Testimony to the
Maryland Business Tax Reform Commission
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Chairman Wacks and Members of the Commission, thank you for inviting me to provide the Council On State Taxation's views on Maryland's tax system. My testimony covers three related issues: 1) the current state and local tax burden on Maryland's businesses; 2) how Maryland's unique economic position among states should inform its policy choices; and 3) the impact on jobs and investment in Maryland of policy options before the commission, including combined reporting, expansion of the sales tax base and alternative base (gross receipts) taxes.

About COST

COST is a nonprofit trade association based in Washington, DC. COST was formed in 1969 as an advisory committee to the Council of State Chambers of Commerce and today has an independent membership of nearly 600 major corporations engaged in interstate and international business. COST's objective is to preserve and promote the equitable and nondiscriminatory state and local taxation of multijurisdictional business entities.

Measuring the State Business Tax Burden

Ernst & Young, in conjunction with COST, annually estimates the total state and local tax burden imposed on businesses in each state. Our seventh annual report was released in February, 2009.[1]

This "State Tax Burden" study provides estimates of the taxes paid by businesses in each state, an important first step in any evaluation of business taxes or tax reform. To enable comparisons across states, the study also expresses business taxes as a share of total state and local taxes and as an effective tax rate on private sector economic activity (taxes as a share of gross state product).

[1] Phillips, Andrew, Robert Cline and Tom Neubig, *"Total State and Local Business Taxes: 50-State Estimates for Fiscal Year 2008,"* February 2009, http://www.cost.org.

These comparative measures were developed to answer questions from legislators asking, "Are businesses paying their fair share of taxes?" Increasing economic competition among states and around the globe has transformed the initial question into a more fundamental query: "What is the basis or rationale for business taxation at the state or local level?" The basic rationale for business taxes, recognizing that the economic burden of business taxes are ultimately borne by consumers or owners of factors of production (including workers), is to pay for government services that directly benefit businesses.

If state and local business taxes were equal to the value of the benefits business received from state and local public services, they could be considered a payment for services, and taxes would not influence business location decisions or impact competitiveness. However, if state and local business taxes exceed the value of the benefits received from government services, the difference represents an excess cost to business that will reduce profitability in the absence of shifting the tax through higher prices or lower payments to labor. When such excess costs exist, they can affect a company's choice of locations.

In FY 2006, the study estimates that Maryland businesses paid $8.6 billion in state and local taxes while benefitting from only $5.9 billion in state and local expenditures. In other words, the state and local tax burden on Maryland businesses is 46% higher than justified by the services government provides to businesses. The economic impact of these excess taxes falls on consumers through higher prices, workers through lower pay or reduced employment, or shareholders through reduced profits.

Maryland's Public and Non-Profit Sectors

According to the study, Maryland ranks below the national average both for business taxes as a share of total taxes relative to economic activity, and compared to the value of public services benefitting businesses. Maryland, however, occupies a unique position among states with respect to the composition of its economy. According to a recent study[2] conducted for the Maryland Chamber of Commerce, Maryland derives a significantly higher share of its personal income and employs more workers in federal government civilian positions than any other state. In fact, the income generated by non-taxable federal government activities in Maryland far surpasses any other state, creating 6.2% of Maryland's total personal income – nearly *three times* the national average of 2.2%. This demographic advantage lets Maryland place a greater reliance (without higher tax rates) on taxes favored by economists, *i.e.,* state and local individual income taxes, thereby allowing a corresponding reduction in its reliance on taxes received by businesses.

Despite this advantage, Maryland must be vigilant in maintaining its business competitiveness among its regional neighbors. Business investment decisions are often regional and are primarily based on differences in effective tax rates on capital income. Although Maryland compares favorably to the national average from a tax burden perspective, it falls well short of three of its primary competitors in a more relevant measurement of competitiveness –

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[2] Ernst & Young LLP, "*Total Maryland Business Taxes: A Study of the State and Local Taxes Paid by Maryland Businesses,*" February 2004. The study is available at www.cost.org.

the ratio of state and local business taxes to private-sector gross state product, in effect a calculation of the total effective business tax rate (TEBTR) for each state. For FY 2008, Maryland's TEBTR is 4.1%; three of this State's primary competitors are significantly lower – Virginia's TEBTR is 3.9%, Delaware stands at 3.8%, and North Carolina's TEBTR is 3.6%. In addition, Virginia, perhaps the state's chief competitor for jobs and investment, scores lower (*i.e.,* more favorably) than Maryland in its ratio of business taxes to those state expenditures that benefit business.

