

## **Business & Occupation Tax Reform, Part I**

*Characteristics of a responsible business tax system*

by Carl Gipson

Director, Center for Small Business

June 2008

### **Introduction**

The *Oxford American Dictionary* defines “tax” as, “a sum of money to be paid by people or business firms to a government, to be used for public purposes.”

Today, taxes are used to pay for public goods such as schools, roads, airports, utilities, museums, social work, sports, and more.

But taxes also affect the daily decisions of not just individuals but also businesses – and especially small businesses, which may not possess similar resources as larger corporations to handle the complexity of our national, state and local tax regulations.

Too often, policymakers pass off increased business taxes with some sort of impersonal sentiment such as, “Oh, it’s a big business, they have the money.” This becomes justification for just about any of the taxes businesses currently pay.

But businesses don’t pay taxes. People pay taxes. And the more taxes a business pays, in reality, the more taxes people pay.

The 19<sup>th</sup> century American economist Henry George said, “The mode of taxation is, in fact, quite as important as the amount. As a small burden badly placed may distress a horse that could carry with ease a much larger one properly adjusted, so a people may be impoverished and their power of producing wealth destroyed by taxation, which, if levied in any other way, could be borne with ease.”

This series examines just one of the more than 50 taxes that Washington citizens and businesses pay, and one of the taxes most maligned in the public’s eye—the state’s Business & Occupation Tax. This series does not discuss the projects that the B&O tax funds, nor does it argue for ending or starting any particular taxpayer funded program or service.

It is an examination of the shortcomings of our 70+ year-old gross receipts tax—a tax system that hardly any other states rely on. Part II will focus on the pyramiding effect of the tax. The final piece of this series will lay out potential reforms to the current B&O system that will lead to further economic development and fewer of the unintended consequences caused by this form of taxation.

### **Characteristics of a Responsible Business Tax System**

There is no question that individual states compete for businesses and the jobs those businesses bring. The more businesses and family-wage jobs there are,

*Businesses don’t pay taxes.  
People pay taxes. And the  
more taxes a business pays,  
in reality, the more taxes  
people pay*

*Finding a tax code that encourages capital investment and business expansion has, and should continue to be, a core function of state policymakers.*

the stronger a state's economy is and the more tax revenue the government can collect. Finding a tax code that encourages capital investment and business expansion has, and should continue to be, a core function of state policymakers.

A responsible tax system is one that imposes limited interference upon normal market activity. All taxes are a burden, but a burden that must be shared by all—ideally equally. These six characteristics of a responsible tax system emphasize the principles of limited government and place qualifying parameters around any tax system a government would enact.

- 1) **Broad Base.** A responsible taxation system should have a broad base—a wide range of tax contributors. A system that spreads the economic interference of taxation across a wide range of payers is preferable to a system that overtaxes fewer citizens. It should be broad-based in order not to rely too heavily on a few sources of revenue. A broad B&O tax base is one of the justifications for Washington's current tax system.
- 2) **Simplicity.** The tax code should be easy for the average business owner to understand, and it should minimize the cost of complying with the tax laws. The more tax complexity, the higher the cost to the taxpayer without increasing public good. A simple tax structure also helps governments because it is easier to administer and promotes efficient, low-cost administration.
- 3) **Economic Neutrality—Equity and Fairness.** The purpose of a tax system is to raise needed revenue for the government, not to control industry through tax incentives. The tax system should exert minimal impact on the spending and business decisions of both individuals and businesses. The government should not use the tax system to pick winners and losers in business, or unfairly shift the tax burden onto industries that lost the “lobbying” game.
- 4) **Competitive and Balanced.** A low tax burden can be a tool for Washington's economic development by retaining and attracting productive business activity. A high quality revenue system will be responsive to competition from other states.
- 5) **Reliability.** A high-quality tax system should be stable, providing certainty in taxation and in revenue flows. It should provide certainty of financial planning for individuals and businesses. Businesses rely on certainty and predictability in determining potential capital investments.
- 6) **Transparency.** A responsible tax system should be fully transparent to taxpayers (whether businesses or personal). Policymakers should be able to clearly demonstrate exactly what is being taxed and how the tax burden affects the overall economy and the benefit the taxpaying public receives as a result of the tax burden.

While these guiding principles are important, there are inherent problems—or necessary evils—with any system of taxation. Taxation reduces spending on private sector goods and services traded in a free market. The benefits of free exchange—for both purchaser and seller—are reduced when trade is restrained by taxation.

