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Future State Business Tax Reforms: A conference summary

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On September 17, 2007, the Federal Reserve Bank of Chicago, Ernst & Young, and the Office of Tax Policy Research at the University of Michigan's Ross School of Business brought together over 120 business people, academics, and public policymakers to examine the changing dynamics of state business taxation.

Materials presented at the conference are available at www.chicagofed.org/news_and_conferences/conferences_and_events/2007_tax.cfm.

Recent changes to state business tax structures in Ohio, Texas, and Michigan have reinvigorated interest in how states should (and should not) tax business. The program held at the Federal Reserve Bank of Chicago examined the complete range of business taxes, including income, sales, and property taxes, as well as value-added and gross receipts taxation.

State taxes and the benefits principle

George Zodrow, Rice University, discussed the underlying economics (particularly the increasing mobility of capital and high-skilled labor) that policymakers should consider when designing tax systems. Consumption taxes (usually sales taxes at the state level) have broad appeal to policymakers. However, a primary fault of sales taxes is that they fall on business input purchases and, therefore, result in tax pyramiding, making the effective rate of the tax higher than the nominal rate. Zodrow argued that the sales tax base should be as broad as possible with a low rate to limit distortions. Income tax adjustments or rebates to the poor, he added, should be used as compensating mechanisms. In addition, taxes on business inputs should be avoided.

Among general business tax structures, Zodrow said he preferred taxes based on the "benefits principle," which are designed to reflect the value of the government services a firm receives. Granted, developing appropriate proxies for benefit taxes can be difficult, he said. In addition, states are likely to want to tax benefits arising from location-specific rents that firms receive and, particularly, from resource rents such as mineral production or natural resource extraction.

Finally, Zodrow questioned the appropriateness of the corporate income tax when applied to multistate firms. When states apply formula apportionment to the tax base, the corporate income tax in reality becomes a three-factor tax on labor, property, and sales. If the intent of policymakers is to tax each of these factors of production separately, he said, they should do this directly.

William Testa, Federal Reserve Bank of Chicago, criticized the current labeling of taxes as levied on business versus individuals. For example, many so-called business taxes are labeled as such for political reasons, even though the burden is shifted to households. Testa argued that tax and expenditure systems would be made more transparent to voters under a benefits principle of general business taxation. Such an approach would confine business taxes to a general levy on firms that aligned with the costs of public services that are directly used in the firms' production.

Looking at broad and varied taxes in each state that today fall under the rubric of "business taxes," Testa noted that the bulk of taxes fall on capital inputs to production and that this should be of concern to policymakers hoping to foster economic development in their states. A general business tax based on the benefits principle, he said, would help citizens make decisions based on the real tax costs of government services that are provided to both businesses and households. This would also help government to plan and deliver those services that are valued by firms, thereby supporting state economic growth and development.

Testa then described a methodology for assigning tax-funded expenditures to the business and household sectors to estimate what benefits the business sector receives through taxation. If the current hodgepodge of so-called business taxes were to be replaced with a single business tax based on benefits received, what would be the approximate size of the tax?

Based on a distribution of state and local expenditures across the business and household sectors, Testa concluded that the business sector is paying a significantly higher amount in taxes than it is receiving in government expenditures. Thus, a single business tax based on a benefits principle would likely assign lower tax liabilities to businesses than they face today.

Of course, the basis on which businesses are assigned tax liability under benefits taxation must be a good proxy for government services received. Testa concluded that a value-added tax (VAT) would be a suitable proxy because it would avoid large biases for or against the use of capital versus labor across a state's many businesses. Such a tax base would be defined by the "origin" of a firm's value added, that is, the location where production takes place. This would align best with services a firm receives from the state government.

Robert Cline, Ernst & Young, discussed some recent moves by states to improve their tax competitiveness—e.g., by reducing taxes on capital and shifting from origin-based taxes to destination-based taxes. In addition, states seem willing to shift to a benefits principle and away from ability to pay. Other reform objectives include: reducing business tax volatility; finding an effective way to tax the service sector; adopting more uniform taxes that apply to all forms of business; increasing taxes on "out-of-state" companies; and finding tax sources to pay for health care expenditures.

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Income, sales, property, and value-added taxes

William Fox, University of Tennessee, noted that corporate income tax accounts for only about 9% of the business tax total and has been declining. The decline is being driven by state and federal policy decisions, as well as tax planning by businesses. States have been trying to shore up the business tax base through efforts such as requiring combined reporting and disallowing certain deductions between related businesses.

