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An Opportunity to Improve Mississippi's Tax Climate

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Introduction & Executive Summary

Good state tax systems levy low rates on a broad base, and treat all taxpayers the same while minimizing economic distortions. The more riddled a tax system is with special preferences, the less likely it is that business decisions will be made in response to market forces. As companies become increasingly sophisticated and our global economic system increasingly integrated, jobs and growth will increasingly flow to low-tax and low-burden jurisdictions.

The Tax Foundation's 2008 edition of the *State Business Tax Climate Index*, released in October 2007, ranked Mississippi as the 18th best tax climate in the country. Regionally, Mississippi is about middle-of-the-pack compared with Florida (5th), Texas (8th), Missouri (15th), Tennessee (16th), Georgia (20th), Alabama (21st), Louisiana (32nd), and Arkansas (35th). Similarly, in our 2007 edition of *State and Local Tax Burdens*, which calculates the tax burden as a percentage of income, Mississippi ranked about middle-of-the-pack nationally (29th highest state-local tax burden). Improving the state's business tax climate and reducing state and local tax burdens could give Mississippi a comparative advantage in its region.

In early 2008, Governor Haley Barbour announced the creation of the Mississippi Tax Study Commission, which is tasked with preparing a comprehensive study of the state's tax system and recommending suggested improvements. One specific aspect the Commission has been asked to examine is how Mississippi's state tax system functions in combination with the federal tax code. The Commission, which brings together members with a wide range of business, legal, academic, and legislative expertise, has been instructed to prepare a report of its findings by August 31, 2008.

This fresh and all-inclusive look at Mississippi's tax system by an independent panel represents a great opportunity for the Magnolia State to reform its tax system in accordance with the principles of sound tax policy.

This fresh and all-inclusive look at Mississippi's tax system by an independent panel represents a great opportunity for the Magnolia State to reform its tax system in accordance with the principles of sound tax policy. By applying these principles, and reviewing the state's current performance as described by the *State Business Tax Climate Index*, we can identify several areas ripe for improvement.

In the area of business taxation, Mississippi should (1) repeal at least one of its corporate franchise, inventory, and intangibles taxes, thus reducing compliance and tax burdens while giving the state a comparative advantage over its neighbors; (2) resist calls to raise corporate tax rates or add new brackets, which would be at odds with the global trend of attracting business by lowering corporate tax rates; (3) flatten brackets because multiple rates on corporate income achieve no logical or progressive goal; (4) adjust brackets annually for inflation and conform to the federal tax base, to reduce compliance costs; (5) eliminate or reduce special incentives; and (6) resist calls to adopt economic nexus.

In the area of sales taxes, Mississippi should consider (1) eliminating the sales tax on machinery and other business-to-business transactions, to reduce tax pyramiding and economic distortions; (2) broadening the sales tax base while lowering the sales tax rate, to improve neutrality and reduce administrative complexity; and (3) avoiding gross receipts taxes, which are economically harmful and distorting.

In the area of personal income taxes, Mississippi should consider (1) flattening brackets, adjusting brackets annually for inflation, and conforming to the federal tax base, all to reduce compliance costs; and (2) resisting calls to raise personal income taxes or add additional brackets, which would punish entrepreneurs vital to economic growth and give up one of the state's best competitive advantages.

Elsewhere, Mississippi should aim to improve budget transparency and avoid reliance on cigarette or gambling revenues.

Ireland, once a poor country, has successfully used its newly lowered corporate tax rate to attract massive amounts of new capital investment, dramatically lower unemployment, and become the "Celtic Tiger," leaping past its neighbors in economic and job growth. Likewise, the report of the Mississippi Tax Study Commission will give the Magnolia State an excellent opportunity to improve its tax climate and become an attractive place for capital, jobs, and entrepreneurs compared to its regional, national, and international competitors.

Principles of Sound Tax Policy

As a nonpartisan educational organization, the Tax Foundation has earned a national reputation for independence and credibility. However, it is not devoid of perspective. All Tax Foundation research is guided by the following principles of sound tax policy, which should serve as touchstones for good tax policy everywhere:

- **Simplicity**: The tax system should be as simple as possible, and taxes should be easy to understand and comply with.
- **Transparency**: Taxes should be as visible as possible to taxpayers, and should make clear who and what is being taxed.
- **Stability**: Tax law should not change continually, and changes in tax law should not be retroactive.
- **Neutrality**: Taxes should aim to raise revenue with a minimum of economic distortion, and should not attempt to micromanage the economy.

