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Tax Reform in Michigan: Replacing the Single Business Tax

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I. Introduction/Summary

On January 1, 2008, Michigan's dreaded Single Business Tax (SBT) will phase out of existence. This presents a historic opportunity for pro-growth tax reform during the 2007 Michigan legislative session. It is anticipated that the incoming legislature and governor of Michigan will spend much of 2007 forging a consensus on what taxes—if any—will replace the SBT.

Unfortunately, the current tax debate in Michigan is marred by a focus on replacing the revenue generated by the SBT—approximately $2.1 billion per year—and several political constraints.[1] Recent news of a $500 million budget deficit will also make things difficult for lawmakers. All told, there is a real danger that lawmakers will replace the SBT with a business tax system that is decidedly less than optimal from an economic perspective, which is a luxury they can no longer afford if they also raise taxes to fix the deficit.

The SBT debate in Michigan is a prime example of the crucial importance of business tax structure.

The SBT will disappear thanks to at least ten years of effort by a cross-section of Michigan citizens and businesses, culminating in a 2006 initiative drive by Oakland County Executive Brooks Patterson. After Governor Granholm vetoed a legislative initiative that would have repealed the SBT, Patterson took his case to the voters and when he received enough signatures to get the issue on the ballot, the legislature again passed the bill without the need for the Governor's approval.

Key Findings:

- *Single Business Tax replacement plans should be consistent with the principles of sound tax policy: simplicity, transparency, stability, neutrality, and growth-promotion*
- *SBT replacement plans have some differences, but most of them rely on business taxation and a majority rely on a business gross receipts tax*
- *A gross receipts tax is an economically flawed tax and would not—by itself—constitute an improvement on the SBT*
- *Both sides of the SBT replacement debate should acknowledge that business taxes are ultimately paid by individuals*
- *The SBT debate currently lacks a proposal that would rely on mainstream revenue sources (i.e. taxes on sales and corporate and individual income) to replace the SBT*

1 According to Table 11 of the 04-05 Annual Report of the Michigan State Treasurer, the SBT collected over $2.1 billion in revenues in Fiscal Year 2005. *See* http://www.michigan.gov/documents/AnnualReport2004-05_170764_7.pdf.

The SBT purports to be a tax on value-added, but it deviates from that base in numerous, complex ways. Hence the outcry from the Michigan business community for repeal.

The best replacement taxes for the SBT are those that are consistent with the Tax Foundation's principles of sound tax policy.

The SBT debate in Michigan is a prime example of the crucial importance of business tax structure. Unfortunately, most state tax debates center around the tax burden—i.e. the total amount of taxes paid (as a percentage of income) by citizens to government. While tax burden is an important tax policy consideration, it should not overshadow the issue of tax structure—i.e. the system of laws, rules and regulations by which the government collects the tax burden.

Most of the complaints concerning the SBT are centered on how it is structured, not on how much revenue it generates. Tax burden has not been an issue because Michigan's business tax burden is below average, according to a report released annually by the Council on State Taxation (COST).[2]

This crucial debate features a number of rhetorical arguments that are not helpful in a debate about the sound economics of SBT replacement. First, almost all legislators are arguing that the SBT should not be replaced by taxes on individuals. Second, they are insisting that any SBT replacement should fall as much as possible on out-of-state taxpayers. Third, many proposals rely on gross receipts taxes to replace the SBT. Fourth, all the replacement plans on the table are just as "outside the mainstream" of state taxation as the SBT.

As the SBT replacement debate heats up in the 2007 legislative session, it will be helpful for both sides to avoid these four pitfalls. Otherwise, there is a real danger that the SBT

