

# Understanding Business Taxation

April 2007

AN EDUCATIONAL GUIDE FOR MINNESOTANS



Focusing on How  
Minnesota Taxes  
Business

(Research Arm of the Minnesota Taxpayers Association)



Minnesota Center for Public Finance Research  
Research in Government

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## References Cited in This Booklet

Where to Go for More Information

1. *Total State and Local Business Taxes, 50-State Estimates for Fiscal Year 2006*, prepared in conjunction with the Council on State Taxation by Robert Cline, et. al., Ernst & Young, February 2007, available on their web site: <http://www.statetax.org/COSTHome.cfm>.
2. *State-Local Business Taxation And The Benefits Principle*, William H. Oakland and William A. Testa, Economic Perspectives, Federal Reserve Bank Of Chicago. Available on the Internet at <http://www.chicagofed.org/publications/economicperspectives/1996/epjan96a.pdf>
3. *Taxing Business: Taxes Received versus Cost of Services Provided by State and Local Government in Minnesota*, Minnesota Taxpayers Association, April 2007, [www.mntax.org](http://www.mntax.org).

**Understanding Business Taxation 2007**

**Minnesota Center for Public Finance Research**

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So all in all, Minnesota’s business taxes are competitive in some cases and not competitive in others. It is not an overriding issue for Minnesota businesses in general, but competitiveness must be kept in mind when considering tax reform, and it can usually be improved.

**Q: So what would be your ideal business tax?**

**A:** First, it would be more like a fee, set as closely related to the cost of a specific government service as possible. Second, the overall level of business payments to government would be closer to the amount of state and local government spending directed toward business. Third, it would not discriminate among different types of businesses—in other words, it would be “economically neutral.” Fourth, it would have a very low rate and a very broad base, for competitive reasons.

With these general concepts, several variations of a good business tax could be designed. Whether or not such a tax can actually be enacted into law will depend on pressure from the voting public. It is only if voters grasp that they are already paying all business taxes anyway that they will ask that these hidden tax costs be brought into the light.

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### Minnesota Center for Public Finance Research

The Minnesota Center for Public Finance Research, formerly known as the Minnesota Tax Foundation, incorporated in 1982 as a charitable educational organization, is a foundation created to support the [Minnesota Taxpayers Association](#). Our mission is to provide objective research and analysis on state and local tax and spending issues in support of effective, efficient, and accountable government.

### Minnesota Taxpayers Association

The Minnesota Taxpayers Association is a non-profit, nonpartisan organization dedicated to being an independent voice for good government and sound tax policy. Its membership is statewide, open to all, and representative of every category of taxpayer. It was founded in 1926 and incorporated in 1958.

### Acknowledgements

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### *Q: Do you have other goals regarding business taxation?*

**A:** Something that is always a concern regarding business taxes is competitiveness, that is, how does Minnesota's taxation of business compare with other states and even nations, since our competitors are no longer simply our neighboring states, but countries around the world.

### *Q: How competitive are Minnesota's taxes on business with other states and countries?*

**A:** There is no single measure of competitiveness regarding Minnesota's business taxes that adequately answers that question. One ranking from the Ernst and Young report cited previously shows that Minnesota ranks 35<sup>th</sup> highest in the U.S. on the measure of business taxes as a percent of private economic activity. A large part of that activity used in that measure, however, is wage income, and since wages are higher in Minnesota than in many parts of the country, that tends to reduce Minnesota's rank on that measure. It doesn't necessarily mean Minnesota is very competitive on business taxes.

The Minnesota Taxpayers Association has conducted property tax comparison studies since 1995 that rank property taxes on commercial and industrial parcels for the largest city in each state and a typical small town in each state. Minneapolis' business property tax rankings have improved over the years compared to the other states' largest cities, from highest in the country in 1995 to anywhere from 7<sup>th</sup> highest to 31<sup>st</sup> highest in the country depending on the type and value of property and its location.