State Corporate Income Taxes & Mandatory Unitary Combined Reporting

State corporate income taxes seem to garner an inordinate amount of attention from policymakers, commentators, and interest groups – perhaps because the tax is often perceived by the uninformed to be the primary source of business taxation levied by states. In fact, state corporate income taxes contribute relatively small amounts to state coffers. Nationally, in FY 2008, state corporate income taxes generated only 9.6% of total state and local business taxes. Here in Maryland, it comprises roughly 8% of all business taxes, and only 2.46% of total state and local taxes. Yet because the tax is inherently unstable (it only operates when a corporation earns income), and because the myriad of bases, rates and rules among states allow tax planning opportunities, it is widely vilified as rife with "loopholes" that need "closing." State corporate income taxes are also tremendously complex, creating costs of compliance and tax administration that are far out of proportion to other significant taxes paid by businesses, such as property or sales taxes.

Indeed, many public finance economists "find little justification for the state corporate income tax" in the first instance.[3] Professor Charles McLure says:

> It is hard to think of a good reason to tax corporate income….The case against state corporate income taxes is even stronger. It is common among economists to acknowledge that a small open economy (one that cannot affect the world price of capital) should not tax the return required to elicit investment within its boundaries….The difficulty of actually taxing corporate income where it originates is a further reason for not trying to tax it.[4]

Despite the economic consensus that the state corporate income tax is a poor tax, it exists. And, because of the erroneous public perception that the corporate income tax is the primary business tax, one of the most controversial business tax policy issues currently debated by state legislators, tax administrators, and corporate taxpayers is how a state should determine the corporate income tax base for multistate corporations with multiple businesses and entities. One possible method—mandatory unitary combined reporting (MUCR)—is touted by proponents as a "loophole closer" and as a way to stop "income shifting" to low tax jurisdictions. In actuality, however, mandatory unitary combined reporting carries severe economic consequences: it

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[3] Fox, William F., Matthew N. Murray and LeAnn Luna, "*How Should a Subnational Corporate Income Tax on Multistate Businesses Be Structured?"* National Tax Journal, March, 2005.
[4] McLure, Charles, "*How to Improve California's Tax System: The Good (But Infeasible), the Bad, and the Ugly,"* California Commission on the 21st Century Economy, February 2009.

arbitrarily assigns income to a state, negatively impacts the real economy, and imposes significant administrative burdens on both the taxpayer and state.[5]

- Arbitrarily Assigns Income – Although proponents of MUCR argue that it helps to overcome distortions in the reporting of income among related companies in separate filing systems, the mechanics used under MUCR create new distortions in assigning income to different states. The MUCR assumption that all corporations in an affiliated unitary group have the same level of profitability is not consistent with either economic theory or business experience. Consequently, MUCR may reduce the link between income tax liabilities and where income is actually earned. Many corporate taxpayers may conclude that there is a significant risk that MUCR will arbitrarily attribute more income to a state than is justified by the level of a corporation's real economic activity in the state.

- Negatively Impacts the Real Economy – Proponents of MUCR have focused on the benefits in terms of reducing tax planning opportunities, but they fail to acknowledge that MUCR may result in higher effective corporate income tax rates for certain industries. Economic theory suggests that these higher effective tax rates will ultimately be borne by labor in the state through fewer jobs (or lower wages over time) or by in-state consumers through higher prices for goods and services.

- Uncertain Revenue Impacts – Revenues derived from adoption of MUCR are notoriously difficult to estimate. Depending on the composition of the unitary group and the location of profitable and not so profitable entities, MUCR will raise taxes for some unitary groups but will result in tax savings for others. If the unitary group as a whole is not profitable, as during a recession, no combination of entities will result in increased revenues. Tennessee recently asked Professor William F. Fox, a noted PhD public policy economist and Director of the Center for Business and Economic Research at the University of Tennessee, to conduct a study[6] of the revenue effects of combined reporting. After conducting extensive analysis, the authors conclude in the study that: "…we find no evidence that states with combined reporting collect more revenue than states using separate accounting given the other elements of their tax system and their economy." Although technically still in session, the Tennessee legislature is expected to reject MUCR this year. It has already been rejected this year by legislatures in New Mexico, Iowa, Missouri, Alabama, and Florida.

