

***Michigan's Business Taxes and Economic Development:
Possible Reforms***

Testimony prepared for the
Tax Restructuring Subcommittee, Tax Policy Committee,
Michigan House of Representatives

by

Timothy J. Bartik
Senior Economist
The W.E. Upjohn Institute for Employment Research
300 S. Westnedge Avenue
Kalamazoo, MI 49007
bartik@upjohn.org

February 14, 2006

The Upjohn Institute is a non-profit and non-partisan research organization located in Kalamazoo that focuses on research related to employment policy, broadly defined. The findings and recommendations in this testimony are those of the author, and should not be construed as reflecting official views of the Upjohn Institute. I thank Claire Black for her assistance with this testimony. The testimony has been revised to correct minor writing errors in the text, and to add the following footnotes, in part in response to questions that came up at the February 14 hearing: footnotes 8, 9, 10, 12, and 15.

I appreciate the opportunity to testify before the Tax Restructuring Subcommittee this morning. You are to be commended for being willing to consider fundamental reforms to Michigan's tax system.

My testimony this morning is closely related to extensive research I have done over the years on what affects state and local economic development (the references to this paper provide some citations to relevant papers and books I have written). More specifically, I want to discuss what role reforming Michigan's business taxes can plausibly play in increasing the state's economic development.

There is a majority view among economists on the effects of state and local business taxes on economic development. As stated by Wasylenko (1997), which in turn largely draws on Bartik's (1991) review of 57 studies, a 10 percent decrease in overall state and local business taxes, holding public services and other location factors constant, increases the long-run level of economic activity in a state (e.g., employment, gross state product) by about 2 percent. The percentage effects on state economic activity would go up or down proportionately for different percentage decreases or increases in overall state or local business taxes. These are the effects on economic development for percentage changes in overall state and local business taxes; the effects on economic development of a percentage change in any particular state or local business tax, which is just one portion of the overall state and local business tax burden, would be lower. For example, Michigan's Single Business Tax (SBT) is estimated to constitute about 14 percent of overall state and local business taxes in Michigan.¹ Therefore, a 10 percent decrease in the

¹This is based on a recent study by Ernst and Young (2005) that state and local business taxes in Michigan are about \$14 billion; Single Business Tax (SBT) revenues are roughly \$1.9 billion.

Single Business Tax, holding public services and other location factors constant, would be estimated to increase long-run business activity in Michigan by about 3/10ths of 1 percent.²

What are the implications of these estimated effects of business taxes on state economic development? First, there is clearly no Laffer Curve rationale for a revenue gain from cuts in state business taxes. To get a gain in business tax revenues from cuts in state and local business taxes, a cut in overall state and business tax rates of 10 percent would have to increase the business tax base by more than 10 percent. The scholarly consensus is that the effect of a 10 percent business tax cut is to increase business activity and hence the business tax base by only 2 percent, which is only one-fifth of the responsiveness one would need to get an increase in business tax revenue. Therefore, although cuts in state and local business tax rates can under some circumstances boost a state's economy, these cuts will also result in a net loss in business tax revenue.

Second, an across-the-board cut in state and local business taxes is a relatively expensive way of creating jobs in the state. Based on estimates that total state and local business tax revenue per job in Michigan is about \$4,000, an across-the-board cut in business taxes would have an annual cost of about \$16,000 per job created.³ This calculation assumes that the cut in

²A 10 percent decrease in the SBT decreases overall Michigan state and local business taxes by 14 percent of 10 percent, or 1.4 percent, and a 1.4 percent decrease in overall state and local business taxes would have 14 percent of the effect of a 10 percent decrease in overall state and local business taxes of 2 percent. Fourteen percent of 2 percent is about 3/10ths of 1 percent.

³The type of calculation behind these numbers has been presented in several scholarly publications (Bartik, 2005a, 2004a, 1992). The basic calculation is as follows. Suppose total business tax revenue R is equal to the tax rate per job T times the number of jobs J , or $R = T * J$. Then for a small change in the business tax rate, the total change in business tax revenue is $dR = J * dT + T * dJ$. Then some manipulation of this expression indicates that the business tax revenue effect per job created is equal to $dR / dJ = (T / E) + T$. E here is the elasticity of state business activity with respect to the state and local business tax rate, which is the percentage effect on business activity of a percentage change in overall state and local business taxes, or $(dJ / J) / (dT / T)$. The estimated elasticity, as stated in the text, is -0.2 , which is the ratio of the percentage change in business activity with respect to a percentage change in business taxes of -0.2 ; in other words, a 10 percent reduction in business taxes increases business activity by 2 percent. The estimate of Michigan business tax revenue per employee, updated to 2005 dollars, is \$3,946 (Ernst and

business taxes is financed in a way that does not require cuts in public services, for example by increasing household taxes. This calculation also allows for increases in business tax revenues from the new jobs created by the tax cut, but does not adjust for any increases in required public services due to the newly created jobs. Furthermore, it should be noted that this \$16,000 cost is an annual ongoing cost in foregone business tax revenue, not a one-time cost. Using a real discount rate of 3 percent, the present value of the cost per job created would be a little over a half million dollars.⁴

A \$16,000 cost per job created, paid by higher household taxes, might seem worthwhile to create an average job that perhaps pays \$35,000 per year. However, research studies indicate that when new jobs are created in a state, there is considerable in-migration. Estimates suggest that for every five new jobs created in a state, four go to persons who otherwise would have lived in another state (Bartik 1993). Therefore, it is not clear that Michigan households should be willing to pay \$16,000 for a \$35,000 job if the odds are that this job will go to someone who currently does not live in Michigan. Finally, a full benefit-cost analysis of the economic development effects of business tax cuts would have to take into account many other factors, such as environmental issues, household taxes, increases in public service costs, congestion costs, and who gets the Michigan share of the new jobs (Bartik 2005a, 1991).

