CHAPTER 20

BUSINESS TAXES

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"Do businesses pay their fair share of taxes?"

Although asked almost daily, for the most part this is the wrong question. Businesses don't pay taxes; people do. Some of you know instinctively what I mean by that; others will have to read on.

Let's consider a simple and common situation. Wearing your consumer "hat," you go into the hardware store to buy something to fix a dripping sink faucet. The plumbing supplies cost $100, plus $4.16 the hardware store calls a general excise tax, for a total of $104.16. The store owner eventually pays your $4.16 (4 percent of $104.16) to the State. In this simple situation the tax technically was paid by the business, but as a practical matter it was passed on ("shifted") to you, the consumer. This seems like a pretty straight-forward process, but there is much more to it.

The excise tax is only one of many taxes imposed on businesses. If they own or lease the land on which they operate, they must also pay property taxes. In addition, businesses pay taxes on utilities, fuel, insurance premiums, for Social Security, unemployment insurance and on and on. All are called "indirect" taxes. Eventually, they are borne by people as a result of shifting. Since indirect taxes on businesses inevitably are shifted to people, the important question is "which people?"

In life, we wear many hats, often at the same time. We are, for example, consumers, workers, suppliers, creditors and business owners (if not direct owners, then through stocks, mutual funds or pension funds). When a business "pays" a tax, that cost generally is borne by the owners or stockholders (who are also consumers), or shifted to customers or workers. The direction and extent of shifting depends on market conditions. Let's consider several examples.

The property tax paid by a retail store is a cost of doing business. If that store is selling products in a very competitive market, the tax cannot be completely passed on in higher prices since the customers can switch to catalogue shopping or to stores that are more efficient. The tax thus results in lower profits to the owners. However, we should remember that owners include stockholders, and that most stockholders are also consumers. The pension plan to which you probably belong surely holds stocks, and lower profits reduce the investment income of that pension. Thus, even taxes not immediately shifted to customers or workers end up being paid by other consumers who happen to be direct or indirect business owners.

Borne by workers? Owners and stockholders are not the only ones who may be burdened with a tax that can't be shifted directly to customers. It also may be borne by those who work for the taxed business. For example, consider the unemployment insurance tax levied on business payrolls. This money goes to pay unemployment benefits to those who lose their jobs for reasons beyond their own control. While the business writes the check to the tax collector, it is likely that the cost of this tax is borne by the worker. A large employer who negotiates wages with its workers' union must consider not only the direct wages but also the related cost of fringe benefits and payroll taxes. If the employer is faced with higher payroll taxes, it may not be possible to pay the workers more. Thus, the tax on the business reduces the wages of the employee. It can work similarly in the case of smaller employers and nonunion workers.

Since the mid-1980s, Hawaii has increased taxes on the visitor industry, primarily by levying a hotel-room tax and by setting much higher property-tax rates on hotels and resorts than on residential properties. In each case, the tax burden probably is shifted, at least in part, to nonresidents. It is readily seen that the hotel-room tax probably will be shifted to "guests," mostly from out-of-state. In a different way, the higher tax on hotel property will reduce its value to the owners, but they probably will try to pass the tax on to hotel guests. If tourists react to the higher prices by vacationing elsewhere, hotels may lose some profits and hotel workers may lose some wages, or even jobs.

Who pays? Since tax shifting is an inevitable result of taxing businesses, it is important to understand the process and the consequences in order to make rational tax policy choices.

When indirect taxes are imposed on businesses, we don't know exactly who will bear them. Unlike an income tax paid by a readily identifiable household, the burden of an indirect tax is known only after the extent and direction of shifting have been measured. This is a difficult calculation since we don't know all the circumstances that will allow a business to shift or not shift its tax burdens. Yet, in spite of these difficulties, it is important to estimate shifting of indirect taxes. From a tax policy standpoint, it is critical that we have some idea who actually bears the burden of a particular tax. For example, an indirect business tax that is shifted to low-income consumers or workers may not be deemed desirable by policy makers.

