

Chicago Fed Letter

New Developments in State Business Taxation: A conference summary

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On April 4, 2007, the Federal Reserve Bank of Chicago, the National Tax Association, and the University of Illinois's Institute of Government and Public Affairs brought together a distinguished group of state tax experts to discuss emerging trends in business taxation.

How should states tax business? Does business pay its fair share of the tax burden? And are state revenues growing fast enough to meet future expenditure needs? These were just a few of the questions discussed at the conference that convened at the Federal Reserve Bank of Chicago.

Tax principles and recent experience

William Testa, Federal Reserve Bank of Chicago, argued that a state's tax revenue system should be structured around time-tested principles. Otherwise, the end product will likely be flawed, while, with the passage of time, the tax system will become further distorted through political maneuverings by special interest groups.

Two general tax principles fall under the rubrics of equity and efficiency. The most common notion of tax equity is the "ability to pay," which prescribes that the tax burden should vary directly with an individual's wealth or income. In this regard, general business taxes are often designed to extract payment from the well-to-do. However, Testa argued that general business taxes are ill-conceived to accomplish such equity. That is because business tax burdens are frequently shifted forward to consumers in prices paid for goods and services, while, in other instances, these burdens are shifted backward onto workers in the form of lower wages.

Also, empirical studies have not been effective in establishing "who pays" with any degree of confidence, making it unclear whether business taxes can be designed to achieve equity.

For these reasons, states should abandon the goal of achieving income redistribution or tax equity through general business taxation. Instead, those in charge of designing business taxation should focus on efficiency. In particular, state business taxes should be fashioned along the lines of the "benefit principle," which would require businesses to pay taxes in rough proportion to the amount of public services they consume. From an efficiency standpoint, a system run under the benefit principle would motivate the business sector to articulate its public service needs to state and local governments. This, in turn, would promote state economic growth and development. Also, this approach to business taxation would have salutary efficiency effects on the remainder of a state's fiscal system. By removing the illusion that business taxes are being paid by the well-to-do, voters and their elected representatives would more accurately perceive the actual costs of the public services accruing to households.

How does a gross receipts tax (GRT) align with the benefit principle? Not very well. Testa noted that under GRT

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

systems, tax liabilities are haphazard and do not closely correspond to a company's general business activity (and benefits received from public services). GRT liability tends to "pyramid" or cascade, since the tax is levied on the value of gross receipts each time a product or service is sold or transacted within a state. For example, a wholesale business would pay the GRT on its purchase price of a product within the state. Then, if a retail business purchased the same product from the wholesaler, the GRT would be levied once again on its value. Under such a mechanism,

this decline, states are looking to reduce tax avoidance, improve revenue stability, and promote both vertical and horizontal equity. States also want to adopt business tax structures that can promote economic development and that avoid undue administrative costs.

While most of these tax strategies are not novel, Luna said, they are bolstering corporate income tax revenue. For example, mandatory unitary combined reporting improves neutrality by better ensuring that income is apportioned to the state where it is earned. Tax amnesties have

which would tax gross receipts (at a rate of 0.125%), business income (at a rate of 1.875%), and assets (at a rate of 0.125%), all of which would be apportioned based on a 100% sales factor. In addition, the governor has proposed a 2% excise tax on selected service activities; this would raise \$1.5 billion. The tax would apply to a mix of consumer and business services, as well as to some intermediate purchases by business.

In response, the Michigan Senate has proposed a GRT of 0.54% that excludes inventories and purchases of capital expenditures. Fisher characterized this as approaching a consumption-oriented, value-added tax. The tax would be apportioned based on a 100% sales factor and would include a minimum tax payment of \$100 for all businesses, as well as various tax credits. The second part of the senate's proposal would include a 1.5% business net income tax, also apportioned based on a 100% sales factor. In total, these taxes would raise \$1.56 billion and would carry a growth cap to ensure that future gains in business tax revenues would be limited. Fisher also described three alternative proposals from several business groups in the state, each of which would reduce business taxes by at least \$400 million.

When states are thinking about changing tax structures, the relevant comparison is the potential performance of the new tax relative to the existing tax.

the ultimate tax liability on a good or service is haphazard, depending on the number of transactions within its chain of production and sales. More generally, Testa argued that the proposed GRT in Illinois would likely collect revenue in excess of what is needed to cover any additional public services related to business activity.

