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October 19, 1988

Public Sector Reports

PUBLIC POLICY ADVISOR

The Michigan Single Business Tax: Burden or Benefit?

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INTRODUCTION

The Michigan single business tax (SBT) has generated considerable controversy during its nearly 13 years of existence. One reason is that it is unlike any other tax levied in this country. Of the 45 states that levy a general tax on business, 44 use net income (or profits) as the tax base. Only Michigan uses the value added during the processing of a raw material or service, with a number of adjustments, as its business tax base. Most businesspeople do not understand the concept of value added, and many are unhappy with a tax that must be paid even when their business does not earn a profit. As a result, there have been numerous proposals over the years to repeal the SBT. The most recent was put forward last May, when Governor Blanchard proposed to replace the SBT with a profits tax for small firms. In response, the Republican-controlled Senate introduced legislation to allow some firms the option of paying either a profits tax or the SBT. This paper discusses the concept of taxing the value added, examines the history of the SBT, analyzes the current proposals, and recommends changes in the tax.

WHAT IS A VALUE-ADDED TAX?

A value-added tax (VAT) is a form of sales tax levied on the difference between the cost of goods purchased from other businesses that went into the product and the value of the product at sale. In a typical business operation, a firm purchases materials from its suppliers and produces a product or service by processing, manufacturing, distributing, or otherwise "adding value" to goods, services, and materials purchased from other firms. The value added may be calculated in various ways, but it is easiest to think of it simply as the increase in value between a firm's purchases of goods and its sales. If a firm buys $60 worth of raw materials from other firms and produces a product that sells for $100, the value added is $40. A 10 percent tax would produce a tax liability of $4.

Since most firms usually produce a good for the market, it is convenient to think of the retail price or value of a product or service as being equal to the total of all values added in the production and distribution process. A loaf of bread, for example, will sell for the total of the value added by the farmer, miller, baker, trucker, grocer, and anyone else involved in getting it to the consumer. Thus, a value-added tax that extends through the retail level would collect essentially the same amount of tax on a product as would a retail sales tax levied at the same rate of tax. The difference is that the sales tax is collected exclusively at the retail level, whereas a VAT is collected at each stage of the production-distribution process or directly from each firm, depending on the method of calculation used. (See discussion below.)

There are three ways in which a VAT may be levied: on gross product, on income, or on consumption. The difference is how capital is treated. If gross product is taxed, neither the cost of capital invest-

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ment nor its depreciation is deducted. Under the income variant, the cost of capital investment is not deducted, but the depreciation on it is deducted. A VAT levied on consumption provides a deduction for the cost of capital investment but not for its depreciation. (The Michigan SBT law requires that depreciation be added back to the tax base as it is deducted from federal taxable income, which is the starting point for calculating the tax.) The Michigan SBT is a consumption VAT.

Although value added most easily is thought of as the difference between a firm's sales and its purchases, the tax liability may be calculated by three methods: subtraction, credit, or addition. The three methods are illustrated in Exhibit 1. Under the subtraction method, a firm calculates its VAT liability by subtracting its outside purchases from its sales and applying the tax rate to the difference.

EXHIBIT 1

Comparison of Three Methods of Calculating Value-Added Tax Liability (10 percent value-added tax)

		Stage of Production			
		Firm A Manufacturer	**Firm B Wholesaler**	**Firm C Retailer**	**Total Economy**
1.	**Subtraction Method**				
	Sales	$350	$850	$1,100	$2,300
	Purchases	100	350	850	1,300
	Value added (sales minus purchases)	250	500	250	1,000
	VAT	25	50	25	100
2.	**Credit Method**				
	Sales	$350	$850	$1,100	$2,300
	Tax on sales	35	85	110	230
	Purchases	100	350	850	1,300
	Tax on purchases	10	35	85	130
	VAT liability (tax on sales less tax on purchases)	25	50	25	100
3.	**Addition Method**				
	Factor payments plus net profit				
	Wages	$150	$300	$200	$650
	Rent	50	100	20	170
	Interest	25	75	20	120
	Profit	25	25	10	60
	Total	250	500	250	1,000
	VAT	25	50	25	100

SOURCE: U.S. Department of the Treasury, *Tax Reform for Fairness, Simplicity, and Economic Growth,* November 1984.

