



House Research Department

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Evaluating How to Cut Minnesota’s Business Taxes

by Joel Michael, Legislative Analyst

An examination of the economic principles for cutting state business taxes

Legislators frequently propose to cut business taxes—often because they hope to encourage investment or more business activity in Minnesota, but also for other reasons. This publication describes the basic principles that economic theory suggests should be used to evaluate tax policy and, then, applies those principles to some of the most common proposals for Minnesota state business tax cuts. It does not discuss whether or how much Minnesota business taxes should be reduced, though.

Basic tax policy principles are widely accepted—fairness or equity, neutrality, simplicity, and so forth. But evaluating business taxes and tax cuts presents some special challenges. In particular, although business entities legally are required to “pay” taxes, business firms are only legal entities or constructs; the final burden of business entity taxes must fall on (reduce the income or wealth of) individuals—the

people who own the businesses, work for them, or sell to or buy from them. Thus, in applying policy principles to business taxes (particularly the equity principle), a key issue is who ultimately bears the tax and who will benefit from a tax reduction. Unfortunately, there is not a consensus as to these effects, because they involve complex issues of how human behavior responds to tax policies.

Although not a classic tax policy principle, the most common

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The most common rationale that legislators use to support business tax reductions is to stimulate in-state economic activity

rationale that legislators use to support business tax reductions is to stimulate in-state investment and economic activity. But evaluating the merits of these claims is difficult. Empirical studies show mixed results of the correlation between business taxes and a state's economic growth, even though theory predicts a causal relationship (crudely, reducing tax yields more investment or economic activity; increasing tax yields less). To the extent effects occur, the studies suggests they are likely small. Moreover, common sense and theory suggest being cautious in relying on business tax cuts yielding a sort of “fiscal dividend”—that is, producing a net increase in state revenues (over the amount of the reduced business taxes paid and the cost of public services related to any expanded business activity).

These considerations may suggest:

- Since the equity effects of business tax cuts are uncertain, focus should be directed to the other principles in designing tax cuts, such as neutrality, simplicity, and transparency. That could argue for reducing the most complex and the least neutral business taxes—for example, the corporate franchise tax, which is widely accepted to be the most complex state tax and which applies a higher level of state tax to a small subset of businesses (mainly publicly held companies).
- If the goal is to increase investment and economic activity or to seek a fiscal dividend, the best approach is to focus the tax cut on firms that (1) are engaging in the desired activity (investment, hiring, and so forth) in Minnesota; (2) can locate or expand outside Minnesota; and (3) have more highly paid employees or are more profitable (i.e., people who are more likely to pay more in tax than they use in government services). These considerations would help to focus the tax cuts on businesses that are more likely to yield the desired effects—the potential for more investment, economic activity, and revenue—although there are no guarantees. They probably favor reductions in the sales tax on capital purchases over across-the-board property or income tax reductions.

About House Research Department Primers

The House Research Department is the research and legal services office of the Minnesota House of Representatives. Primers are designed to educate legislators on matters of public policy that will inform their legislative decision making.

The author **Joel Michael** is a legislative analyst specializing in the area of tax policy. For questions about this issue, contact Joel at joel.michael@house.mn.



Introduction

Legislators often propose to reduce Minnesota’s business taxes. The 2017 Legislature, for example, enacted substantial business tax reductions as part of an overall tax reduction bill.¹ A common rationale is to increase investment or economic activity in the state, although occasionally other justifications are offered. This publication discusses some basic policy considerations that may be helpful to legislators in deciding which business tax to cut and how to do so. It does not discuss whether business taxes should be cut or by how much, but rather how to do so.

The publication has three parts:

- A discussion of the basic tax principles used to assess changes in tax policies
- A description of four frequently proposed options for a general Minnesota business tax reduction
- A table that applies the basic tax principles to the common options

Evaluation Criteria or Tax Principles

The principles for evaluating tax policy are well known by public finance economists and analysts, frequently restated in tax studies, and widely accepted as conventional wisdom.²

The generally accepted principles are:

- Equity, both vertical and horizontal
- Neutrality
- Revenue adequacy
- Ease of compliance and administration
- Simplicity and transparency
- Competitiveness

These basic principles are used to evaluate existing taxes, as well as tax

¹ *Laws 2017, 1st spec. sess. ch. 1. The main reductions were made in the state general tax imposed on commercial-industrial properties—by exempting the first \$100,000 of market value from the tax and by repealing the annual increase in the amount of the levy.*

² *See, e.g., Richard A. Musgrave and Peggy B. Musgrave, Public Finance in Theory and Practice, 235 (3rd ed. 1980) for one of the standard public finance textbook’s statement of the “Requirements for a ‘Good’ Tax Structure[.]” A version of these principles is codified as “property tax principles” in the Property Tax Benchmark statute. Minn. Stat. § 270C.991, subd. 2. The Minnesota Department of Revenue uses them in evaluating property tax bills.*

In evaluating proposals for cutting taxes, economists consider a variety of principles:

- **Equity**
- **Neutrality**
- **Revenue adequacy**
- **Ease of compliance and administration**
- **Simplicity and transparency**
- **Competitiveness**



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increases and reductions. This section discusses how to use these criteria to evaluate business tax cut proposals.

Equity

How will the tax cut affect the “fairness” of the tax or tax system generally?

This principle evaluates how the benefits of the tax cut are distributed among individuals.³ There are two dimensions to the equity principle:

Equity evaluates how the tax cut affects the “fairness” of that tax

- **Vertical equity**—is the tax cut progressive, proportional, or regressive? A progressive tax imposes a larger percentage tax as income increases, while a progressive tax cut would provide larger percentage tax reductions as income decreases. Conversely, a regressive tax imposes a smaller percentage tax as income increases, while a regressive tax cut would provide smaller percentage tax reductions as income increases. There is no consensus as to whether taxes should be progressive (or how progressive), but most agree that they should not be regressive.
- **Horizontal equity**—does the tax reduction treat individuals in equal circumstances (e.g., with the same amount of income or consumption) equally?

Business firms are intermediaries and business taxes ultimately are borne by individuals. Thus, analysis of equity must look beyond the business that remits the tax to the individuals who ultimately bear its burden through their transactions or relationships with the business. Judging which individuals end up paying business taxes (or benefit from reductions) is complex and experts often disagree about the effects. Three factors are worth noting:

- **The individuals who ultimately benefit from a business cut will depend on how businesses adjust their prices or input costs in response.** The result depends upon market behavior—will the business reduce its prices (giving the benefit of the tax cut to its customers), increase its wages paid (benefiting labor), or increase its dividends or owners’ distributions

³ *This discussion assumes that the tax is not being justified under the “benefit principle”—that is, it is not a charge for or designed to be in proportion to the government benefits received by the payer, such as maintaining roads and highways, snowplowing, and the like. Rather, it is a tax intended to raise general revenues. A benefit tax or user charge is akin to paying for the public services the payer uses. In that sense, it is unlike a traditional “tax” that generates revenues for general government purposes. The gas tax, which is used to fund construction and maintenance of roads and bridges, is a common benefit tax, since it is imposed in rough proportion to use of the highways, streets, and roads.*



(benefiting capital)? The responses may ripple through several layers by affecting the prices and wages of supplier firms. The responses will vary based on the market that the business operates in and how many of its competitors receive the tax cut. If the business operates in a market where its competitors are not affected by a Minnesota tax cut, its managers and owners can choose what to do with the savings. But if most or all of the firms it competes with receive the tax reduction, the market may compel the business to pass along the cut to its customers. *Thus, effects vary based on the types of businesses affected by the tax cut and the markets they operate in.*