Recent state business tax reforms

LeAnn Luna, University of Tennessee, discussed how states have fashioned their business taxes in response to the 2001 recession. Corporate income tax receives a surprising amount of policy attention, she noted, given that it only made up 9.4% of total state and local taxes paid by business in FY2006.¹ The state corporate tax burden, as measured by taxes as a share of profits, has steadily declined from nearly 7% in 1989 to 3.6% in 2006. Luna attributed the decline in part to a cyclical downturn in the level of business profits, but said this was not the primary cause. She said the following were more important factors: state policy actions that have often lessened the tax burden, the erosion of the federal corporate income tax base (which affects states that couple their state tax structure to the federal base), and more strategic tax avoidance planning by businesses. In response to

shown a more mixed performance.

While they often give a short-term boost to revenues, the benefits may be overstated, since the gain from the amnesty often includes accounts receivable that would have been collected with or without the amnesty. Also, repeated use of amnesties does not appear to improve revenue yield. Finally, alternative tax structures (such as GRT) act to broaden the tax base and have the potential for significant revenue gains and greater revenue stability than a corporate income tax. However, they also entail significant compliance and administrative costs.

Tax reform in Michigan

Ronald Fisher, Michigan State University, described the state of Michigan's efforts to replace its Single Business Tax, which has been in place since 1975. The tax is a consumption-oriented, value-added tax that has become increasingly unpopular with the public and will be eliminated by the end of 2007. Because the tax raises \$1.9 billion (FY2007) and makes up 22% of the state's general fund revenues,² the state needs a replacement revenue source. Further, Michigan is in poor fiscal health; it has a projected deficit of \$1 billion for FY2007 and an estimated gap of \$3 billion for FY2008.

Michigan Governor Jennifer Granholm has proposed the Michigan Business Tax,

GRT in New Mexico and Ohio

Tom Pogue, University of Iowa, described New Mexico's long experience with a GRT, which dates back to 1935. It was revised in 1966 with the adoption of the Gross Receipts and Compensating Tax. The tax is on a very broad base, including most services, and has a rate that ranges from 5% to 7%, depending on local and county add-ons. A compensating tax rate of 5% is applied to out-of-state purchases that would be subject to New Mexico's tax if made in state, but Pogue noted that this provision is not fully enforced.

The tax is a significant revenue raiser for both state government (\$1.8 billion in FY2007) and local government (\$1.2 billion). Much of the very broad base included in the 1966 legislation, Pogue said, has been eroded by piecemeal attempts to reduce pyramiding on the grounds that taxing business-to-business transactions is unfair and increases the costs

of in-state production. Pogue added that this approach is not guided by any fundamental principle and makes the tax more complex and difficult to administer.

New Mexico's revenue from the pyramiding of business-to-business sales is estimated to equal 15% to 30% of total GRT revenue. Given that the GRT is responsible for about one-third of the state's budget, eliminating pyramiding would require the creation of a new revenue source. Citing specific examples of pyramiding across sectors, Pogue suggested that the impact is not high. The largest increases in final prices due to the tax are 1.33% in manufacturing and 1.31% in transportation.

Pogue offered the following two insights. First, what you originally legislate is rarely what you end up with. New Mexico's GRT has not been stable and continues to evolve toward a retail sales tax. And, second, when states are thinking about changing tax structures, the relevant comparison is the potential performance of the new tax relative to the existing tax.

Ohio has reformed its business tax structure to encourage capital investment and job creation by broadening the tax base and lowering tax rates, according to Frederick Church, Ohio Department of Taxation. Importantly, the tax reform was coupled with significant spending restraints that helped garner business community support.

The state's new Commercial Activities Tax (CAT) is a broad-based (all gross receipts excluding portfolio income), low-rate (0.26%) GRT on business activity in Ohio. The tax is a business privilege tax and not a sales or income tax. This allows Ohio more flexibility in defining the nexus for taxation.³ As such, the tax applies to imports, but not exports, of goods and services. It uses an economic presence test, which taxes based on the degree to which a business makes in-state sales. The tax structure is explicitly designed to benefit manufacturing and reduce the taxation of capital.

In FY2006, Ohio's revenues from the CAT exceeded the original estimate by 27.5%, Church said, and so far in FY2007,

current revenues are still ahead of projections, even after the base estimates were increased by 15%.

Illinois Governor's proposal

John Filan, Illinois Governor's Office, discussed Governor Rod Blagojevich's proposed tax reform and spending plan in the context of the larger fiscal issues facing the state. These include a structural budget deficit that is exacerbated by an outdated corporate income tax and expenditure pressures for health care, education, and pensions.