Table 1
Single Business Tax Replacement Plans Have Good, Bad Features

General Approach	No SBT Replacement	Partial SBT Replacement			Full SBT Replacement		
Plan/Sponsor	Detroit Chamber	Michigan Chamber	Detroit Chamber	Grand Rapids Chamber	Governor Granholm	Michigan FairTax	Prof. Wolfram
Revenue Implications	$2.1 Billion Tax Cut	Tax Cut of $350 to $500 Million			No Tax Cut or Increase (Revenue Neutral)		
Positive Features	- Major tax reduction - No compliance costs - Helps all firms equally	- Net tax reduction - Income tax and license tax are relatively simple	- Net tax reduction - License tax is relatively simple	- Net tax reduction - Low compliance costs - Eliminates tax incentives	- Low rate of business income tax - Small net tax reduction	- Eliminates all income taxes - Simple to understand - Broad- based	- Simple tax system - Neutral to investment decisions
Negative Features	- Possible neutrality problem between C-corps and other business forms	- Reliance on gross receipts tax - Reliance on business taxation - Businesses must comply with two tax systems	- Reliance on gross receipts tax - Reliance on business taxation	- Reliance on gross receipts tax (mitigated by cost of goods sold deduction) - Reliance on business taxation	- Reliance on gross receipts tax - Reliance on business taxation - Businesses must comply with three tax systems - Tax incentives narrow tax base	- Potential for cross border evasion - Goes well beyond SBT replacement - Uncertainty in practice	- Uncertainty in practice - Reliance on business taxation

2 *See* Robert Cline, Tom Neubig, and Andrew Phillips, *Total State and Local Business Taxes*, Council on State Taxation (2006).

replacement tax could be based on misleading political rhetoric and not sound tax policy.

The rhetorical insistence that SBT revenue cannot be replaced by taxes on individuals has greatly constrained many of the SBT proposals.

Various groups across Michigan have floated at least seven SBT "replacement plans" with unofficial revenue estimates. One proposes no replacement revenue, a substantial tax cut. Three propose replacing most of the SBT revenue, leaving a small tax cut; and three propose revenue-neutral, dollar-for-dollar replacement.

The best replacement taxes for the SBT are those that are consistent with the Tax Foundation's principles of sound tax policy:

1) *Simplicity*: The tax system should be simple, easy to understand, and not impose excessive compliance burdens.

2) *Transparency*: Taxes should be visible to taxpayers, who should easily be able to understand who and what is being taxed.

3) *Stability*: Tax law should not change continually, and changes in tax law should not be retroactive.

4) *Neutrality*: Taxes should aim to raise revenue with a minimum of economic distortion, and should not attempt to micromanage the economy.

5) *Growth-promotion*: Taxes should raise revenue for programs while consuming as small a portion of national income as possible, and should interfere with economic growth, trade and capital flows as little as possible.

As Table 1 shows, all the plans have positive and negative features in light of these principles.

As lawmakers move forward with replacing the SBT, they should look to the motto of the medical profession: "First, do no harm." Lawmakers can certainly avoid doing "harm" to the Michigan economy by only adopting proposals that are consistent with the principles of sound tax policy.

II. Barriers to Effective SBT Replacement

On a more detailed level than general principles of taxation, the Michigan SBT replacement debate has revealed that even legislators and usually well informed reporters have been spreading misconceptions about how business taxes work. Those fall into four general categories, and each of them is a pitfall that could fatally wound the SBT replacement process.

Business Taxes vs. Individual Taxes

The first and most damaging notion is that the SBT should not be replaced by a tax on individuals. Nearly all lawmakers in leadership positions—on both sides of the aisle—have made this pledge. What this means is that the state's taxes on individual income and sales—accounting for nearly 74 percent of state general fund revenues[3]—are off limits as replacement revenues because they are sent in directly to state government by individuals.

This politically motivated rhetoric about refusing to shift the burden of the SBT from businesses to individuals defies economic reality. From an individual pocketbook perspective, there is little difference between business taxes and individual taxes.

While individuals are certainly not filling out the SBT tax return and directly remitting

3 *See* House Fiscal Agency, "Quarterly Revenue Report for the State of Michigan: August 2006", located at http://house.michigan.gov/hfa/PDFs/revaug06.pdf. Total Michigan general fund revenues were $5.131 billion, with individual income and sales tax collections at $3.779 billion (74 percent).

funds to the state, they do bear the burden of the tax indirectly because businesses have been passing the tax burden of the SBT to them either through: 1) higher prices for the goods or services they sell; 2) lower wages for their employees; and 3) lower return on investment for shareholders. Thus, the people of Michigan are already bearing the burden of the SBT. Eliminating it in favor of increased taxes on individual income or sales would not harm Michigan taxpayers in the long run, nor would it shift the tax burden from businesses to individuals. Such a move would, however, make the tax system more transparent by making individual taxpayers understand the true cost of the government services they consume.