- **The Department of Revenue tax incidence study provides estimates and underlying assumptions of these shifting effects for the existing Minnesota tax system.**⁴ However, the study is clear that these estimates should not be used to judge the effects of changes in tax policy—increases or reductions in tax—because they are based on average incidence, not incremental policy changes.⁵ The study suggests that increases in business taxes are more likely to fall on consumers or labor than the amounts reported in study. Similarly, reductions are more likely (in the long-run) to reduce the tax paid by consumers as higher prices and by labor in lower wages and to be more progressive than the business taxes are on average.
- **Short-run and long-run effects need to be distinguished—how businesses use a tax reduction may differ in the short-run, compared with assumed long-run effects.** In some cases, proponents of a business tax cut may contend it will lead to businesses investing in or relocating to Minnesota, but that may not be easy given various other factors that constrain businesses. The high costs of relocation (or even changing where marginal investments are made) may require a business to expect long-term payback in tax savings. But because tax rules change regularly due to constantly shifting political sands, it may not be clear how permanent a tax cut really is and whether it justifies making a significant long-term business investment.⁶ Reductions targeted to businesses competing in national

⁴ *Minnesota Dep't. of Revenue, 2017 Minnesota Tax Incidence Study, Appendix B, pp. 98–109 (March 28, 2017). The assumptions used in the DOR study are widely accepted as conventional wisdom in Minnesota policy circles. However, the consensus by experts on the appropriate assumptions may be less clear. See, e.g., Juan Carlos Suarez Serrato and Own Zidar, Who Benefits from State Corporate Tax Cuts? A Local Labor Markets Approach with Heterogeneous Firms, NBER Working Paper No. 20289 (July 2014) (finding capital bears a larger share of state corporate taxes than DOR's assumptions).*

⁵ *Ibid.* pp. 64 – 65; 109 for a discussion of this effect.

⁶ *This is a complicated calculus, since the firm must judge not just the effects of the current tax policy in Minnesota and the potential location states, but if a large capital investment*



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Neutrality evaluates how the tax reduction affects market behavior

markets may take a long time to generate benefits, if the assumption is that these reductions will lead to increased investments and business operations in Minnesota. In the short run, the primary effect of these reductions may simply be to increase profits of local businesses (benefiting owners, not workers or purchasers of the firm's output). Short-run effects that differ from long-run assumptions could persist for long periods.

Neutrality

How will the tax reduction (or revised tax structure) affect behavior?

The neutrality principle is premised on the idea that taxes should affect private market behavior as little as possible. This is sometimes called the efficiency principle, using "efficiency" in the technical way that economists do. Nearly all taxes affect or can affect behavior, so this principle favors policies that minimize those effects.⁷ It is based on the notion that markets are generally the best way to allocate scarce resources. Applying the principle to tax reductions suggests cutting taxes that most distort market decisions.

This principle generally favors two business tax reduction policies:

- **Business taxes should be roughly scaled to the cost of providing the public services directly used by business firms.** This approach recognizes the reality, described above, that businesses pass the taxes they pay on to individuals; the tax will ultimately be embedded in a business firm's prices, wages, or the returns on its capital. Since who pays will be unclear (because of the uncertainty associated with shifting as discussed above), it is generally thought best to structure business entity taxes like benefit taxes and primarily fund other government services with broad-based taxes imposed directly on individuals where the equity and other effects are clearer and easier to determine.⁸ Under such a regime, market prices would

is being made, whether those policies will persist for a long period of time. Forecasting political behavior (since that is what is required) is very uncertain, even in the short run. Businesses may simply default to judgments about the favorability of the political culture toward the business or business in general—unless the benefits are to be realized in the short run (e.g., an upfront tax credit or sales tax exemption) that cannot later be withdrawn.

⁷ *The classic case of taxes that do not distort or affect market behavior are (1) head or per capita taxes and (2) taxes on land value. Neither of these taxes can easily be shifted or avoided by changing one's behavior. Nor has either been a very popular tax, although many economists favor taxes on land value.*

⁸ *See William H. Oakland, "How should business be taxed?" in State Taxation of Business: Issues and Policy Options (National Tax Association, 1992).*

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reflect market factors, rather than hidden charges for general government funding. This rationale may suggest the total state and local taxes paid by a firm should not be lower than the approximate cost of providing services to it.

- **Taxation of businesses should not vary based on organizational type, sector, or vertical integration.** Given a goal of minimizing market distortions, the tax system should not favor one type of business over another—whether based on organizational structure (e.g., C corporations versus pass-through entities), sector (e.g., manufacturers versus retailers), or vertical integration (i.e., the extent to which the firm relies on other firms for its inputs). Thus, tax reductions could be structured to reduce or minimize this type of differential treatment. The neutrality principle suggests that at a minimum, tax reductions should be provided equally to all business types so that the reduction itself does not increase market distortions.

Revenue Adequacy

How will the proposal affect state and local government revenues?

The primary purpose of taxes is to raise revenue to fund government. Tax cuts, thus, need to be evaluated for their revenue effects. The legislature should make sure a tax cut does not unbalance the budget. The more general point is to judge the tax cut's effect on the capacity to generate revenue and on the overall mix of tax revenues on two separate bases:

- **Growth potential**—will the tax cut reduce the extent to which the tax grows with increases in economic activity or with price changes? The assumption is that government costs grow with increases in inflation and the size of the economy (e.g., population or economic activity) and that tax revenues should grow similarly.
- **Stability or volatility**—are revenues from the tax relatively stable or volatile? This is also sometimes referred as the predictability of the revenues. Stable revenues make budgeting and planning for government expenditures easier and help to reduce the need to make changes in tax and spending policy that are not driven by policy considerations. This principle would favor tax cuts that reduce the volatility or unpredictability of revenue or conversely that increase their stability or reliability.

An ideal tax from a revenue adequacy perspective would generate stable and predictable revenues that grow with increases in prices and the economy. However, the two components of the revenue adequacy principle may be at odds with each other. Taxes whose revenues have high growth potential tend to be more

Revenue adequacy evaluates how the tax cut affects government revenues



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volatile and less predictable.⁹

In the context of a proposed business tax cut, the relevant question for legislators is whether the cut will make the state's overall mix of tax revenues more or less predictable. Cutting a highly predictable and stable tax would increase the share of state revenues coming from more volatile taxes, making the state's revenue mix more sensitive to changes in economic activity. Conversely, cutting a more volatile tax would make state revenues more stable, but less likely to benefit from economic growth (and less likely to suffer during economic downturns).¹⁰

Ease of Compliance and Administration

Will the tax cut make the tax easier for taxpayers to comply with and for the government to administer?

Compliance and administrative costs are part of the burden of a tax—they increase its price to taxpayers and effectively reduce net revenues. Compliance and administrative costs are a loss to the economy, since the services are not ends in themselves (nobody seeks to consume tax compliance or administration other than out of necessity). A tax cut that reduces compliance and administrative costs may promote other principles—for example, competitiveness—by reducing the real cost of a tax policy. Thus, business tax reductions that minimize or reduce compliance and administrative costs should be favored and those that add complicating features should be avoided.

Simplicity and Transparency

Does the reduction make the underlying tax simpler and easier to understand or does it increase its complexity?

Taxes that are simple and easy to understand are favored both because they reduce the compliance and administrative costs and because they promote political accountability by making the tax system more understandable. Simpler taxes make it easier for the public to see the cost of government and to judge the effect of a tax.

⁹ *The revenues from an individual income tax on capital gains provide a good example—they have high growth potential but are very volatile. Conversely, taxes with stable and predictable revenues often have low growth potential. An unindexed volume-based excise tax on alcohol purchases would be a typical example—revenues grow only as the total volume of alcohol purchased increases and are insensitive to inflation (either in general or in alcohol prices).*

¹⁰ *For a discussion of the volatility of Minnesota state tax revenues and tradeoff with other tax principles see Budget Trends Study Comm'n, Commission Report to the Legislature pp. 17 – 23 (January 12, 2009).*



Competitiveness or Economic Development Considerations

Will the tax cut make Minnesota a more attractive location for business investment or increased business activity?

