BUSINESS TAXES IN MICHIGAN

Presentation for:

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Jay Wortley, Senior Economist

Mitchell E. Bean, Director

Public Finance Principles/Practice

- Taxation principles:
  - Equity
  - Simplicity
  - Stability
  - Efficiency
  - Economic growth
- Equity (fairness) measures for tax incidence (who pays):
  - Vertical equity
  - Horizontal equity

Equity

- Vertical equity measures tax burden by income group
  - Regressive taxes levy higher % of tax relative to income (RTI) for lower income groups than for higher income groups
  - Proportional (flat) taxes levy same % of tax RTI for all income groups
  - Progressive taxes levy higher % of tax RTI for higher income groups than for lower income groups
  - Effective tax rate (final tax liability after credits and exemptions) measures vertical equity
- Horizontal equity measures tax burden on taxpayers who have the same tax base

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Simplicity

- Complex tax structures:
  - Make compliance more difficult/costly
  - Provide more opportunities—for taxpayers and tax administrators—for error
  - Afford more opportunity to avoid/evade tax liability
- Compliance costs (record keeping, legal, accounting, etc.) are known as excess burden
- Simplicity in tax code minimizes excess burden
- Simplest tax is broad-based and has a low rate

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Stability

- Stable revenue sources minimize the need for budget revisions
- Broad-based revenue sources tend to be more stable through business cycle highs and lows
- An advanced capitalist economy requires:
  - Educated workforce
  - Infrastructure
  - Police and fire protection
  - Proper regulatory environment
  - System of courts

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Efficiency

- Efficient tax policy will minimize or have no influence on consumer and business economic choices
  - Efficient tax policy minimizes distortions and incentives that cause a change in economic behavior

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Other Considerations

- State, national, and world economies are integrated
- National tax policy plays a significant role in state economies
- Impact of federal fiscal/monetary policy can overwhelm state efforts to stimulate economy with tax policy

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Other Considerations

- Tax policy debate often includes consideration of:
  - Ability to pay
    Taxpayers should contribute to the support of public goods and services in proportion to their financial capacity
  - Benefits received
    Taxpayers that benefit from public goods or services should pay the costs of the goods/services
- Ability to pay and benefits received conflict when an individual who receives a benefit from the state is not able to pay for that benefit

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Other Considerations

- A revenue system must produce revenue
- Tax systems can export some tax burden
  - Taxes raised by Michigan state and local government do not have to be paid by Michigan residents
  - Tax exporting occurs when government arranges for residents of other jurisdictions to pay some of the taxes; examples include:
    - Retail sales taxes relying on tourist spending
    - Deductions for state/local income/property taxes under the federal income tax

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Other Considerations

- Tax collection administrative and compliance costs should be minimized
- Base erosion should be minimized
  - Special exemptions, deductions, exclusions, and credits cause base erosion
  - Base erosion is associated with high costs of administration and compliance

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Other Considerations

- Problems associated with earmarking should be recognized
  - Lower-than-anticipated revenue may lead to less funding for programs that do not receive earmarked funds
  - Earmarking may encourage the perception that some programs are entitlements
  - Earmarking may make it difficult for government to respond to changes in budget circumstances and priorities

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The "Best" Tax Would

- Have a broad base and low rate
- Be simple to administer—and fair
- Have low compliance costs
- Be a stable revenue source
- Promote economic growth

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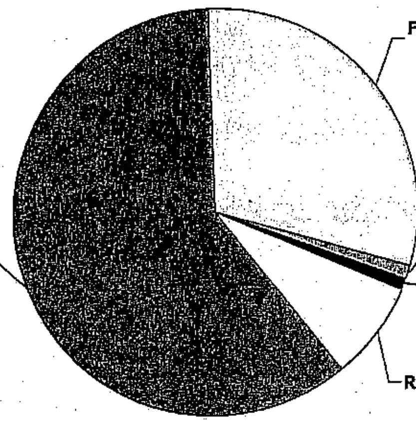
Michigan State Government Revenue

FY 2004-05



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State and Local Government Taxes

- FY 2004-05 STATE Government: $24.6 billion
  - Income
  - Sales/Use
  - Single Business
  - State Education
  - Tobacco
  - Motor Fuels
- FY 2004-05 LOCAL Government: $11.6 billion
  - Property
  - Income