The state and local sales tax collections for Minnesota, some 40% of which is paid by businesses, ranked only 34<sup>th</sup> highest in the country when measured against personal income in the state, and 22<sup>nd</sup> highest per person. This is in spite of a state rate of 6.5%, which is the 3<sup>rd</sup> highest state rate in the nation. The discrepancy is due to our narrow sales tax base mentioned previously, and the fact that Minnesota does not allow a lot of local sales taxes, unlike other states.

Not much information exists comparing Minnesota's state taxes to those in other countries.

**Q:** *So would it be fair to say that one of your goals is to make the business taxes people are already paying through their purchases more visible to them?*

**A:** That's right! Another way to say it is to "move those taxes out from under the cover" of business costs by shifting them to households. It will require a lot of educating the public, though, since the concept of their paying hidden taxes now is not very well known. That is one of the reasons for this booklet—to help bring this information to the attention of more people.

**Q:** *What are some specific ideas you have for making business taxes more visible?*

**A:** One of the most obvious ways to make taxes more visible to the public is to exempt all business purchases from the sales tax, while extending the sales tax to nearly every household purchase of both goods and services. Because Minnesota's current sales tax base is relatively narrow compared to other states (due to the exemption of food, clothing, and most services), the actual sales tax rate could be lowered some, depending on how many current exemptions were eliminated compared to eliminating sales taxes on business inputs.

Another idea talked about quite a bit is to eliminate the corporate franchise tax on profits. Taxing profits does not encourage companies to make profits, but to always look for ways to lower them, either through accounting practices or other means. Such taxes also have no connection with the benefits businesses receive from government. The corporate income tax is also notoriously complex and imposes many compliance costs on both governments and taxpayers.

The small share of state tax revenues that come from this tax could be replaced with a much broader based tax on some measure of government services provided directly to businesses. Because the base would be very broad, and the level of tax needed from business would be lower (to reflect the cost of services provided), the rate could be very low. New Hampshire has such a tax with a rate of only 0.5%.

# Understanding Business Taxation

## Introduction

The Minnesota Taxpayers Association, through its educational and research arm of the Minnesota Center for Public Finance Research (MCPFR), has produced two educational booklets that help explain complex government finance systems in Minnesota. The first one is called *Understanding Your Property Taxes* and was first published in the fall of 1991 for property taxes payable in 1992, with the latest edition being prepared for taxes payable in 2006.

Our more recent educational booklet is called *Understanding Education Finance*, first published in January 1997 for the 1996-97 school year. It has recently been updated for the 2005-2006 school year. Both of these educational booklets are available on MCPFR's website at [www.mntax.org/cpfr](http://www.mntax.org/cpfr). Both of these booklets are also written in an easy-to-understand format of questions and answers, with useful appendices containing additional data and information.

Yet, we have felt that our educational series is incomplete. There is a third topic about which we believe there is general and widespread confusion, misunderstanding, and even frustration, and that is the topic of the taxation of business.

Anyone following the historic 2005 legislative session is aware that there is disagreement among legislators and policy makers regarding this topic. There has been a great deal of discussion and disagreement on several questions regarding the taxing of businesses:

- Are businesses paying their "fair share" of taxes?
- Are businesses paying too much in taxes to be competitive with businesses in other states and around the world?
- Are businesses being treated unequally from one business type to another?

Each advocate group for one of these views is armed with a thicket of statistics to back their claims. Even policy makers have trouble making sense of the jumble of charts, graphs, and tables presented by lobbyists across the political spectrum in their testimony before legislative committees. The average citizen tends simply to tune out.

We offer this booklet, *Understanding Business Taxation*, to help bring some clarity to the debate, add to the knowledge of Minnesotans regarding what good business tax policy principles are, and examine Minnesota's current business taxes using those principles.

If you are interested in how businesses are and should be taxed, and are confused by current discussions about that, then you are reading the right booklet. We have stayed with our familiar question and answer format from our previously produced educational booklets to make this topic as straightforward and as understandable as possible.