Since taxes lower the economic welfare of citizens, workers and employers, policymakers should try to minimize the economic and social problems that taxation imposes. A lower and more responsible taxation system, applied fairly with minimal complications, leads to faster economic growth, greater wealth creation for all economic strata, and less micromanagement of the economy by the government.

## How does the B&O tax stack up?

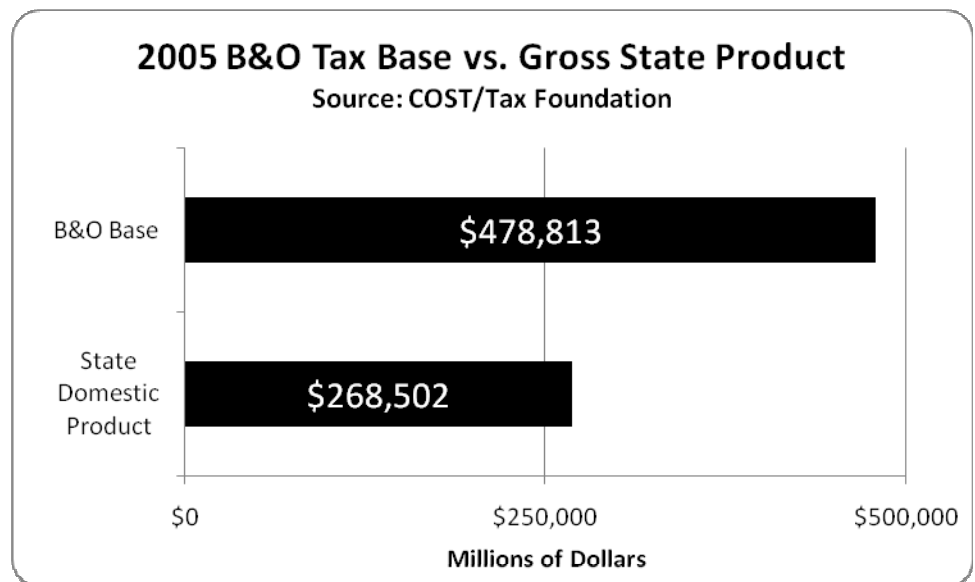
### 1) Broad Base

A broad gross receipts base is the result of the final valuation of a product plus the cost value of the transactions that led to the final product. Figure 1 shows that the tax base is approximately 177 percent of the state's domestic product. This essentially means that the value of what is subject to being taxed (including transactions) is greater than what is being produced – Gross State Product (GSP). GSP is defined as the total value of all goods and services produced by Washington's economy in a single year.

That the tax base is broader than the state's GSP is accounted for because there are often numerous transactions for any single product from the time of production until final sale to the consumer. Each time a transaction takes place, it is subject to taxation, even though the inherent value of the good remains static.

The broad base contributes to the relatively low B&O tax rates. For instance, the tax rate for manufacturing, wholesale and certain other activities is one of the higher B&O rates and yet it is only 0.0484 percent of eligible receipts (more on exemptions and credits in section 2). However, this low tax rate applies to all revenue coming to a business, so the effective tax rate has the potential to be higher depending on the businesses' profit margin.

*Each time a transaction takes place, it is subject to taxation, even though the inherent value of the good remains static.*



### 2) Simplicity – Tax Inconsistencies Lead to Confusion and Favoritism

A recent Washington State Department of Revenue (DOR) report on tax exemptions lists 567 “exclusions, deductions, preferential tax rates, deferrals and credits,” and runs over 300 pages. The number of different tax incentives changes every year during the legislative session.

Not all 567 exemptions are geared towards industry and commerce. However, as described by the Department of Revenue, 246 exemptions are aimed at “business incentive,” “other business,” and “Agriculture.” If the categories of “commerce” and “services” are included, that number rises to 272. Forty-eight percent of the total tax exemptions target the business community, whereas the other exemptions focus on individuals and property owners.