Under the credit method, which is used most commonly in levying a VAT, a firm's tax liability is determined by allowing the firm to subtract the VAT it paid on purchases from the tax it owes on its sales. An important characteristic of the credit method is that the tax on a product depends on the tax rate that prevails at the final taxable stage, such as the retail level. Thus, any VAT evaded by firms prior to the retail level would result in higher taxes at that level. This discourages tax evasion and is a major reason the VAT is widely used in Europe and elsewhere in the world.

Under the addition method, which is used to calculate the Michigan SBT, a firm's VAT liability is calculated by adding up the components of value added (wages, rent, interest, depreciation, and profit) and applying the tax rate to that sum.

HISTORY OF THE MICHIGAN SBT

The Michigan SBT was adopted in 1975 (effective January 1, 1976) to replace the corporate income tax, the financial institutions income tax, the corporate franchise tax, the savings and loan association privilege fee, the local property tax on inventories, and the intangibles tax on business. The adoption of the SBT marked a return to the value-added concept that prevailed from 1953 to 1967 in the form of the Business Activity Tax (BAT). The BAT was never very popular with small business and was replaced by the corporate income tax in 1967 as a complement to the newly enacted personal income tax. As indicated in Exhibit 2, the corporate income tax (the largest revenue source replaced by the SBT) was very unstable. It also was unpopular with many large corporations because it was applied to their worldwide income, and for this and other reasons it was the subject of much litigation.

EXHIBIT 2

Corporate Income Tax Collections, FY 1968-69 to FY 1987-88

Fiscal Year	Amount (millions)
1968[a]	$38.5
1969	210.4
1970	185.0
1971	151.2
1972	260.0
1973	357.8
1974	295.2
1975	223.3
1976[a]	155.0
1977-1988[b]	57.4

SOURCE: Senate Fiscal Agency.
[a]Partial year
[b]The tax was repealed as of December 31, 1975, but residual payments have been received every year.

The first effort to enact a true VAT was in 1972, when the tax was included in a ballot question that proposed changing the method of financing K-12 education. The proposal would have replaced a portion of the revenues from the school property tax with revenues from a VAT and from an increase in the personal income tax. The proposal was not approved by the voters, and the VAT did not surface again until 1975, when the state was facing a fiscal crisis due to the deep 1974-75 recession.

Governor Milliken proposed a value-added tax as a means to raise additional revenue and to reform the taxation of business in Michigan. The change was recommended for five major reasons.

- The value added to goods and services is a much more stable tax base than corporate profits, particularly given the cyclical nature of the Michigan economy. As indicated in Exhibit 3, SBT revenue has grown at about the same rate as personal income; it declined in dollar amount only in two years, FY 1980-81 and FY 1986-87, in the latter case due to factors not related to economic activity.
- A VAT is more favorable to capital investment than a corporate profits tax, as it allows the immediate deduction of capital investment (under the consumption variant) and is levied on both labor and capital, whereas the corporate profits tax is levied on capital only. The investment write-off can be particularly beneficial to new firms.

EXHIBIT 3

Michigan Single Business Tax Collections, FY 1976-77 to FY 1987-88

Fiscal Year	Amount (millions)	% Change from Previous FY	% Change In Michigan Personal Income from Previous FY	As a % of Michigan Personal Income
1976	$288.5[a]	NA	NA	—
1977	803.5	NA	NA	—
1978	899.4	11.9	11.6	1.12%
1979	1,001.3	11.3	10.1	1.13
1980	1,076.0	7.5	6.2	1.14
1981	942.3	-12.4	6.4	0.94
1982	943.2	0.1	1.1	0.93
1983	999.7	6.0	6.1	1.93
1984	1,289.2	29.0	9.9	1.09
1985	1,372.7	6.5	8.0	1.08
1986	1,521.9	10.9	6.2	1.12
1987	1,497.6	-1.6	4.2	1.06
1988	1,715.0 (est.)	14.5	4.5 (est)	1.16 (est.)
1977-1988	—	113.4%	104.6%	—

SOURCE: Senate Fiscal Agency.
[a]Partial year. The tax took effect on January 1, 1976.
NA = Not applicable.

- Compared to other business taxes, a VAT is fairer because it covers all forms of business, not just corporations, and is more neutral because it taxes all business activity, not just profits. The more neutral a tax, the less it interferes with the natural workings of the marketplace.
- A single tax on business is easier to administer and to pay than are several separate taxes.
- The transition from the old to the new system of taxation resulted in a one-time revenue gain of about $200 million needed to balance the budget. (On an annual basis, however, the SBT rate was set to generate the same revenue at the time of adoption as had been generated by the taxes it replaced.)