## Questions and Answers

### Overview

**Q:** *I guess I've never really thought much about it before, but how are businesses taxed in Minnesota now?*

**A:** There are two main ways businesses are taxed in this state. The one probably the most people are aware of is through taxes specifically designed for certain types of businesses, such as the corporate income tax. But the other way is one most people are not aware of, but which accounts for most of the taxes businesses pay, and that is through taxes common to nearly everyone, such as property, sales, and individual income taxes.

**Q:** *You mean businesses pay more than just the corporate income tax? What kinds of taxes do businesses pay?*

**A:** Yes, businesses pay many more kinds of taxes than just corporate income taxes. Here is a list of the kinds of taxes businesses pay in Minnesota:

#### Taxes Designed Specifically for Businesses

*Corporate Franchise (or Income) Tax*—This tax was combined from the corporate income tax and bank excise tax in 1987, and is designed to tax the Minnesota allocated net income of a business that is incorporated at a rate of 9.8%. (See the text box on the next page for the various legal forms businesses can take for tax purposes.)

*Insurance Premiums Tax*—for insurance companies' gross premiums received minus any returned premiums, at rates of 0.5% to 2%

*Health Care Provider Surcharges and Provider Taxes*—part of the

## Ideas for Business Tax Reform

**Q:** *What do you think should be done about the gap between what businesses pay in taxes and what they receive in services from government?*

**A:** The Minnesota Taxpayers Association has, for many years, advocated for a more accountable state and local tax system, one that keeps taxes as visible as possible while recognizing taxes must be based to a certain extent on a person's ability to pay. Because business taxes are invisible to voters, MTA advocates for assessing businesses on a fee basis to reflect as closely as possible governments' cost of providing services to business.

**Q:** *Would it be difficult to move to more of a fee basis for taxing business?*

**A:** It is difficult on several levels, including the process of identifying services provided by government that could be converted to a cost-fee basis, but that process is not impossible. The most difficult part, however, is probably the political resistance it would generate.

**Q:** *Why would there be "political resistance" to making business taxes more like fees?*

**A:** To say that it is a policy goal to move toward assessing businesses on a fee basis to align revenue obtained from business as closely as possible with the government costs of providing services to business may not create much resistance at first. Once this goal is re-phrased in common language, however, to say "cut business taxes by 50% to 60% and increase taxes on households by 30% to pay for it"—it is obvious why there would be resistance to that.

The resistance from such a re-statement would not be based on facts, though. Because businesses pass their tax costs on like all other costs, as discussed earlier, households are already paying these taxes—they just don't know it.

reasonably be described as benefiting businesses.

**Q: What do the studies show about the cost of government services provided to businesses?**

**A:** One such study by William Testa and William Oakland, published in 1996 as an Economic Perspectives paper of the 7<sup>th</sup> District Federal Reserve Bank of Chicago<sup>1</sup>, estimated that in 1992, 13.8%, or \$94.1 billion, of state and local government expenditures in the United States directly benefited business, while the remaining 86.2% of the expenditures primarily benefited households. The paper's estimate for the portion of state and local taxes in the U.S. paid by business was 29%, or \$160.5 billion.

In a study the Minnesota Taxpayers Association conducted that replicated Drs. Testa and Oakland's methodology for 2002 state and local government spending in Minnesota<sup>2</sup>, the portion of such spending attributable to benefiting business was 13.8%, or \$3.6 billion. MTA's estimate of the portion of state and local taxes paid by businesses was 36.9%, or \$8.4 billion.

**Q: So in Minnesota, in 2002, businesses paid \$8.4 billion in state and local taxes, but only received \$3.6 billion in benefits from state and local governments?**

**A:** The numbers cited above are the result of reasonable assumptions made about what spending should be considered to be a benefit to businesses versus households, and reasonable people could disagree. The magnitude of how much more businesses are paying may not be exactly a 1.7 to 1 ratio (the \$160.5 in taxes divided by the \$94.1 billion in spending for the U.S.) or a 2.3 to 1 ratio (the \$8.4 billion in taxes divided by the \$3.6 billion in spending in Minnesota). Nevertheless, it seems clear from these studies that regardless of assumptions used that businesses are paying more in taxes to state and local governments than they receive in benefits from them.