According to the DOR's quadrennial report on tax exemptions, over 70 percent of the value of the exemptions date from the 1930s. The 38 exemptions in 1935,

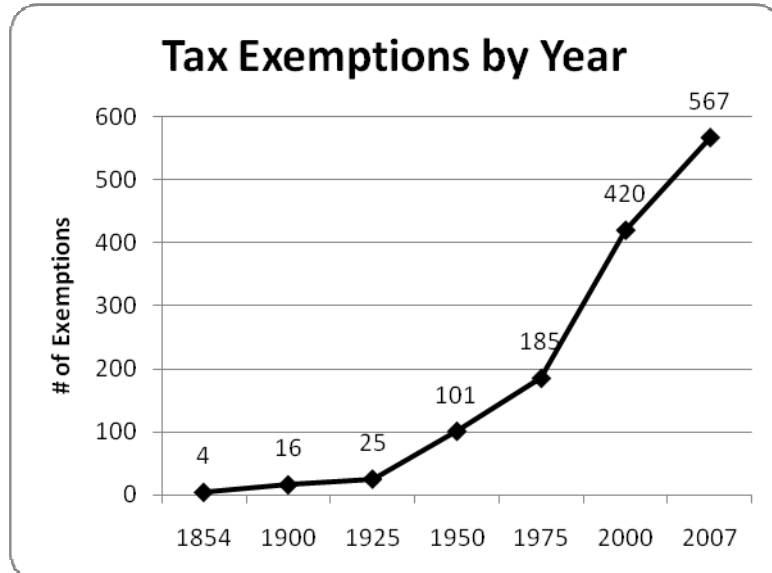
which define major excise tax bases contained in the Revenue Act, represent the most new exemption statutes in a specific year.<sup>1</sup> The year with the second most exemption was 2003 when the legislature passed 35 exemptions.

Large numbers of exemptions are a sure way to remove the simplicity from any tax code—whether aimed at businesses, property owners or citizens. Even though the exemptions are passed with good intentions, often the exemptions suppress economic neutrality, equity and fairness among the industries. With all the confusion, business owners can reasonably ask, why does one industry receive preferential tax treatment but another industry does not?

Justifications for the myriad tax breaks range up and down the political spectrum. But that is just the point—tax systems set upon *political* justifications instead of *economic* reasons should be considered suspect.

The chart above shows that the number of all (business plus others) tax exemptions rose sharply after the 1970s. Since 2001, the legislature passed 147 exemptions, deductions or credits to the tax code. This is an average of 21 per year. The previous 25-year period, 1975-2000, averaged just over 9 exemptions per year. The 25-year period of 1950 through 1975 averaged fewer than 4 exemptions per year.

*With all the confusion, business owners can reasonably ask, why does one industry receive preferential tax treatment but another industry does not?*



As lawmakers insert more exemptions into the state’s tax code, it is becoming more difficult for the small business community to navigate the disparate code. Any business plan should incorporate the tax code and small businesses have disproportionately higher compliance costs for taxes and regulations—as much as 60percent higher than larger businesses according to a United States Small Business Administration report.<sup>2</sup>

### 3) Economic Neutrality – Equity and Fairness

As shown in the above section, the B&O tax system is anything but neutral to certain industries. With the number of deductions, credits and exemptions in the hundreds and growing each year, favoritism and the legislature’s inability to stand up to special interests has led to some industries being favored over others.

<sup>1</sup> Washington State Department of Revenue, “2008 Tax Exemption Report.” Available online at [http://dor.wa.gov/docs/reports/2008/tax\\_exemptions\\_2008/tax\\_exemptions\\_2008.pdf](http://dor.wa.gov/docs/reports/2008/tax_exemptions_2008/tax_exemptions_2008.pdf)

<sup>2</sup> W. Mark Crain and Thomas D. Hopkins, “The Impact of Regulatory Costs on Small Firms.” The Office of Advocacy, U.S. Small Business Administration.

The B&O tax intentionally pyramids (more on the detrimental pyramid effect in Part II of this series) so that products moving from one firm to a different firm at different stages in the chain of production are each subject to the tax. This means that the same product can be subject to tax multiple times. The cost is then passed onto the consumer in the form of an unseen price hike.

This pyramid system gives an advantage to vertically integrated firms – firms that are able to incorporate an in-house system that moves a product from basic resources to final production to distribution to final sale. The B&O tax disproportionately harms smaller businesses and puts them at a disadvantage against their larger competitors that might have the resources, capabilities and systems to be vertically integrated and insulate themselves from multiple B&O tax hits.

#### 4) Competitive and Balanced

If a low tax burden can be a tool for Washington’s economic development, how does the B&O tax shape up? As of January 2007, ten different B&O tax rates apply to various classifications of business activities.

