

Chicago Fed Letter

State and local business taxation: Is there a better way?

by Richard Mattoon, senior economist

Over 80 academics, business leaders, and public policymakers came to the Federal Reserve Bank of Chicago on September 13, 2004, to explore how state and local governments tax business. The conference, which was co-sponsored by the National Tax Association, examined proposals to improve business tax efficiency and equity.

Businesses paid \$404 billion in state and local taxes in fiscal 2003, accounting for 43% of state and local tax receipts.

In welcoming remarks, Charlie Evans, Chicago Fed senior vice president and director of research, provided the following description from a mid-twentieth century article on business taxation: “At best it is the disordered product of fiscal expediency and piecemeal legislation—a more or less accidental conglomeration of tax laws, enacted at different times and applied to different businesses or different attributes of the same business, according to the exigencies of the moment.”¹ Evans noted that although this article was written in 1940, one could argue that the description still applies today.

Fred Giertz, executive director of the National Tax Association, noted that many advocate for the abolition of corporate income taxes. However, it is difficult to see what tax base might replace this revenue source.

State and local business tax burden

Tom Neubig from Ernst & Young and president of the National Tax Association presented joint work identifying the total state and local tax burden on business.² His study measures the effects of property taxes, sales taxes, excise taxes on business inputs and investments, franchise taxes, gross receipts taxes, as well as unemployment insurance, workers’ compensation, and business license taxes. The study finds that businesses paid \$404 billion in state and local taxes in fiscal 2003, accounting for 43% of state and local tax receipts.

In terms of (state and local) revenue raised by type of tax, 39% of business tax receipts derive from the property tax. The sales tax on business inputs is responsible for 25% of the total, while the corporate income tax raises only 9%. Neubig noted that roughly 67% of state and local taxes fall principally on capital—at least initially—before the burden can be shifted into prices or elsewhere. Neubig also presented estimates of state and local taxes across industries as a percentage of industry value added. For all industries, the tax share of value added was 3.8%, with the bulk falling on capital. The rates varied widely across industries, ranging from a high of 8.2% in agriculture and mining to a low of 2.2% for services. Finally, Neubig argued that policymakers should consider total business taxes and determine the economic incidence of business taxes (how much falls on resident versus non-resident consumers, capital owners, and workers and landowners) and whether the tax burden is proportionate to the public services that businesses consume.

Is there a better way to tax business?

William Oakland, professor emeritus from Tulane University, suggested that business taxes should recoup the cost of providing public services to businesses. Taxation should also be firm specific—the business tax burden should vary directly with each firm’s production activity and government services consumed.

In this way, the tax burden acts as a price signal for firms, voters, and state–local governments. Applying the benefits principle would: reduce windfalls to the private sector; promote locational neutrality; promote production efficiency; and promote better political decisions by revealing the real cost of public services and any cross subsidy paid by business.

This system would require identifying and apportioning the public services provided to businesses. At the top of the list, Oakland said, unemployment compensation represents a direct benefit service to the business community and should be fully paid for by business taxes. Many public services are designed to benefit both consumers and businesses, such as public safety and transportation, and these costs could be apportioned between the two sectors. Oakland argued that safety net expenditures and educational expenditures should not be funded by business taxes. Because businesses compensate workers for the cost of their education with higher wages, taxing businesses directly to pay for education would amount to double taxation. In a 1995 study, Oakland and his co-author William Testa of the Chicago Fed argued that businesses should be responsible for funding 16% of tax-financed state and local combined expenditures.³ However, they estimated that 38% of state and local expenditures were actually supported by business taxes.

Oakland recommended the adoption of two different tax structures. On the state level, the corporation income tax and the sales tax on business purchases should be replaced with an origin-based value added tax (VAT). This would apply to all forms of economic enterprise, including service firms and non-profits (since even non-profits use public services) and would create a large, non-distortionary tax base. At the local level, the reliance on the property tax should be balanced by a local earnings tax, and business property taxes should exclude payments to schools. Oakland concluded that this structure would promote efficiency and identify the true cost of public services.

Matt Murray from the University of Tennessee presented joint work on restructuring the state corporate income tax.⁴ Murray highlighted the following

five key issues: defining the taxable base (what businesses and types of income should be taxed); establishing nexus for taxation, including establishing substantive nexus (the power to tax) and enforcement nexus (the power to compel collection); making a choice between separate and combined reporting of the corporate entity; determining the distribution of the tax base for multi-jurisdictional firms—apportionment and allocation rules; and determining whether to use a throwback rule where sales to non-tax states are included in the sales factor numerator in the state where the sale originated.

When it comes to defining the taxable base, Murray said, the key is to be guided by neutrality. The inclusion or exclusion of certain types of income should not lead to economic distortions. In the case of nexus, Murray favored using an economic presence nexus standard. This would tax income where it is earned, which occurs at both origin and destination. Murray also favored the use of combined reporting, where firms file a combined tax return for a unitary group of companies. This would help eliminate some of the distortions that can occur through transfer pricing, the assignment of royalties, and the sharing of overhead when separate reporting is used. Further, in the case of apportioning the tax base of multi-jurisdictional firms, Murray cautioned that allocation can create distortions by allowing firms to assign income to low tax states. Finally, Murray argued that throwback rules create inconsistencies in the tax base by assigning income to a state that may not have had a role in producing the income.