<sup>1</sup> *State-Local Business Taxation And The Benefits Principle*, William H. Oakland and William A. Testa, Economic Perspectives, Federal Reserve Bank Of Chicago. Available on the Internet at <http://www.chicagofed.org/publications/economicperspectives/1996/epjan96a.pdf>

<sup>2</sup> *Taxing Business: Taxes Received versus Cost of Services Provided by State and Local Government in Minnesota*, Minnesota Taxpayers Association, March 2007, [www.mntax.org](http://www.mntax.org).

### Types of Legal Organizations for Business

(Source: Minnesota Department of Revenue Application for Business Registration Instructions)

#### **Taxed Under the Corporate Franchise Tax System**

You are a **C corporation** if you are incorporated.

A **financial institution** is any national or state bank, bank holding company, savings and loan, or any other corporation doing business that a bank or other financial institution would be authorized to do, as defined in M.S. 290.01, subd. 4a. (Banks were taxed under the Bank Excise Tax until 1987.)

#### **Taxed under the Individual Income Tax System**

A **sole proprietor** is an individual who owns an unincorporated business and is not in partnership with anyone else.

You are an **S corporation** if you elected to be taxed under Subchapter S of the Internal Revenue Code (IRC).

You are an **estate or trust (fiduciary)** for Minnesota tax purposes if you are required to file federal Form 1041, *U.S. Income Tax Return for Estates and Trusts*.

A **partnership** is two or more persons or entities (e.g. two corporations).

A **limited liability partnership** is a general partnership that is registered as a limited liability partnership with the Minnesota Secretary of State (giving it the legal protection from certain liabilities like a corporation without having to incorporate).

A **limited liability company (LLC)** is an authorized organization registered with the Minnesota Secretary of State.

- An LLC with **one member only** may be taxed as a corporation or sole proprietorship. If the LLC chooses to be taxed as a sole proprietorship, there is no need to register the LLC unless a Minnesota ID number is required for another purpose.
- An LLC with **two or more members** (e.g., partnerships and limited partnerships) may choose to be taxed as a partnership or corporation. Both federal and state ID numbers are required, even if the LLC has no employees.

#### **Other Types of Business Organization**

A **cooperative** may be a corporation or an unincorporated association (taxed under various systems, or not taxed, depending on organization)

You are a **nonprofit organization** if you are exempt as defined in M.S. 290.05 (not taxed).

**Nonprofit corporation** is the same as a corporation except that it cannot pay out dividends of its profits (which are not subject to tax).

funding for the MinnesotaCare health insurance program for low-income Minnesotans, these surcharges and taxes are on nursing homes, wholesale drug distributors, hospitals, dentists, home health care, clinics, and other health care providers.

*Occupation Tax*—a tax similar but not identical to the corporate franchise tax imposed on the mine value of ore.

*Airflight Property Tax*—for air carriers engaged in air commerce, in lieu of a registration tax.

*Mining Production Taxes (Local)*—charged mining companies by the ton for each ton of taconite or direct reduced iron produced.

*Other Mining Taxes*—including severed mineral interests, unmined taconite, and aggregate material production taxes.

*A Variety of Local Franchise Fees and Licenses for Business*—these are generally in the form of a small percentage of a company’s receipts, typically from 1% to 3% (in the case of fees), or a flat amount (in the case of licenses) as part of the cost of the privilege of doing business in a city.

#### Taxes Paid by Individuals That Are Also Paid by Businesses

*General Sales and Use Tax*—like everyone else, businesses must pay sales taxes on all their purchases, unless it is for certain types of equipment, or is for materials consumed in a manufacturing process.

*Individual Income Tax*—businesses organized as “sole proprietors” or in various forms of partnerships and professional associations do not pay the corporate income tax, but instead pay the individual income tax on their income after expenses are deducted. (Again, see the text box on the previous page for the various legal forms businesses can take for tax purposes.)