Third, the same studies that show that business tax cuts affect job creation also show that public services affect job creation. There are several studies that suggest that business tax cuts, if financed by cutting productive public investments such as spending on infrastructure or spending on education, will in the long run hurt a state's economic development (e.g., see reviews by

Young 2004). Plugging these numbers in gives a cost per job created from business tax cuts of \$15,784.

⁴\$15,784 divided by 0.03 = \$526,133.

Fisher [1997] and Bartik [2005b] and studies by Bartik [1999, 1989], Munnell [1990], and Helms [1985]).

I want to be clear that although there is a majority view within the economics profession that the effects of business taxes upon state economic development are modest, there are other views among economists. Among economists, there is a sizable minority that thinks state and local business tax effects on economic development are so small as to be negligible (e.g., see McGuire 2003). This group bases its position on the fact that although the effect of business taxes on economic development averaged across different studies is modest, many well-done studies find no business tax effects on economic development. Therefore, their argument is that the research evidence for business tax effects is too fragile for state policymakers to rely on such effects in making tax policy. In addition, there is a much smaller minority in the economics profession that thinks business tax effects on state economic development are larger than believed by the majority of economists.

Why are business tax effects on state economic development so modest? I think the biggest reason is that variations in state and local business taxes really aren't that large compared to many other local costs of production. For example, overall state and local business taxes in Michigan are estimated to be about \$3,946 annually per employee. In the state with the lowest business taxes (Utah), overall state and local business taxes are \$2,588 annually per employee.⁵ The difference between Utah and Michigan in business taxes per employee is about \$1,358, which is only about 68 cents per hour for a full-time, full-year employee who works 2000 hours

⁵These estimated taxes per employee come from Ernst and Young (2004) figures for 2003, updated to 2005 dollars using changes in the Consumer Price Index.

per year. Average hourly wages in the U.S. are about \$18 per hour,⁶ so the variation across states in business taxes can readily be offset by modest changes in wages, benefits, or labor productivity levels. In addition, because any given business tax is typically only a small proportion of overall business taxes, the effects of even abolishing a business tax are not large compared to other costs. For example, abolishing the Michigan Single Business Tax would be equivalent in its cost reduction impact to reducing wage rates of full-time employees by about 27 cents per hour.⁷

Given the likely modest effects of business taxes on state economic development, what principles should be taken into account in considering business tax reforms that might allow us to have positive effects on economic development at a lower cost to households?

First, policymakers should consider that it is the total tax burden on business that matters, not its specific components. The Single Business Tax is only \$1.9 billion out of the \$14 billion in total state and local business taxes in Michigan. Other business taxes are more important. For example, business property taxes in Michigan are estimated to be \$6.2 billion (Ernst and Young, 2005). Business property taxes probably deserve much greater attention from policymakers than the Single Business Tax.

Second, what should matter most in affecting business investment is the marginal tax rate on new business investment, not the average tax rate on existing business capital. It is possible with deductions for new capital investments, or investment tax credits, to have low or even zero

⁶This is based on my calculations of average wages per hour using data from the 2004 Outgoing Rotation Group of the Current Population Survey, updated to 2005 dollars using the CPI. The resulting average wage per hour is \$18.27. The average wage including benefits would be higher.

⁷Michigan's Single Business Tax is \$1.9 billion out of total state and local business taxes of \$14 billion, based on Ernst and Young (2005). Therefore, abolishing the SBT would reduce business tax costs per employee by \$535.53 per year (= 3,946 times 1.9 divided by 14). \$535.53 divided by 2000 annual work hours is 27 cents per hour.

marginal tax rates on new business investment, and yet sizable average tax rates on existing business capital, which will collect considerable revenue.

One of the most serious problems in the business tax debate in the state of Michigan is that neither the executive branch nor the legislature has adequate information about how different tax options affect marginal tax rates on business investments. In the debate over the Single Business Tax last year, I saw many analyses reporting how various options would change the average tax rates paid by different industries or different types of businesses. I did not see any analysis that looked at how the different SBT options affected the marginal tax rate on investments in different industries or different types of businesses. It is this marginal tax rate on new investments that affects business location or expansion decisions. Such analyses of marginal tax rates on investments can be readily done if either the executive or legislative branch devotes modest resources to creating a hypothetical firm simulation model that can model how different tax options affect the returns to different types of investments by firms. You should ask some combination of the Michigan Treasury Department and the House and Senate Fiscal Agencies to construct such a simulation model.

Third, what should matter most to a state's economic development is the marginal tax rate on business investment by export-base businesses. The term "export-base businesses" means businesses that either sell their goods and services outside the state or compete with businesses that import from other states into this state. For those businesses that sell solely to a local market with no significant outside-the-state competitors, business taxes are probably largely shifted forward to consumers, and therefore changes in business taxes probably are offset by changes in consumer prices, with little net effect on economic development.

