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Introductory Discussion of an Alternative to the Single Business Tax

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Michigan's experience with the Single Business Tax has been somewhat checkered. While it has been more stable than a corporate income tax from the state's perspective, its unpopularity and drain on economic activity come from two sources. First, the rate of the tax is too high. Michigan's first experience with a value-added tax, the Business Activities Tax, was applied at a rate of .4% in 1953 and had increased to .75% when the tax was repealed in favor of an income tax in 1967. The Single Business Tax, on the other hand, began with a rate of 2.35%, which has been reduced gradually to a rate of 1.9%.

The second problem with the tax is that it is viewed as a form of profits tax that must be paid even when a firm does not make profit. This is a misconception. The base of the tax is value-added, not profit. However, in politics, perception is reality. Thus, while one seldom hears from retailers that they feel it unfair that they must pay the sales tax even when they do not make a profit, this is a major complaint of the SBT.

My suggestion is that the Single Business Tax be replaced with a combination of two taxes. Businesses will be free to choose which of the two taxes to pay. This is similar to the current situation under section 36 of the Single Business Tax Act where certain small businesses may choose to pay a profits tax rather than the value-added tax.

The primary tax will be much like the old Business Activities Tax, and would be so-named. It would be a consumption-based value-added tax calculated using the subtractive method. That is, firms would pay a tax that is based on their gross receipts minus their purchases from other firms. There would be a deduction for capital acquisition, which would be similar to the original capital acquisition deduction of the Single Business Tax. (While the old capital acquisition was held to be in violation of the Commerce Clause by a lower court, it is quite possible to write a deduction for new capital that meets constitutional muster.)

Business could opt to calculate their tax under an alternative profits tax, using as the tax base their business income as calculated for their federal tax. Firms might be allowed to make a choice between the value-added tax and the profits tax on an annual basis, or they might be required to maintain one method for a fixed number of years.

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A difficulty with using the subtractive method is the tax treatment for firms that make sales in other states. This is similar to the problem of the treatment of exports and imports in the value-added tax used in most other industrialized nations. The problem, of course, is that Michigan cannot require other states to collect the tax on the sale of items outside of Michigan.

One could tax the sale of goods into Michigan, using the same tax base as for firms that are entirely in Michigan, that is, sales minus purchases from other firms, and not tax sales made in other states. This would not capture the value-added at the last stage by the retailer that exported to other states, but it would capture instead the value-added of the retailer that sold into Michigan. It would take some further research to determine the net effect of this provision. But the tax would none-the-less capture most of the value-added in Michigan for firms that chose to pay the tax in this way.

There are several benefits to this tax structure. First, firms that have high value-added relative to their profits would not be discouraged by the tax scheme from locating in Michigan, as is currently the case. Such firms could choose the alternative profits tax. This tax rate should be a flat rate 6 %. This rate is competitive with states such as Virginia. Yet Michigan would also be attractive for high-profit firms, as they could choose the value-added tax component of the Business Activities Tax.

Second, this tax would be a tax on consumption. The economic base of this tax is the same as a retail sales tax on all goods and services in a closed economy. As such, the tax would be very close to the proposed "Fair Tax", the application of the retails sales tax on all goods and services. Both taxes would favor adding to the capital stock and thus labor productivity in Michigan, leading to higher wages and incomes in the intermediate to long term.

A major part of the reason to move to the Business Activities Tax would be to reduce the taxation of business activity. It is expected that the reduction in tax burden on business activity will increase business activity in Michigan in the medium term. I have discussed the fact that Michigan has a high tax burden on business and the relationship between economic activity and business tax in several white papers as well as an article in *The Wall Street Journal*. There is a good deal of economic research to support this contention, and the rate chosen for the Business Activities Tax should be much closer to the .75% rate of the old Business Activities Tax than the current 1.95% rate of the current Single Business Tax.

Since the Business Activities Tax is essentially the same as the SBT, just calculated in a different and simpler manner, and gives firms the opportunity to choose a profits tax instead of the value added tax, the Lansing political landscape of lobbyists should favor the Business Activities Tax as well.

In summary, Michigan should repeal the Single Business Tax in its present form and replace it with the Business Activities Tax. This tax would allow firms to choose a consumption-based value-added tax calculated as the firms gross receipts minus its purchases from other firms, or to choose a simple profits tax. The tax rates should be set sufficiently low to result in an overall tax cut of at least $100 million per year, with the rates declining as tax revenue increases.

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