Fair, Effective Tax Reform Should Focus on Profits Rather than Business Inputs

Letter of Information Regarding House Bill 1554

Given before the House Ways and Means Committee

House Bill 1554 aims to address three serious shortcomings of Maryland's current tax code. Our tax code is inadequate, falling billions short of the revenue we need to support vital public services like education, child care, and transportation. It is unfair, allowing powerful corporations to get out of paying their fair share. And it is outdated, leaving the growing services sector virtually untapped. However, this bill's approach is misguided. It does not effectively target large corporations and wealthy shareholders; nor does it follow consensus design principles endorsed by tax experts of all ideological stripes. **The Maryland Center on Economic Policy urges lawmakers to instead focus on taxing business profits through measures like worldwide combined reporting and closing the LLC loophole.**

Maryland's Sales Tax Is Outdated. Household consumption has shifted significantly during the last half century, with consumption of generally taxable tangible goods declining and consumption of generally untaxed services increasing. Services grew from 30% of nationwide household purchases in 1970 to 45% as of 2011,[i] and almost certainly account for an even higher share today. This shift is a major contributor to slow revenue growth that makes Maryland's sales tax a less effective part of our revenue system than it was in the past. As part of a broader reform package, a well-designed base expansion to tax certain services would strengthen Maryland's fiscal outlook.

However, experts near-unanimously advise against taxing business inputs. For example, the Institute on Taxation and Economic Policy,[ii] the Center on Budget and Policy Priorities,[iii] Ernst & Young in a report commissioned by the Council on State Taxation,[iv] and the Mercatus Center have all written on the disadvantages of applying the sales tax to business inputs.[v]

Sales taxes are inherently lopsided. For example, Maryland's sales tax is eight times as expensive for low-income families as for the wealthiest 1% (as a share of income).[vi] This is why even well-designed sales tax reforms are best as part of a broader package that taxes wealthy individuals, closes corporate tax loopholes, and strengthens working family tax credits.

Taxing business inputs is not more equitable. Because it is easy for businesses to pass taxes on in the form of higher prices, the bulk of revenue ultimately comes from working families:

- From a business's perspective, a tax on inputs is equivalent to an increase in those inputs' prices – just as for consumers, the retail sales tax is equivalent to paying a higher price. Businesses would respond to this increase in costs in the way they respond to any increase in costs – by raising prices.
- Any consumer good that has a multi-step supply chain would include multiple levels of taxes on the same product. This has the potential to significantly increase retail prices in a way that is opaque to the consumer.
- Taxing business inputs increases the ultimate price of essentially all products, including those that are

exempt from retail sales taxes. This means that consumers would newly pay hidden sales taxes on necessities such as groceries.
- Because the exemption for necessities in our current sales tax is intended to make it more equitable by reducing the taxes low-income families pay, taxing business services could make Maryland's sales tax more lopsided, not less.

There is no question that large, profitable businesses should contribute more to the public services that keep Maryland's economy going. Taxing business *profits* is the more effective way to do this. Why?

- When businesses decide how much to charge for their products or services, they aim to maximize profits.
- Taxing inputs shifts the profit-maximizing price. If after-tax unit production costs increase, businesses can reduce the impact on their margins by raising prices. Even if sales decline somewhat, that will partially offset the increase in total production costs. In other words, if a company charges more for widgets, it may not sell as many widgets, but it also does not have to make as many widgets.
- Taxing profits does not shift the profit-maximizing price. If a company pays 8.25% of profits in corporate income tax, the only way to pay less tax is to make less money. Because after-tax profits are always 91.75% of pre-tax profits, decreasing one invariably decreases the other.

There is a better way. The Fair Share for Maryland Act (House Bill 1014) includes multiple provisions to ensure big businesses pay their fair share:

- **Worldwide combined reporting** to prevent artificial profit-shifting to low-tax states or offshore tax havens
- **The throwback rule** to eliminate "nowhere income" when corporations make sales into states that lack legal authority to tax them
- **Closing the LLC loophole** that allows even giant companies to avoid corporate income taxes by organizing as pass-through entities

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i Michael Leachman and Michael Mazerov, "Four Steps to Moving State Sales Taxes into the 21st Century," Center on Budget and Policy Priorities, 2013, https://www.cbpp.org/research/state-budget-and-tax/four-steps-to-moving-state-sales-taxes-into-the-21st-century

ii "Chapter Three: Sales and Excise Taxes" in *The ITEP Guide to Fair State and Local Taxes*, Institute on Taxation and Economic Policy, 2011, https://itep.org/wp-content/uploads/guide3.pdf

iii Michael Mazerov, "Expanding Sales Taxation of Services: Options and Issues," Center on Budget and Policy Priorities, 2009, https://www.cbpp.org/research/state-budget-and-tax/expanding-sales-taxation-of-services-options-and-issues

iv Andrew Phillips and Muath Ibaid, "The Impact of Imposing Sales Taxes on Business Inputs," Ernst & Young for the Council on State Taxation, 2019, https://www.cost.org/globalassets/cost/state-tax-resources-pdf-pages/cost-studies-articles-reports/1903-3073001_cost-ey-sales-tax-on-business-inputs-study_final-5-16.pdf

v Justin Ross, *A Primer on State and Local Tax Policy*, Mercatus Center at George Mason University, 2014, https://www.mercatus.org/system/files/Ross_PrimerTaxPolicy_v2.pdf

vi Meg Wiehe, Aidan Davis, Carl Davis, Matt Gardner, Lisa Gee, and Dylan Grundman, "Who Pays? A Distributional Analysis of the Tax Systems in All 50 States," Institute on Taxation and Economic Policy, 2018, https://itep.org/wp-content/uploads/whopays-ITEP-2018.pdf Maryland-specific data available at https://itep.org/whopays/maryland/