This rhetorical insistence that no direct individual tax be raised has greatly constrained many of the SBT proposals. Since the SBT raises an enormous amount of revenue from businesses, replacing it with a standard corporate income tax rate would require an extremely high rate—possibly as high as 15 percent according to a 2002 Michigan Department of Treasury study. This would not represent a substantial improvement over the SBT since 15 percent would be the highest corporate tax rate in the U.S., meaning other sources of revenue have to be found. This is why the gross receipts option is so deceptively appealing, because it combines a low rate on an extremely broad-base, allowing substantial revenue collections without the specter of a high rate. Of course, gross receipts proponents are merely trading one problem (a high corporate income tax rate) for another (tax pyramiding).

Table 2
Michigan Rankings at a Glance

From the Bureau of Labor Statistics	
Michigan Unemployment Rate (Nov 2006)	6.9% (49th)
National Unemployment Rate	4.5%
Average in surrounding states (IL, IN, OH, WI)	4.7%
From the Census Bureau (2000 to 2005)	
Michigan population growth	1.65% (42nd fastest)
National population growth	5.14%
Average in surrounding states (IL, IN, OH, WI)	2.25%
From the Bureau of Economic Analysis (2000 to 2005)	
Michigan personal income growth	12.60% (49th fastest)
National personal income growth	21.41%
Average in surrounding states (IL, IN, OH, WI)	16.15%
From the Bureau of Labor Statistics (2000 to 2005)	
Michigan job growth	-3.75% (49th fastest)
National job growth	4.64%
Average in surrounding states (IL, IN, OH, WI))	-1.03%
From the Tax Foundation	
2007 Business Tax Climate Index Overall Rank	27th Best
Corporate Tax Index	50th
Individual Income Tax Index	12th
Sales Tax Index	15th
Unemployment Insurance Tax Index	41st
Property Tax Index	35th
Tax Freedom Day in 2006	April 24th (19th latest)
State and Local Tax Burden	10.8% (16th highest)
Federal Tax Burden	20.3% (22nd highest)

Tax Your Neighbor, Not Yourself

The second damaging notion is that the SBT replacement tax should fall as much as possible on taxpayers located outside the state.

Funding programs by taxing residents of other states and cities is something economists call "tax exporting." In general, tax exporting makes state and local governments less accountable to voters and encourages overspending on projects that are not really economically sensible. That overspending occurs because tax exporting severs the link between the demand for public spending and the cost of that spending—it is like dining out, but having the bill paid by the next table.

Gross receipts taxes suffer from severe flaws that are well documented in the economic literature.

This is a growing trend in the states and it reveals itself in diverse efforts ranging from the imposition of rental car excise taxes to aggressive income tax auditing of out-of-state companies. This particular contest to see who can extract the most revenue from out of state is an economically damaging, beggar-thy-neighbor policy.

On a basic level, most people view that type of taxation without political representation as unfair. It is also economically inefficient, and in the last few years it has led to a wave of bad tax policies.

The most common form of tax exporting proposed by the various SBT replacement plans is a gross receipts tax based on sales in Michigan. Such a tax would ensnare out-of-state sellers without physical presence in Michigan.[4]

Tax exporting also invites congressional regulation and oversight. Congress has the authority and the responsibility to regulate interstate commerce among the states. Congress has, in the past, restricted the imposition of corporate taxes against out-of-state taxpayers.[5] A bill in the 109th Congress (H.R. 1956, which had a number of Democrat co-sponsors in the House as well as in the Senate) would have expanded these prohibitions against gross receipts taxes like those proposed in Michigan. Thus, Michigan lawmakers should be aware that Congress is watching the SBT replacement debate, and overt shifting of the Michigan tax burden to out-of-state taxpayers may add impetus to congressional action on H.R. 1956 and thus frustrate Michigan's efforts to reform their business tax system.

Rising from the Crypt: Gross Receipts Taxation

Four of the prominent replacement plans have provisions for gross receipts taxes—a long discredited type of tax that states first enacted during the 1920s and '30s and later repealed in most cases. These taxes appear simple but they have the potential to badly distort business investment.[6] No state that has ever enacted a gross receipts tax has kept it in its "pure" form; thus there is no reason to expect that Michigan would have a different experience.

Advocates of gross receipts taxes generally promote them on two grounds. First, it is argued that their simple structure makes them easy for states to administer and for companies to comply with, in contrast to corporate income taxes or, in the case of Michigan, the notoriously complex SBT (similar in many respects to a gross receipts tax). Second, because they tax an expansive base of all transactions in the economy, they are able to raise a given amount of revenue at lower rates than any other tax, making them politically attractive to lawmakers.

