

How Closely Do Business Taxes Conform to the Benefits Principle?

Richard H. Mattoon and
William A. Testa
FTA
Federal Reserve Bank of Chicago

September 21, 2010

Context

- GRT's have emerged from the dead. Ohio, Texas have recently adopted GRTs and Illinois had major GRT proposal. Why the sudden popularity?
- Larger issue—the growing difficulty of taxing business. Traditional structures fail to capture revenue from new business forms such as LLPs and S corps.
- Philosophical issue—how should we tax business? What tax principles should guide the discussion?

What should guide business taxation?

- ❑ Benefits principle would seem to be best candidate (Oakland and Testa).
- ❑ **Businesses should pay based on the benefits they receive for public services (or for their social costs). (User charges preferable)**
- ❑ Can you really tax business rents or export the burden? If not, over-taxing business leads to poor public choices...may over-consume government services...since voters don't think they are paying for them
- ❑ **Salutory effects on current development policy?**
- ❑ Current evidence suggests state and local business taxation is significantly too high

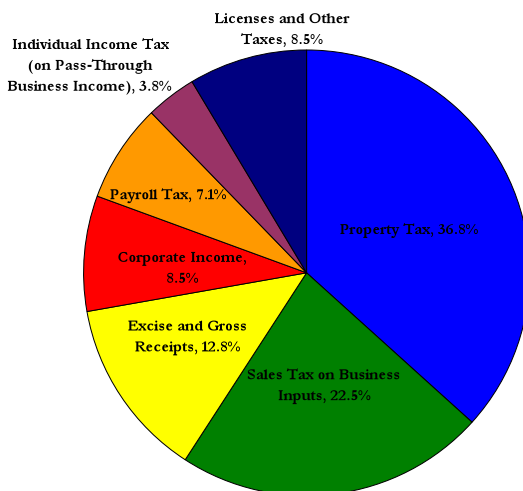
State & local business taxes in the United States, 2005

	Total (\$ billions)	Percent of business	Percent of total state-local taxes
Property Tax	\$182.8	36.7	16.0
Sales Tax on Business Inputs	\$111.7	22.5	9.8
Excise and Gross Receipts	\$63.7	12.8	5.6
Corporate Income	\$42.1	8.5	3.7
Unemployment Insurance Tax	\$35.5	7.1	3.1
Individual Income Tax (on Pass-Through Business Income)	\$19.1	3.8	1.7
Licenses and Other Taxes	\$42.5	8.5	3.7
Total Business Taxes	\$497.4	100.0	43.6
Total Taxes	\$1140.6	--	--

Source: Ernst & Young

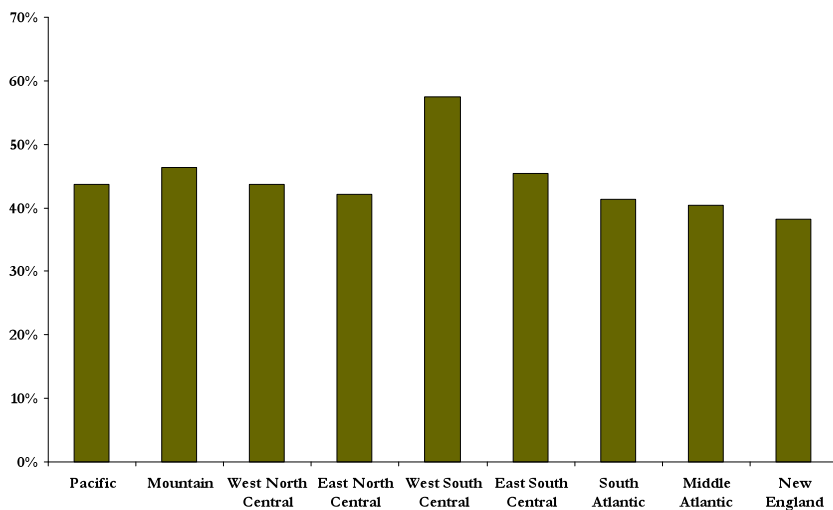
- **Business taxes fall heavily on capital returns and investment**