Fox highlighted the tendency to move business taxes in the direction of sales taxes. For example, when states adopt single factor sales apportionment for their corporate income tax, the tax essentially becomes a gross receipts tax (GRT) with the rate dependent on firm profitability. The GRT has the advantage of capturing a broader tax base and making avoidance of the tax more difficult than a corporate income tax. However, tax pyramiding in the GRT causes a number of distortions and can be a particular burden for low-margin/high-volume firms for which the tax paid may have little relationship to the firms' economic presence in the state. Additional burdens for states adopting GRTs are administrative issues, such as defining what is taxable, and nexus issues. However, for policymakers, Fox explained, the relative revenue stability of a GRT and its sizable revenue potential are likely to be attractive features.

Matthew Murray, University of Tennessee, described the decline in the sales tax base. Policymakers have been reducing sales taxes on business inputs and exempting basic consumer items, such as food and drugs, thereby reducing the sales tax base. In response, sales tax rates have continued to rise and, when combined with local tax add-ons, now exceed 10% in some jurisdictions across the nation. The business sector's payments in all states made up 43% of the sales tax total in 2003.

Murray noted that, while an expansion in scope of business exemptions for the sales tax would constitute good policy, it faces many political hurdles, including perceptions of corporate welfare, diminished capacity to export the tax base, and the practical problem of shifting the tax burden to make up for the loss of sales tax revenue from business.

Murray said the consumer side of the sales tax base could be expanded to include health services, educational services, residential construction services, personal services, and amusement and recreation. Standing in the way of these efforts are concerns about tax fairness (particularly for lower-income consumers), administration, and compliance. There is also a concern over the appropriateness of taxing human capital investments. Murray concluded that in optimal tax theory, if you cannot tax the output, it may be appropriate to tax the input.

Andrew Phillips, Ernst & Young, discussed trends in property tax reform. Noting that property taxes account for the largest share of business taxes, Phillips explained that property tax reductions have been crucial elements of state business tax reform efforts in Ohio, Texas, and Michigan. Increasingly, homeowners are also voicing their dissatisfaction with the property tax. Property taxes play a central role in funding local government, so the push for reductions is putting policymakers under pressure to find alternative revenue sources.

One focus of business property tax reform has been to reduce or eliminate the personal property tax that places a burden on business capital. For example, Ohio's tax reform includes a five-year phase out of the personal property tax in the state. The fiscal impact of this change is estimated at over $1.2 billion and requires that the state's new Commercial Activities Tax raise sufficient revenue to reimburse local governments for the lost personal property tax income. In Michigan, the new Michigan Business Tax (MBT) provides for a 23% cut in the personal property taxes of commercial taxpayers and a 46% cut in those of industrial taxpayers.

Laura Kalambokidis, University of Minnesota, discussed prospects for a state-level value-added tax. The VAT is appealing because it is a broad-based tax on consumption. In theory, a VAT on both labor and capital does not distort business decisions. It also is neutral with regard to business type because it is levied on all businesses. It also might apply to a broader range of out-of-state firms than the corporate income tax. Further, if the VAT is based on origin, the tax is perceived as more closely relating to the benefits a business receives through public services. Because state-level VATs are relatively new, more work needs to be done to understand their effects on business tax structure.

Recent state tax reforms

Scott Schrager, Michigan Department of Treasury, described the new Michigan Business Tax. The MBT replaces Michigan's Single Business Tax that was a VAT-style tax instituted in the late 1970s.

The MBT is in fact two taxes. The first is a business income tax of 4.95% that includes noncorporate entities. The second is a modified gross receipts tax of 0.8%. In addition, the new tax structure allows for significant reductions in business personal property taxes. The new tax raises $1.9 billion, with one-third of the revenue from the business income tax and two-thirds from the modified gross receipts tax.

Businesses that will pay less under this new system will include manufacturers, firms with $10 million to $20 million in gross receipts, construction firms, firms with less than $10 million in gross receipts and more than $115,000 in owners' income, and Michigan-based multistate firms. Some businesses will see their taxes increase. These businesses include finance, insurance, and real estate firms; firms with little personal property; and firms that operate in Michigan but have little payroll or property in state. Finally, Schrager noted that the new MBT has a clearly defined revenue limit to ensure that it does not produce a significant revenue increase.