Adoption of any of the seven replacement options currently on the table would result in Michigan's tax structure remaining well outside the mainstream.

But while gross receipts taxes appear to be a simple alternative to complex corporate taxes like the SBT and conventional corporate income taxes, this simplicity comes at a great cost. Gross receipts taxes suffer from severe flaws that are well documented in the economic literature, and they rank among the most economically harmful tax structures available to lawmakers.

The chief flaw is tax pyramiding—that is, the gross receipts tax applies to a good or service at each state of the production process. If a firm is vertically integrated, however, the gross receipts tax only applies at the final stage of production when the good or service is sold to its final consumer. This means that gross receipts taxes favor large, vertically integrated companies at the expense of small and medium sized companies that are part of an independent production chain.

4 Federal Public Law 86-272 protects out of state taxpayers from the imposition of state corporate income when the out of state taxpayer is merely making sales in a state. P.L. 86-272 does not apply, however, to gross receipts taxes or the SBT.

5 *See* P.L. 86-272, supra.

6 *See* Andrew Chamberlain and Patrick Fleenor, *Tax Pyramiding: The Economic Consequences of Gross Receipts Taxes*, Tax Foundation Special Report (December 2006). The Tax Foundation and the Council on State Taxation will also shortly publish a study on gross receipts taxes by Professor John Mikesell of the Indiana School of Public and Environmental Affairs.

These problems with gross receipts taxes are not the result of poor implementation by lawmakers. The flaws are inherent in their design, and they exist in the SBT as well since it is partially based on gross sales. State lawmakers searching for alternatives to the SBT should therefore be wary of gross receipts taxes and instead seek more economically neutral ways of taxing business.

Better the Devil You Know

The final pitfall concerns the curious fact that none of the SBT replacement plans currently on the table rely on standard, mainstream state tax systems. It is not impossible for a state to enact an unusually good, new tax, but unusually bad ones are more common. The SBT certainly falls into that latter category.

It is strange that no one in the Michigan debate has proposed a conventional corporate income tax, which the nation's tax administrators have learned the ins and outs of so well.

The SBT is unique among state business taxes, leading to compliance nightmares for its taxpayers—especially new investors in Michigan. It purports to be a tax on value-added, but it deviates from that base in numerous ways—largely through the use of investment tax incentives. Furthermore, the SBT uses the addition method to determine value-added, instead of the more popular European subtractive method. Thus, not only is the SBT out of the mainstream of state business taxation, but it is even out of the mainstream when compared to other value-added taxes.

Unfortunately, all the SBT replacement plans are also outside the mainstream. As mentioned above, gross receipts taxes are making an unlikely comeback, growing in popularity among some lawmakers. (Ohio, Texas, and Kentucky have recently enacted new gross receipts-style taxes.) Yet they are still imposed by only a handful of states, and they are rare for a good reason—they do not measure up to sound tax principles, and in practice they've proven to be bad for a state's economy.

On the other hand, while a broad-based "FairTax" on all goods and services does measure up to tax principles, it is even more unusual. In fact, no state has ever enacted one, and so the risks of pioneering new tax territory are obvious.

In short, adoption of any of the seven replacement options currently on the table would result in Michigan's tax structure remaining well outside of the mainstream.

It is strange indeed that no one in the Michigan debate has proposed a conventional corporate income tax, which the nation's tax administrators have learned the ins and outs of so well. What would such a plan look like? A good option would be to impose a standard corporate income tax at a rate between 6 and 8 percent. According to one Department of Michigan study, that would raise as much money as the SBT.[7] If it were estimated to fall short of revenue, a good supplementary option would be to broaden the consumer sales tax base to services not currently taxed. This plan would give Michigan a business tax structure that is consistent with those in most other states, rather than a new system that is just as odd as the SBT.

III. SBT Replacement Proposals: Description and Analysis

A. Michigan Chamber of Commerce

Description:

The Michigan Chamber has presented two replacement options for the SBT.[8] Both options combine a corporate income tax with a gross receipts-based tax called a "license" tax. The

7 *See* http://www.michigan.gov/documents/SBT_2000-2001_153736_7.pdf

8 *See* http://www.michamber.com/ba/MCC%20Business%20Tax%20Proposal%20Final.pdf.