Washington state and local business taxes totaled just under \$15 billion for fiscal year 2006, nearly 53 percent of all taxes collected. However, the amount of business taxes collected equaled 6.2 percent of the state’s gross state product – the total market value, in terms of current dollars, of all final goods and services produced by the private sector in the state in one year. The national average of state and local business taxes collected as a percentage of gross state product is 5.1percent. The numbers show that Washington’s businesses shoulder a heavier state and local tax burden than the businesses of many other states.

*The B&O tax disproportionately harms smaller businesses and puts them at a disadvantage against their larger competitors that might have the resources, capabilities and systems to be vertically integrated and insulate themselves from multiple B&O tax hits.*

#### Total Washington business taxes as a percentage of Gross State Product<sup>3</sup>

Fiscal Year	Total Business Tax (billions)	Percentage of GSP
2007	\$14.9	6.2%
2004	\$11.9	5.7%
2000	\$10.4	5.3%

This table shows the growth in Washington’s business taxes collected since fiscal year 2000—an almost 143 percent increase.

However, it is also important to keep track of the percentage of GSP that taxes add up to in order to show the cost the government imposes on the economy. The larger percentage of GSP a governing body commands, the more private sector productivity is required to make up the difference. A low percentage of taxes in comparison to GSP often indicates a less intrusive, smaller, perhaps more efficient government. It also means more of the wealth created by citizens is left in the private sector to go home with employees in the form of higher paychecks, reinvested capital into the business community, or lower prices to consumers.

#### 5) Reliability

One of the few perceived benefits of the current B&O tax system is that it is said

<sup>3</sup> Several sources including “Total state and local business taxes: 50-state estimates for fiscal year 2007,” Ernst & Young and the Council on State Taxation (COST). Data also pulled from WashACE’s “2006 Competitiveness Redbook.” Also, “Total State and Local Business Taxes,” by COST.

to be more reliable during an economic downturn than a personal or corporate income tax. An unstable taxing system can exacerbate a faltering state economy when lawmakers are unable to adequately account for drastic shifts in revenue collections. Often when this happens, proposals to increase revenue (tax increases) gain momentum despite the negative impacts that higher taxes have on an economy – particularly a recessionary economy.

In 2007, the Tax Foundation released a study comparing the revenue stability of Washington state's gross receipts tax and retail sales tax with Oregon's individual and corporate income taxes. The Tax Foundation reports, "On the basis of Washington's evidence, the gross receipts tax appears to be slightly less stable than the retail sales tax but more stable than taxes on corporate profits or individual income."<sup>4</sup>

## **6) Transparency**

The B&O tax is a very stealthy tax from the consumers' standpoint. Nowhere does the cost of the B&O tax show up in a line item for the purchase of a good or service the way a sales tax or a surcharge shows up on a customer receipt. This makes it difficult for consumers to know how much they pay in tax, or account for the taxes they pay as a percentage of their income, or even just as a percentage of the product they are purchasing. A large component contributing to the lack of transparency is the pyramid effect. The cost of taxing each stage of production for a product is included in the final price of the product – but nowhere does the consumer see that information.

It is important to note that the B&O tax is not transparent, and many consumers are under the mistaken impression that changes in the B&O system have no impact on their economic well being.

## **Conclusion**

There will likely never be complete agreement among policymakers, media, citizens, businesses and any other stakeholder on the best business taxation system. However, a collaborative effort is the only way to ensure that positive reform takes place.

Policymakers on both sides of the aisle have expressed concern about the effect the current system has on the business community – particularly small and unprofitable businesses. There are close to 200 exemptions, deductions and credits for the B&O tax (almost 600 for the overall tax code), which is a symptom of a larger problem – a complex, micromanaged and non-transparent business taxing system that caters to certain industries in lieu of helping the entire economy.

It is possible for the B&O system to be reformed without scrapping the entire program and replacing it with a less desirable, less reliable system (e.g. personal and corporate income taxes). There are steps that policymakers can implement that will help further economic development without cherry-picking industries, and that will aid new and unprofitable businesses without exacerbating the current financial difficulties that include \$2.5 billion deficit projection for the 2009-11 biennium.

A good place to start in determining such reforms is with the six characteristics of a responsible business tax system listed above.

---

<sup>4</sup> John L. Miskell, "Gross Receipts Taxes in State Government Finances: A Review of Their History and Performance." Tax Foundation and Council on State Taxation. January, 2007.

*Carl Gipson is director for small business, technology, and telecommunications research at Washington Policy Center, a non-partisan independent policy research organization in Seattle and Olympia. Nothing here should be construed as an attempt to aid or hinder the passage of any legislation before any legislative body.*