*Excise Taxes*—these are like sales taxes but are usually imposed as a flat amount per unit, rather than as a percentage of price (but not always). Examples of these are the gasoline tax, and alcohol and tobacco taxes (on any such purchases businesses make), and mortgage and deed registry taxes.

*Property Taxes*—these have been mostly local in recent decades, but beginning in 2002, business and cabin properties are now subject to a statewide property tax. Businesses must pay property taxes directly on most properties they own, or indirectly through rent paid in buildings they lease.

**Q: That’s a lot of different kinds of taxes! How much do businesses pay in these taxes every year?**

**A:** There is no precise accounting of just how much businesses pay, primarily because for so many of them, business tax payments are mixed in with those paid by individuals, too. Studies have been done, however, that use various sources of information to estimate the portion of all state and local taxes that are paid by businesses.

Charging businesses fees for the benefits they receive from government services would be an economically efficient way to collect revenue from businesses, and would at the same time minimize the amount of tax revenue hidden from the general public in the cost of doing business.

**Q: What kinds of benefits do businesses receive from government services?**

**A:** Before answering this more broadly, it may be helpful to think of some specific examples. Suppose that you are in the business of selling coffee over the Internet. When you receive an order, you package it to mail to the customer’s address. Your package may be carried by a truck to its destination. On what did the truck travel to get to its destination? City streets and major state and national highways, most likely.

Various levels of government have raised significant amounts of money to build and maintain these streets and highways, which together with other public improvements are called “infrastructure.” Funding such transportation infrastructure is a service provided by government that benefits business.

Other services include such things as court systems for enforcing contracts and protecting private property, police and fire services for additional property protection, sewer services for public health and safety, and so forth. Their value to business is more immediately apparent to anyone who has tried to conduct business in parts of the world where these kinds of services are not provided at all, or are not provided very well.

**Q: Do we know how much it costs government to provide these types of services to businesses?**

**A:** Not precisely. Just as we do not know precisely what portion of the total tax burden business pays, we aren’t exactly sure just what benefits from government services businesses get, nor how much they cost.

Studies have been done, however, just like in the tax area, that estimate what portion of state and local government spending can

business receives from government.

Another little known fact about taxes that businesses pay is that when they are traced to where they end up—on households based on purchases of goods and services, wages, and investments—lower income households are shown to pay a greater share of their income in hidden business taxes than higher income households. See Table 2 for how the Minnesota Department of Revenue believes taxes paid by business actually affect Minnesota households by income level.

**Table 2: State and Local Business Taxes Allocated to Minnesota Households as Percent of Income by Income Level, 2004**

Population Decile	Income Range	Nonresidential Local Property Taxes (mostly business)	Total State Taxes		
			Total on Individuals	Total on Businesses	State Taxes Total
First	\$10,175 & under	2.0%	4.5%	5.5%	9.9%
Second	\$10,176 - \$16,816	1.3%	2.9%	3.3%	6.2%
Third	\$16,817 - \$23,135	0.8%	3.9%	2.6%	6.5%
Fourth	\$23,136 - \$29,766	1.0%	4.9%	2.4%	7.3%
Fifth	\$29,767 - \$37,559	0.7%	6.1%	2.1%	8.2%
Sixth	\$37,560 - \$47,192	0.8%	6.7%	2.0%	8.7%
Seventh	\$47,193 - \$59,748	0.7%	7.0%	1.9%	8.9%
Eighth	\$59,749 - \$76,437	0.6%	7.5%	1.8%	9.2%
Ninth	\$76,438 - \$105,450	0.5%	7.8%	1.6%	9.4%
Tenth	\$105,451 & over	0.4%	7.7%	1.2%	9.0%
<b>TOTALS</b>		<b>0.6%</b>	<b>7.1%</b>	<b>1.7%</b>	<b>8.8%</b>
Top 5%	Over \$146,809	0.4%	7.7%	1.1%	8.9%
Top 1%	Over \$354,758	0.3%	7.7%	0.9%	8.5%

Source: MN Department of Revenue *Tax Incidence Study, 2007*, published 3/2007.