Michigan Chamber's plan also advocates $500 million in annual net business tax cuts. The key difference between the two options is the availability of personal property tax relief.

Option #1 would create a business income tax levied at a rate of 3.05 percent. Taxpayers would apportion their income to Michigan based on a single-sales factor formula with no throwback.[9] Taxpayers would file their tax returns on a mandatory, unitary filing basis.[10]

Under option #1, business taxpayers would also pay a general business license tax at a general rate of .48 percent, or .24 percent for wholesalers and retailers. The base of the license tax would be the gross receipts (or gross sales) of the business.

Several features of the license tax narrow its base. The first $350,000 in gross receipts would be exempt from the tax. A minimum tax of $150 would be charged to any business with employees that has gross receipts less than $350,000. License tax liability would be capped at $2 million per return. Inter-company sales would be removed from the tax base of unitary filers. Finally, transition rules would allow tax incentives, such as MEGA credits, Brownfield credits and Renaissance Zones, to continue for many taxpayers.

Option #1 also provides a 50-percent personal property tax credit for all industries.

Option #2 is quite similar to option #1, but it omits the personal property tax credit and the rates are lower. The business income tax rate would be 1.85 percent and the general rate for the business license tax would be .24 percent, with the rate on wholesale/retail equaling .18 percent. The tax base for both the income and license tax would remain the same.

Analysis:

This plan receives good marks for growth promotion, mixed marks for simplicity, but poor marks for transparency and neutrality. The chief culprit is the license tax which is based on gross receipts. This plan would significantly improve if the gross receipts-style license tax were not present. Its best features include:

- The relative simplicity of both the income tax and the license tax—though lawmakers will create more complexity if they allow taxpayers to continue to claim tax incentives.
- The overall tax cut (around $500 million) will promote economic growth by putting more money into the hands of businesses and entrepreneurs. Though Michigan is not a high tax state, the additional private investment that will flow from a $500 million tax cut will help Michigan reverse its economic slide.
- The income tax will be neutral between firms if tax incentives are eventually eliminated. Since a corporate income tax is levied on profits (receipts minus costs), it creates no incentives for artificial integration or segregation (unlike a gross receipts tax).
- The income tax rates would be the lowest top-rates in the country, giving Michigan a competitive edge on that basis. This is important if Michigan wants a tax system they can promote to new investors.

Negative features of the Michigan Chamber plan include:

- The gross receipts tax is highly non-neutral and leads to inefficient tax pyramiding[11]; it also favors Michigan firms who export over those who sell mostly in Michigan[12]
- It requires compliance with two separate business tax systems (the gross receipts tax and the income tax). This means that companies must spend more money to

9 For a better understanding of apportionment, single-sales factor apportionment formulas, and throwback, *see* Chris Atkins, "A Twentieth Century Tax in the Twenty-First Century: Understanding State Corporate Tax Systems," *Tax Foundation Background Paper No. 49* (September 2005), located at http://www.taxfoundation.org/news/show/1096.html.

10 *See* id.

hire lawyers and accountants instead of continuing to invest in their own productive capacities.

- Business taxes are inherently non-transparent and hide the true economic cost of taxation. Someone—either a shareholder, a customer, or an employee—pays the true economic cost of a business tax. Unlike a sales tax or an income tax, a business tax falls on people who are only vaguely aware of the tax and certainly unaware of its magnitude. This lack of transparency can lead to a host of problems, most seriously to a misconception about the true cost of government services.

- Mandatory unitary filing will present a compliance challenge to many taxpayers. This measure would require a Michigan company to include the income of its out-of-state affiliates when it files its Michigan tax return. In addition to the extra compliance burden, mandatory unitary filing might also cause the tax burden of some businesses to rise or fall depending on the profitability of their out-of-state affiliates.

B. Detroit Regional Chamber

Description:

The Detroit Regional Chamber has two recommendations for SBT replacement: first, its primary recommendation is to not replace the SBT at all; second, if the SBT must be replaced then they recommend a license tax that would provide a $500 million overall reduction in business taxes.[13]

The Detroit Regional Chamber's replacement tax plan would institute a business license fee structure that would charge businesses a flat fee based on their annual Michigan sales. This license fee would be similar to a gross receipts tax, but liability would be fixed within a range of sales. The definition of Michigan sales would remain unchanged from what is used currently (the numerator in current SBT sales factor calculations). Total sales beneath $350,000 would be exempt from the license fee. The maximum license fee is $1 million per year for businesses with Michigan sales in excess of $100 million.