In an ideal tax system, individuals and businesses would spend a minimum amount of resources to comply with the tax system; understand the true cost of the tax system; base their economic decisions solely on the merits of the transactions, without regard to tax implications; and not have the tax system impede their growth and prosperity.

State Business Tax Climate Index

States do not enact tax changes in a vacuum. Every tax law will in some way change a state's competitive position both regionally and globally, particularly in today's world where states must compete not only with Indiana, but also India. Entrepreneurial states can take advantage of the tax increases of their neighbors to lure businesses out of high-tax states and countries. States with the most competitive tax systems are best suited to generate economic growth.

Promoting long-term business investment requires fiscal policies that recognize the importance of a competitive tax system. Each year the Tax Foundation publishes its *State Business Tax Climate Index*. This comprehensive study of the 50 state tax systems is designed as a guide to lawmakers who wish to make their state's business tax climate more competitive in the regional, national and international marketplace. The *Index* compares the states on 115 variables in five general areas of taxation: business taxes, individual income taxes, sales and gross receipts taxes, unemployment insurance taxes, and taxes on assets.

Mississippi currently ranks favorably in our unemployment insurance (5th), corporate income tax (8th), and individual income tax (16th), but lower in property tax (32nd) and sales tax (35th) rankings.

Business Taxation

Business taxes affect business decisions, job creation and retention, plant location, competitiveness, the transparency of the tax system, and the long-term health of the state's economy. More importantly, businesses are collections of individuals and ultimately do not pay taxes; people do. The cost of taxes is passed along either to consumers (through higher prices), workers (through lower wages or fewer jobs), or shareholders (through lower dividends or share value).

While Mississippi already compares favorably in our corporate income tax rankings (see Table 1), there are areas of potential improvement that should be considered.

Mississippi is the only state among its neighbors to tax both inventory and intangibles, and by 2009 will be the only state in the nation to do so.

Repeal the Corporate Franchise Tax

Mississippi's franchise tax is certainly one of the most economically damaging provisions in the state's code, imposing a $2.50 levy for every $1,000 in capital that is used, invested, or employed by an organization. Unlike a corporate income tax that only taxes profitable companies, the franchise tax hits firms when they're down. Calculating the tax, particularly for the multi-state and multi-national corporations Mississippi seeks to attract, requires large compliance costs. Its abolition would give business a huge boost, even if most of the lost tax

Table 1
National and Regional Rankings of Mississippi's Corporate Income Tax

State	National Rank	Regional Rank
Georgia	6	1
Mississippi	**8**	**2**
Missouri	10	3
Tennessee	12	4
Florida	14	5
Louisiana	18	6
Alabama	21	7
Arkansas	35	8
Texas	47	9

Source: Tax Foundation's 2008 *State Business Tax Climate Index.*

Table 2
Taxes on Inventory and Intangibles in Mississippi and Neighboring States

State	Inventory Tax	Intangibles Tax
Alabama	No	Yes
Arkansas	Yes	No
Florida	No	No
Georgia	Yes	No
Louisiana	Yes	No
Mississippi	**Yes**	**Yes**
Missouri	No	No
Tennessee	No	No
Texas	Yes	No

Source: Tax Foundation's 2008 *State Business Tax Climate Index.*

revenue were made up elsewhere. Further, because many of Mississippi's neighbors levy this tax, its repeal would provide a comparative advantage for the state.

Repeal the Inventory Tax

Mississippi is the only state among its neighbors to tax both inventory and intangibles, and by 2009 will be the only state in the nation to do so. The inventory tax, which exists in only about 15 states, is levied on the value of a company's inventory and is especially harmful to large retail stores and other businesses that store large amounts of merchandise. Inventory taxes are highly distortionary because they force companies to make decisions about production that are not entirely based on economic principles, but rather on how to pay the least amount of tax on goods produced. Inventory taxes also create strong incentives for companies to locate inventory in states where they can avoid these harmful taxes. Several states have recently repealed their inventory taxes, and Mississippi should join them. Because many of Mississippi's neighbors levy an inventory tax (see Table 2), its repeal would give Mississippi an advantage over its neighbors that would not go unnoticed by businesses.