Policy makers often use “competitiveness” to evaluate the desirability of tax policies and alternative business tax cuts, although textbook public finance analysis does not consider it to be a principle of good tax policy. Using competitiveness to evaluate alternatives is premised on the idea that state governments should use their tax systems to intervene in the private market—that is, to try and attract and retain investment and business activity to the state (and implicitly away from other states). Following conventional economic theory, that is not a traditional function of government, since attracting and retaining business is not a public good.¹¹ Rather, many “competitiveness”-motivated tax policies are designed to distort private market decisions—that is, to change where the market would otherwise deem to be the best place for private investment.¹² See the box for an alternative justification for taking competitiveness into consideration in making tax policy.¹³

Competitiveness looks at whether the tax cut will make the state more attractive for businesses

11 Public or social goods are nonrival and/or nonexcludable; one’s use does not diminish someone else’s use of them and no one can own them as private property and thereby exclude others from using or possessing them. Typical examples would be national defense, clean air and water, public safety and so forth. The private market does not work to provide these goods; as such they are the classic purpose for government.

12 One could argue that competitiveness arguments follow conventional economic theory, if the premise is that Minnesota business taxes overall are too high and this reduces in-state business activity as a result. But that argument goes to the overall level of business taxes, which is beyond the scope of this publication.

13 Proponents of the “competitiveness principle” often justify it as either necessary to protect in-state businesses or counter efforts by other states. These consideration probably do not change the basic points made in the text. Valuing existing businesses more highly than attracting new investment falls into the “loss aversion” fallacy, which behavioral economists identify as a common deviation from rational economic behavior (e.g., by assigning a higher value to the risk of losing than to the prospect of earning with an equal expected value). See, e.g., the discussion in Daniel Kahneman, Thinking, Fast and Slow, pp. 278 – 309 (2011). A state’s investment in infrastructure and human capital that serves existing businesses may suggest assigning a slightly higher value to retaining businesses than attracting new ones. But the effect likely is small, at most, and hard to assess.

Many states use tax policies and direct spending (“economic development”) programs to “compete” for businesses. That is the norm, rather than the exception. Does this compel other states to act similarly—that is, as de facto private investors rather than as traditional governments? That notion is accepted by many policy makers, but there is little hard empirical evidence to support it and much of the focus tends to be “one-handed,” ignoring the value of services funded by



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As a practical matter, competitiveness considerations are the primary way that many legislators evaluate state business taxes. Competitiveness as a policy criterion has been considered by Minnesota tax study commissions¹⁴ as a goal for tax system and seems to be a constant in Minnesota tax policy discussions. Therefore, it is important to discuss some of the relevant factors to consider in determining how alternative tax policies score under the competitiveness principle.

A basic case commonly made by proponents of policies justified by “competitiveness” is that making state taxes more competitive will result in more business investment or other activity that increases state revenues¹⁵ and these revenues will exceed the associated public expenditures that result from the increased business activity.¹⁶ In other words, basing tax reductions on “competitiveness” justifications makes state government essentially akin to a private investor seeking to obtain a net return on investment, rather than an entity raising revenues to fund expenditures on public goods. The key to determining success, thus, depends upon whether the tax cut actually increases net tax revenue by stimulating increased economic activity (or sufficiently increases overall per capita income). That likely means increasing investment and activities by business firms that sell their output to purchasers outside of the state (exporters), since that is what is most likely to increase net tax revenue or income in the state.¹⁷ It is also important to keep in mind that tax policies affect businesses in different ways, depending upon their structures and their profiles (capital intensity, inputs, and so forth). Some policies may attract one type of business and disadvantage others. Judging the competitiveness effects of policies must take many different factors into account.

taxes and the cost of providing services to new businesses and employees.

14 For example, two of the five “guiding principles” of Governor Pawlenty’s tax reform commission were essentially variants on the competitiveness principle (they were titled the “Inherently Competitive” and “Friendly to Economic Growth” principles). The Governor’s 21st Century Tax Reform Commission, Minnesota’s Millennium: Launching a New Generation of Competitive Leadership and Economic Growth, p. 6 (Feb. 13, 2009), <https://www.leg.state.mn.us/docs/2009/other/090277.pdf>.

15 An alternative goal could be to increase the per capita income of residents.

16 New business investment may require direct public services (e.g., new infrastructure) or attract new state residents who will use public services. These costs must be accounted for, since this is a return on investment calculation.

17 In theory, increasing the productivity of in-state firms that sell locally could also have that effect. The limited understanding of productivity (e.g., ongoing debates about whether it is being correctly measured) and how to foster its growth nationally suggests that such a goal of state tax policy would not be appropriate.

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A major challenge to formulating tax policy to increase a state's "competitiveness" is that public officials have only the most imprecise knowledge about how tax changes affect private business behavior either in particular cases (e.g., if the policy provides case-by-case incentives) or generally (e.g., for broad, general tax policies). And that is the key question: how will businesses¹⁸ respond to the incentives provided by alternative changes (reductions or cuts) in taxes? Unless they respond by investing or otherwise increasing activity in-state in a significant way, the premise of the cuts by most accounts will have failed. However, even if one cannot be sure pro-competitive tax policy changes will increase net revenues or investment, structuring taxes in a way that is perceived as "friendly" to business and investment still may have merit in assessing potential policy changes: economic theory suggests there is an effect and that it affects the state's image or attractiveness to investors.

18 To complicate matters, businesses will respond differently, depending upon the type of business, capital intensity, inputs used, and a myriad of other factors.

An Alternative: Making Sure Minnesota's Taxes Are Not Out of Line

A more defensible use of the competitiveness to make sure that the state's tax policy is not so far out of line with other states that it begins to have an effect on business location and investment decisions. For example, the 1984 Minnesota Tax Study Commission (often referred to as the Latimer Commission after its chair) described competitiveness as a goal of the tax system in more or less that way:

Minnesota's tax rates and tax burden distribution should be compared to those of other states, and evaluated for their effects on the growth of the state's economy and employment, and on the migration of residents as the state competes for economic activity. *Final Report of Minnesota Tax Study Commission*, vol. 1, p. 5 (1984).

This is a more modest statement of the goal or principle than is typically advanced in legislative policy debates, which often focus on attracting businesses or investment, increasing employment or similar. This approach just focuses on making sure Minnesota's tax system isn't an impediment to the health of the state's economy, rather than trying to formulate policies specifically to foster economic development.



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The rest of this section discusses some factors that may increase the likelihood that a business tax cut will have a positive rate of return and, thus, score well under competitiveness criteria:

- **Are the affected businesses mobile? Could they easily site the investment outside Minnesota?** Business firms can be divided into two categories: (1) mobile firms that sell their output outside of local markets and can easily site some or all of their operations at a variety of locations, and (2) firms that must locate close to customers or suppliers and cannot easily move. The former include many manufacturers and service providers selling in national markets; medical device makers and insurance companies are two examples. These firms' costs are typically not very sensitive to a specific location. By contrast, restaurants, dry cleaners, gas stations, most medical providers and many retailers must locate close to their customers. Other businesses are tied to the location of key inputs—farms, agricultural processing facilities, and mines for example. Policies that focus tax reductions on mobile firms are more likely to have the desired effect of increasing in-state activity. Focusing reductions on mobile firms cuts against the neutrality and simplicity principles, since it may argue for treating business firms unequally and often will increase complexity.
- **Are the reductions tied to new investment or increased activity? Do they benefit “new” rather than “old,” or existing, capital?** To encourage or attract more capital investment or business activity, tax cuts that apply only to firms that actually invest or increase their activity are superior to those that benefit any and all businesses. This is simply a matter of targeting or focusing the tax benefit “at the margin” where most economic decisions are made to increase the expected “return” relative to the amount of the tax cut.