Federal tax reform

Next, Rudolph Penner, senior fellow at the Urban Institute, discussed federal tax reform. Penner noted that in the early 1990s proposals ranged from the adoption of a flat-rate income tax to the creation of a national sales tax. Some bipartisan interest was shown in a progressive consumption tax. Efforts were also made to reduce the tax burden on capital. However, the removal of a tax on capital would cause the after-tax rate of return on investments to rise and that in turn would lead to a rise in discount rates.

As the discount rate increases, the value of existing capital declines. Another transition issue is the potential to have to compensate corporate taxpayers for prepaying taxes. Corporations can accumulate many types of tax credits and future tax savings that are often treated as assets on the balance sheet. Tax reform that wipes out these assets would require very high levels of compensation that would force any new tax structure to initially carry very high marginal rates, which would be politically unpalatable.

Penner noted that much of tax reform is geared toward social engineering rather than business tax improvement. Estimates suggest that social tax expenditures (foregone tax revenue) in the federal budget now equal 5.3% of gross domestic product (GDP). In contrast, special credits for business equal 1.2%. In addition, many tax reform efforts are complicated or temporary. The 1997 tax reforms added many exemptions and credits with little clarity, and recent tax cuts for dividends, capital gains, and estate taxes have all been passed as temporary measures.

Further, even apparently clear-cut, targeted measures sometimes fall prey to special interests. For example, in response to the World Trade Organization's ruling that U.S. tax subsidies to exporters are illegal, lawmakers sought to compensate U.S. export firms (particularly manufacturers) for losing this subsidy. However, Penner noted, what originally was geared as tax relief for manufacturers has broadened to cover a host of industries, including energy, tobacco, sellers of ceiling fans, and native subsistence whalers. One of the problems with trying to create a tax structure that compensates firms for lost subsidies is that it does not establish tax incidence. As Penner noted, there is a difference between the direct portion of taxation that stays with the seller and the indirect portion that is shifted forward. Ideally he argued, this would support the adoption of an origin-based VAT.

Looking ahead, Penner said that decisions would have to be made on which expiring tax benefits will be extended or made permanent. Second, the alternative minimum tax has never been indexed for inflation but is now beginning to grow very large and pervasive.

Measuring state business tax competitiveness

Robert Tannenwald of the Federal Reserve Bank of Boston discussed indicators used to rank the competitiveness, fairness, and adequacy of state business taxes.

However, he argued, many of the indicators used to judge these criteria are flawed. Those purporting to gauge tax competitiveness fail to provide a comprehensive assessment of the effect of taxes on long-run profitability or the marginal return on investment for businesses. In addition, popular tax indicators fail to account for the degree to which business tax burdens may be shifted over time to customers, workers, and others. For example, one widely cited indicator of competitiveness ranks states based on the fees, taxes, and charges raised per \$1,000 of statewide personal income. This measure provides no insight into the distribution of tax burdens and public service benefits between businesses and households. Similarly, Tannenwald described a Massachusetts group's analysis of historical trends in the revenues from the state's corporate excise tax as a share of total state tax receipts and per \$1,000 of personal income. In both cases, Tannenwald noted that these measures could establish neither whether business was paying its fair share of the tax burden nor whether the corporate excise tax was affecting firm profitability.

Further, Tannenwald noted that another widely quoted business tax indicator—the business sector's share of total state and local taxes—is a more passive reflection of the capital intensity of a state's economy than an indicator of competitiveness.

Tannenwald offered a new indicator of business tax competitiveness that compares states in terms of business taxes paid as a percentage of profits earned within a state. He also touted the representative-firm approach, whereby the state and local tax liability is calculated as a percentage of pre-tax corporate income for a specific hypothetical firm in an industry group. However, this measure evaluates the effect of taxes in the absence of other factors, such as relative property and labor costs, that might swamp the effect of the reported tax

structure. He concluded that what is really needed is a comprehensive measure of business climate and not just tax climate. This can only be achieved if businesses are more willing to share information about the effects of policy on their bottom line.

Michigan, Illinois, and Indiana

Next, Doug Roberts of Michigan State University (and former state treasurer for Michigan) spoke about Michigan's single business tax (SBT). Adopted in 1975, the SBT was an effort to introduce an origin-based business value added tax (based on a benefits received principle) to replace a business tax structure that tended to produce revenue booms and busts. The SBT replaced seven existing business taxes with one broad based/low rate (2.35%) tax, which could be computed in one of two ways. A firm could either pay a 2.35% tax against its tax base (calculated as compensation, profits, depreciation, and interest paid) or pay a 1.175% tax on the basis of total gross receipts. In the latter case, the maximum tax base could not exceed 50% of gross receipts.

Roberts credited the passage of the SBT to a convergence of strong political leadership with a state fiscal crisis. However, over time revisions to the SBT have significantly reduced its revenue raising ability. Currently, the tax is being phased out; it is scheduled to expire on December 31, 2009.