- Maryland has Already Closed a Major "Loophole" – MUCR is often favorably cited by proponents for its ability to shut down the income shifting between related entities that is possible under a separate return filing methodology. Most separate filing states, including Maryland, have already addressed such tax planning techniques through

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[5] A thorough discussion of the problems associated with MUCR can be found in the study prepared for COST by Ernst & Young LLP, *"Understanding the Revenue and Competitive Effects of Mandatory Unitary Combined Reporting"* (www.cost.org).
[6] Fox, William F. and LeAnn Luna, "*An Evaluation of Combined Reporting in the Tennessee Corporate Franchise and Excise Taxes,"* January, 2009. (www.cost.org).

enactment of "addback" statutes – laws that require corporations to add back to income any expenses incurred in transactions between related entities for the sale or licensing of intangibles and related interest. Thus the primary "loophole" targeted by MUCR is effectively closed, and the State is already collecting additional revenues from such legislation.

- Imposes Significant Administrative and Compliance Burdens

    - *Determining the Unitary Group* – The concept of a "unitary business" is uniquely factual and universally poorly-defined. It is a constitutional (Due Process) concept that looks at the business as a whole rather than individual separate entities or separate geographic locations. In order to evaluate the taxpayer's determination of a unitary relationship, state auditors must look beyond accounting and tax return information. Auditors must annually determine how a taxpayer and its affiliates operate at a fairly detailed level to determine which affiliates are unitary. Auditors must interact with a corporation's operational and tax staff to gather this operational information. In practice, however, auditors routinely refuse to make a determination regarding a unitary relationship on operational information and instead wait to determine unitary relationships until after they have performed tax computations. In other words, the tax result of the finding that a unitary relationship exists (or does not exist) often significantly influences, or in fact controls, the auditor's finding. Determining the scope of the unitary group is a complicated, subjective, and costly process that is not required in separate filing states and often results in expensive, time-consuming litigation.

    - *Calculating Combined Income* **–** Calculating combined income is considerably more complicated than simply basing the calculations on consolidated federal taxable income. In most MUCR states, the group of corporations included in a federal consolidated return differs from the members of the unitary group. In addition to variations in apportionment formulas among the states that apply to all corporate taxpayers, further compliance costs related to MUCR result from variations across states in the methods used to calculate the apportionment factors.

Maryland should not adopt mandatory unitary combined reporting.

"Alternative Base" Business Taxes

In part because of the flaws associated with the corporate income tax, a handful of states have considered or enacted new business taxes that are based on some alternative base. These alternative base taxes are generally derived from—or linked to—gross receipts. Gross receipts taxes are widely acknowledged to violate numerous tax policy principles. The remainder of this section is excerpted from a paper titled "Gross Receipts Taxes in State Government Finances: A Review of Their History and Performance" (January 2007). This paper was prepared for COST and the Tax Foundation by John Mikesell, professor of public finance and policy analysis and director of the Master of Public Affairs program at the Indiana University School of Public and Environmental Affairs. The paper can be viewed in its entirety at http://www.cost.org.

Gross receipts taxes had largely disappeared as an important revenue source for state governments by the later years of the twentieth century, usually after considerable effort by state business groups to eliminate them. Analysts and scholars presumed that these taxes—also known as "turnover taxes"—had forever been replaced with options that made more sense as ways of distributing the cost of government and had less undesirable impact on the taxpaying public, including businesses, and generally lost interest in them. In recent years, however, such broad-base, low-rate taxes have again entered state tax policy discussions. With this re-emergence comes a need for a new analysis of gross receipts taxes to aid policymakers who are unfamiliar with their structure and drawbacks.

This examination of American and European experience with gross receipts taxation has identified several significant conclusions about the tax. These may be summarized:

- Broad Base – The gross receipts tax base can be broad, broader than the total value of production of the economy, but it lacks any link either to capacity to bear the cost of government services or to the amount of government services used—the normal standards for assigning tax burdens.

- Low rate -- Whether a gross receipts tax has a low rate depends on how much revenue the government intends to raise from it. Unlike most taxes, the effective rate of a gross receipts tax is higher than the statutory (or advertised) rate. A broad-based, low-rate gross receipts tax is unlikely to contribute a major share of tax revenue to a modern state government.

- Stable revenue – A gross receipts tax appears to be roughly as stable as a retail sales tax. Its variations do not contribute to the overall stability of total state revenue because its fluctuations follow generally the same pattern as other major taxes.

- Economic neutrality – A gross receipts tax interferes with private market decisions. Its pyramiding creates a haphazard pattern of incentives and disincentives for business operations. Most significantly, it establishes artificial incentive for vertical integration and discriminates against contracting work with independent suppliers and the advantages of scale and specialization that production by independent firms can bring.