Consider, for example, a tax reduction that is given to every business as a percentage of its property or income. (That would be roughly the effect of an across-the-board reduction in business property taxes or a cut in the corporate tax rate.) The business can do whatever it chooses with the tax cut—it could invest it in Minnesota or hire more Minnesota employees; it could invest outside Minnesota; or it could use the tax cut to pay dividends to its owners. Such a cut is not focused on businesses that increase in-state investment or activity. By contrast, an investment credit or a sales tax exemption for specified business purchases could be provided, focusing the reduction on businesses that increase Minnesota investment or activity. The former tax reduction would apply to all capital and mainly to existing or “old” capital, while the latter is focused on “new” capital. Focusing the reduction on businesses making new in-state investments increases the probability that the cut will have the desired effect of increasing economic

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activity, but it is no guarantee, since the businesses may have invested without the tax cut.¹⁹ Put another way, conditioning a tax reduction on investing in Minnesota does not ensure that the tax cut actually *caused* the Minnesota investment. Note, again, that targeting the tax cut in this way goes against the neutrality principle by favoring some businesses over others. It is also more complicated for taxpayers and the state than simply reducing rates for all businesses.

- **Do the businesses earn high returns and/or pay their employees above-average wages?** Recall that the goal is to generate an increase in net state revenues or state income. Expanded business activity typically will also lead to more demands for public spending, because the business itself uses services or it may attract employees or suppliers to the state who use public services. It is reasonable to assume that, on average, a business and its employees pay taxes equal to the government services that they consume. So attracting an average business is unlikely to generate a positive net return to the state in excess of the revenues foregone through the tax cut. Since the taxes paid by the business and its new employees must exceed the increase in public expenditures, the competitiveness principle argues for tax cuts that primarily benefit more profitable businesses or those with highly paid employees (i.e., those who pay more in state and local taxes than they use in government services). This increases the difficulty of designing policies that achieve those goals—both because of the lack of

Many factors could affect the likelihood that a business tax cut would have a positive rate on return

¹⁹ Recently published studies illustrate the uncertainty of the empirical effects of what one expects economic theory to predict. For example, one typically would expect that increasing or reducing a direct tax on capital investment—e.g., by imposing a state sales tax on capital inputs—would directly affect the businesses’ capital investment and indirectly affect their employment or wages. John L. Mikesell and Justin M. Ross, “The Labor Incidence of Capital Taxation: New Evidence from the Retail Sales Taxation of Manufacturing Machinery and Equipment,” *National Tax Journal*, vol. 70, no. 2, pp. 258 – 93 (2017), analyzed the effects of differential state sales taxation of manufacturing capital equipment in border counties. Using sophisticated statistical techniques the authors did not find significant losses or gains in manufacturing employment from the tax. (The businesses may have increased or reduced labor inputs to the effects of the tax changes.) The authors, however, did not appear to control for differences in personal property taxation, which may have affected their results. By contrast, Amy Hageman, Donna Bobek, and LeAnn Luna, “The Influence of State Sales and Use Taxes on Manufacturers’ Capital Expenditures and Employment,” *Public Finance Review*, vol. 43, no. 4, pp. 458 -84 (2015), using different data and empirical methods found modest sensitivity of capital expenditures and employment to sales tax exemptions for manufacturers’ expenditures on machinery and inputs. The authors observe, however: “The[ir] results suggest policy makers will have a difficult time justifying additional [sales and use tax] incentives, given their modest impact on jobs and investment.” p. 460.



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certainty about behavioral responses to tax policy, but also because it is key to get the “right” businesses to respond.

- **Is the investment sticky or enduring, or could the business easily abandon its commitment?** The advantages of a permanent or more enduring investment seem obvious: the state is buying a longer (more valuable) stream of benefits. Once a business invests in or locates in a state, inertia will typically favor its remaining. Some types of commitments are more likely to be permanent than others—for example, construction of a large special-purpose facility compared to renting a facility or building a facility that can be used for many purposes. Thus, tax cuts that favor capital investments, particularly permanent ones (e.g., buildings, rather than equipment that can easily be moved), are superior to simply reducing taxes on ongoing operations. For example, a sales tax exemption on building materials would be better than a reduction in the taxation of business income.
- **Does the cut help reduce a highly visible or headline policy that tends to define Minnesota as unfriendly to business?** Very visible tax features, such as a high corporate tax rate or a high top individual income tax rate, may signal to potential investors, particularly those not familiar with the details of the state tax policy, that the state is not business friendly or a good place to invest. Other features, such as the definition of the tax base, may offset the high tax rate. However, it is conceivable that potential investors never get beyond the headline (high rates) to read the full story (reasonable tax burden because of other features). This is contrary to traditional economic theory which assumes businesses and investors carefully analyze all the effects to determine the relevant tax price on investments. But it is not clear that all or most firms are that diligent and careful.²⁰ The Tax Foundation, a conservative tax policy research organization, has long advocated that it is important to reduce headline tax rates for states to be competitive. Although empirical studies do not necessarily validate its views, they cannot be categorically rejected. So, all else being equal, it is certainly preferable to avoid policies that make the state stick out or appear to be “high-tax” or unfriendly to business.²¹

²⁰ *There is empirical support for the notion that corporate managers do not correctly evaluate the effective tax rate applicable to investments. See John R. Graham, Michelle Hanlon, Terry Shevlin, and Nemit Shroff, “Tax Rates and Corporate Decision Making,” Review of Financial Studies (January 2017), available at https://papers.ssrn.com/sol3/Papers.cfm?abstract_id=2548641 (many companies use GAAP rate, rather than the correct marginal tax rate).*

²¹ *John Shannon, director of the now-defunct Advisory Commission on Intergovernmental Relations, characterized this as avoiding sticking out like a “sore thumb” compared with*

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Caveat: Exercise caution in relying heavily on competitiveness as a reason for tax reductions. Economic theory predicts that business investment and activity respond to net tax costs; thus, one would expect well-designed business tax cuts to lead to more investment and economic activity. But actual effects often are unclear because so many factors affect investment and economic activities. Careful empirical studies suggest that tax effects are relatively small.²² This may be because it is difficult statistically to isolate their impact from other factors or because humans behave in complex and unpredictable ways (and not necessarily in the way that economic theory says they do). Further, any effects likely appear only in the long run. Changes occur at the margin and are incremental. Inertia weighs against realizing quick results; it may be easier for a business to continue operating at existing locations. Moreover, stability and predictability may be keys to attracting investment; designing tax policy explicitly to attract investment (smokestack chasing) could suggest that the state has an unpredictable or instable tax policy climate: states that regularly adopt the tax policy *du jour* to attract businesses may be viewed as also more likely to abandon that feature a few years later when the latest new idea comes along or when they impatiently conclude that the hoped-for results have not materialized. As a result, businesses may consider these states to be unreliable partners that will abandon the tax feature that attracted their investment.

Policymakers must make tradeoffs. The key to the art of tax policy is making tradeoffs among these principles. Promoting the ends of one principle will frequently demote the ends of another. Thus, the relative merits of each must be weighed against the others and compromises made.

other states' tax policies. Quoted in Harley T. Duncan, "Interstate Tax Competition: The Good, the Bad, and the Ugly," paper presented at the 84th annual conference of the National Tax Association, (Nov. 13, 1991), available at <http://www.taxanalysts.com/www/features.nsf/Articles/24BD4E294161717085257CFB00693828?OpenDocument>

²² See David R. Agrawal, William F. Fox, and Joel Slemrod, "Competition and Subnational Governments: Tax Competition, Competition in Urban Areas, and Education Competition," *National Tax Journal*, vol. 68, No. 35, pp. 701 – 735 (2015) for a general discussion of the theory and literature. It should be noted that competition extends beyond simple tax competition, since state and local governments also compete with one another based on the types and quality of the government services that the taxes fund.