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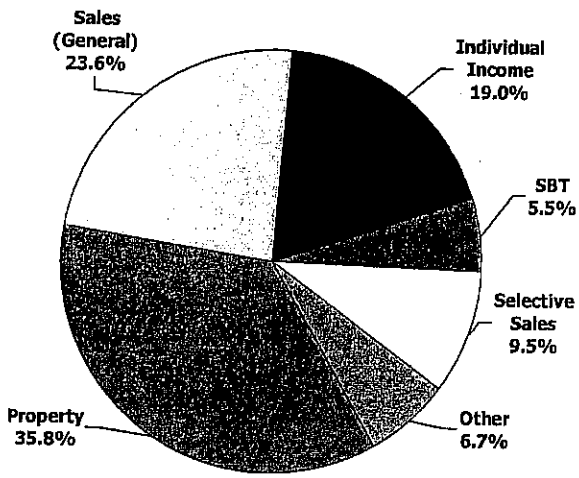
Michigan State/Local Tax Revenue



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Michigan Taxes on Business

	(Millions) FY 2004-05 Revenue
BUSINESS TAXES	
Single Business	$1,907.2
Personal Property, General Property	1,316.7
Unemployment Insurance	1,436.1
Insurance Company	249.5
Casino Gaming	145.8
Utility Property	99.1
Oil and Gas Severance	68.1
GENERAL TAXES	
General Property–Real	3,097.5
Sales and Use	2,400.4
State Education	559.1
Motor Fuels	285.1
Vehicle Registration	296.6
OTHER	379.7
TOTAL TAXES PAID BY BUSINESS	$12,237.9

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Single Business Tax (SBT)

- Taxes Replaced by SBT
- Reasons for Adopting SBT
- Who Pays the SBT?

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Taxes Replaced by SBT

	(Millions) FY 1973-74	% of Total
Corporate Income Tax	$295.1	39.0%
Corporate Franchise Fee	157.7	20.8%
Inventory Property Tax,	253.0	33.4%
Financial Institutions Tax	17.1	2.3%
Intangibles Tax (business portion)	28.8	3.8%
Income Tax on Unincorporated Business	4.0	0.5%
Saving and Loan Privilege Tax	0.6	0.1%
Insurance Privilege Tax	1.2	0.2%
TOTAL REVENUE	$757.5	100.0%

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Reasons for Adopting SBT

- Corporate Income Tax: volatility in revenue creating budget problems
- Economy: doing poorly—business taxes blamed in part for poor business climate
- Switch to SBT: generated one-time gain in revenue to help balance the budget
- SBT would:
  - Reduce tax burden on capital—compared with corporate income tax
  - Help stimulate capital investment and business expansion, and create new jobs

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Who Pays the SBT?
(By Size of Tax Liability)

	Number	% of Total Businesses	(Millions) Total Tax Liability	% of Total Tax
Did Not File	45,124	23.3%	0.0	0.0%
Filed But No Tax	41,214	21.3%	0.0	0.0%
Tax Liability <$1,000	25,399	13.1%	11.6	0.5%
Tax Liability $,1000–$9,999	56,845	29.3%	207.3	9.8%
Tax Liability $10,000–$49,999	18,803	9.7%	409.7	19.4%
Tax Liability $50,000–$499,999	6,015	3.1%	748.5	35.5%
Tax Liability >$499,999	461	0.2%	729.5	34.6%
Subtotal: Had A Tax Liability	107,523	55.5%	$2,106.6	100.0%
TOTAL BUSINESSES	193,861	100.0%	$2,106.6	100.0%

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Based on 2000-01 Data

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Who Pays the SBT?
(By Type of Business)

Business Sector	% of Firms Filing SBT	% of SBT Liability	% of Private GSP
Agriculture	1.5%	0.5%	1.0%
Construction	10.5%	6.1%	5.6%
Manufacturing	10.0%	30.1%	28.3%
Retail Trade	23.4%	14.6%	10.4%
Finance, Insurance, Real Estate	11.1%	6.9%	16.8%
Services	29.9%	24.3%	22.0%
Other	13.6%	17.5%	15.9%
TOTAL	100.0%	100.0%	100.00%

Based on 2000-01 Data

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Michigan's Personal Property Tax

- Most business property is subject to personal property tax
- Business inventories, special manufacturing tools, agriculture personal property, and household personal property are exempt
- Personal property accounts for about 9% of total taxable value
- Personal property tax accounts for:
  - About 15% of total property taxes
  - About 33% of property taxes paid by business
- 35 other states tax most personal property
- 11 states tax business inventories