Notice that as incomes increase, the percentage of income households pay in hidden business taxes (the shaded columns) decreases, even though total state tax burdens are relatively flat across all incomes. This is known as a *regressive* pattern of tax incidence. The pattern shown by the “Total on Individuals” column is known as a *progressive* pattern, with tax rates rising as income increases.

**Q:** *So should governments only charge fees to businesses and not tax them at all?*

**A:** In theory, yes, but it is widely recognized that it is not always possible to determine specifically which businesses benefit from certain government services and what is the cost of those services.

One such study from the Council on State Taxation in Washington, DC is *Total State and Local Business Taxes* conducted by the Ernst & Young accounting firm (see citation in Table 1 below). Their latest study gives estimates of how much of the total state and local tax burden businesses pay by state. Table 1 shows their estimates for 2006, the latest year available.

**Table 1. Minnesota State and Local Business Taxes, By Type, FY2006**  
(Dollars in Billions)

Type of Tax Paid by Businesses	Amount of Tax	Estimated Portion of Tax Type Paid by Businesses*
Property Tax	\$4.5**	49%
Sales Tax on Business Inputs	1.9	40%
Excise and Gross Receipts	1.3	50%
Corporate Income	1.1	100%
Unemployment Payroll Tax ***	0.9	100%
Individual Income Tax on Pass-Thru Business Income	0.4	6%
Licenses and Other Taxes	0.6	Not readily available
<b>Total Business Taxes</b>	<b>\$8.6</b>	<b>42.5%</b>

Source: *Total State and Local Business Taxes, 50-State Estimates for Fiscal Year 2006*, prepared in conjunction with the Council on State Taxation by Robert Cline, et. al., Ernst & Young, February 2007.

\*Estimated from separate data by MTA.  
 \*\*Includes utility, rental, and farm property.  
 \*\*\*The study includes unemployment payroll taxes as part of the business tax burden, something not traditionally included in a list of state and local taxes, but which are still a real tax cost.

**Q:** *Wow! That is a lot more than I thought they would be paying. I've heard a lot about businesses paying their fair share of taxes. Why do people say that if businesses are already paying a lot?*

**A:** When people talk about businesses paying their “fair share” of taxes, they are most likely talking about one tax in particular, and that is the corporate income tax. Corporate income tax collections have dropped as a percent of Minnesota’s total state tax collections, from a high of over 10% in the late 1970s to a recent low of just over 4% in 2002. They have since climbed back up to about 7.2% of the state’s total tax collections.

**Q:** *So businesses pay over 40% of all the cost of state and local government?*

**A:** Actually, they pay about 42% of state and local *taxes*, but businesses also pay many *fees* to both state and local governments. There isn't readily available data for the fees, especially local ones, and determining businesses' portion would be a large and difficult project.

**Policy Background**

**Q:** *There was a lot of talk about “taxes” versus “fees” in a recent legislative session. What is the difference between the two?*

**A:** The distinction between a tax and a fee is not as clear cut as you might think. Think of the difference as a line, with taxes on one end and fees on the other end, with gradations of each from one end of the line to the other. The exact point at which a tax becomes a fee is somewhat a matter of opinion, but the extremes on either end of the line are more obvious.



At one end of the “tax-fee” line, a tax is something paid to government by all or most people for government services that benefit the population at large. The amount of the tax is set primarily through the political process, to collect an overall amount of money deemed appropriate for the level of services provided, and not tied to the cost of a particular service.

At the other end of the line, a fee is an amount of money paid for a specific service to the one paying the price. The price is typically set to recover the cost of providing that service, or some portion of the cost.

**Q:** *Why is it so important whether or not something is a fee or tax?*

**A:** In practical terms it may not be very important to our day-to-day life whether something is a fee or a tax. But from a public policy point of view, it is more important.