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Menu of Tax Reduction Options

Four business taxes²³ (those paid directly by business firms) are the typical candidates for reductions:

Four business taxes are typical candidates for tax reductions

- corporate franchise tax
- commercial/industrial property taxes
- sales tax on business purchases
- individual income tax on business income

Corporate franchise tax—this is the most visible business tax. It is imposed on the net income of “C” corporations (often larger corporations whose stock is traded on public stock exchanges). Pass-through entities (S corporations, partnerships, and LLCs) are not subject to the tax. C corporation income is taxed twice—once under the corporate tax and again when the profits are distributed as dividends.²⁴ Two basic tax cut options are usually proposed:

- **Reduce the tax rate or completely repeal the tax**
- **Provide some sort of targeted exemption for a subset of taxpayers**—for example, an increase in the research credit, expanding deductions, changing apportionment rules, or similar

Commercial/Industrial (C/I) property taxes—nearly all businesses in Minnesota pay property taxes either directly because they own real property or indirectly because they lease it. Property taxes (unlike the corporate tax) apply to all forms of businesses. The property tax has two components:

- **The state general tax** which is imposed statewide at a uniform rate on all C/I property and whose revenues go to the state general fund
- **Local property taxes** which apply at varying rates depending upon the local mix of property and the spending (property tax levies) of the local units of government in which the business’s property is located and whose revenues go to counties, cities, school districts, and other special taxing districts

²³ Taxes on specific industries, such as special taxes on public utilities or mining, are not evaluated.

²⁴ A second level of tax applies even if the corporation retains the earnings rather than paying dividends. When the shareholder sells the shares, the retained earnings will be capitalized into a higher share prices and subjected to capital gains taxation. For many corporations, the shareholders will avoid Minnesota tax on the dividends or capital gains because they are nonresidents or tax exempt (e.g., pension funds). But nonresidents will pay their resident states’ individual income taxes, if any. So two levels of state taxes still apply.



Sales tax on business purchases—most purchases made by businesses are subject to sales and use taxation. Purchases for resale and purchases of a limited class of “capital equipment” are exempt, but most other purchases are taxable. Business purchases comprise over 40 percent of the sales tax base. Reductions could be made by either:

- **Expanding the capital equipment exemption**—for example, by including more equipment (the exemption is now limited mainly to defined equipment used by manufacturers), by extending it to building materials, or by expanding it to all purchases of smaller businesses (e.g., those with gross sales or profits under a specified level); or
- **Exempting a percentage of or all purchases by businesses**—this would include purchases of noncapital items, such as supplies, utilities, and taxable services.

Individual income tax on business income—business firms other than C corporations, such as “pass-through” entities²⁵ and sole proprietors, pay tax on their income under the individual income tax. This tax burden is roughly the analogue of the combined (1) corporate franchise tax and (2) the individual income tax imposed on dividends and capital gains on stocks of C corporations. The individual income tax on this business income could be reduced or eliminated or the state could reduce the individual income tax on pass-through businesses (and also the corporate tax on C-corporations) by conforming to federal rules for section 179 expensing or bonus depreciation (i.e., allowing more favorable treatment of capital purchases).

Application of Principles to Tax Cut Options

The table applies the tax principles described in the first section of the paper to the menu of tax reductions described in the second section of the paper; it does not cover special or limited reductions, such as expanded tax credits or deductions since they cannot be addressed generically. Following the table, there is a more detailed explanation about how the tax cut principles are affected by the various tax cut options.

For special competitiveness considerations related to the corporate franchise tax see the Appendix.

²⁵ These include S corporations and LLCs and partnerships that do not elect to be taxed as C corporations. These entities do not pay the corporate franchise tax, rather their income or losses are “passed-through” to their owners who report it and pay tax on their individual income tax returns.



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Comparing Alternative State Business Tax Reductions					
Tax principles	Tax cut option				
	Corporate franchise tax – repeal or reduce tax rate	State general tax – repeal or reduce levy	Sales tax – exempt select capital purchases	Sales tax exempt a percent of all business purchases	Individual income tax – exempt business income
Vertical equity – progressivity or regressivity	Progressive	Progressive	Progressive	Progressive	Regressive
Horizontal equity – equal treatment of equals	Positive	Neutral	Positive	Positive	Negative
Neutrality or efficiency	Positive	Neutral	Positive	Positive	Negative
Revenue – growth	Negative	Positive	Neutral	Neutral	Negative
Revenue – volatility	Positive	Negative	Positive	Neutral	Positive
Ease of compliance and administration	Positive	Neutral	Negative	Negative	Negative
Simplicity and transparency	Positive	Positive	Positive	Positive	Negative
Competitiveness:					
<i>Mobility of recipients</i>	Negative	Negative	Negative	Negative	Negative
<i>Old versus new capital</i>	Negative	Negative	Positive	Neutral	Negative
<i>High value added</i>	Neutral	Negative	Negative	Negative	Negative
<i>Durability of investment</i>	Negative	Positive	Positive	Negative	Negative
<i>Reduce negative headline feature of the tax (e.g., high top tax rates)</i>	Positive	Neutral or negative	Neutral	Neutral	Negative



The following section provides some detail on the rationales for the scores assigned in the table:

Corporate franchise tax: Repealing or reducing the tax rate

- **Vertical equity:** Reducing the corporate franchise tax can be expected, over the long run, to reduce the regressivity of the Minnesota tax system, since the corporate franchise tax is more regressive than overall Minnesota state and local taxes.²⁶
- **Horizontal equity:** Reducing the corporate franchise tax should increase horizontal equity by helping to equalize the tax imposed on C corporations with that imposed on pass-through entities and sole proprietors. Pass-through entities and sole proprietors avoid the corporate franchise tax altogether, while C corporations pay the tax and their shareholders also must pay individual income taxes on the dividends (or on capital gains realized when they sell their stock) that represent the profits remaining after the corporate tax. To the extent investors in C corporations bear the burden of the corporate franchise tax, reducing it will help equalize their burdens compared with that of investors in pass-through entities and sole proprietors.
- **Neutrality or efficiency:** By reducing the tax penalty for operating a business as a C corporation, corporate franchise tax reductions will decrease the tax system's incentive to organize businesses as pass-through entities and the disincentive to operate as publicly held corporations, making the tax system more neutral.
- **Revenue Growth:** Historically, revenues under the corporate franchise tax have tended to grow both with inflation and overall economic growth. They also grow faster than total state general fund revenue.²⁷ As a result, reducing corporate franchise taxes will reduce the overall growth potential or elasticity of Minnesota state general fund taxes.
- **Revenue Volatility:** Of the state's major revenue sources, corporate

Option: Repealing or reducing the corporate franchise tax

²⁶ *The Suits Index, an overall measure of progressivity, for the corporate franchise tax is -0.198 versus -0.029 for the overall tax system (higher numbers reflect greater progressivity with a minimum value of -1 and a maximum of 1). Minn. Dep't of Revenue, 2017 Minnesota Tax Incidence Study, p. 117 (March 28, 2017). Perhaps, more importantly as discussed on page 5, these measures are based on the incidence of the existing taxes. Reductions in business taxes are likely to be more progressive in the long run because they will reduce the tax paid by consumers.*

²⁷ *Laura Kalambokidis, Minnesota Revenue Volatility, presentation to House Taxes Committee (January 22, 2015), PowerPoint slide 3 (showing a corporate franchise tax growth rate of 7 percent and a total general fund revenue growth rate of 3.3 percent).*



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franchise taxes are the most volatile.²⁸ As a result, reducing them will make state revenues more stable and predictable.