The first phase of the governor's plan would address the state's underfunded pension liability of \$45 billion. The proposal would sell the state lottery and issue pension bonds to infuse \$26 billion into the pension system and bring the plans funded ratio (fund assets to projected actuarial liability) to 83% from 60%. With a predictable payment schedule, the pension system would reach 90% funded status by 2040 and would save the state \$60 billion through lower interest payments over the life of the plan.

The second phase of the plan is a GRT that would raise \$7 billion in new revenue by taxing the gross receipts of companies with receipts over \$2 million, at a rate of 0.85% for manufacturing and construction and 1.95% for services; companies with gross receipts under \$2 million would pay the corporate income tax. Filan noted that the \$2 million receipts tax threshold would exempt 85% of Illinois businesses from the GRT. In addition, all goods and services exported from Illinois would be exempt from the GRT; essential products, including food, drugs, and payments that hospitals, doctors, and dentists receive from the state for service to Medicaid patients, would be exempt as well. Finally, corporate income taxes would receive a 100% credit for gross receipts taxpayers.

Filan argued that the GRT in other states, such as Washington, has not adversely affected economic growth. Further, he emphasized that the new revenue raised will not expand state government employment, but rather it will fund household purchases of health care and support local education and property tax relief.

Commenting on the governor's plan, Fred Giertz, University of Illinois, argued that because it exempts food and exports from the tax base, the proposed tax becomes less of a tax on business and more of an inefficient sales tax. In addition, the pyramiding issues are real and can have detrimental effects, depending on a firm's specific structure and purchasing habits. The two-rate GRT structure and the \$2 million threshold for paying the tax, Giertz said, also counter the notion that this is a broad-based, low-rate tax. Finally, he noted that a GRT does not permit federal deductibility, so the tax cannot be exported to the federal government.

Giertz questioned the magnitude of the large revenue increase, implying that it was out of proportion to the state's underlying fiscal problems. He suggested that new revenue should be used to address existing problems before program expansions. Still, Giertz said that a case could be made for the GRT if it were structured as a very low-rate and broad-based tax. However, his preferred solution would be to increase income tax rates for both individuals and business (while also increasing the tax exemption for low-income individuals) and to broaden the sales tax to include some services.

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Tom Johnson, Taxpayers' Federation of Illinois, pointed out that Illinois has a clear structural budget deficit, with the state spending roughly 15% more than it receives in revenues. The state faces other funding issues beyond those outlined by the governor. Paying for health insurance for state employees (particularly in retirement) looms as a significant cost, and the state has not saved for this. Additionally, the state's infrastructure needs, particularly for transit, must be addressed. Finally, the state's school funding system is still too dependent on property taxation.

Johnson said that it is unclear whether the state should provide universal health care coverage. The governor's proposal to help shore up pensions may hold more promise, stated Johnson, and it may not be inappropriate to sell off the lottery, which after all is not a core function of government. Also, by issuing pension bonds, the state creates a hard debt that will increase fiscal discipline in meeting pension funding obligations.

As for the GRT, Johnson questioned both the high tax rate and the lack of visibility of the tax. He added that the incidence of the tax on firms with significant sales but low margins could be unduly punitive, and its effects could even differ markedly across firms in the same industry. This would call into question the fairness of the tax and its possibly distortive effects.

Finally, Johnson suggested that having a unique tax presents both structural and administrative issues. For business entities, familiarity can be a good thing when it comes to tax structure. Accordingly, he would favor adjustments to more visible and existing tax vehicles, such as the income tax (both rate and base), as well as the extension of sales taxes to some services.

Conclusion

State business tax systems are currently receiving considerable public policy attention. In the near term, efforts to

increase tax revenue from business is likely to encourage tax changes ranging from adjusting rates and bases of existing taxes to adopting new structures such as the GRT. The policy debate should also focus on analyzing the real economic impact of different tax structure choices and how those choices relate to sound tax principles.

¹ Robert Cline, Tom Neubig, and Andrew Phillips, 2006, "Total state and local business taxes," Ernst & Young and Council On State Taxation, report, March.

² Michigan has a multifund budget with the general fund making up less than 50% of total state spending. As a percentage of the total state budget, the Single Business Tax is 4.6%.

³ A firm pays the tax if it has any of the following: property of \$50,000 in Ohio; payroll of \$50,000 in Ohio; annual taxable gross receipts of \$500,000; at least 25% of total property, payroll, or receipts in Ohio; or is domiciled in Ohio.