Given those principles of what aspects of state and local business taxes most affect economic development, how does Michigan's business tax system measure up? First, Michigan's overall state and local business taxes are quite competitive, both with the United States as a whole and especially with neighboring states.⁸ According to the 2005 study of state and local business taxation by Ernst and Young for the Council on State Taxation, Michigan's state and local business taxes in Fiscal Year 2004, as a percentage of the value of total private production in the state, were 4.3 percent. Michigan's overall business tax rate is below the U.S. average, and at or below all of our nearby states (see Table 1).⁹

In addition, Michigan's business taxes are below those of many states that are faster growing. Table 2 ranks all states by their percentage employment growth since the last business cycle peak. Of the top ten fastest growing states over this time period, eight have higher overall state and local business taxes than Michigan. Of the ten slowest growing states over this time

⁸The position that Michigan's business taxes are not unduly high has also been argued by others, for example Kleine (2005).

⁹Why should we believe these numbers, and how do we reconcile these numbers with other studies, for example studies by the Tax Foundation that rank Michigan 36th in business taxation (Anderson 2006), or reconcile these numbers with the conventional wisdom that Michigan is a high-business-tax state? First, the methodology described in the Ernst and Young study (2004, pp. 15–17) makes sense. Essentially, data on total tax collections for 25 different state and local taxes is combined with other data that enable these taxes to be allocated between businesses and households. Second, the Ernst and Young authors have a solid academic reputation—for example one of the authors, Bill Fox, is former president of the National Tax Association, the leading U.S. scholarly group concerned with tax analysis and tax policy. Third, the Ernst and Young estimates are consistent with business tax estimates compiled by others, for example the estimates of Boston Federal Reserve economist Robert Tannenwald (2004). Fourth, the Tax Foundation's rankings do not purport to measure the overall business tax burden of state and local taxes; rather, these rankings are a result of an average of a variety of indices of state and local business taxes, with the weighting and measure of different items bearing no obvious relationship to how that item affects a typical firm's tax burden (Fisher 2005, Chapter 2). Fifth, Ernst and Young's numbers do suggest that Michigan is a high-tax state for some very visible taxes. For example, the Single Business Tax is a larger share of business revenues than is constituted by the average state's corporate income tax, and business property taxes in Michigan are a larger share of business tax revenues than in the average state (Ernst and Young 2005, Appendix Table 2). However, Michigan is below the national average in its share of business taxes from sales taxes on business inputs, excise and gross receipts taxes, and licenses. Finally, Michigan's reputation for high business taxes may be based on its past history, stemming from a time when Michigan's business taxes were higher. For example, Ernst and Young's (2004, Figure A-3) figures for FY 2003 for Michigan show that business taxes were 5.0 percent of private gross state product but declined to 4.3 percent in FY 2004.

period, four have lower overall state and local business taxes than Michigan.¹⁰ If we construct a figure with these data (Figure 1), there is no obvious correlation between state and local business taxes and recent state employment growth trends. The calculated correlation between state and local average business tax rates and recent state employment growth trends is actually positive; that is, higher state employment growth is positively associated with higher state business taxes, but the estimated correlation is statistically insignificant.¹¹ These results from this simple data analysis should not be taken to mean that business taxes don't matter to state economic development. A more rigorous analysis would need to consider multiple business cycle periods and control for many more characteristics of states—for example, each state's industrial mix. As mentioned before, on average, more rigorous analyses do find modest effects from state business taxes.

Second, what about Michigan's marginal tax rates on business investment? To my knowledge, there hasn't been any recent comprehensive analysis of such marginal tax rates for all states. The best and most recent work on this issue is Peters and Fisher's (2002) research that looks at marginal tax rates on new branch plant investments in the leading industrial states in

¹⁰How do we reconcile these data with the position that Michigan did well in the 1990s, when it is asserted that business taxes were being cut, compared to the present decade, when it is asserted that business taxes are no longer being cut (Anderson 2006, and in oral testimony on February 14, 2006)? First, as mentioned in a previous footnote, in fact there have been some business tax cuts in Michigan in recent years. Second, a plausible alternative explanation of Michigan's changing fortunes is that the state has risen and fallen with the fortunes of the U.S. auto industry, which probably have little or nothing to do with the state's business tax structure. This is consistent with evidence presented in Bartik, Eisinger, and Erickcek (2003, Figure 14.3) that the portion of Michigan's real GSP growth in manufacturing that cannot be explained by Michigan's industry mix shows no long-run or short-run trends from 1964 until 1999; Michigan's manufacturing industries have on average lost a little bit of national market share over this time period, with year-to-year fluctuations, but there is no sign that this market share loss has trended towards becoming better or worse over this time period or over any particular sub-period. Third, regardless of what happened to Michigan in the 1990s and in this century, this is at most two observations on one state's medium growth trends, which cannot by themselves show much of anything about how taxes or other factors affect state economic development.

¹¹The estimated correlation is 0.11. A regression of state employment growth on the business tax rate results in an estimated coefficient of 0.52, with a standard error of 0.68 in this coefficient estimate.

different industries. In our chapter on Michigan's economic development policy for the book *Michigan at the Millennium*, Peter Eisinger, George Erickcek, and I used Peters and Fisher's data to calculate average marginal business tax rates on new branch plant investment in Michigan compared to nearby states, both before and after the application of typical economic development incentives. Table 3 reproduces the relevant table from our chapter. What this table shows is that Michigan's business tax rate on new branch plants is quite competitive with neighboring states, even without any incentives. After usual property tax abatements, Michigan is even more competitive than nearby states. Finally, with either MEGA incentives or Renaissance Zone incentives, Michigan's business tax rates on new branch plants are far below the rates of nearby states. As mentioned previously, we need more of this type of research, which would use modeling of hypothetical firms to consider a much broader variety of business investment decisions, if we are to do a better analysis of Michigan's business tax system from an economic development perspective.