Tom Zaino, currently with McDonald Hopkins and former tax commissioner of Ohio, described the evolution of Ohio's gross-receipts-style Commercial Activities Tax (CAT), which was prompted by the state's declining economic performance. A guiding principle was that it would be better to collect the same level of tax revenue by taxing consumption rather than investment.

The CAT base is taxable gross receipts at a rate of 0.26%. Taxable entities include virtually every type of business (regardless of form), as well as trusts, associations, societies, and clubs. The only entities not subject to the CAT are those with less than $150,000 in gross receipts, certain public utilities, banks and financial institutions, insurance companies, and nonprofits. Many of these are covered by separate tax structures.

Permitted exclusions from the gross receipts base include interest (except on credit sales), dividends, and wages. Zaino added that the proof of success for the CAT will be whether the state realizes improvements in jobs, gross state product, and personal income.

The new Texas Margin Tax was discussed by Billy Hamilton, former deputy comptroller of Texas. Motivating the creation of the margin tax was a desire to reduce property taxes. Texas had significantly reduced its support for local education (from 50% in the late 1990s to just 39% in 2007), putting a strain on the local property tax base. In addition, the state wanted to reduce the tax planning opportunities available under the franchise tax and to provide taxpayers with a choice of tax bases.

The new tax is a broad-based, low-rate tax based on the net margin of a firm. The rate is 0.5% for retailers and wholesalers and 1% for everyone else. Firms not required to pay the tax include sole proprietorships, general partnerships, insurance companies, nonprofits, certain passive entities, grantor trusts and estates, passive investment partnerships, and real estate and mortgage investment conduits. The tax base is the lesser of the following three bases: 70% of total revenue, total revenue minus cost of goods sold, or total revenue minus wages and benefits.

The tax is projected to raise $6 billion in the first year—more than double the state's current business tax collections. However, the new tax does not raise enough revenue to fully finance the state's property tax cut.

Conclusion: Key perspectives on the new tax systems

A panel of experts from business, academia, and government concluded the conference with a discussion of emerging state business tax structures.

Gary LeDonne, Ernst & Young, said that states would continue to pursue combined reporting. He added that federal actions might affect the options available

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to the states. The need to raise revenues to fund Medicare and Social Security at the national level might even lead to a federal VAT.

Lorna Turner, Hyatt Corporation, said that policymakers should be realistic about who actually ends up paying for a business tax. In the case of Hyatt (and any other hotel), local sales taxes and fees will be passed on to the guest if at all possible. Thus, what was intended to be a business tax ends up as a consumer tax.

Joel Slemrod, University of Michigan, suggested that academics need to do a better job explaining tax principles and the consequences of tax policy changes. For example, many policymakers have misunderstood the academic principles of favoring a broad-based, low-rate tax and have used this to support adoption of the gross receipts tax. Slemrod suggested that the key is having a *sensible* broad base.

Slemrod offered the following ideas for states pursuing tax reform: First, offer low origin-based taxes on mobile factors of production, and second, have a level playing field for all types of business. Increasing the top rate on personal income would prove beneficial, Slemrod argued, as well as taxing services. Sector-specific tax incentives should be avoided, he said, particularly because governments have shown little ability to pick which firms offer the greatest growth potential to their local economy. Finally, Slemrod argued that part of why we tax business is simply for convenience. It is much easier for governments to collect taxes from businesses than from individuals.

What might happen in the next five to ten years? George Zodrow said that, while it might be wishful thinking, he hoped states would move toward a VAT. Richard Levin, tax commissioner of Ohio, argued that the business sector wants predictability and that his charge was to ensure that the rate for the CAT remains stable and that the tax base is not gradually whittled away. Fred Giertz, University of Illinois at Champaign–Urbana, and Doug Lindholm, Council n State Taxation, said they expected states to continue to look at GRTs, although they suggested that the distortions in the GRT base and the tendency to slowly raise the rate made this an inappropriate tax. In contrast, Harley Duncan, Federation of Tax Administrators, said he expected states to try to preserve the corporate income tax, particularly through expanded use of combined reporting.

Slemrod concluded that there is a need to carefully examine the outcomes from the reform efforts in Ohio, Michigan, and Texas. Measuring the economic effects will provide guidance to other states.