Composition of business taxes U.S. 2005



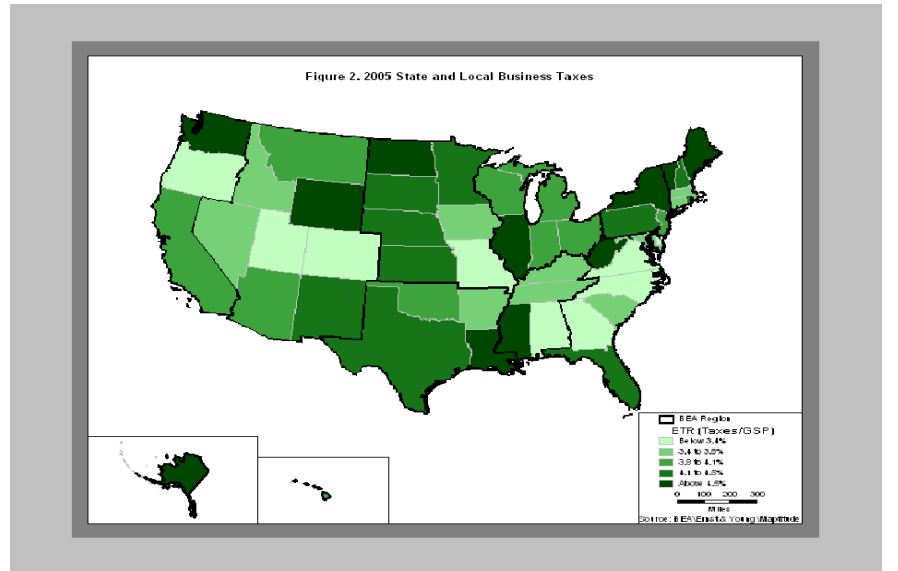
Source: Ernst & Young

Business Share of Total Taxes BEA Regions 2005



Source: Ernst & Young

Estimated tax rates for single tax on economic activity(S/L Business taxes/GSP)



Crude estimates of benefit principle in business taxation and state-local expenditure

- ▣ How much does state-local government currently spend on unpriced inputs to production?
- ▣ How do these expenditures compare to current business taxation?

Methodology for estimating tax-funded expenditure

In estimating "business expenditures," we would want to exclude those expenditures already funded by user fees and by the federal government.

Step 1: Deriving tax-funded expenditures

State-local expenditure by category	Intergovernmental grants by category	User charges by category	Tax-funded expenditures (un-allocated)
-------------------------------------	--------------------------------------	--------------------------	--

Step 2: Parsing expenditures to the household versus business sector

Result from step 1: Tax-funded state-local expenditures to be allocated to businesses and households, FY 2005

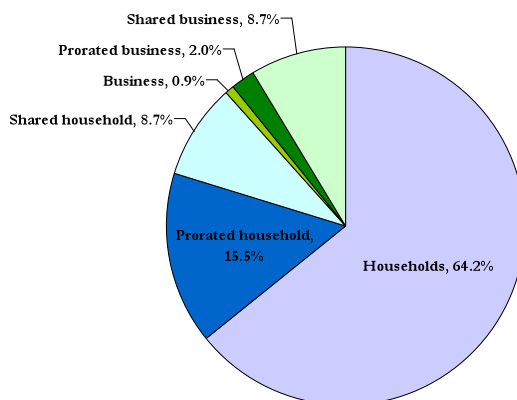
Spending category	Total (\$ millions)	Share of Total (percent)
Education	512,189	42.24
Libraries	7,078	0.58
Housing and community development	4,949	0.41
Natural resources (fish + forestry)	3,961	0.33
Natural resources n.e.c.	10,951	0.90
Parks and recreation	19,820	1.63
Sewage	3,220	0.27
Solid waste management	7,207	0.59
All other and unallocable	17,141	1.41
General interest on debt	76,823	6.34
Financial administration	32,808	2.71
General public buildings	10,300	0.85
Judicial	33,194	2.74
Other government administration (L+CS)	18,273	1.51
Corrections	57,764	4.76
Fire protection	23,445	1.93
Police	62,529	5.16
Protective inspection and regulation	11,824	0.98
Health	40,777	3.36
Hospital	23,728	1.96
Veteran services	1,349	0.11
Welfare	134,559	11.10
Air transportation	876	0.07
Highways	67,775	5.59
Parking	-196	-0.02
Water transport	493	0.04
Unemployment insurance	29,816	2.46
Total	1,212,652	100.00

Source: Census Bureau

Step 2: Census Expenditure Categories as Allocated (Summary)

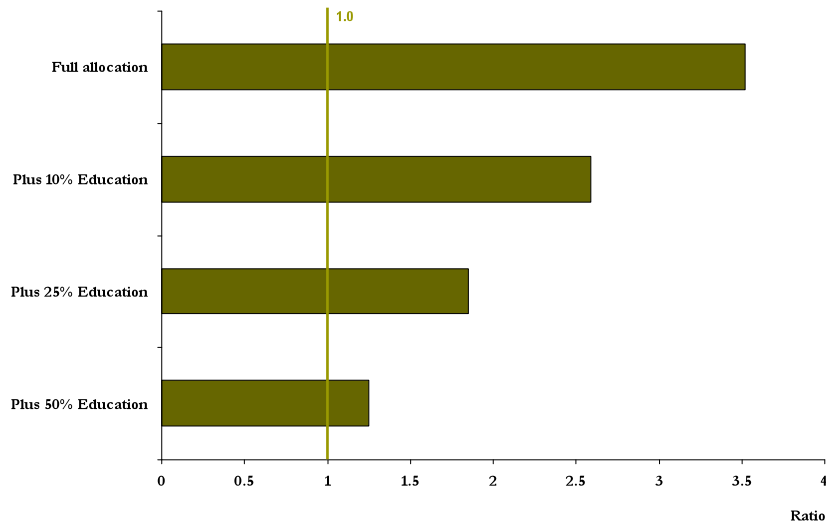
Households	Business	Shared	Pro-rated
Education	Natural resources n.e.c.	Sewage	All other and unallocable
Libraries	Water transport	Solid waste management	General interest on debt
Housing and community development		Judicial	Financial administration
Parks and recreation		Fire protection	General public buildings
Natural resources (fish + forestry)		Protective inspection and regulation	Other government administration (legislative + central staff)
Health		Police	Corrections
Hospital		Air transportation	
Veteran services		Highways	
Welfare		Parking	
Unemployment insurance			

