Will the Single Business Tax Catch On?

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At the National Tax Association's conference earlier this month, one of the most interesting sessions dealt with state value added taxes. These taxes, often given the label of single business taxes, exist only in two states, Michigan and New Hampshire, but they have been proposed by study commissions in both West Virginia and the District of Columbia and are at different stages of consideration in Minnesota and Texas. While no tax is without problems of defining the base or of enforcement, the potential for expansion of the single business tax is significant.

But why now, of all times? State revenue growth has been fairly high in most states. Some of that is due to the length of the current economic expansion. State revenue growth, however, has been even faster than the rate of growth of the economy. This above-average growth reflects many factors, including the higher capital gains realizations that are also reflected in federal tax collections.

State individual income taxes are not indexed for real growth and, in many states, neither are they indexed for inflation. Bracket creep, therefore, has also added to many state coffers. The average state individual income tax rate has also tended to rise because income distribution has become more unequal and the percentage of two-earner families continues to rise.

Corporate profits are up, increasing corporate income tax payments as well. Unlike the federal income tax, in many states the corporate rate is higher than the combined tax rate on individuals from other direct taxes. Thus shifts of income toward corporations and away from individuals also tends to increase state revenues faster than the income growth in the economy.

Many of these sources of revenue growth, however, are unstable and uncertain for the future. Large increases in capital gains realizations reflect a high-valued stock market; income distribution cannot be expected to become more and more uneven; and corporate profits tend to rise and fall significantly over business cycles. Despite the strong growth in individual tax revenues, moreover, states find that their other major sources of revenues, such as sales taxes, tend to grow more slowly than the economy.

One of the major reasons for considering single business taxes, therefore, is simply that they are a fairly stable source of revenue. While they don't have the type of bracket creep that makes individual tax rates rise over time, neither are they as cyclical or uncertain as taxes on corporate profits; and they don't decline over time in relative importance like most sales and excise taxes. In general, they tend to adopt a base that expands at roughly the same rate as the economy as a whole.

Even recessions do not tend to cause a large fall in single business tax collections, but rather a fall that is commensurate with declines in overall consumption and income. Historically states have tended to follow balanced budget rules, which left them spending most or all of their revenue in good times. Then whenever the next recession hit, many were unprepared. It was during these downturns that demands under many welfare-type programs rose even while revenues fell relative to the economy. With balanced budget rules, there then would be some expenditure cuts elsewhere, some game playing with such items as deposits to state pension plans, and also tax rate increases so that each state's fiscal house could be put back in order. A single business tax provides more flexibility and less need for reactive legislative action and less need for revenue changes that are so hurried that they proceed with inadequate consideration of long-term tax policy principles.

The single business tax is also considered by many to be more adaptable to future changes in the marketplace. Most sales taxes today are assessed on purchases of goods, not services. While taxing services is an issue of great controversy, it is obvious that the more the economy centers on services and information, and the less on goods, the less reliable will be any revenue source that does not directly or indirectly include either the sale of services or the income that is generated in the service sector.

Note that the issue is not necessarily the raising of revenues but of maintaining a broad enough base that rates can be kept low and stable over time. Contrast a single business tax with an equal yield sales tax on goods only. The latter continually raises fewer taxes relative to the size of the economy. That is one of the major reasons sales tax rates have tended to rise continually over the past few decades, increasing the tax on goods relative to services. The higher the rate differential, moreover, the more economists would argue that distortions in behavior arise. Such distortions result in too much consumption of services and too little consumption of goods, decreasing the well-being of consumers in general. Much of the momentum behind single business taxes comes from efforts to reduce or replace other taxes. In some cases, like Michigan, governors have run on platforms of removing or reducing taxes, particularly property taxes. Then they hunt around for some substitute. The rapid push for equalization of school financing throughout a state also reduces the dependence on property taxes and causes the search for some alternative.

In the case of West Virginia, its Commission on Fair Taxation bravely proposed reform that included the repeal of a wide range of distorting taxes that tended to "pick" on particular forms of activity or that simply were not worth the extra tax enforcement costs. These included the personal property tax that largely applied to business machinery, equipment, and inventory, the telecommunications tax, a health provider tax, an insurance premiums tax, an auto privilege tax, and a soft drink excise tax. The single business tax is also proposed to replace a business franchise tax, a corporate charter tax, a business registration tax, and a business and occupation tax. Many of these business taxes result in a double tax on different forms of income or consumption based mainly on organizational form or how many layers of business are involved in the final production. Such taxes are believed to be very distorting.

The District of Columbia's case is somewhat unique in that so many services, particularly those of lawyers and other professionals, are produced by residents outside the District who then pay little or no tax on the income they earn inside the District on the value of services they provide. A single business tax represents yet one more attempt to get at this issue.

None of this means that a single business tax is by any means some perfect form of taxation. None exists. Like many other areas of taxation that depend on geographical location, there are many border tensions as to whether income or consumption should be taxed by source or residence; even when one or another is chosen in theory, enforcement and implementation can be problems in practice. Transition problems can be significant. Like so many other state taxes such as the income tax, apportioning the tax base across jurisdictions is not only difficult but is threatened by inconsistent rules in different states. These rules cause some consumption or income to be taxed twice in two different jurisdictions; others to be taxed not at all.

Whatever the future of the single business tax, it could unwind only over a long period of time. Any expansion is likely to go hand-in-hand with a reduced reliance on other taxes. It could give states more elastic and stable tax sources. At the same time, it would raise new issues of tension across state boundaries, and it could even affect the federal government's own choices with respect to income and various forms of consumption taxes. Stay tuned.

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