Two additional advantages of a VAT compared with a corporate income tax are that (1) the VAT is not directly tied to the federal tax code and subject to the vagaries of Congress, and (2) the VAT, in effect, is a sales tax on services, which escape taxation in many states. The tax proposal originally submitted to the legislature was for a 2 percent addition method VAT with a low base exemption and no credits or other exemptions. When it became apparent that many firms would be faced with very large tax increases, however, the legislature made numerous changes and added several special provisions. Some were designed to ease the transition to the new system, and others were the result of heavy special-interest lobbying. The major changes include an increase in the base exemption, a deduction for firms with high labor costs, a deduction that limited the tax base to 50 percent of gross receipts, and a credit for unincorporated businesses. Accommodating these measures required an increase in the tax rate to 2.35 percent. Largely because of the small business and labor intensity provisions of the SBT, revenues have been more cyclical than under a pure VAT.[1]

The SBT barely passed in the legislature and was soon under attack from a number of firms that found their tax bill much higher than under the old system. Protest came mainly from unincorporated businesses in the services sector, particularly such professionals as doctors and lawyers, and from construction contractors, farmers, and low-profit corporations in manufacturing and services. In response to the storm of criticism, Governor Milliken appointed a task force to recommend revisions. The major change proposed was a credit for small, low-profit firms with (1) gross receipts of $3 million or less, (2) adjusted business income of $300,000 or less, and (3) no shareholder or officer paid more than $60,000. The credit, which was limited to 50 percent of the tax liability, was adopted by the legislature in 1977 along with several other changes, including the exemption of agriculture from the SBT.

Beginning in 1984, the eligibility limits for the small business tax credit were increased to (1) gross receipts of $6 million, (2) adjusted business income of $450,000, and (3) shareholder or officer income of $90,000, and the 50 percent maximum was raised to 90 percent. Exhibit 4 illustrates how the credit operates. Note how the credit increases as adjusted business income (profitability) declines. In effect, the small business credit turns the tax into an income tax for many small firms.

1 Even without all the special provisions the SBT would not be a pure VAT because rent paid is excluded from the base and rent received included, and the tax is levied on a destination rather than a point of origin basis. Firms having sales in the state but no payroll or property in the state are subject to the tax, whereas a pure VAT would tax only firms with payroll and property in the state. This could be done by using a two-factor allocation formula (payroll and property) rather than a three-factor allocation formula (payroll, property, and sales). However, such a change would be unpopular, as it would increase taxes on in-state firms and reduce taxes on outstate firms.

EXHIBIT 4

SBT Small Business Credit, Illustrative Examples

Value-Added Base	Base after Reductions	Adjusted Business Income	Tax before Credit	Credit (90% Maximum)	Tax after Credit	Tax as % of Adjusted Business Income
$ 100,000	$50,000	$50,000	$1,175	$0	$1,175.00	2.35%
100,000	50,000	40,000	1,175	153.56	1,044.44	2.61
100,000	50,000	30,000	1,175	391.67	783.33	2.61
100,000	50,000	20,000	1,175	652.78	522.22	2.61
100,000	50,000	10,000	1,175	913.89	261.11	2.61
100,000	50,000	0	1,175	1,057.50	117.50	0
1,000,000	700,000	300,000	16,450	5,483.33	10,966.67	3.66
1,000,000	700,000	200,000	16,450	9,138.89	7,311.11	3.66
1,000,000	700,000	100,000	16,450	12,794.44	3,655.56	3.66
1,000,000	700,000	50,000	16,450	14,622.22	1,827.78	3.66
1,000,000	700,000	0	16,450	14,805.00	1,645.00	0

SOURCE: Taxation and Economic Policy Office, Michigan Department of Treasury.

NOTE: For FY 1980-81, about 30,500 firms received a small business credit that reduce taxes by about $25.6 million. This credit was of particular benefit to firms in forestry, fisheries and agriculture, construction, and retail trade. For example, in the forestry and fishery sector, the credit was equivalent to a tax base reduction of 6.4 percent. More than 70 percent of small business credits went to firms in the retail, services, and construction sectors.

Despite the various revisions, there has been periodic criticism from segments of the business community. Dissatisfaction with the SBT increases when the economy is weak and many firms experience low profits or losses. The major complaints have been that the SBT imposes a large burden on small businesses, that it is levied even when a firm loses money, and that unemployment and workers' compensation payments should not be included in the base of the tax. From time to time, automobile dealers have protested the inclusion of interest paid in the base.