In addition to tax abatements and other economic development incentives, part of what makes Michigan's tax system quite competitive when considering marginal tax rates on new branch plants are provisions that favor investment and favor export-base companies. Michigan's Single Business Tax has an investment tax credit that cuts the effective tax rate on new investment by over one-third. In addition, the overweighting of the sales tax factor in the Single Business Tax is enormously favorable for export-base companies that sell their goods or services outside the state. This overweighted sales tax factor was recently shifted from a 90 percent weight on sales to a 95 percent weight on sales. At the extreme, for a company that sells all of its goods or services outside the state and has almost all its property and payroll in Michigan, this

implies that the company's effective Single Business Tax rate is lowered by 95 percent from what would be paid by the same company if all its sales were in Michigan.

Third, the marginal tax rate of Michigan's business tax system can be lowered by revisions that would move the Single Business Tax back closer to its original concept, before everyone tried to "fix" it.¹² As originally designed, the SBT included a 100 percent capital acquisition deduction (CAD) that essentially meant that the tax had no effect on marginal incentives to invest in Michigan. The CAD over the years was modified because of concerns that it would be ruled unconstitutional for favoring Michigan investments over out-of-state investments. The Michigan SBT now includes an investment tax credit (ITC), but these credits are usually not high enough to be equivalent to the original CAD in favorable effects on investment incentives. The marginal tax rate on investment of the SBT can be lowered by restoring the CAD to its original 100 percent level or by making the ITC rate the same as the SBT rate; either of these changes would avoid any marginal burden of the SBT on investment. Depending on legal advice, a restored CAD or a larger ITC could apply either only to Michigan investments or to all investments. To avoid business tax revenue losses that might require cuts in public services, which would discourage economic development, expanded SBT investment incentives could be paid for by removing some of the provisions in the SBT that complicate the system and move it away from a true value-added concept. These include the gross receipts deduction, the excess compensation deduction, and numerous other deductions. In addition, with a CAD or ITC that eliminated or significantly reduced the marginal tax burden on business investment, it would not be as important to favor export-based businesses through Michigan's

¹²A good discussion of the changing treatment of investment under the SBT is provided by Hines (2003), who also seems to believe that this tax would be more efficient if its original treatment of capital expenditures was restored.

extreme overweighting of the sales factor. Removing some of these provisions would probably not only finance lower marginal tax rates on investments but also allow a lowering of the overall SBT rate without a revenue loss.¹³

Fourth, the marginal tax rate on investments by export-based businesses can be lowered by SBT revisions that would increase the SBT credit for personal property taxes on industrial property. To avoid a large revenue loss but still provide the same incentive for marginal business investments, this tax credit should only apply to new investments in industrial property. Ideally, this credit would be made refundable, would apply to new investments in real industrial property as well as to personal industrial property, and would be set at a rate of 100 percent. If all of this were done, local tax abatements on new investments in industrial property would become superfluous and could be abolished, which would over time significantly increase local tax revenue. Even though manufacturing companies would then pay increased property taxes, the abolition of abatements would be more than made up for by these SBT refundable tax credits. The tax credits would mean that Michigan's business property tax system would impose no marginal tax burden on new investment from manufacturing businesses. Refundable credits equal in magnitude to current industrial property tax abatements could probably be funded by

¹³Given that the investment tax credit under the SBT already reduces the marginal tax rate on investment by at least one-third, and that this provision costs \$132 million in FY 2006 (Executive Budget Appendix on Tax Credits, Deductions, and Exemptions for Fiscal Year 2006), the total cost of lowering this marginal tax rate on investment to zero probably is less than an additional \$264 million per year. The excess compensation reduction provision costs \$218 million per year, and the gross receipts reduction provision costs \$161 million per year. In addition, the exemption for UI, workers' compensation, and social security payments costs \$151 million per year. If we ignore interaction between these SBT provisions and other SBT provisions, eliminating just these three provisions of the SBT would raise \$530 million per year. In addition, Michigan Senate Fiscal Agency memos from December 14, 2005, and September 14, 2005, suggest that rolling back the sales factor weight raises about \$24 million per 5 percent rollback; e.g., the state would collect \$24 million more in revenue if the sales factor was reduced from 95 percent to 90 percent, and by much more with a more extensive rollback of the sales factor. Therefore, it appears likely that changes in all these SBT provisions could fully finance both expanded investment tax credits and a lower SBT rate.

modifying some of the previously mentioned provisions in the SBT that move the SBT away from a value-added tax base.¹⁴ Permanent, 100 percent tax credits for property taxes on new property investment would probably require some additional sources of financing.

What would be the economic development impact of these suggested reforms?

Unfortunately, it is difficult to estimate the impact with assurance, without having some model that simulates how the population of firms in the state would be affected by these lower marginal tax rates and how they would respond with new investment. Potentially, the impact could be quite significant, as these reforms lower the effective marginal tax rate on industrial investment from the property tax, which is more than 40 percent of overall Michigan business taxes. A proper analysis would need to create a model with a representative sample of Michigan firms and compare how favorable the proposed tax treatment of industrial investment is under my suggested reforms, as opposed to the current SBT investment tax credit, credit for industrial property taxes, and local tax abatements. As I said before, I think it would be feasible to achieve significantly lower marginal tax rates on business investment without sacrificing business tax revenue, if the legislature and governor are willing to substantially limit various deductions in the SBT.

