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TESTIMONY ON BUSINESS ACTIVITY TAX BEFORE THE JOINT COMMITTEE ON STUDENT SUCCESS SUBCOMMITTEE ON REVENUE

February 7, 2019

Chair Hass, Chair Nathanson and members of the subcommittee, good evening. I am Sandra McDonough, President and CEO of Oregon Business & Industry. I am joined by my colleague Mike Stober, who is our policy director specializing in tax and fiscal policy.

As you know, Oregon Business & Industry is the largest statewide business organization representing approximately 1,600 businesses that employ nearly 300,000 Oregonians. Our members cover virtually every industry in Oregon and more than 80 percent of them are small businesses with fewer than 100 employees.

There are several issues before the Legislature this year that will impact our members, including the work of the Joint Committee on Student Success, both your efforts to improve education outcomes and your efforts to raise new tax revenue.

In fact, we deeply appreciate the work of the Joint Committee on Student Success and your effort to take a focused look at how we can improve Oregon's education system. We agree that targeted education investments are necessary to improve the potential for all Oregon students to achieve success, and we agree that additional revenue for that purpose is necessary.

A few things matter to us. First, we care about how and where the money will be invested to maximize the benefit to Oregonians. Second, we care about how the revenue will raised; third, we believe – and will continue to say – that raising new revenue without dealing with underlying cost issues is not a sustainable way to fix our state's education system, and finally, we are concerned about the cumulative cost of all the legislation we expect to see enacted in this legislative session.

On revenue, we have raised concerns about the Gross Receipts Tax model. We believe that kind of a tax system is deeply flawed, particularly because of the economic distortions caused by its pyramiding characteristics, which are inevitable in a GRT no matter how low you set the rate. The tax pyramiding results in inequities, because some products and processes end up with a different effective tax rates than others. Mike Stober will walk through how that works. But I will say that many of our members remain strongly opposed to the Gross Receipts Tax model because of that pyramiding impact.

As we have raised this concern about the GRT over the last few years, many of you have challenged us to come to the table with an alternative option. We are doing that now. For the last year, Oregon Business & Industry has been working with our partners in the Oregon Business Plan to develop an alternative revenue option that could be deployed to fund targeted investments in education.

We refer to our option as the Business Activity Tax. It is a form of a broad-based consumption tax with a base that is calculated by subtracting purchases from other businesses from gross receipts.

We contracted with consultants at the State Tax Research Institute to develop the Business Activity Tax option, which, for many companies, works better than a GRT. Mike is going to walk you through how it works.

For us, this is still a research project. We have convened partner business organizations to work with us, and we are developing a tool that will enable individual businesses to calculate the potential tax impact of both the GRT and our Business Activities Tax model. We want to be well prepared to answer your questions about individual business impacts when the time comes.

I expect your question to me will be whether we are ready to endorse a new tax based on our model, and my answer will be it is too early to say. Today, we are talking about broad concepts. We don't yet know how this tax option – or any other – will ultimately look, in terms of rates, exclusions and other very important details. And we don't know what other adjustments you may make to the Oregon tax code as you develop a new plan.

Until we have that complete picture, I can't say where we will be. But I can tell you this: We are committed to being part of the conversation. It's the reason we have proactively developed a Business Activity Tax option, and why we have spent the past year traveling the state to discuss the issue with legislators, chambers of commerce, businesses, industry associations, and other stakeholders.

Before I turn it over to Mike, I want to address the other factor we believe is critically important to this discussion.

We are committed to being part of the revenue discussion and improving funding for Oregon's education system. But we also want to make sure the dollars get to the classrooms and programs where they will really make a difference. This next biennium, and for many biennia after that.

That is why we will continue to stress that you must address the state's structural budget deficit, starting with the rising costs of the Public Employees Retirement System or PERS.

As this chart shows, increasing costs of PERS will consume much of the new revenue from a $2 billion education funding package, and that doesn't count the cost to local governments.

We believe that there are legal, meaningful steps that the Legislature can take to slow the growth in PERS costs, including passing Senator Knopp's Employee Choice and Shared Responsibility Act, SB 148.

Thank you. I will turn it over to Mike Stober.

Mike Stober

Thank you, Sandi. Chair Hass, Chair Nathanson, members of the Subcommittee, I am Mike Stober, OBI's policy director for tax and fiscal policy.

We know that the Subcommittee has established or is in the process of establishing guiding principles. OBI has done the same, establishing tax policy principles to guide our engagement with you this session. Fortunately, there is broad overlap between the concepts we have each established.

Here are a few of the guiding principles OBI will use as we evaluate revenue proposals:

- Broad base (no favorites among industries)
- Level playing field (similar impacts among competitors)
- Recognize needs of low-margin businesses
- Support economic, employment, and wage growth
- Reduce volatility of state revenues and promote stability through reserves and fiscal discipline

As Sandi mentioned, the Business Activity Tax model we have developed with our Oregon Business Plan partners is a value-added or consumption-based tax that equals total sales minus business input purchases, including all capital purchases. This is a subtraction method concept as opposed to the additive New Hampshire Business Enterprise Tax the subcommittee discussed last week as well as briefly earlier this week.

The Business Activity Tax would apply to every business, no matter how it is structured, whether that's as a C-Corp or a pass-through entity.