The decision to use the addition method to calculate the tax base probably has contributed to dissatisfaction because it makes the taxable components more visible. The advantage, however, is to make the tax more understandable, and the addition method is similar to that used to calculate an income tax, with which most businesspeople are familiar.

RECENT PROPOSALS FOR CHANGE

In May 1988 Governor Blanchard proposed that the SBT be replaced by a profits tax for firms with gross receipts of less than $7 million. (The governor's proposal is in HB 5669, under consideration by the House Taxation Committee.) In response, the Senate introduced SB 878, which would eliminate the small business credit and allow some firms the option of paying either the SBT or a 4 percent profits tax. (This bill has passed in the Senate and is now also in the House Taxation Committee.) To qualify for the optional tax contained in the Senate bill, a business must have (1) gross receipts of no more than $7 million, (2) federal taxable income (business income) of no more than $550,000, and (3) no officer or shareholder paid more than $110,000.

Both the governor's and the Senate's proposal would provide a significant tax reduction for a large number of small and medium-sized firms. The Senate Fiscal Agency has estimated that 40,000 to 50,000 firms would qualify for the optional profits tax in SB 878, compared to 30,000 firms currently receiving the small business credit; the resulting revenue loss to the state would be $35 million to $50 million. The governor's bill is roughly revenue neutral.

The few firms that would pay higher taxes under SB 878 are those currently eligible for the small business credit because they have a low taxable SBT base relative to the total tax base. For example, a small firm with $100,000 in value added, including $9,000 in profits, currently pays $211 in taxes, but it would pay $360 if subject to the 4 percent profits tax. Because of the loss of the small business credit, this firm would pay more than $360 if it opted to pay the SBT.

COMMENT AND RECOMMENDATIONS

There are four major problems with the proposals to turn the SBT into a profits tax for small firms. First, a system that imposes different types of taxes on firms on the basis of their size or profitability is inequitable. It is likely that two competing firms of similar size, for example, with $6 million and $8 million in gross receipts, respectively, could be taxed on a completely different basis. The tax burden would be shifted from low-profit to high-profit firms. In many cases, efficient firms would be subsidizing government services for inefficient firms; an efficient firm that earns good profits should not be so penalized.

Second, allowing an option adds instability to a tax system even more than does a straight profits tax. During an economic downturn, when profits are lower, many firms would choose the profits tax; during a recovery, when profits are higher, they would switch to the SBT. This would cause wide swings in revenue collections, although limiting this option to small firms reduces the effect significantly.

Third, it is fallacious to argue that small (or any size) firms should not pay taxes when they report no profits. The underlying concept of a value-added tax is that firms should pay for government services they receive. Since these services continue even when a firm is unprofitable, paying taxes to support them also should continue. The local property tax is a type of levy for benefits received in that payments are due regardless of the profitability of the firm, yet no one is proposing to turn the property tax into a profits tax. Furthermore, critics of the SBT fail to remember that most of the taxes repealed when the SBT was enacted also were not based on profits.

Fourth, the perception that the SBT places an unfair burden on small business is false. On average, firms with tax bases of less than $500,000 pay a lower-than-average effective rate. Specifically, the effective rate rises from .13 percent for the smallest firms to 1.68 percent for businesses with tax bases between $2 million and $5 million, and it then declines to 1.43 percent for firms with tax bases above $5 million. As Exhibit 5 shows, firms with a tax base of $500,000 or less account for 91.3 percent of all businesses, but they pay only 15 percent of the total tax. Also, the total dollar burden is light for most small firms, averaging $475 or less for 77 percent of all firms. About 60 percent of all firms have no SBT liability. (See Exhibit 6.) In a 1985 report on the SBT the Michigan Department of Treasury concluded:

EXHIBIT 5

Distribution of Businesses by Adjusted Tax Base, FY 1982–83

Adjusted Tax Base Class	Number of Businesses	% of Businesses	% of Michigan Tax Base	% of Adjusted Tax Base	% of Tax Paid
$ 0	17,580	13.9%	-0.8%	-8.5%	0%
1–39,999	27,507	21.8	1.3	1.3	0.1
40,000–99,999	35,077	27.8	4.4	5.2	2.2
100,000–499,999	35,075	27.8	14.8	17.3	12.7
500,000–999,999	5,630	4.4	7.7	9.0	7.9
1,000,000–1,999,999	3,004	2.4	8.2	9.6	9.2
2,000,000–4,999,999	1,670	1.3	9.9	11.5	11.5
5,000,000–	873	0.7	54.4	54.6	56.4
TOTAL	126,416	100.0	100.0	100.0	100.0

SOURCE: Taxation and Economic Policy Office, Michigan Department of Treasury.
NOTE: Adjusted tax base is the apportioned (Michigan) tax base minus capital acquisition deductions. Only those businesses filing SBT returns and part of the tax rate sample are included.