Distribution of state and local expenditures U.S. 2005



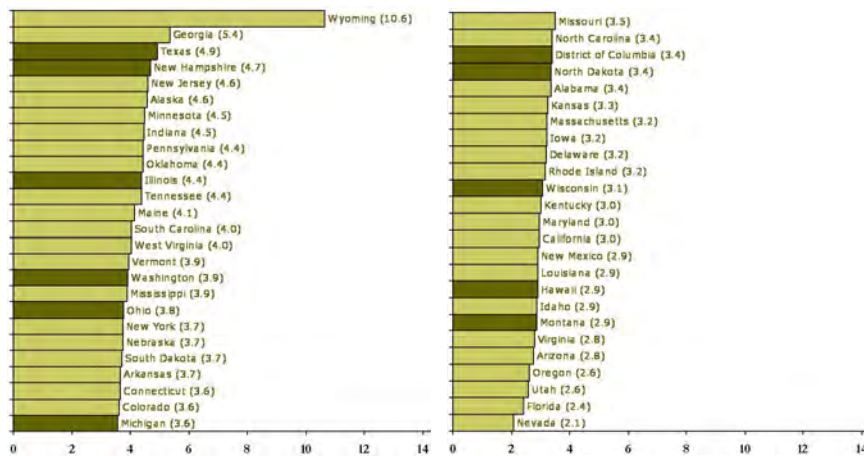
Source: Census Bureau

Result: Ratio of Business Taxes to Business Expenditures– U.S. Average



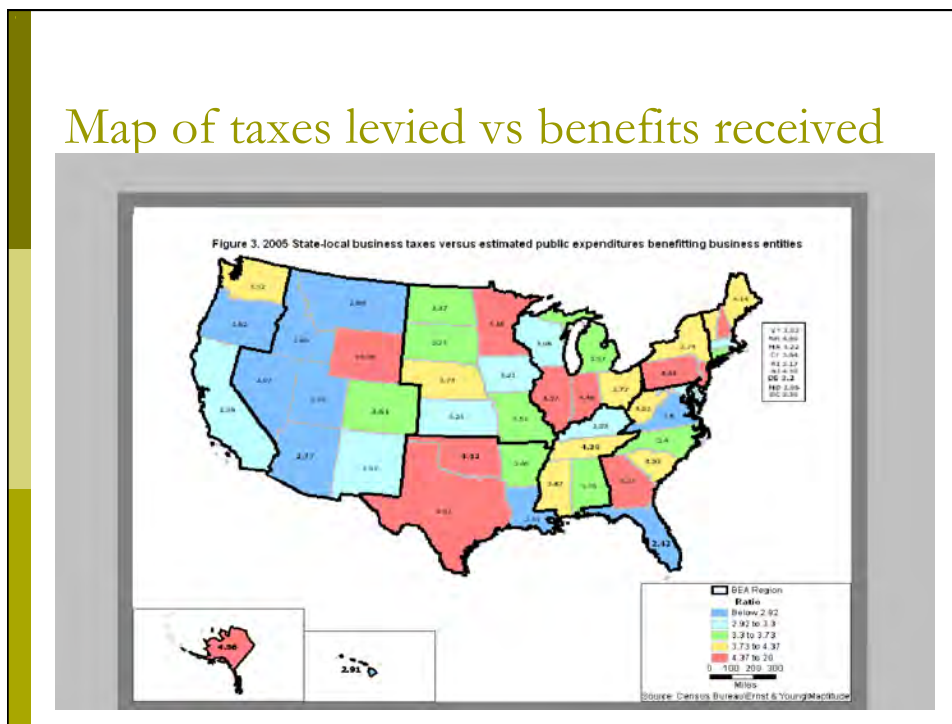
Source: Ernst & Young\Census Bureau

Business Tax/Benefit by State 2005 (ranked)



Source: Ernst & Young\Census Bureau

Map of taxes levied vs benefits received



Conclusion

- ❑ States are trying to find appropriate tax structures for a shifting economy—particularly taxing services, and are turning to what look like “business taxes”
- ❑ The current structure of business taxation is skewed toward capital returns and usage; they do not fare well against a benefits principle yardstick
- ❑ VAT-type business tax approach would be the better option, particularly if the rates are set based on benefits received...
- ❑ Based on benefits principle estimates of current business taxation, income and consumption taxes should be considered to fund state-local spending