**Sound Business Tax Policy**

**Q:** *It sounds to me like you are saying the best way for the government to raise money is with fees. Is that right?*

**A:** It is true, as mentioned earlier, that tax policy experts and economists generally recommend that fees be used by governments whenever possible. This makes government costs visible to voters (a concern of some tax policy people) and helps ensure that government's prices are reflective of the benefits costs so as not to stimulate demand for the services (something economists tend to worry about).

It is especially true when assessing businesses for the cost of government services.

**Q:** *Why is that especially true for businesses?*

**A:** Remember the discussion about the consumer, worker, and investor actually paying business taxes as part of the cost of doing business? The more businesses are subject to general taxation, the less relationship there is between the taxes they pay and the cost of the government services provided to them. Since these tax costs are passed on in one form or another, voters end up paying the taxes without realizing it, undermining the visibility and economic efficiency of a government's revenue raising system.

There is another problem with the general taxation of business: since the nature of business varies so much from one company to another, a generally applied tax can have a much different effect on one type of business versus another.

For example, consider a grocery store versus a computer training company. Since a grocery store buys nearly all of its inventory for resale to customers, it does not pay a lot of sales tax on its purchases. A computer training company, however, has to buy all its computers for use in training. It must pay a sales tax on nearly every purchase. The amount of sales tax paid by each company on its purchases (not collected from customers of the two businesses, but actually paid by the business itself), would be much different, with little or no connection to the amount of services each type of

**Costs of Doing Business**  
 Here are some examples of the “costs of doing business” that must be recovered by a business in order to stay in business:

Cost of Goods Sold

- Any raw materials purchased
- Wages for labor to assemble the materials
- Overhead
  - Any supervisors’ salaries
  - plant maintenance
  - general supplies
  - depreciation of plant and equipment
  - insurance
  - electricity and other utilities
  - etc.

Operating expenses

- Selling expenses—any expense incurred to produce sales
- Administrating expenses—any expense incurred to manage the company

Interest on Debt

Taxes, Fees, and Licenses

- Federal
- State
- Local

government—for services rendered to the business. That means that all payments businesses make to government should technically be called fees or charges, even though much of the money is paid by businesses to governments in the form of general taxes.

One final point about the “cost of doing business:” for any business to survive, much less thrive, these costs *must* be recovered eventually or the business cannot continue to function. These costs are recovered through prices paid by customers for whatever goods or services the business is offering. When you as a customer think of it in these terms, you may begin to realize that *you are actually paying part of the costs of the business by purchasing goods or services, including any taxes and fees they*

*pay to government.* (Consumers don’t pay all the costs. Economists also believe workers and investors pay part of the costs of businesses, too, through lower wages and lower returns on investments.)

**Q:** *You mean I am paying the taxes a business pays when I buy from that business?*

**A:** That is correct. You are also helping to pay the taxes of the employer you work for, in the sense that, absent any tax bill, the employer could pay you higher wages. If you invest in a company, you help pay its taxes, too, because your return is lowered by any taxes and fees the company pays.

Any functioning government requires money to operate. This is highlighted in a couple of famous quotes about the necessity of taxes:

**I like to pay taxes. With them I buy civilization.**

~Oliver Wendell Holmes, Jr., Associate Justice of the U.S. Supreme Court, 1902-1932 (another version has him saying “**Taxes are the price we pay for a civilized society.**”)

**Taxes, after all, are dues that we pay for the privileges of membership in an organized society.**

~Franklin D. Roosevelt, 32<sup>nd</sup> President of the United States, 1933-1945

Both quotes have to do with taxes, but their emphasis is different. The Roosevelt quote emphasizes paying for a privilege that is not necessarily related to a particular cost or price, which is a characteristic of general taxes. “Dues” for “privileges” tend not to be cost-based. The Holmes quote emphasizes buying something with taxes—a more “price conscious” way of discussing taxes that is actually more consistent with fees.