Analysis:

The no-replacement plan would provide the maximum economic stimulus and the least complexity. It would, however, make Michigan the only state with a personal income tax but no corporate income tax, which could create some unique neutrality problems.[14]

The license fee replacement option gets good marks for simplicity and growth promotion but poor marks for transparency and neutrality. Like the Michigan Chamber's plan, the use of a gross-receipts style tax is a major detriment here. Its best features include::

- The "no replacement" option, which would inject approximately $2.1 billion annually into Michigan's private sector, would provide the maximum amount of economic stimulus and completely minimize compliance and administrative costs for business taxpayers.

- The "no replacement" option would also enhance transparency of the Michigan

11 Gross receipts taxes cause tax pyramiding because they apply at each stage of the production process with no deduction for purchases from other firms. The Chamber's proposal tries to alleviate this somewhat by levying the tax at the unitary business group level. This would eliminate inter-company transfers from the gross receipts tax, but non-vertically integrated production chains would still face pyramiding problems.

12 Under the Chamber's license tax proposal, 2 identically sized Michigan firms with identical gross receipts would face different license tax burdens merely based on where their customers are located. If one firm sold exclusively within Michigan, it would pay the full license tax on its gross receipts; while if the other sold completely outside Michigan, it would pay no license tax on its gross receipts. This obviously gives Michigan companies two incentives: 1) to grow their exporting business; 2) to source their gross receipts outside Michigan.

13 *See* http://www.detroitchamber.com/docs/public_affairs/SBT.doc.

14 Many small and medium-sized businesses, and a few large businesses, are organized as pass-through entities that do not file corporate income tax returns. These S corporations, partnerships and sole proprietorships might well be expected to continue paying taxes on the individual side of the code because they pass business income through the firm to the individual owners where it shows up as personal, taxable income. In the event that the SBT expires with no major replacement, a wave of re-organizations might be expected, although the state's guidance on how they would administer the new system could mitigate that problem.

tax system since shareholders, customers and workers would no longer face a hidden tax on their activities.

- A $500 million tax cut in the license fee option would also promote economic growth by shifting resources from the public to the private sector.
- The license fee is relatively simple and would require fewer compliance resources than the SBT.

Negative features of the Detroit Regional Chamber plan include:

- The no-replacement option would entail a $2.1 billion revenue reduction, which is over 12 percent of FY 2005 revenues. Even during recessions, such a sudden contraction would be rare. Public sector workforces and services are notoriously difficult to reduce at all. To say the least, it would require a heroic political effort to balance the budget without short-changing essential public services with such a substantial cut in one year.The Mackinac Center has published thoughtful recommendations for lawmakers willing to take this political challenge.[15]
- The reliance on a business tax (the license fee) has the same transparency problems discussed earlier.
- Tax pyramiding caused by the gross receipts-style license fee will harm economic growth.
- The license fee gives an advantage to exporting businesses over those with most of their sales in Michigan.
- It favors large, vertically integrated businesses at the expense of small and medium-sized businesses.

C. Grand Rapids Chamber of Commerce

Description:

The Grand Rapids Chamber of Commerce's SBT replacement proposal also calls for the complete elimination of Michigan's personal property tax (PPT).[16] SBT and PPT revenue would be replaced by imposing a tax on business gross receipts, called the Business Activity Tax (BAT).

The BAT would have a single rate that would not exceed .75 percent, with local rates added on to replace local personal property tax revenue. The BAT does not apply to the first $350,000 of gross receipts; those under this threshold would pay an annual fee of $150. The BAT would define sales in a manner similar to current SBT law. Taxpayers would pay the BAT on a separate entity basis with the option of filing on a consolidated basis.

The BAT provides a deduction for purchases of tangible personal property for purposes of resale, manufacturing, leasing or cost of funds for financial institutions. This would be similar to a cost-of-goods-sold deduction. The total revenue replacement for SBT and PPT is not to exceed 90 percent of current revenues, which should deliver tax relief of approximately $350 million per year.

Existing tax incentives would be grandfathered into the new system. Future incentives, however, would take the form of cash subsidies, keeping the BAT tax base clean.