Knowing to whom taxes are shifted provides some insight into the eventual burden of a business tax. Taxes largely shifted to consumers have a different impact than do taxes borne by business owners. For instance, a tax that cannot be shifted to consumers, workers or others will have a greater impact on high-income taxpayers since business owners tend to fall into that category.

A consultant retained by the Hawaii State Tax Review Commission studied the extent to which taxes were shifted in 1988. Of the $996 million collected in excise taxes, 90 percent was shifted to consumers, of which 63 percent was paid by Hawaii residents. Only 8 percent was actually borne by business owners, workers or suppliers. In contrast, of the $73 million in corporate income-tax collections, only 62 percent was shifted to consumers; 27 percent was borne by business owners.

The business-property tax is harder to trace. The commission study did not separate business and nonbusiness property taxes. However, in 1988 business accounted for 41 percent of all property tax collections.

Since the commission estimated that 52 percent of the property tax was paid by consumers, some business-property taxes had to be shifted to consumers.

Given that businesses "don't pay taxes" and the impact of indirect business taxes is so difficult to measure, why do we go through the effort to tax business?

Reasons for business taxes. There are both "good" and "bad" reasons for taxing businesses. One good reason is that it is easier for the government to collect sales or excise taxes from a few thousand businesses than from a million consumers. Another is that it may be the only way to "reach" out-of-state owners and consumers. Still another is that businesses (and thus their consumers, owners, workers and suppliers) benefit from such government services as roads, harbors, sewers, street lights and police protection, and should pay a share of their costs.

A bad reason for taxing businesses is the notion that businesses are better able to pay taxes than people are. This is nonsense. I hope that, by now, every reader understands that "businesses don't pay taxes, people do." Any attempt to increase business taxes will just place an additional strain on consumers, owners, workers, creditors or suppliers—people. When we tax business, we hide the true tax burden since the effects of shifting are neither easily measured nor well understood.

Hawaii's business taxes. Are business taxes in Hawaii "fair"? First, if business taxes are levied on the basis of the "good" reasons noted above, they can be considered fair.

Property taxes should reflect benefits received. Since, however, hotels, resorts, commercial and industrial property in Hawaii pay higher taxes than other property classifications, and it is doubtful whether business property benefits from government service more than other property, it would seem that the property tax is "unfair" in this way.

Another way to judge fairness is to see if our business taxes are out of line with those of other states. Hawaii's maximum corporate income tax is 6.4 percent. At least 30 states have rates above that. Hawaii's excise tax has a deceptively low 4 percent rate. Thirty states are above that. Thanks to our long-term high employment rate, unemployment taxes in Hawaii presently are lower than in virtually all other states. In 1988, only nine states had lower unemployment taxes.

Hawaii has been accused of being a "Tax Hell." Some of this is deserved, but most is not. In part, the reputation is not due to business taxes at all. Our individual income-tax rate (10 percent at its maximum) is one of the highest in the nation. Some of the reputation is due to nontax business costs. For example, Hawaii's regulatory environment, high land rents, high workers compensation insurance rates, high transportation fees and labor shortages all contribute to making it a costly place to live and conduct business. However, our business-tax rates are not out of line with those in other states. Taking into consideration all major business taxes, the State Tax Review Commission determined in 1984 that Hawaii's business tax burden was lighter than in most Western states, including California, Oregon and Arizona. This conclusion is dated, but nothing major has changed since then.

Thus, while some aspects of Hawaii's tax structure are burdensome to business, the overall tax environment is by no means "Hell." The reasons for that label will have to be found elsewhere in this book. My own picks include land-use policies that raise land prices and rents to exorbitant levels, the lack of competition in transportation and distribution, stifling regulatory policies, sky-high insurance costs and too few well-educated workers. All of these have greater impacts than the tax environment.


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