The policy implications of which method governments emphasize to raise taxes are related to the cost/price issue of taxes versus fees in a couple of ways:

1. *Making costs visible and understandable*
  - *Taxes*—Governments that raise most of their money through general taxes that are not closely tied to the cost of the services may not be as concerned with making the cost of those services visible and understandable to the public. The costs represented by the taxes paid are spread across the population, usually more closely aligned with incomes of taxpayers than any other characteristic. The mechanism of raising money through general taxes makes the price of the services nearly invisible to the typical beneficiary of the many services of government.

- *Fees*—Governments that raise most of their money through fees, on the other hand, may tend to emphasize the price tag for the services they offer, and promote a clearer understanding to the taxpayer (or “fee payer”) of the cost of the services offered. A government that raises its money primarily through fees that are closely related to the cost of the services makes prices very visible to those receiving the services.

2. *Effect on Demand for Services*

- *Taxes*—If the price of government services is perceived by the majority of voters to be cheap or free, it is fairly easy to see that this would result in an increased demand for such services. When a majority of a society values expanding government services and wants the funding of those to be as painless as possible on the majority of voters, revenue will tend to be raised for those services through general taxation, especially based primarily on the ability to pay.
- *Fees*—If voters are aware that any request for more services will result in a direct increase in the amount they pay to government, it is fairly easy to see that this would tend to encourage more careful consideration on the part of the voters before requesting more services.

**Q: What is the right way for governments to raise their money?**

**A:** There is no one “right” way to raise government money. Some services are not easily priced to the individual and must be paid for through general taxation. Other services could be paid for by taxes or fees, with the choice of funding largely a political matter. A combination of taxes and fees, with different kinds of taxes, is typically considered the best approach.

Having said that, there is a consensus among academics who study tax policy that using fees as much as possible in order to make the cost of government services as transparent as possible to voters is the better approach for a self-governing tradition such as we have in this country.

The governments shown in the text box vary across the entire “tax-fee” spectrum in how they raise money. All levels of government use some combination of taxes and fees. The “tax-fee” mix generally reflects preferences of the voting population in the area.

<p align="center"><b>LEVELS OF GOVERNMENT</b> <i>(with primary forms of taxation for each level)</i></p> <p>Each level has a different set of services it provides, though there is significant overlap in some cases. Each level is also shown with its primary (but not only) forms of taxation.</p> <ol style="list-style-type: none"> <li>1. Federal government: income tax on individuals and corporations</li> <li>2. State governments: income and sales taxes</li> <li>3. Local governments: property and sales taxes</li> </ol>
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**Q: It makes sense that the clearer the price tag is the more careful people will be in requesting more services. How does this “tax-fee” discussion relate to business taxes?**

<p align="center"><b>Synonyms for “Business”</b></p> <p><b>BUSINESS, COMMERCE, TRADE, INDUSTRY</b> mean activity concerned with the supplying and distribution of commodities or services.</p> <p><b>BUSINESS</b> may be an inclusive term but specifically designates the activities of those engaged in the purchase or sale of commodities and services or in related financial transactions.</p> <p><b>COMMERCE</b> and <b>TRADE</b> imply the exchange and transportation of commodities.</p> <p><b>INDUSTRY</b> applies to the producing of commodities, especially by manufacturing or processing, usually on a large scale.</p> <p>Source: Merriam-Webster Dictionary Online (<a href="http://www.m-w.com/">http://www.m-w.com/</a>)</p>
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**A:** It has to do with the nature of business itself. “Business” is basically the selling of goods or services or both (see the text box for some common synonyms for “business”). In order to have something to sell, in the case of goods, or to make people aware of your business, in the case of services, you must spend money either to buy the goods to sell or to advertise your services. Such purchases are known as “the cost of doing business” (see the box on the next page) and include

additional purchases, too, such as paying rent for space, utilities, supplies, and wages for anyone you hire to help you in your business. Government acknowledges these costs by allowing businesses to deduct such expenses from their income taxes before reporting any profits that are to be taxed.

Taxes and fees paid to governments are also part of “the cost of doing business,” shown by the fact that the federal government allows state and local taxes to be deducted from income as part of business expenses. Consistent with the cost/price discussion above, these are best seen as payments to a vendor—in this case