Analysis:

The Grand Rapids Chamber's BAT plan gets good marks for simplicity and growth promotion but poor marks for transparency. The BAT plan is dragged down by the use of a gross receipts base, but it mitigates that somewhat by offering a cost-of-goods-sold deduction. The plan's best features include:

- The $350 million tax reduction in business taxes would promote economic

15 http://www.mackinac.org/article.aspx?ID=7602

16 *See* http://www.grandrapids.org/advocacy/documents/SBT-PPTAlternativePlan2006.pdf.

growth by shifting resources from the public to the private sector.

- The relative simplicity of the BAT would lower compliance costs.
- Separate entity filing would continue standard Michigan practice and provide lower compliance costs than mandatory unitary filing.
- The conversion of tax incentives into cash subsidies will keep the tax base broad. If state lawmakers want to subsidize companies engaged in a politically popular activity, then they should use the budget to do that, not the tax code. The Grand Rapids Chamber's plan recognizes this fact.
- The deduction offered for the cost of goods sold will mitigate the negative impact of the gross receipts-style BAT.

Negative features of the Grand Rapids Chamber plan include:

- The reliance on business taxation is inherently non-transparent and hides the true economic cost of taxation.
- The tax pyramiding caused by the gross receipts style BAT will harm economic growth.
- It favors exporting businesses over businesses with a majority of sales in Michigan.
- It favors large, vertically integrated businesses at the expense of small and medium-sized businesses.

D. Michigan FairTax

Description:

The Michigan FairTax—promoted by Michigan State Representative Fulton Sheen—would replace the SBT, individual income tax, personal property tax, sales tax and statewide education tax, with a broad-based sales tax on all goods and services consumed in Michigan.[17]

The rate needed to replace all those taxes would be 8.58 percent, which is 2.58 percentage points higher than the current rate of 6 percent. The base would be much larger than the current sales tax base, and would include the sale of all goods and services to consumers. All business-to-business transactions would be exempt from the FairTax base. The FairTax would provide a "prebate" to all consumers that would reimburse them for the sales tax paid on "necessities." This is designed to reduce the regressive nature of the sales tax.

Analysis:

The Michigan FairTax plan receives good marks based on the Tax Foundation's principles of sound tax policy since it is essentially a sales tax levied on the broadest possible base and since it would replace all direct business taxation in Michigan.[18] While many commentators have expressed skepticism at the implementation of the FairTax (particularly at the federal level), several new studies suggest that those concerns are exaggerated.[19] Good features of the FairTax plan include:

- It would create a simple, broad-based tax on consumption, where all goods and services are taxed once.
- It would create little or no distortion of business decisions since business-to-business (B2B) purchases are exempt from the FairTax base. Including B2B transactions in the sales tax base has an impact similar to that of a gross receipts tax, since a product that moves through a vertically integrated chain would have a lower retail sales price than a product that does not.

17 *See* http://iaam.net/associations/2466/files/GOVT%20RELATIONS%20-%20Michigan%20Fair%20Tax%20Estimates%20-%2011-05.pdf.

18 This should not be construed as a general endorsement of the FairTax. While the FairTax—in theory—is consistent with many of our principles, its adoption on the federal level has many more pitfalls than its adoption at the state level.

19 *See, e.g.,* Sabine and Kotlikoff, *Simulating the Dynamic Macroeconomic and Microeconomic Effects of the FairTax* (September 2006); Bachman, Haughton, Kotlikoff, Sanchez-Penalver, and Tuerck, *Taxing Sales Under the FairTax: What Rate Works?*, 2006 STT 224-2 (November 21, 2006).

- Replacing five major taxes (the SBT, the individual income tax, the sales tax, the personal property tax, and the statewide education tax) would give Michigan's economy a much needed boost and would dramatically lower system-wide tax compliance costs.

- The FairTax would be good for transparency since consumers would pay it and therefore realize the full economic cost of taxation that is often hidden in business taxes like the SBT.

Negative features of the FairTax plan include:

- The high rate, compared to other state sales taxes, creates a potential for cross-border sales which would have a negative impact on border retailers.

- The high rate also could create an opportunity for tax evasion.

- The prebate adds a daunting layer of administrative complexity to a tax proposal that is touted as simpler. All citizens would expect and depend on a check from the government each year.