- Competitiveness – A gross receipts tax interferes with the capacity of individuals and businesses to compete with those in other states and other parts of the world. The tax embedded in prices grows as the share of a production chain within the state increases, so there is incentive to purchase business inputs from outside the state. It discourages capital investment by adding to the cost of factories, machinery, and equipment, and the disincentive increases as more of those capital goods are produced in the taxing state. This tax structure does not promote the growth and development of the state.

- Fairness – A gross receipts tax does not treat equally situated businesses the same. Firms with the same net income will face radically different effective tax rates on that income, depending on their profit margins. Low-margin firms will be at great disadvantage relative to higher-margin firms, regardless of their overall profitability. Many new and expanding firms have low margins (or even are initially unprofitable) and the gross receipts tax reduces the chance that these firms will survive. This also is not consistent with a climate for growth and development.

- Transparency – A gross receipts tax is a stealth tax with its true burden hidden from taxpayers. Hiding the cost of government is inconsistent with efficient and responsive provision of government services and contrary to the fundamentals of democratic government.

There is no sensible case for gross receipts taxation. The old turnover taxes—typically adopted as desperation measures in fiscal crisis—were replaced with taxes that created fewer economic problems. They do not belong in any program of tax reform.

Sales Taxes on Business Inputs

The sales tax is one of the larger state and local tax imposed on business in Maryland, generating $1.5 billion in tax revenue in FY08.[7] Approximately 41% of all sales tax revenue in Maryland comes from impositions on business inputs.[8]

Imposing sales taxes on business inputs violates several tax policy principles and causes significant economic distortions. Taxing business inputs raises production costs and places businesses within a State at a competitive disadvantage to businesses not burdened by such taxes. Taxes on business inputs, including taxes on services purchased by businesses, must be avoided.

Like the gross receipts tax, sales tax on business inputs violates several tax policy principles—economic growth, equity, simplicity and efficiency—and causes a number of economic distortions. Notably, these distortions result from pyramiding, where a tax is imposed at multiple levels, such that the effective tax rate exceeds the retail sales tax rate. Companies are forced to either pass these increased costs on to consumers or reduce their economic activity in the State in order to remain competitive with other producers who do not bear the burden of such taxes.

All states that impose sales tax currently tax business inputs to some extent, but few states tax services principally purchased by businesses. Proposals to eliminate existing sales tax exemptions for business inputs or to extend the sales tax to services purchased primarily by businesses further exacerbate the adverse economic distortions from the current taxation of

[7] Phillips, Andrew, Robert Cline and Tom Neubig, "*Total State and Local Business Taxes: 50-State Estimates for Fiscal Year 2008,*" February 2009, http://www.cost.org. This figure includes sales taxes paid on business purchases of operating inputs and capital equipment; it does not include taxes collected on sales to final consumers.
[8] Cline, Robert, John Mikesell, Tom Neubig and Andrew Phillips, *"Sales Taxation of Business Inputs: Existing Tax Distortions and the Consequences of Extending the Sales Tax to Business Services,"* January 2005, (www.cost.org).

business purchases. For example:

- Taxing business inputs encourages companies to self-provide business services to avoid the tax rather than purchasing them from more efficient providers and paying tax (vertical integration);

- Taxing business inputs places companies selling in international, national and regional markets at a competitive disadvantage to many of their competitors, leading to a reduction in investment and employment in the State;

- Taxing business inputs unfairly and inefficiently taxes some products and services more than others by imposing varying degrees of tax on inputs in addition to a general tax rate on final sales; and

- Taxing business inputs unfairly hides the true cost of government services by embedding a portion of the sales tax in the final price of goods and services.

Efforts to extend the sales tax to services purchased primarily by business also suffer from the significant administrative complexities associated with determining where such services are "used" or consumed. This determination is much more complicated for services purchased primarily by business than it is for tangible goods.[9]

Numerous attempts to extend the sales tax to services purchased primarily by businesses have failed, including broad efforts by Florida and Massachusetts and narrower, more recent efforts in Michigan and notably here in Maryland. Not only have these efforts been hindered by the administrative complexity of such taxes but also by the recognition that such taxes are fundamentally flawed and increase the cost of doing business in a state.

When considering any changes to Maryland's existing sales tax base, the Commission would do well to understand the economic burdens associated with taxing business inputs, including the relatively high level of such taxes already imposed by the state.

Conclusion

In reviewing the existing tax system, the Commission should seek opportunities to minimize obstacles to investment and job creation. Proposals that would further exacerbate the state's current excess business taxation, including those that would impose mandatory unitary combined reporting or a sales tax on services purchased primarily on business, should be avoided.

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[9] *Ibid*.