Repeal the Intangibles Tax

Besides Mississippi, only Alabama, Ohio, and Pennsylvania tax intangibles such as stocks, bonds, and trademarks; Florida repealed its intangibles tax in 2007. (See Table 2 for a regional comparison.) This tax is highly harmful to businesses that hold large amounts of their own or other companies' stock, and those that have valuable trademarks. Mississippi should repeal it.

Resist Calls to Raise Corporate Tax Rates or Add New Corporate Tax Brackets

Mississippi's rates are reasonable, and keeping the top rate no higher than the personal income tax rate limits economic distortions. A millstone around Mississippi's neck is the high federal corporate tax rate, which means that businesses pay a combined 38.3 percent adjusted tax rate, higher than virtually every other industrialized country. Reducing this burden effectively would require federal government action, but the last thing Mississippi should consider is going against global trends and increasing corporate income tax rates. Indeed, even David Brunori, contributing editor to *State Tax Notes*, university instructor, and a former columnist with *Governing* magazine—hardly an anti-tax zealot—has argued that state corporate income taxes are "neither efficient nor effective" and "not worth the administrative and compliance costs." He and other scholars have recognized that states would be wise to rely less on corporate income taxes, not more.

Flatten Brackets and Adjust for Inflation

Mississippi's corporate income tax brackets are not indexed for inflation, which can result in "bracket creep" as the same amount of real income is subject to a greater tax burden year after year without legislative action. Furthermore, because corporations do not pay taxes (people do), low-income workers and consumers are better off with lower corporate tax rates. It is thus illogical to adopt the argument for progressively higher individual income tax rates to the corporate income tax context. Flattening brackets and adjusting them for inflation would improve the stability and neutrality of Mississippi's corporate income tax.

Conform Mississippi's Tax Base to the Federal Tax Base

Mississippi is in the small minority of states that do not conform to the federal income tax base. The recent adoption of stimulus bonus depreciation provides benefits that Mississippi businesses will be unable to take advantage of on their state corporate income tax. This puts Mississippi at a disadvantage relative to most other states. Conforming Mississippi's tax base to the federal base would considerably reduce the cost of tax compliance for businesses and administrative burdens for governments.

Eliminate or Reduce Special Incentives

State lawmakers, trying to be mindful of their states' business tax climates, are often tempted to lure business with lucrative tax incentives and subsidies instead of pursuing broad-based tax reform. This can be a dangerous proposition, as a case in Florida illustrates. In July of 2004, Florida lawmakers cried foul because a major credit card company announced it would close its Tampa call center, lay off workers, and outsource those jobs to another company. The reason for the lawmakers' ire was that the company had been lured to Florida with a generous tax incentive package. Lawmakers create these deals under the banner of job creation and economic development, but the truth is that if a state needs to offer such packages, it is most likely covering for a woeful business tax climate.

While officials roll out the red carpet for new businesses, existing in-state employers are taken for granted and are stuck paying higher taxes.

Mississippi offers *at least 16 major corporate income tax credits*, each with application processes and bureaucratic red tape. A booklet produced by Mississippi's State Tax Commission, listing available credits, runs *98 pages long*. While officials roll out the red carpet for new businesses, existing in-state employers are taken for granted and are stuck paying higher taxes. A far more effective approach is to systematically improve the business tax climate for the long term so as to improve the state's competitiveness. Businesses are treated the same, and politicians aren't put in the position of picking economic winners and losers.

Resist Calls to Adopt Economic Nexus

In recent years, many states have sought to tax businesses with no physical property or employees in the state. Because of this, businesses increasingly face a complex, unpredictable, and unfriendly business environment, with the costs of litigation and accounting passed on to consumers. States that adopt such an "economic nexus" standard risk double-taxing entrepreneurs, scaring away economic activity and benefits, creating enormous uncertainty, and increasing collection and compliance burdens. Other states may also retaliate against Mississippi businesses with customers elsewhere. States like Mississippi should continue to resist schemes purporting to boost state tax revenues at the expense of interstate commerce, as doing so will harm more than it helps.

