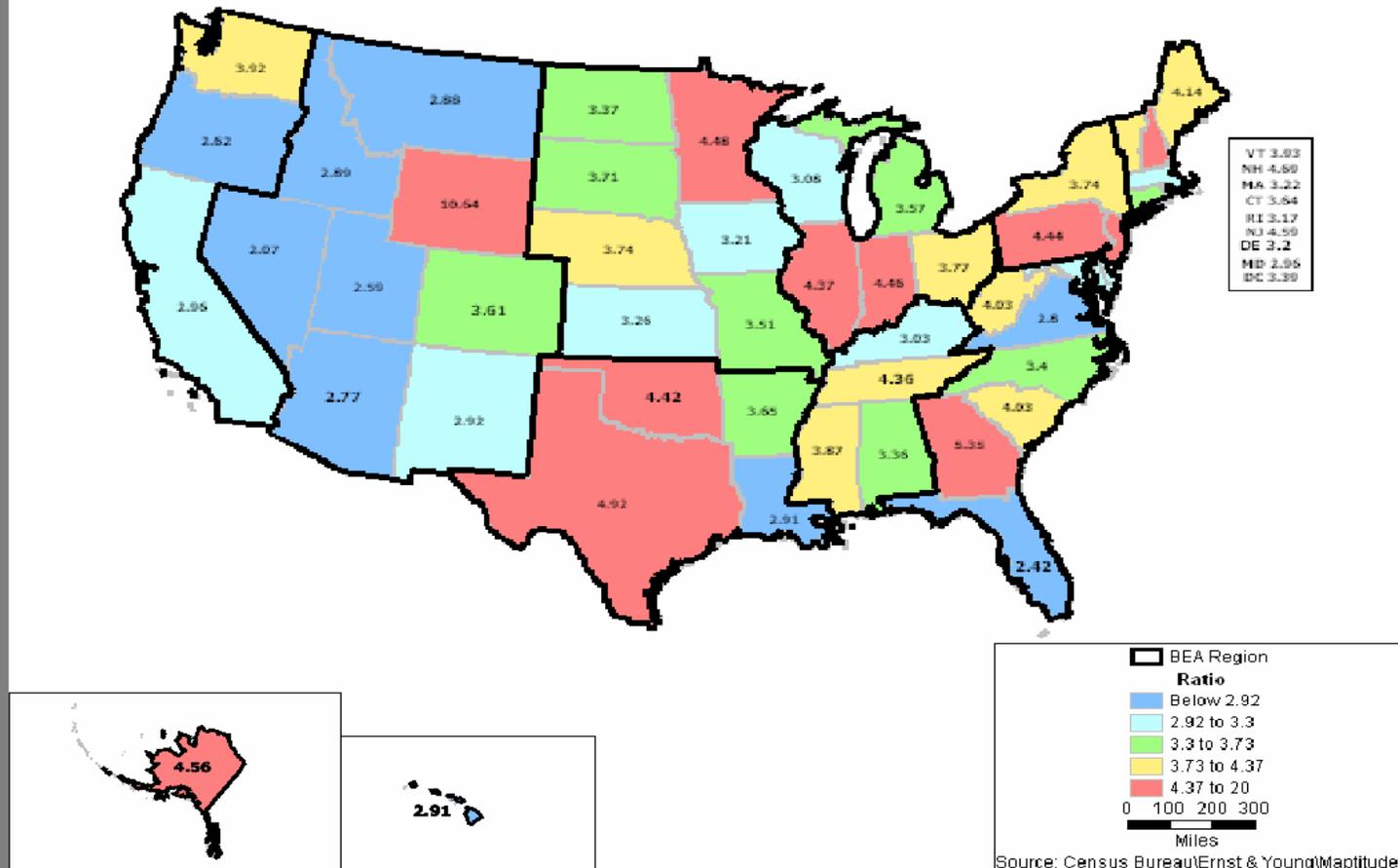


Business Tax/Benefit by State 2005 (ranked)



Map of taxes levied vs benefits received

Figure 3. 2005 State-local business taxes versus estimated public expenditures benefiting business entities



Conclusion

- ❑ States are trying to find appropriate tax structures for a shifting economy—particularly taxing services, and are turning to what look like “business taxes”
- ❑ The current structure of business taxation is skewed toward capital returns and usage; they do not fare well against a benefits principle yardstick
- ❑ VAT-type business tax approach would be the better option, particularly if the rates are set based on benefits received...
- ❑ Based on benefits principle estimates of current business taxation, income and consumption taxes should be considered to fund state-local spending