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Michigan 2005 Personal Property Tax Revenue

Tax	(Millions) Estimated Amount
General Property	$1,316.7
State Education	172.7
Industrial and Commercial Facilities	215.0
State Utility Property	84.0
ESTIMATED TOTAL PERSONAL PROPERTY TAXES	$1,788.4

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How Other States Tax Business

- 44 states have corporate income tax; of these states
  - 11 have minimum tax that must be paid
  - 5 pay the greater of corporate income or net worth tax
  - 1 also assesses valued added tax (NH)
- 17 states assess some type of franchise or net worth tax (most in addition to corporate income tax)

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How Other States Tax Business

- 2 states have broad-based gross receipts tax
- Several states levy gross receipts tax on a particular industry (banking, telecommunications, insurance)
- 11 states have a property tax on inventories
- 35 states tax most personal property

Texas Business Tax Changes

- Texas recently replaced franchise tax with "margin" tax
- Margin tax starts with gross receipts; allows businesses to claim:
    - Cost of goods sold deduction, or
    - Compensation paid deduction
  - After deductions, major portion of tax base is either business income or value added
  - Tax rate is 0.5% for wholesalers and retailers; 1.0% for all other businesses
- Texas is phasing out its personal property tax

Ohio Tax Restructuring

- Ohio enacted sweeping changes to business tax structure in 2005; most changes phased in over 5 years
  - Corporate franchise tax (income tax):
    - Repealed for most businesses
    - Phased out over five years
  - Income tax (graduated rates): reduced 21% over 5-year period
  - Sales tax: rate reduced from 6% to 5.5% effective July 1, 2005 (Ohio also has local sales taxes)

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Ohio Tax Restructuring

- New commercial activity tax (CAT):
  - Basically gross receipts tax; includes a business privilege tax
  - Business privilege tax (BPT) is flat $150
  - Gross receipts tax will be 0.26% when fully phased in
  - Businesses with gross receipts
    - <$150,000 do not pay either tax
    - $150,000 to $1 million pay only $150 BPT
    - >$1 million pay $150 BPT plus 0.26% of gross receipts
  - Major advantage: broad base and low rate
  - Major disadvantage: tax pyramiding

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Ohio Tax Restructuring

- Personal property tax:
  - Local tax on business personal property (includes inventories) being phased out for existing property
  - Beginning 2006, new manufacturing machinery and equipment is exempt from the tax
  - State government will reimburse local governments for loss in revenue
- Cigarette tax: increased from $0.55 per pack to $1.25 per pack
- Real property tax: 10% rollback in business real property taxes eliminated in 2006

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Tax Comparisons

(Selected Large Manufacturing States)

	Corp Income Tax Rate	Tax on S-Corps/ Partnerships	Minimum Tax	Franchise Tax
Florida	5.5%	No	No	No
Illinois	7.3%	Yes	No	Yes
Indiana	8.5%	No	No	No
New Jersey	9.0%	Yes	Yes	No
New York*	7.5%	Yes	No	Yes
North Carolina	6.9%	No	No	Yes
Pennsylvania	9.99%	No	No	Yes
Tennessee	6.5%	Yes	No	Yes

**New York businesses pay the higher of the corporate income tax or franchise (net worth) tax*

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Tax Comparisons

(Selected Large Manufacturing States)

	Business Personal Property	Inventories	Property Tax Assessment Ratio
Florida	Taxable	Exempt	100%
Illinois	Exempt	Exempt	
Indiana	Taxable	Exempt	100%
MICHIGAN	Taxable	Exempt	50%
New Jersey	Exempt	Exempt	
New York	Exempt	Exempt	
North Carolina	Taxable	Exempt	100%
Ohio	Taxable	Taxable	see footnote
Pennsylvania	Exempt	Exempt	
Tennessee	Taxable	Exempt	30% (Industrial & Commercial)
Texas	Taxable	Taxable	see footnote

INDIANA: *partial corporate income tax credit for personal property taxes; inventories essentially exempt beginning 2007; initiating 3-year credit—75% (1st), 50% (2nd), 25% (3rd)—for new personal property*
MICHIGAN: *provides partial credit on SBT for property taxes on machinery/equipment*
OHIO: *see Slide #27 regarding personal property* ***TEXAS:*** *see slide #24 regarding personal property*

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