- **Ease of compliance and administration:** The corporate franchise tax has highest compliance and administrative costs of any major state tax.²⁹ However, to realize major savings, it probably is necessary to fully repeal the tax. The costs and complexity are inherent in applying the tax; simply imposing it at lower rates will not yield much saving in compliance costs to taxpayers or in administering it by the state.
- **Simplicity and transparency:** The transparency and simplicity of the tax will increase, since the corporate tax is both hidden (i.e., ordinary citizens and voters are largely unaware of the tax³⁰) and complicated (see previous bullet). One could make a case that it is more complicated than any of the other business taxes.
- **Competitiveness**
 - **Mobility of recipients:** A general reduction in or repeal of the corporate franchise tax would not be explicitly targeted to mobile firms; rather all C corporations would benefit, including national retailers not headquartered here, large manufacturers with only sales and service offices in-state, and so forth. Because C corporations are largely big, publicly held national or multi-national firms, reductions in the tax may tend to favor firms that are somewhat more mobile (e.g., manufacturers). But as discussed in the Appendix, single-sales apportionment neutralizes many of the anti-competitive effects of the corporate franchise tax. This reality is an important caveat to keep in mind in judging all the competitiveness effects of reductions in the corporate franchise tax.
 - **Old versus new capital:** A general reduction of the corporation franchise

²⁸ *Ibid.* (showing corporate tax revenues are more than four times as volatile as overall general fund revenue and well over twice as volatile as the individual income tax revenues, the largest and second most volatile major source of state revenues).

²⁹ That the administrative and compliance cost of the corporate franchise tax are the highest of the major Minnesota state taxes is conventional wisdom. This is supported, but not directly documented for Minnesota, by estimates for federal and other state taxes. See, e.g., the discussion in Joel Slemrod, "Which is the Simplest Tax System of Them All?" in H. Aaron and W. Gale, eds., *The Economics of Fundamental Tax Reform*, 1996, pp. 355-91.

³⁰ Corporate financial and tax professionals obviously know the amount of tax paid by the corporations that they work for, but there is a vigorous debate among economists as to who actually bears the burden of the tax (e.g., by paying higher prices or by receiving lower dividends or wages). The current debate in the media over the potential economic effects of reductions in the federal corporate tax rate demonstrate this lack of clarity or consensus.



tax would apply equally to capital already in place and new investment, so it scores poorly under this criterion.

- **High value added:** Because the corporate tax applies mainly to public companies and these companies tend to pay higher wages, the beneficiary firms likely score well under this criterion. But that assumes that reductions in the tax will affect location decisions and result in more highly paid employees in Minnesota; that is, that it will cause these firms to increase their Minnesota investment and employment. Because of single sales apportionment, rate reduction or repeal likely will do little to make Minnesota a much more friendly location for firms that sell their products outside the state.
- **Durability of investment:** It is untargeted, since a general reduction would not be tied to making new investments in long-lived, immobile investments (e.g., construction of new buildings or installation of large equipment in-state that it is difficult to move).
- **Reduce negative headline feature:** The corporate tax is the most visible of Minnesota's collection of business entity taxes. It is the tax that the average individual thinks of as *the* tax on business. Moreover, Minnesota has one of the highest nominal corporate tax rates, even if its effective rate is more average.³¹ As a result, the high headline rate may create a perception of a bad business climate. Reducing the rate would put Minnesota more in line with other states; repeal would move Minnesota to the handful of states without corporate taxes.

State general tax: Repealing or reducing the tax levy on commercial and industrial property

- **Vertical equity:** Reducing the state general tax levy can be expected, over the long run, to reduce the regressivity of the Minnesota tax system, since the state property tax is more regressive than overall Minnesota state and

³¹ *Minnesota corporate franchise tax rate (9.8 percent) is the third highest in the country after Iowa (12 percent) and Pennsylvania (9.9 percent). Federation of Tax Administrators, Range of State Corporate Income Tax Rates (January 1, 2017), available: https://www.taxadmin.org/assets/docs/Research/Rates/corp_inc.pdf; however, Minnesota's corporate tax collections as a percent of personal income over the last decade have ranged from 14th to 8th highest in the nation, lower than the rate alone would suggest. Minn. Dep't of Revenue, tax rankings website, available: http://www.revenue.state.mn.us/research_stats/Pages/Historical_Rankings_Tables.aspx.*



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Option: Repealing or reducing the levy on commercial and industrial property

local taxes.³²

- **Horizontal equity:** Reducing the state general tax levy will provide tax reductions to all business properties, generally in proportionate to their market values. Thus, on the surface, this option is largely neutral from the perspective of horizontal equity. However, commercial-industrial properties pay higher effective property tax rates than other properties (e.g., farms and residential properties), so it could be thought to increase horizontal equity from that view. Perhaps more importantly, it is commonly thought that property taxes are capitalized into the market values of properties. To the extent that is true, previous owners may have borne much of the effect of tax, because they received lower prices when they sold their properties. Given that, a portion of the reductions will provide essentially a “windfall” benefit to owners and could be perceived (in the short run) to reduce horizontal equity.
- **Neutrality or efficiency:** This option provides proportionate reductions to all business properties, so it is unlike to either increase or diminish efficiency or neutrality, beyond the effects of a general or across-the-board reduction in business taxes.
- **Revenue Growth:** The state general tax is set by law at a fixed dollar amount. Reductions will not affect the growth potential for state revenues.
- **Revenue Volatility:** Since the tax is a fixed levy amount that is almost fully collected each year, this option will reduce one of the most stable and predictable state revenue sources.
- **Ease of compliance and administration:** Reducing or repealing the state levy leaves property tax administration and compliance costs unchanged, since local property tax administrators must continue to value properties and collect the local property tax.
- **Simplicity and transparency:** By making the property tax exclusively a local tax, public understanding of the tax should modestly improve.
- **Competitiveness**
 - **Mobility of recipients:** Since tax reductions apply to all commercial and industrial property, the reductions are not targeted to mobile businesses. Moreover, the benefits for many years will primarily apply to immobile business assets—land and buildings that were constructed before the tax

³² *The Suits Index, an overall measure of progressivity, for the state property tax is -0.162 versus -0.029 for the overall tax system (higher numbers reflect greater progressivity with a minimum value of -1 and a maximum of 1). Minn. Dep’t of Revenue, 2017 Minnesota Tax Incidence Study, p. 132 (March 28, 2017). See also discussion in note 26.*



reduction was enacted.

- **Old versus new capital:** The reduction applies equally to capital already in place and to new investment.
- **High value added:** It is not targeted to businesses with high profits or highly paid employees, since it applies to all commercial-industrial properties.
- **Durability of investment:** The reduction applies to very durable investments (i.e., land and buildings); it simply is not targeted to *new* investments.
- **Reduce negative headline feature:** The option scores poorly under this criterion, since the property tax is a low visibility tax (in the sense that the state wide details of the tax tend to be obscure—e.g., the extent to which it applies personal property, the rates that apply, and so forth) and property tax is essentially a universal feature of all state and local tax systems.