Let me briefly consider other suggested reforms to Michigan's business tax system.

SBT abolition, proposed by, among others, Oakland County executive Brooks Patterson, and implicit in current law after 2009. The problem with this proposal, assuming there is no

¹⁴If the refundable tax credit for new investment in industrial property was limited in term and percentages in a similar manner to the current industrial property tax abatements, the long-run cost of this refundable tax credit would be similar to current property tax abatements, but the costs would be borne by the state rather than by local governments. The FY 2006 estimated cost of industrial property tax abatements, according to the Executive Budget Appendix on Tax Credits, Deductions, and Exemptions, is \$330 million. In the short-run, a refundable tax credit for industrial property through the SBT would have much lower costs, as it would only apply each year to the incremental new investment of that year.

offset by increases in other taxes, is the loss of revenue and the resulting likely loss in public service quality. The economic development research literature suggests that the likely loss in public service quality would have a good chance of more than offsetting the incentive effects of SBT abolition, so that abolition of the SBT could actually harm the state's economic development. Furthermore, abolition of the SBT is not needed for Michigan to have good incentives for economic development, as we can have an SBT that raises significant revenue yet has low or even zero marginal tax rates on capital investment by export-base businesses.

SBT replacement by a gross receipts tax, as proposed by the Detroit Chamber of Commerce (Detroit Chamber 2004). A gross receipts tax suffers from the problem of pyramiding taxes, as a firm and its suppliers will both pay taxes on their gross receipts. This tax structure encourages vertical integration of businesses, in which businesses buy out other businesses in the supply chain to reduce their total tax burden. Also, a simple gross receipts tax does tax marginal business investment. This could be fixed, but only with a revenue loss or a higher gross receipts rate to offset the revenue loss.

Michigan personal income tax abolition, as recently proposed by David Littmann (senior economist at the Mackinac Center) before this subcommittee. Although there is research evidence that higher state and local business taxes have modest negative effects on state economic development, there is not strong research evidence that personal income taxes—at least at the modest rates that states typically impose—have significant negative effects on state economic development. Therefore, I do not think there is a significant research consensus that abolishing a state's personal income tax would significantly improve a state's economic

development. The resulting effects on public services, which also affect economic development, would also need to be considered.

A so-called FairTax, as proposed for the nation by a national coalition and for Michigan by, among others, Michigan Representative Fulton Sheen, the chairman of this committee. The FairTax proposal is essentially a universal sales tax applied to all goods and services, with a rebate for the poor, as a replacement for all other personal and business taxes. I am sympathetic to the general concept of broadening the tax base and lowering rates, particularly in state tax systems, which by their nature are limited in their ability to significantly redistribute income because of personal and business mobility. However, research suggests that the rate required for a broad sales tax to replace other taxes is much higher than estimated by FairTax proponents. At the national level, the research of William Gale (co-director of the Urban Institute–Brookings Institution Tax Policy Center) suggests that the revenue-neutral national FairTax rate is much higher than the 23 percent rate claimed by FairTax proponents, and under plausible assumptions could be greater than a 45 percent sales tax rate (Gale 2005). The basic problems leading to higher estimates of a revenue-neutral FairTax rate include 1) whether it is really politically feasible that government would impose a tax on sensitive consumption items such as housing, health care, food, and credit card interest; 2) the need to allow for realistic amounts of tax evasion; 3) the need to correct for changes in the gap between producer prices and consumer prices. Similar arguments suggest that the FairTax proposed for Michigan of 8.58 percent would not raise enough revenue to fully replace the revenue from the taxes the Michigan FairTax is supposed to supplant (the state income tax, the current state sales tax, the personal property tax,

and the SBT). I agree that Michigan should consider broadening the base of the sales tax, but we should be realistic about what revenue gains are actually feasible from such base broadening.

Wolfram's proposals for SBT reform. Dr. Gary Wolfram (Professor of Economics, Hillsdale College) has proposed an SBT reform package that includes some of the investment incentives I support for the SBT, but that also suggests that businesses be permitted to choose between the value-added tax base and the profits tax base (Wolfram 2005). I think this would result in more volatile business tax revenues, as businesses would opt for the profits tax base during recessionary low-profit years. Professor Wolfram mentions the possibility of forcing businesses to choose which base to use for a number of years; this would still increase the volatility of business tax revenues, as some businesses would be free to switch in any given year, and to the extent that businesses chose the profits tax base, the profits tax base would be more volatile than the value-added tax base. In addition, I have some technical concerns about whether the subtraction method value-added tax that Professor Wolfram proposes is feasible for a state, which, unlike a country, does not control shipments of goods or services over all of its borders. The current SBT is an addition method value-added tax—the tax is calculated by adding various components to profits—and we know such a tax is feasible for a state to implement.¹⁵

In conclusion, state and local business taxes have modest effects on economic development which deserve consideration by state policymakers, but these modest effects should not be exaggerated. State economic development is not only affected by business taxes but also by many other factors, for example public services and the quality of labor. Michigan's business

¹⁵Another proposal for replacing the SBT has been made by Douglas Drake (2003). His essential proposal is to replace the SBT with miscellaneous smaller taxes varying with the type of business. What this loses in economic efficiency it may makeup in political appeal, and in the argument that miscellaneous smaller taxes are more invisible to the business community.

taxes are far more competitive with other states than is commonly understood, as measured both by the average impact of state and local taxes on businesses and by the impact of state and local taxes on marginal incentives for business investment by export-base businesses. Tax reforms could further lower Michigan's marginal tax rates on business investment by export-base businesses without a significant net loss in tax revenue, if some other business tax provisions are simultaneously modified. Such reforms would promote state economic development without costing significant state revenue. Preserving the state's revenue helps maintain public services that are also needed to promote state economic development.