The Business Activity Tax would follow the 100 percent destination sales apportionment market sourcing concept. This means that Oregon businesses exporting to other states or countries would not have to pay the Business Activity Tax on revenue generated from those exports. It also means that businesses located in other states would have to pay the Business Activity Tax on their Oregon sales.

While there are a number of other policy and political decisions to be made in designing a Business Activity Tax, there are some important features we believe it should have.

The Business Activity Tax should include an exemption for small businesses or businesses with less than $500,000 in gross receipts in Oregon. This avoids placing an unnecessary financial and administrative burden on firms with relatively few sales in the state.

The tax should exempt government services, charities, public/nonprofit colleges and universities, as well as financial services and insurance companies. States that have implemented versions of a Business Activity Tax in the past have typically exempted financial services and insurance, because their main costs of doing business are interest paid to depositors and loss payments to policyholders. Since these would not be deductible as they are not payments to other businesses, the Business Activity Tax would significantly overstate their value added. Financial services firms and insurance companies would then be subject to the current corporate income tax regime.

Finally, just as with the corporate income tax, companies with a negative Business Activity Tax liability should be able to carry forward their negative liability for a period of 20 years in order to offset future Business Activity Taxes.

Here is how a Business Activity Tax would work for a business – a grocery store, for example. The grocery would take the revenue generated from all its sales at the register and subtract all its purchases from other businesses. That includes its inventory – the groceries – as well as its shelves, checkout stands, electric and water bills, etc. The dollar amount that remains would be multiplied by the Business Activity Tax rate to determine the grocery's Business Activity Tax.

Contrast that with a Gross Receipts Tax that is applied to the same product at the same rate in every stage of the process, from initial production to the consumer's shelf. In that system, the tax compounds or pyramids as you can see in this slide.

As Sandi said, many of OBI's members are opposed to a gross receipts tax due to the economic distortions the pyramiding effect creates. The only detailed pyramiding study we are aware of is a 2002 study of the Washington Business & Occupation tax. However, the lessons clearly apply to today's conversation. That study found that the pyramiding effect resulted in an average effective tax rate 2.5 times the statutory rate for Washington State businesses.

There was also a wide variation across industries: the multiplier is 6.7 for food manufacturing, 4.1 for apparel/textile manufacturing, 3.3 for construction, 1.8 for professional services, and 1.5 for utilities.

Again, that's Washington state. However, we also had our consultants at the State Tax Research Institute look at an Oregon-specific example. Under a gross receipts tax, an Oregon transportation equipment manufacturer will face an estimated pyramiding ratio of 3.85. That means the manufacturer will effectively pay almost 4 times the rate set in law by the time the consumer buys their product.

Another way to look at this is the difference in total taxes under a Business Activity Tax and under a gross receipts tax. Assuming tax rates that generate the same amount of total economy-wide revenue – that would be 1.0% for the Business Activity Tax and 0.384% for a gross receipts tax – the transportation equipment manufacturing industry in Oregon would pay 3.2 times more taxes under a gross receipts tax than it would under the Business Activity Tax.

The pyramiding that results from a gross receipts tax could also put Oregon businesses at a competitive disadvantage relative to out-of-state businesses selling into Oregon. If the out-of-state business' supply chain is also located out-of-state, that business would only be taxed on the final sale into Oregon. In contrast, an Oregon business with an in-state supply chain would be subject to pyramiding and be forced to charge a higher price for the final product and/or accept a lower margin.

As a result of these same dynamics Oregon consumers may, where possible, be inclined to purchase goods and services from businesses that are not based in the state, because they will be less expensive.

The pyramiding that results from a gross receipts tax may also incent Oregon businesses to either vertically integrate or source from outside of the state. Neither is a desirable outcome in our minds.

Again, because the Business Activity Tax is not subject to pyramiding, it is also not subject to these economic distortions.

Given the conversations that have occurred in the subcommittee over the last couple weeks, I would like to take a brief moment to address a few potential questions.

The first is, does this tax penalize hiring by taxing labor? The short answer is no. Labor is not a purchase from another business, and so it is not deducted from a business' Business Activity Tax base. However, a firm's Business Activity Tax does not automatically increase when it hires a new employee. It should also be noted that labor costs are not deducted from a gross receipts tax.

The second question is, is this tax subject to avoidance? Because a Business Activity Tax is calculated by subtracting purchase from other firms from gross receipts, the only way to avoid or reduce your Business Activity Tax is to purchase more goods or services from other firms or increase your capital investments. Both of those are good for the economy, and the tax is still being paid by the firm or firms that are selling the goods and services. The tax is designed to capture 100 percent of value added. It's just a matter of where along the production chain it is captured.

The third question is, will it be hard to implement a Business Activity Tax? As with any tax, it will take time to implement a Business Activity Tax. Once in place though, it should be easier to administer than the corporate income tax. It may be slightly easier to administer a gross receipts tax, but as we've shown today, that will come at a significant economic cost.

Thank you for the opportunity to testify this evening. Please know that OBI would like to continue to serve as a constructive participant in these conversations. To that end, we would also hope that this Subcommittee does not view its work in isolation. This is important work, but it must be examined in the context of the cumulative impact of actions taken by the legislature this session. New revenue for Medicaid funding, cap-and-trade, and education has the potential to significantly increase the cost of doing business in Oregon going forward.

Thank you again, and we're happy to answer any additional questions you may have.