Sales tax: Exempt select capital purchases

- **Vertical equity:** Reducing the state sales tax on all or an expanded list of business capital purchases can be expected, over the long run, to reduce the regressivity of the Minnesota tax system.³³
- **Horizontal equity:** Reducing the sales tax on business purchases generally (whether limited to capital purchases or not) will reduce the differences in the sales tax embedded in different types of purchases, making the effective rate of the sales tax closer to the statutory or nominal rate of the tax.³⁴
- **Neutrality or efficiency:** Reducing the state sales tax on all or an expanded

Option: For sales tax, exempt certain capital purchases

³³ *The tax incidence study does not have a separate estimate of the incidence of the sales tax on business purchases (or specifically business capital purchases). However, it seems reasonable to conclude that the incidence is similar to the general sales tax. See *ibid.* p. 105 (tax in intermediate business purchases “would almost certainly be shifted forward to consumers in higher prices”). The Suits Index, an overall measure of progressivity, for the general sales tax is -0.259 versus -0.029 for the overall tax system (higher numbers reflect greater progressivity with a minimum value of -1 and a maximum of 1). *Ibid.*, p. 132. See also the discussion in note 26.*

³⁴ *It is widely accepted by public finance economists that the sales tax imposed on business purchases is passed along to consumers in higher prices. E.g., see discussion in note 33. This means that consumers are paying varying effective sales tax rates as part of the prices of the goods and services that they purchase. The extent of these embedded taxes (i.e., the effective sales tax rates) will vary from product to product, depending upon the extent to which the sector of businesses that produce and sell the product are subject to sales taxes.*



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list of business capital purchases will likely make the tax system more neutral or efficient both because it will reduce (1) the variation in tax burdens that result from how vertically integrated businesses are (i.e., how much of the relevant production is done “in-house” so that the sales tax does not apply) and (2) the variation in effective sales tax rates, as described above under the horizontal equity criterion.

- **Revenue Growth:** It seems reasonable to conclude that the growth potential for capital purchases is little different than that for the overall general sales tax base.
- **Revenue Volatility:** Capital spending is correlated with the business cycle; during business expansions, almost by definition, businesses increase their capital purchases and during contractions reduce them. Reducing the amount of capital purchases in the sales tax base should make sales tax revenue more stable across the business cycle. The effect, however, is likely to be small.
- **Ease of compliance and administration:** To exempt more business capital purchases (or all capital purchases) would require enacting and administering legal distinctions that identify the qualifying purchases. This will increase both compliance and administrative costs. However, similar costs exist under present law which exempts a limited list of manufacturing capital equipment purchases from tax. Depending upon the breath of the exemption, it may be possible to develop a regime that is simpler than the current law rules.
- **Simplicity and transparency:** By reducing a “hidden” tax, lowering or eliminating the sales tax on business purchases will improve the transparency and simplicity of the sales tax.
- **Competiveness**
 - **Mobility of recipients:** The exemption is not targeted to mobile businesses; any firm buying or using the relevant items qualifies.
 - **Old versus new capital:** The exemption would apply only to new investments, increasing the chance that it will affect decisions to buy or invest.
 - **High value added:** Exempting capital purchases is not explicitly targeted to businesses with higher profits or highly paid employees, although businesses with higher amounts of capital per employee likely pay higher wages.
 - **Durability of investment:** This option is limited to capital purchases, which tend to tie a business to their location, particularly for building materials and heavier machinery.

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- **Reduce negative headline feature:** The sales tax on capital equipment is not a high visibility tax; most states do not have this exemption, other than for fairly narrowly defined equipment of manufacturers (as Minnesota does).

Sales tax: Exempt a percent of all business purchases

- **Vertical equity:** Reducing the state sales tax on all or an expanded list of business purchases can be expected, over the long run, to reduce the regressivity of the Minnesota tax system.³⁵
- **Horizontal equity:** Reducing the sales tax on business purchases will reduce the differences in the sales tax embedded in different types of purchases, making the effective rate of the sales tax closer to the statutory or nominal rate of the tax.³⁶
- **Neutrality or efficiency:** Reducing the state sales tax on all or an expanded list of business purchases will likely make the tax system more neutral or efficient both because it will reduce (1) the variation in tax burdens that result from how vertically integrated businesses are (i.e., how much of the relevant production is done “in-house” so that the sales tax does not apply) and (2) the variation in effective sales tax rates, as described above under the horizontal equity criterion.
- **Revenue Growth:** The growth potential for business purchases is likely little different than that for the general sales tax base.
- **Revenue Volatility:** Other than for capital purchases (see discussion above), exempting business purchases from sales tax is unlikely to affect the volatility of sales tax revenues—purchases of intermediate business inputs likely track closely those of general consumer purchases.
- **Ease of compliance and administration:** Providing a sales tax exemption for all business purchases will dramatically increase the volume of purchases made with exemption certificates. This may encourage or facilitate business owners to purchase items for their personal consumption (rather than business use), using their exemption certificates and degrading compliance. Increasing the tax rate to offset the revenue reduction would increase the incentive for business owners (employees or others with access to exemption certificates) to do so.
- **Simplicity and transparency:** By reducing a “hidden” tax, lowering or eliminating the sales tax on business purchases will improve the

Option: For sales tax, exempt a percent of all business purchases

³⁵ See the discussion in note 33.

³⁶ See the discussion in note 34.



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transparency and simplicity of the sales tax.

- **Competiveness**
 - **Mobility of recipients:** The exemption is not targeted to mobile businesses; any firm buying or using the relevant items qualifies.
 - **Old versus new capital:** The exemption would apply to both new capital and purchases for ongoing operations.
 - **High value added:** Because the exemption would apply across-the-board to all businesses, it is not targeted to businesses with high profits or highly paid employees.
 - **Durability of investment:** Other than the tax that would apply to capital purchases, the exemption is not targeted to durable investments.
 - **Reduce negative headline feature:** The tax is not a high visibility tax. No state with a general sales tax has a universal exemption for all business purchases, so this would be an unusual (but potentially attractive) state tax feature.

Option: Exempt or cut the tax rate for business income

Individual income tax: Exempt or reduce tax rate that applies to business income

- **Vertical equity:** Exempting or reducing the tax on business income is likely to make the individual income tax less progressive and the overall tax system more regressive. Receipt of business income is heavily concentrated in the very top income strata.³⁷ Thus, reducing the tax burden on it will make the income tax less progressive.
- **Horizontal equity:** Since this option favors business income over other types of income, such as wages, dividends, and interest, it will reduce horizontal equity. Individuals with the same amounts of income but from different sources (i.e., business income versus other types) will pay different amounts of tax.
- **Neutrality or efficiency:** Because this option expands the already more favorable tax treatment for pass-through entities compared with C corporations, it will exacerbate the current disadvantage for operating businesses as C corporations and make the tax system less neutral.
- **Revenue Growth:** This option will reduce revenue growth potential,

³⁷ See House Research Department, Taxation and Small Business in Minnesota (January 2011), p. 18 (for tax year 2007, 70 percent of pass-through business income was reported by returns with taxable incomes exceeding \$300,000). Perhaps more sobering, research suggests that recent growth in national income inequality and particularly in the very top income share is heavily

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because it will eliminate or reduce a revenue sources that increases with growth in the economy. In recent years, this component of income has grown more rapidly than the rest of the individual income tax base. For the last 15 years (ending with tax year 2014), adjusted gross income grew about 67 percent nationally, while net partnership and S corporation income grew by 160 percent.³⁸

- **Revenue Volatility:** Reducing tax on or exempting business income is likely to slightly reduce the volatility of income tax revenues. Although this type of income has grown more rapidly than overall adjusted gross income, the amount fluctuates more year-to-year across the business cycle.³⁹
- **Ease of compliance and administration:** An exemption or partial exclusion of business income will create new distinctions and rules that complicate administration and compliance costs. In addition, it is likely to encourage re-characterization of income as business income and the formation of more pass-through entities.⁴⁰ If the federal tax is modified to provide a preference for this income, as is proposed in federal reform proposals, that would help minimize some of those costs (or more accurately shift them to the Internal Revenue Service and to taxpayers' burden of complying with federal law).

attributable to pass-through income at the very top of the income distribution. See, e.g., Fatih Guvenen and Greg Kaplan, "Top Income Inequality in the 21st Century: Some Cautionary Notes," Quarterly Review, vol. 38, No. 1 (October 2017) (almost all of the growth in inequality since 2000 attributable to pass-through income earned by the top 0.1 percentile); Matthew Smith, Danny Yagan, Owen Zidar, and Eric Zwick, Capitalists in the Twenty-First Century, pp. 6 – 7 ("While top business income rose as a share of total income since 2000, most of this growth took the form of S-corporation and partnership income, rather than C-corporation dividend income, with S-corporation income being the largest category."). The extent to which this national pattern applies in Minnesota is unclear.