Table 1 Michigan's Overall State/Local Business Tax Rate, Compared to the U.S. Average and Nearby States

State	State & local business taxes, as percentage of private gross state product
Michigan	4.3
U.S. Average, All States	4.7
Indiana	4.3
Ohio	4.5
Illinois	4.8
Wisconsin	4.5

NOTE: Figures come from Table 4 in Ernst and Young (2005) and are calculated for fiscal year 2004.

Table 2 States Ranked by Percentage Employment Growth Since March 2001 Business Cycle Peak, Compared With Overall State & Local Business Tax Rate

State	Pct. change in total nonfarm employment, Mar. 2001–Dec. 2005	State & local business taxes as % of private gross state product
Nevada	18.9	4.5
Arizona	10.9	4.7
Florida	9.4	5.0
Montana	9	5.4
Idaho	8.4	4.2
Wyoming	8.1	9.1
New Mexico	7.8	5.9
Utah	7.3	3.7
North Dakota	4.2	6.2
Maryland	4.1	4.4
Oregon	3.9	3.7
Virginia	3.7	3.6
South Dakota	3	5.3
Washington	3	5.7
Rhode Island	2.8	5.0
Vermont	2.7	5.0
Delaware	2.5	3.5
Nebraska	2.1	5.2
New Jersey	1.8	4.3
Arkansas	1.6	4.2
New Hampshire	1.6	5.1
Maine	1.5	5.8
U.S.	1.4	4.7
Texas	1.4	5.8
Iowa	1.1	4.4
California	1	4.5
West Virginia	0.9	6.5
South Carolina	0.8	4.3
Minnesota	0.8	4.5
Alabama	0.7	4.0
Tennessee	0.7	4.5
Wisconsin	0.6	4.5
Kentucky	0.5	4.2
Kansas	0.3	5.3
Pennsylvania	0.2	4.5
Colorado	-0.2	3.8
Indiana	-0.2	4.3

Table 2. (Continued)

State	Pct. change in total nonfarm employment, Mar. 2001–Dec. 2005	State & local business taxes as % of private gross state product
Georgia	-0.3	3.8
Oklahoma	-0.3	5.4
Connecticut	-0.4	3.8
Missouri	-0.6	3.8
North Carolina	-0.9	3.5
New York	-1.4	5.7
Illinois	-2.8	4.8
Mississippi	-2.8	5.7
Ohio	-3.1	4.5
Massachusetts	-4.8	3.9
Michigan	-5.1	4.3
Louisiana	-10.6	6.0

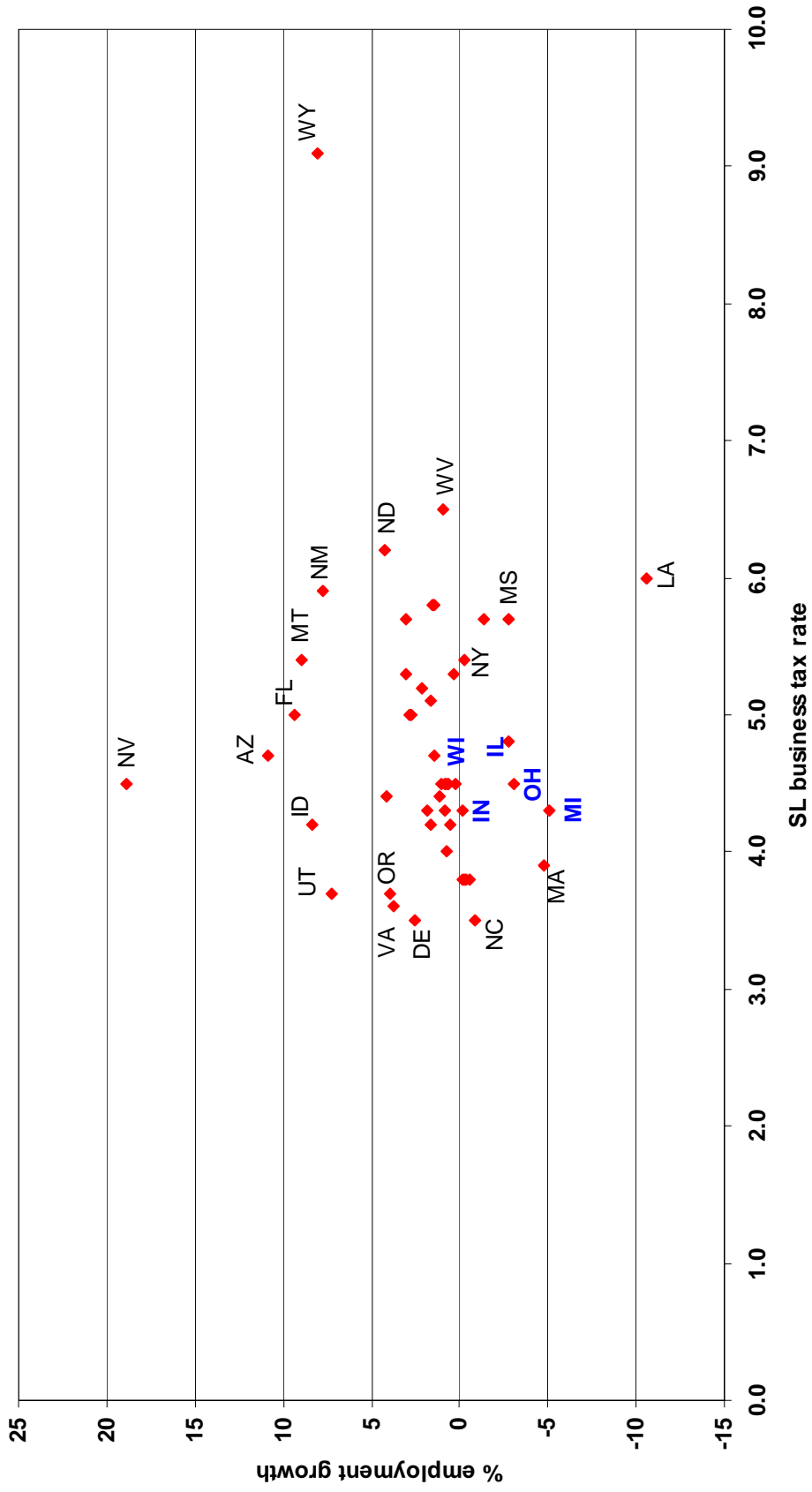
NOTES: Percentage employment growth uses seasonably adjusted figures for nonfarm employment growth, downloaded by author from Website of U.S. Bureau of Labor Statistics. State and local business tax rate comes from Table 4 of Ernst and Young (2005) and are figures for FY 2004. U.S. employment growth and tax burden are averages that include Alaska, Hawaii, and the District of Columbia.