Roberts suggested that many misperceptions have made the SBT unpopular. The first is that it is a small business tax. In reality one-tenth of 1% of all firms in the state account for 27% of the revenue raised, and 2% of all firms pay 60% of the tax. Conversely, 27% of all firms have no SBT liability, with 44% of all firms paying less than \$1,000 per year in SBT taxes. The tax also drew opposition from special interest groups that may not have been previously subject to corporate taxation or disliked paying a tax when their businesses lost money.

Replacing the 27% of general fund revenues the SBT provides will be difficult. Options include keeping the SBT and overweighting the profits factor, enacting a small SBT and combining it with an independent corporate income tax,

or enacting both a gross receipts tax and a corporate income tax. The greatest challenge will be political, Roberts concluded, because any change will likely affect a large number of firms currently paying little or no tax.

Then, Fred Giertz of the University of Illinois and the National Tax Association described recent developments in Illinois, which he characterized as a low state tax/high local property tax state. Illinois has a moderate corporate tax rate of 4.8% plus a 2.5% local personal property replacement tax for local government with a sales tax on many business inputs. The corporate tax rate is limited by the state constitution to a ratio of 8:5 to the personal income tax rate. The property tax is particularly problematic for business. Not only does the state have generally high property tax rates, the state's largest county (Cook) has a classification scheme that taxes business property more than residential property. Giertz concluded that Illinois has a reasonably good business tax structure, with the exception of the property tax burden and the tendency to offer too many types of tax credits.

Recent economic conditions have placed greater stress on Illinois's revenue sources. The state had an outright decline in total revenues for three fiscal years and current revenue growth

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remains sluggish. In addition, Governor Blagojevich has maintained his campaign pledge of avoiding increases in the sales or income tax base, while maintaining service levels in K–12 education and health and welfare. This has led to a reliance on creative solutions to fund the budget, including borrowing, tax amnesties, fund transfers, sale of state assets, and the use of one-time federal aid. Recently, the focus has turned to higher taxes and fees on business. Businesses have faced a range of fee increases, as well as taxes on out of state gas purchases, and trucking and gambling tax and fee increases. Giertz predicted that efforts will continue to shift the property tax burden toward business.

Finally, William Sheldrake of Policy Analytics described Indiana's tax restructuring experience from 2001 and 2002. The state adopted a market value assessment property tax system in response to a State Supreme Court order in 1998. On average, this was expected to boost residential assessments by nearly 33%, representing a huge increase in residential property taxes. Changes in the property tax system provided the state with an opportunity to consider other tax reform measures. Sheldrake noted that Indiana's tax burden was lower than many midwestern states' but that the structure was relatively regressive, imposing a higher burden on lower-income groups. In addition, Indiana's statutory corporate income tax rate is relatively high for the region, and the local

property tax burden is particularly difficult for manufacturing firms with high investments in plant and equipment.

A proposal to reform the state tax system was initiated by then Lt. Governor Kernan, with a goal of improving the business climate. The proposal eliminated or reduced seven major taxes, reducing state revenue in FY 2003 by slightly more than \$2 billion. These cuts were designed to reduce the state reliance on the property tax. To make up for the revenue loss, two taxes were increased (the sales tax rate would rise by 1% and a graduated income tax rate was introduced) and the property tax replacement credit was eliminated.

The second part of the proposal was designed to improve economic development and promote tax fairness. These measures eliminated the corporate gross income tax, increased the research and development credit, expanded the earned income tax credit, and increased the renter's deduction to \$3,000. To pay for these measures, a business franchise tax was instituted and the rate for the corporate net income tax was raised to 8.5%.

Sheldrake noted that the business sector benefited from the repeal of the unpopular inventory tax, as well as the corporate gross income tax. In addition, the property tax burden on business assets was reduced. The major countervailing action was an increase in the corporate net income tax rate by 0.75%. For individuals, the reform reduced the impact of property tax reassessments based on market value and

improved equity for low-income individuals. However, individuals faced higher sales tax rates and cigarette taxes.

Conclusion

The conference discussions suggested that state and local business taxation still lacks clear direction. Immediate revenue needs and political expediency are often primary considerations in developing tax structures. Ideally, business taxes should be restructured to more closely reflect the benefits that businesses receive from government. This could improve tax efficiency and reduce the distortions often associated with current tax structures.

¹ Paul Studenski, 1940, "Toward a theory of business taxation," *Journal of Political Economy*, October.

² Robert Cline, William Fox, Tom Neubig, and Andrew Phillips, 2004, "Total state and local business taxes: A 50-state study of the taxes paid by business in FY 2003," Ernst & Young, report, January.

³ William Oakland and William Testa, 1996, "State and local taxation and the benefits principle," *Economic Perspectives*, Federal Reserve Bank of Chicago, January/February.

⁴ William Fox, Leann Luna, and Matthew Murray, 2004, "Structuring a state corporate income tax," presentation at Federal Reserve Bank of Chicago, September, available at: www.chicagofed.org/news_and_conferences/conferences_and_events/2004_state_and_local_business_taxation_conference_agenda.cfm.

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