³⁸ Internal Revenue Service, *SOI Bulletin Historical Table 1*: <https://www.irs.gov/statistics/soi-tax-stats-historical-table-1>; see also sources cited in note 37.

³⁹ See *Ibid.* (its standard deviation over the 15-year period is about 14 percent higher than that for adjusted gross income).

⁴⁰ *Kansas's recent tax changes (since repealed) that exempted sole proprietor and pass-through income from tax appear to have had this effect. See Jason DeBacker, Bradley T. Heim, Shanthi P. Ramnath, and Justin M. Ross, The Impact of State Taxes on Pass-Through Businesses: Evidence from the 2012 Kansas Income Tax Reform (July 2016) ("pattern of findings overwhelmingly points in the direction that the responses were recharacterizations of income into tax advantaged forms")* https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2958353.



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- **Simplicity and transparency:** By applying a separate set of tax rules to pass-through and sole proprietor income, this option makes the income tax more complex and less transparent. Since anti-abuse rules likely will be required to restrain re-characterization of wages and other income as business income, the added complexity of these rules may be significant.
- **Competiveness**
 - **Mobility of recipients:** A general preference for business income would not be targeted to mobile businesses, since it would apply to any individual earning business income including income from location-bound activity (e.g., rents, income from local service businesses, and similar). Moreover, to satisfy constitutional requirements it would need to apply to residents' income from out-of-state businesses, so it would not be strictly limited to Minnesota business activity. However, business income may be more mobile, on average, than other forms of income—e.g., wages and salaries or passive investment income (e.g., interest and dividends). Thus, it is likely more targeted than a general reduction in individual income tax rates would be.
 - **Old versus new capital:** The exemption applies equally to capital already in place and new investment.⁴¹
 - **High value added:** It is not targeted to businesses with high profits or highly paid employees, since it would apply to all business income.
 - **Durability of investment:** The exemption or reduction in tax is not targeted to capital or other more durable investments, but applies to income from any type of business activity.⁴²
 - **Reduce negative headline features:** This option does not change the most visible feature of the tax, the tax rates, and the resulting reduction in revenue would leave a smaller amount available for potential rate reduction.

⁴¹ *Conforming to federal expensing rules under section 179 would score better under this criterion, because it would be limited to newly purchased investments.*

⁴² *Observation in note 41 applies to this criterion, as well, since conforming to federal section 179 would be targeted to equipment and similar capital purchases.*



Appendix

Corporate Franchise Tax and Competitiveness

It is useful to note two competitiveness effects that derive from the nature of the Minnesota corporate franchise tax. Public finance economists have recognized and documented these effects.

- **Single sales apportionment mutes anti-competitiveness effects of the tax.** Multistate businesses (i.e., those operating both inside and outside of Minnesota) determine their corporate tax based on the percentage of their sales made to Minnesota buyers. To determine Minnesota taxable income they multiply their total net income by the percentage of their sales made to Minnesota buyers. This is often called “single sales” apportionment.⁴³ The key effect is that once a C corporation is subject to Minnesota tax (e.g., most clearly because it has property or payroll in Minnesota⁴⁴), its Minnesota tax does not depend on the size of its Minnesota operations, but rather on the percentage of its sales that are made to Minnesota purchasers. Thus, increasing or decreasing its Minnesota operations will have little effect on its Minnesota tax, unless it can avoid being subject to Minnesota tax altogether.⁴⁵
- The net result is that changes in the corporate tax rate for a state with single sales apportionment is likely to have minor effects on a state’s competitiveness in attracting investment, because the tax will not go up or down if a corporation expands or contracts in the state.⁴⁶ The only sure way to avoid the tax is to avoid selling to in-state buyers, a strategy that few businesses would find attractive, since the tax is usually a fraction of the profit that the business makes on a sale.

⁴³ Apportionment typically has been done by using production factors as well—that is, the percentage of the business’s property and payroll located in the state. Minnesota, like many states, now uses only the sales factor.

⁴⁴ By statute, the corporate franchise tax applies to corporations that do not have property or employees in Minnesota, if the business “obtains or regularly solicits business” in Minnesota. Minn. Stat. § 290.015 subd. 1(b). Public Law 86-272 (federal law) limits this jurisdiction for sellers of tangible personal property and the constitutional limits are somewhat unclear. The Supreme Court has not (so far) held physical presence is necessary to provide “substantial nexus” to tax other than in the context of collecting sales and use taxes. *Quill Corp. v. North Dakota*, 504 U.S. 298, 317 (1992). Most state courts that have decided the issue relative to corporate taxes have concluded physical presence is not required. The U.S. Supreme Court has refused to hear any of these cases.

⁴⁵ Minnesota operations will trigger the minimum fee, which is sensitive to property and payroll. Minn. Stat. § 290.0922. However, this tax is a minor burden for most C corporations. Avoiding the Minnesota corporate franchise tax altogether requires the business to minimize its contacts with Minnesota to the point that it does not have substantial nexus—an ambiguous constitutional standard until the U.S. Supreme Court decides to clarify the standard. See note 29.

⁴⁶ Empirical studies of the effects of state corporate taxes on state economic growth rates that do not include specifications accounting for state-by-state differences in apportionment formulas (and data that allow analysis of apportionment formula factors) should be viewed with caution. This includes both the weighing of sales and throwback rules that treat out-of-state sales for some businesses as in-state sales. See, e.g., Robert S. Chirinko and Daniel J. Wilson, “State Business Taxes and Investment: State-by-State Simulations,” FRBSF Economic Review, 13 – 28 (2010) for an example. The authors specifically note that they do not have sufficient information to take into account either property taxes or apportionment factors. *Id.* note 6, page 17. This omission suggests that the corporate income tax rate effects that their simulations are measuring may reflect other factors.



Cutting Minnesota Business Taxes

Single sales apportionment, however, does not totally negate competitiveness concerns. It may discourage businesses with no obligation to pay the tax from locating in Minnesota, particularly if they are very profitable and have significant Minnesota sales.⁴⁷ Moreover, economic theory suggests that corporations will pass much of the tax forward to buyers. If their buyers are consumers, the effect on competitiveness will be small (no more than a consumer sales tax). But if their buyers are other Minnesota businesses, it may raise their input costs making them less competitive.

- **The base of the tax is profits, making its effect uneven and imposing the heaviest burden on very profitable firms.** Minnesota’s corporate franchise tax is imposed on net income or profits. Thus, the tax is proportional to profits; firms that have higher markups or bigger profits pay more tax.⁴⁸ In terms of the competitiveness principle, these are the firms that are often the most desirable to attract, since they are most capable of paying high wages and are most likely to pay more in tax than they and their employees use in state and local government services. This point provides a slight counter to the effects of single-sales apportionment discussed above and suggests corporate tax reductions or repeal could make Minnesota more competitive.

⁴⁷ These are businesses without nexus—the legal requirement to pay the tax. How extensive this group of businesses is depends upon constitutional rules. Unless the corporation is protected by Public Law 86-272, one would expect that businesses with significant Minnesota sales would have “economic nexus” if that is ultimately permitted by the Supreme Court. See the discussion in note 29.

⁴⁸ This, of course, holds the Minnesota proportion of their sales constant—the point of the discussion under the previous bullet.

House Research Department • Minnesota House of Representatives

600 State Office Building • 100 Rev. Dr. Martin Luther King Jr. Blvd. • St. Paul, MN 55105
Phone: 651-296-6753 • Email: House.Research@house.mn