Table 3 Effects of Economic Development Incentives on Effective State and Local Business Tax Rates, Michigan and Nearby States

State	Effective state and local business tax rate without incentives (% reduction in rate of return)	% reduction in state and local taxes due to normal incentives	% reduction after discretionary incentives such as MEGA	% reduction after state and local enterprise zone incentives
Michigan	11.3	27.7	63.6	85.0
Indiana	20.5	20.0		57.1
Ohio	15.0	22.6	28.1	48.8
Illinois	8.6	6.8		25.6
Wisconsin	9.3	0		31.7

NOTES: This table is a reproduction of Table 14.2 in Bartik, Eisinger, and Erickcek (2003). These tables are derived by simulations of the Tax and Incentive Model (TAIM) developed and maintained by Peter Fisher and Alan Peters of the University of Iowa. Fisher and Peters (1998) describe the model in detail. The model is a hypothetical firm model. State and local taxes and incentives are defined as of 1998 in the current version of the model. The results here are based on results for 16 manufacturing industries at the two-digit level (SICs 20, 23-28, 30-38). The average results reported here are aggregated using GDP shares of each industry in Michigan in 1999. The effective state and local business tax rate is defined as the percentage reduction in the internal rate of return in a project located in the state, compared to locating the same project in a hypothetical state that has no state or local taxes. For example, a reduction from a 10% return to an 8% return is a 20% effective tax rate. The percentage reduction in state and local taxes is simply the reduction in taxes with the incentive in question, divided by the taxes if there were no incentives, and multiplied by 100. Both the discretionary calculations and the enterprise zone calculations also assume all the normal incentives are applied, but the enterprise zone calculations also assume that discretionary incentives such as MEGA are not applied. Michigan and Ohio are the only ones of these states that have truly discretionary incentives.

Figure 1 Scattergram Showing Percentage Employment Growth for Each State Since Business Cycle Peak in March 2001, and Overall State and Local Business Tax Rate in Each State in FY 2004



NOTES: This figure simply reports the data from Table 2. Each data marker is one state. To avoid cluttering the figure, I have only labeled selected states.

References

- Anderson, Patrick L. 2006. "State of the Michigan Economy." Presentation to the Michigan House of Representatives, Committee on Tax Policy, Subcommittee on Tax Restructuring. East Lansing, MI: Anderson Economic Group, LLC, February 14.
- Bartik, Timothy J. 1985. "Business Location Decisions in the United States: Estimates of the Effects of Unionization, Taxes, and Other Characteristics of States." *Journal of Business and Economic Statistics* 3(1): 14–22.
- . 1988(a). "Tennessee's Economic Development: A Case Study." Three chapters in *The New Economic Role of American States*, S. Fosler, ed. New York: Oxford University Press, 139–200.
- . 1988(b). "The Effects of Environmental Regulation on Business Location in the United States." *Growth and Change* 19(Summer): 22–44.
- . 1989. "Small Business Start-Ups in the United States: Estimates of the Effects of Characteristics of States." *Southern Economic Journal* 55 (April): 1004–1018. Reprinted in *Entrepreneurship: Critical Perspectives on Business and Management*, Norris Kreuger, ed. London: Routledge, 2002.
- . 1991. *Who Benefits From State and Local Economic Development Policies?* Kalamazoo, MI: W.E. Upjohn Institute for Employment Research.
- . 1992. "The Effects of State and Local Taxes on Economic Development: A Review of Recent Research." *Economic Development Quarterly* 6(1): 102–110.
- . 1993. "Who Benefits from Local Job Growth, Migrants or the Original Residents?" *Regional Studies* 27(4): 297–311.
- . 1994. "Jobs, Productivity, and Local Economic Development: What Implications Does Economic Research Have for the Role of Government?" *National Tax Journal* (December): 847–861. Reprinted in *Tax Policy in the Real World*, Joel Slemrod., ed. Cambridge: Cambridge University Press, 1999. Also reprinted in *Readings in Urban Economics: Issues and Public Policy*, Robert W. Wassmer, ed. Malden, MA: Blackwell Publishers, 2000.
- . 1999. "Growing State Economies: How Taxes and Public Services Affect Private-Sector Performance." In *The End of Welfare: Consequences of Federal Devolution for the Nation*, Max B. Sawicky, ed. Washington, DC: Economic Policy Institute, pp. 95–126.