Sales Taxation

Sales taxes levied on goods and services at the point of sale to the end user have at least two virtues. They are "transparent," i.e., the tax (so long as it is disclosed) is never confused with the price of goods by customers, and since they are levied at the point of sale, they are less likely to cause economic distortions than taxes levied at some intermediate stage of production.

More detrimental to the business climate are sales taxes levied on business-to-business transactions. When a business must pay sales taxes on manufacturing equipment and raw materials, that tax becomes part of the price of whatever the business makes with that equipment and those materials. Of course, it must then collect sales tax on its own products, with the result that a tax is being charged on a tax. So-called "tax pyramiding" invariably results in some industries being taxed more heavily than others, which causes economic distortions.

Table 3
National and Regional Rankings of Mississippi's Sales Tax

State	National Rank	Regional Rank
Texas	2	1
Georgia	16	2
Florida	19	3
Missouri	22	4
Alabama	25	5
Mississippi	**35**	**6**
Arkansas	37	7
Louisiana	47	8
Tennessee	48	9

Source: Tax Foundation's 2008 *State Business Tax Climate Index.*

Mississippi's sales tax lags behind its competitors both regionally and nationally (see Table 3). State officials should review the large number of goods and services exempted from the sales tax, while at the same time lowering rates and refocusing it so only final retail products are taxed.

Eliminate the Sales Tax on Machinery and Other Business-to-Business Transactions

Mississippi is one of only 15 states to impose sales tax on purchases of manufacturing machinery, although several of these states are clustered in the same region (see Table 4). Businesses have been known to avoid locating facilities or factories in certain states because the factory's machinery would be subject to state sales tax, so eliminating the tax would enable Mississippi to become more attractive to such prospects.

To the extent that manufacturing machinery is a business-to-business input, and not consumed by an end user, it should be exempt from the retail sales tax.

The application of the sales tax to inputs makes every business more expensive to operate. To the extent that manufacturing machinery is a business-to-business input, and not consumed by an end user, it should be exempt from the retail sales tax. Ensuring that the sales tax is charged only on final retail goods and services improves tax transparency, since businesses are not paying hidden taxes that they pass on to consumers, and it eliminates distortions caused by taxes pyramiding on top of other taxes.

Table 4
Sales Taxes on Manufacturing Machinery in Mississippi and Neighboring States

State	Sales Tax on Manufacturing Machinery
Alabama	Yes
Arkansas	Yes
Florida	Yes
Georgia	No
Louisiana	Yes
Mississippi	**Yes**
Missouri	No
Tennessee	No
Texas	No

Source: Tax Foundation's 2008 *State Business Tax Climate Index.*

Broaden the Sales Tax Base and Lower the Sales Tax Rate

According to CCH Incorporated's *State Tax Guide*, Mississippi's sales tax code contains *98 different exemptions and exclusions*, not counting special higher or lower sales tax rates imposed on 28 other goods and services. Such an exemption-ridden sales tax increases compliance and administrative burdens, and because each exemption has a dollar-value cost, the overall rate on what remains taxed must be higher. This hits low-income people the hardest because they spend more of their money on basic, taxable products which now have higher rates.

Many of the sales tax exemptions stem from a paternalistic desire to encourage or discourage various purchases, which is not the purpose of an efficient and effective tax system. Taxes, including sales tax, should be designed to raise revenue, not control behavior; employing the code in such a way often has perverse consequences. For example, many states (not including Mississippi) exempt grocery purchases from the sales tax, while taxing the purchase of already-prepared food, ostensibly to help low-income residents. But low-income residents regularly purchase prepared food, and they often purchase groceries with tax-exempt food stamps. Meanwhile, high-income residents regularly purchase groceries, so low-income residents do not get much benefit from this exemption. Further, because a grocery exemption from the sales tax causes the overall rate to rise by as much as a full percentage point, low-income residents may end up paying a larger portion of their income on sales taxes.

By eliminating such exemptions, broadening the sales tax rate, and lowering the overall rate, Mississippi can improve its sales tax ranking and eliminate the economic favoritism in the sales tax code. Broadly eliminating these exemptions can also help "pay" for other needed reforms.