- The totality of the plan goes well beyond merely replacing the SBT, which makes it difficult to estimate short- and long-term revenue implications. It might be useful to have an estimate of the necessary FairTax rate to merely replace the SBT, the sales tax and the personal property tax, without also eliminating the income tax and the statewide education tax.

E. Governor Granholm's Michigan Business Tax (MBT) Plan

Description:

Michigan Governor Jennifer Granholm's proposal would impose a corporate income tax, a gross receipts tax, an asset tax, and a higher rate of tax in insurance companies. Her plan would also provide personal property tax relief. She estimates that her plan would provide a small ($150 million) overall tax cut.

The business income tax would be levied at the rate of 1.875 percent and apportioned to Michigan based on a single sales factor apportionment formula. The gross receipts tax would be levied at a rate of 0.125 percent on businesses with gross receipts in excess of $350,000. The asset tax would also be levied at a rate of 0.125 percent. Finally, the plan would raise the gross receipts tax rate on insurance companies to 1.25 percent.

Business taxpayers would have to file and pay all the taxes in the Governor's plan (there is no election available). The Governor's plan would also retain most tax incentives currently administered by the state.

Analysis:

Governor Granholm's plan gets good marks for the neutrality of the business income tax and the net tax cut, but poor marks for complexity and the distortion that would be caused by the gross receipts tax. The plan's best features include:

- The income tax base is neutral between firms (as explained in the section analyzing the Michigan Chamber of Commerce plan). Indeed, Governor Granholm's plan is one of only three replacement plans to rely on some form of income taxation.

- The income tax rate structure would include the lowest top rate in the country, giving Michigan a competitive edge on that basis.

Negative features of Governor Granholm's plan include:

- Business taxes are inherently non-transparent and hide the true economic cost of taxation.

- Tax pyramiding caused by the gross receipts tax will harm economic growth.

- Gross receipts taxes favor exporting businesses over businesses with a majority of their sales in Michigan.

- Gross receipts taxes also favor large, vertically integrated businesses at the expense of small and medium-sized businesses.

- The continued presence of many tax incentives narrows the tax base and harms economic growth. Indeed, Governor Granholm's plan is the most insistent on retaining business tax incentives.

- Businesses would have to separately comply with three business tax systems (the income tax, the gross receipts tax, and the asset tax).

- Insurance companies are singled out for a tax increase.

F. Professor Gary Wolfram's SBT Replacement Plan

Description:

Hillsdale College Professor Gary Wolfram proposes a two-tiered replacement for the SBT.[20] A business would choose whether it wants to pay a subtractive method value added tax (VAT) called a business activity tax (BAT) or a broad-based income tax.

The income tax would be levied at the rate of 6 percent on a business's federal income attributable to Michigan. The BAT would be levied at a low rate (as low as .75 percent) and the base would be the difference between a business' gross sales and their purchases from other businesses (value added). Care would need to be taken in determining whether sales into or out of Michigan would be included in the BAT base. Businesses could also take a BAT deduction for their capital acquisitions.

Michigan would require businesses to make an annual election of which tax they will pay, and might even require businesses to fix their election for a set number of years.

Analysis:

Professor Wolfram's plan gets good marks for simplicity, neutrality, and growth promotion but poor marks for transparency. The tax bases used (corporate income and value-added) would be neutral and, in the case of value-added, based on consumption. Good features of Professor Wolfram's plan include:

- The BAT would be a simple, broad based, low rate tax on consumption.

- The value-added-style BAT creates little or no distortion of business decisions.

- The income tax component is more neutral than the current SBT.

Negative features of Professor Wolfram's plan include:

- Business taxes are inherently non-transparent and hide the true economic cost of taxation

- It would require businesses to calculate tax liability under two separate business tax systems, the business activity tax and the corporate income tax.

- No other state uses a similar value added tax so it is uncertain how the tax would work in practice.

IV. Conclusion

Tax reform is a risky business. Replacing the SBT—a complicated tax that few truly understand—is even riskier. Michigan lawmakers have a rare opportunity to remake their business tax system. Will the replacement debate be decided by the principles of sound tax policy or by political expediency? If lawmakers chose the former option, Michigan will take major steps toward improving their business tax competitiveness. If the latter option is chosen, future lawmakers will once again be left with the job of unraveling Michigan's tax system and future taxpayers will be left with the bill.

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