The SBT does not discriminate against smaller firms, but rather taxes smaller firms at a lower rate, on average. Firms with a tax base of less than $500,000 have an effective SBT rate below the state average. For these smallest firms, the $40,000 statutory exemption and the capital acquisition deduction are the major factors reducing taxes.[2]

Our view is that the SBT is a fair, stable source of revenue and should be retained with minor modifications. In FY 1987-88, the SBT generated about $1.7 billion in revenue, approximately 16.5 percent of total state tax revenue. To generate the same amount of money with a corporate income tax would require a rate of about 15 percent (in an average year). This would be the highest rate in the nation and obviously would hurt the Michigan business climate. Also, in a major downturn, revenues could decline as much as $700 million, creating nearly unmanageable budget problems.

Any reforms of the SBT should be designed to simplify the tax, remove special provisions, and reduce the tax rate. Specifically, all special provisions, other than the capital acquisition deduction and a small statutory exemption, should be phased out over several years. These should be replaced with a sliding scale credit based on adjusted business income (the credit should not exceed 50 percent), and the SBT rate should be reduced to 1.8 or 1.9 percent. HB 5714, which is in the House Taxation Committee, eliminates many of the special provisions and reduces the rate to 1.95 percent. This bill, however, is part of a legislative package (HBs 712-5717) that makes a number of revisions in the SBT, some of which are improvements and some not. The changes proposed here, which would make the tax simpler for the taxpayer and the tax collector as well as more equitable for business, would improve the business climate in Michigan.

2 Taxation and Economic Policy Office, Michigan Department of Treasury, *Michigan Single Business Tax*, January 1985, p. 15.

EXHIBIT 6

Single Business Tax Liability, by Liability Classification, 1982-83 Tax Year

Tax Liability Class	Number of Businesses	% of Businesses	Cumulative % of Businesses	Amount of Tax Paid	Average Tax per Firm	Cumulative % of Tax Paid
Did not file form						
No liability[a]	38,000	17.35%	17.35%	$0	$0	0.00%
Filed short form						
No liability[a]	47,700	21.78	39.14	0	0	0.00
Filed complete form						
No liability	47,389	21.64	60.78	0	0	0.00
$0 –100	6,312	2.88	63.66	309,664	49	0.03
100 –1,000	29,283	13.37	77.04	13,920,349	475	1.50
1,000 –5,000	32,230	14.72	91.76	76,486,833	2,373	8.25
5,000 –10,000	7,836	3.58	95.34	55,179,976	7,042	5.95
10,000 –50,000	8,146	3.72	99.06	141,974,714	21,110	18.54
50,000 –100,000	1,121	0.51	99.57	77,766,892	69,372	3.39
100,000 –500,000	805	0.37	99.94	158,397,514	196,767	17.08
500,000–1,000,000	76	0.03	99.97	53,346,983	688,776	5.64
Greater than $1,000,000	66	0.03	100.00	320,953,294	4,862,929	34.61
Total for all classes[a]	218,961	100.00%	100.00%	$927,326,040	$4,235[b]	100.00%

SOURCE: Michigan Department of Treasury.
[a]Estimate.
[b]The average liability for firms that pay is $10,799.

Robert J. Kleine is the senior economist at Public Sector Consultants, Inc. He has extensive experience in state budget, taxation, and economic issues. As director of the Michigan Office of Revenue and Tax Analysis, he was responsible for state revenue and economic forecasting, tax analyses, and assessment of the implication of proposed tax legislation. He played a major role in developing the state single business tax and the property tax relief program.

More recently, Mr. Kleine served as senior analyst in public finance at the Advisory Commission on Intergovernmental Relations in Washington, D.C. His studies on cigarette tax evasion, value added taxation, federal tax reform, revenue and program turnbacks, and state and local tax systems received national recognition.

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