Table 5
National and Regional Rankings of Mississippi's Individual Income Tax

State	National Rank	Regional Rank
Florida	1	1
Texas	7	2
Tennessee	8	3
Mississippi	**16**	**4**
Alabama	19	5
Missouri	23	6
Georgia	24	7
Louisiana	28	8
Arkansas	29	9

Source: Tax Foundation's 2008 *State Business Tax Climate Index.*

Avoid Gross Receipts Taxes

Gross receipts taxes have a simple structure, taxing all business sales with few or no deductions. Because they tax transactions, they are often compared to retail sales taxes. While gross receipts taxes appear to be a simple and profitable alternative to complex corporate income†taxes, this simplicity comes at a great cost. Gross receipts taxes tax all transactions, including intermediate business-to-business purchases of supplies, raw materials and equipment. As a result, gross receipts taxes create an extra layer of taxation at each stage of production that sales and other taxes do not, and rank among the most economically harmful tax structures. Mississippi should avoid calls to institute a broad-based gross receipts tax.

Income Taxation

A state's individual income tax system impacts its business climate because many taxpayers derive a substantial part of their income from business activities, and this proportion has been growing. Less neutral individual income tax systems hurt entrepreneurship, and therefore, a state's overall business tax climate.

Mississippi's individual income tax compares favorably (see Table 5), but could do even better with some changes.

Flatten Brackets and Adjust for Inflation

As with the corporate income tax, Mississippi's personal income tax rates are reasonable. However, not indexing them for inflation leads to similar "bracket creep," pushing individuals into higher tax brackets each year even though their real income remains the same. Eliminating or flattening the lowest brackets can reduce complexity and compliance costs without endangering much revenue. Adopting these improvements would also improve the stability and neutrality of Mississippi's individual income tax and eliminate tax brackets that disproportionately harm low-income earners.

Conform Mississippi's Tax Base to the Federal Tax Base

Mississippi is one of just eight states that do not conform to the federal income tax base, imposing a heavier tax compliance burden on Mississippi residents. Conforming Mississippi's tax base would considerably lower these costs.

Resist Calls to Raise Personal Income Taxes or Add Additional Brackets

Mississippi may face calls to rely more heavily on state income taxes, or to institute higher rates or additional brackets. Such actions would hurt entrepreneurship and business growth, and additional brackets increase complexity and make the tax system less neutral. States with heavy reliance on personal income taxes, such as California, have not escaped budget difficulties and many entrepreneurs have left California, citing its high personal income tax burden. Another consideration is the fact that federal taxpayers may deduct their state income tax or their state sales tax, but not both. If a state has both high income and sales taxes, residents of that state will be at a tax disadvantage compared to residents of a state with only one or the other.

Other Taxes and Revenue

Improve Budget Transparency

A good tax system requires informed taxpayers who understand how taxes are assessed, collected, and complied with. It should be clear to taxpayers who and what is being taxed, and how tax burdens affect them and the economy. Information about Mississippi's budget, including revenue estimates, expenditure categories, and the cost of tax incentives is difficult or impossible to locate or is out-of-date. Improving budget transparency can enable Mississippi's citizens and potential out-of-state employers to be informed and able to make accurate business and voting decisions.

Avoid Relying on Cigarette Tax or Gambling Revenues

Many states have increasingly looked to cigarettes and gambling revenues as a way to raise additional revenue. However, such taxes raise serious policy concerns. Because such taxes discourage the consumption of one activity over another, they are not economically neutral and can result from paternalism by electoral majorities. Such taxes can also be problematic to rely upon, as they put the state in the position of imposing a punitive tax on an activity that will now be relied upon for annual revenue; some states even estimate steady or increasing revenues while rationalizing the tax as a way to reduce the activity! Finally, numerous studies have shown both tobacco taxes and the lottery to be regressive forms of taxation, meaning the poor bear a disproportionately heavy share of the tax burden. Mississippi should be cautious about relying on cigarette tax or gambling revenues.

Improving budget transparency can enable Mississippi's citizens and potential out-of-state employers to be informed and able to make accurate business and voting decisions.

Conclusion

The Tax Foundation's *State Business Tax Climate Index*, coupled with the principles of sound tax policy, enables a state to understand and evaluate potential improvements to its tax system. Mississippi should keep in mind regional, national, and international competition for capital, jobs, and entrepreneurs, as it studies its tax system. The ideal choice for Mississippi would be a tax system that is simple, transparent, stable, and neutral, with broad bases, low rates, and minimal distortion of economic activity.

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