- . 2004(a). “Economic Development.” In *Management Policies in Local Government Finance*, 5th ed., J. Richard Aronson and Eli Schwartz, ed. Washington, DC: International City/County Management Association, pp. 355–390.
- . 2004(b). “Evaluating the Impacts of Local Economic Development Policies on Local Economic Outcomes: What Has Been Done and What Is Doable?” In *Evaluating Local Economic and Employment Development*, Alistair Nolan, ed. Paris: Organization for Economic Cooperation and Development, pp. 113–142.
- . 2005(a). “Solving the Problems of Economic Development Incentives.” *Growth and Change* 36(2): 139–166.
- . 2005(b). “Increasing the Economic Development Benefits of Higher Education in Michigan.” *Journal of Workforce Development* 1(1): 19–28.
- Bartik, Timothy J., Peter Eisinger, and George Erickcek. 2003. “Economic Development Policy in Michigan.” In *Michigan at the Millennium*, Charles Ballard, Paul Courant, Doug Drake, Ron Fisher, and Elisabeth Gerber, eds. East Lansing, MI: Michigan State University Press, pp. 279–298.
- Detroit Chamber of Commerce. 2004. *Securing Michigan’s Economic Future: SBT Task Force Final Report* (August 6).
- Drake, Douglas C. 2003. “Should Michigan Reform Its Current Business Tax System?” *The Michigan Prospect Online*. Okemos, MI: Michigan Prospect.
http://www.michiganprospect.org/html/budget_tax_policy.html (accessed February 16, 2006).
- Ernst and Young, LLP. 2004. “Total State and Local Business Taxes: A 50-State Study of the Taxes Paid by Business in FY 2003.” *Quantitative Economics & Statistics* (January). Report by Robert Cline, William Fox, Tom Heubig, and Andrew Phillips.
- . 2005. “Total State and Local Business Taxes: Nationally 1980-2004 and by State 2000-2004.” Council on State Taxation (COST) Special Report (April 12). Report by Robert Cline, Tom Neubig, and Andrew Phillips, with William Fox.
- Fisher, Peter. 2005. *Grading Places: What Do the Business Climate Rankings Really Tell Us?* Washington, DC: Economic Policy Institute.
- Fisher, Peter S. and Alan H. Peters. 1998. *Industrial Incentives: Competition Among American States and Cities*. Kalamazoo, MI: W.E. Upjohn Institute for Employment Research.
- Fisher, Ronald C. 1997. “The Effects of State and Local Public Services on Economic Development.” *New England Economic Review* (March/April): 53–67.

- Gale, William G. 2005. "The National Retail Sales Tax: What Would the Rate Have to Be?" *Tax Notes* (May 16): 889–911.
- Helms, Jay L. 1985. "The Effect of State and Local Taxes on Economic Growth: A Time Series Cross Section Approach." *The Review of Economics and Statistics* (February): 574–582.
- Hines, James R., Jr. 2003. "Michigan's Flirtation with the Single Business Tax." In *Michigan at the Millennium*, Charles L. Ballard, Paul N. Courant, Douglas C. Drake, Ronald C. Fisher, and Elisabeth R. Gerber, eds. East Lansing, MI: Michigan State University Press, pp. 603–628.
- Kleine, Robert. 2005. "Evaluating Michigan's Business Taxes." *The Michigan Prospect*. http://www.michiganprospect.org/articles_html/op_ed_tax_cuts_print.html (accessed February 16, 2006).
- McGuire, Therese J. 2003. "Do Taxes Matter? Yes, No, Maybe So." *State Tax Notes* (June).
- Michigan Department of Treasury. 2006. *Executive Budget Appendix on Tax Credits, Deductions, and Exemptions: Fiscal Year 2006*.
- Michigan Senate Fiscal Agency. 2005(a). *Memorandum on Business Tax Package Passed by the House* (September 14).
- . 2005(b). *Summary of Legislatively Passed Single Business Tax Reduction* (December 14).
- Munnell, Alicia H. 1990. "How Does Public Infrastructure Affect Regional Economic Performance?" *New England Economic Review* (September/October): 11–33.
- Peters, Alan H., and Peter S. Fisher. 2002. *State Enterprise Zone Programs: Have They Worked?* Kalamazoo, MI: W.E. Upjohn Institute for Employment Research.
- Tannenwald, Robert. 2004. "Massachusetts Business Taxes: Unfair? Inadequate? Uncompetitive?" *Public Policy Discussion Papers* 04-04. Boston, MA: Federal Reserve Bank of Boston. Available online at <http://www.bos.frb.org/economic/ppdp/index.htm>.
- Wasylenko, Michael. 1997. "Taxation and Economic Development: The State of the Economic Literature." *New England Economic Review* (March/April): 37–52.
- Wolfram, Gary. 2005. "Introductory Discussion of an Alternative to the Single Business Tax." Hillsdale, MI: Hillsdale Policy Group Ltd.