

Facts and fiction about the unions' tax initiative

*Answers to the top questions
regarding a margin tax*

**By Geoffrey Lawrence
Deputy Policy Director**

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Executive Summary

Among the most challenging policy decisions facing Nevada lawmakers is designing a state tax system that generates stable revenue to finance critical government operations, such as defining and protecting property rights, without imposing unnecessary distortions or damage upon the economic system.

This brief study examines a business margin tax, as proposed by the state teacher union and AFL-CIO, in the context of the broader goals of tax reform. It concludes that a margin tax would accomplish none of the major goals of tax reform, but would instead add multiple new burdens on the Silver State economy. Of significant concern is that the proposed margin tax would:

- Penalize small businesses.
- Penalize struggling businesses and exacerbate the instance of firm closure or bankruptcy.
- Tax certain sectors of the economy more heavily than others.
- Thwart economic diversification.
- Cause a higher effective tax rate against more complex goods.
- Violate the confidentiality of federal business tax filings.
- Reduce the demand for labor.

A business margin tax in Texas — after which the unions' proposal is modeled — has been widely recognized as a tax-policy failure. In 2009 alone, Texas lawmakers heard more than 100 bills proposing to modify or repeal the tax.

Nevada should look to import successful policies from other states — not failing ones.

Few people enjoy paying taxes.

Even those who advocate for higher taxes show a telling reluctance to voluntarily contribute their own personal earnings to special tax-me-more funds.

Nevertheless, high-tax advocates regularly concoct proposals for hiking taxes on others. They expect to benefit when the new government spending enabled by the tax increases comes back to them, directed by their allies in the legislature.

That's why union bosses from the Nevada AFL-CIO and the state teacher union recently filed an initiative petition with the secretary of state¹ to install a whole new additional system of taxes upon Silver State businesses. They're asking for a new "margin tax" — modeled after a troubled Texas tax instrument of the same name² — to be levied against Nevada's struggling businesses so that the state's government-run and monopolistic education system³ can increase spending.

Over the next few months, Nevadans will be inundated with simplistic propaganda touting the proposal. The actual language of the proposal itself, however, is extremely complex and technical. It would substantially alter the way business is conducted in Nevada and, consequently, impact every Nevada family.

Of course, no tax structure is perfect. Every tax instrument distorts economic behavior in unique ways. An excessive tax burden can also stifle entrepreneurship and job growth. Still, governments are obliged to levy taxes in order to finance their operations. That means lawmakers and voters should give careful consideration to the best means for extracting tax revenue. That is, they should search for the particular mix of taxes that would best minimize the negative impact on the Nevada economy.

A preliminary step to this exercise should be to minimize the need for tax revenue by ensuring that the scope of government activity is limited to those spheres that are necessary for the marketplace to function effectively. That includes, for example, defining and protecting private property rights and adjudicating disputes. These government functions are critical for the voluntary exchange of goods and services as well as the employment of labor and capital in order to produce the things that individuals need and desire.

The next step is to ensure that government services are delivered cost-effectively. A roadmap for controlling expenditures and maximizing cost-effectiveness in government has already been laid out by the Nevada Policy Research Institute with its recent publication of *Solutions 2013: A Sourcebook for Nevada Policymakers*.⁴

Once those important first steps have been accomplished, policymakers need to identify the best approaches to taxation. To that end, NPRI has identified four criteria by which to evaluate tax instruments:⁵

1. **Avoid distortions of economic activity.** Does the tax structure introduce artificial biases into economic decision-making — such as hiring practices, investment decisions, consumer purchasing decisions, etc? These biases result in inferior

economic performance system-wide, and thus less satisfaction of individuals' needs and desires as consumers.

2. **Keep it simple.** Highly complex tax structures — such as those that use complicated arrays of exemptions and credits or stratified income brackets — make it more burdensome for individuals and business owners to navigate the tax structure and calculate the amounts to remit to tax authorities. Because of complexity in the federal income tax, for example, Americans will spend about \$410 billion in 2012 hiring experts to file tax returns on their behalf, according to estimates from the Tax Foundation.⁶ This is a burden placed on taxpayers over and above the direct tax burden itself.
3. **Maintain vertical and horizontal equity.** Individuals in similar circumstances should face roughly similar tax burdens. Simultaneously, individuals at different points along the income scale should face roughly proportional tax burdens. Overly progressive tax structures impede the capital formation necessary for firms and individuals to invest in new technologies that improve labor productivity, the driver of wage growth. Thus, overly progressive taxes inhibit the growth prospects of individuals at every income level.
4. **Minimize volatility.** Taxes on activities that are highly sensitive to changes in the business cycle aggravate the volatility of government revenues. Such volatility should be minimized because it plays an important role in the tax-and-spend cycle: When government coffers are flush with cash, policymakers regularly make new promises to government workers or create new government programs altogether. This new spending creates ongoing commitments that policymakers are then unable to finance during periods of economic recession, causing them to continuously call for ever-higher taxes.

The proposed margin tax satisfies none of these criteria. It would introduce a series of new distortions into the Silver State economy. As Texans have discovered, it's highly complex and has been an impediment to small business growth. It impedes capital formation and would do little to stabilize the state's revenue structure.

Still more problems result from the margin tax, however. It would create tax liabilities even for firms operating at a financial loss, thereby accelerating business failures in Nevada. It would penalize certain sectors of the economy more heavily than others. It would create an escalating tax burden on more complex goods, since the tax is levied at every stage of production — a phenomenon known as “tax pyramiding.” Finally, by creating a penalty against all prospective new business ideas, it would only impede efforts to diversify Nevada's economy.

This brief guide will address the most common misconceptions and questions about the margin tax proposal.

Don't Nevada's schools need more money?

The unions' whole effort relies on a false premise: They claim that Nevada is at the bottom of states in education funding. However, figures maintained by the U.S. Department of Education clearly refute this claim.⁷

During the 2008-09 school year, Nevada taxpayers spent \$10,449 for every child in the state's K-12 system. That's more than taxpayers spent in most neighboring states. Taxpayers in Utah, for instance, spent \$8,446. Taxpayers in Idaho spent \$8,601. In Arizona, they spent \$9,559.⁸

Although Nevada outspends neighboring states on education, the Silver State receives substantially inferior results. Each of the above states boasts significantly higher test scores⁹ and graduation rates.¹⁰ This means that the problems facing Nevada's education system are not financial, but structural. For far too long, the state has insulated ineffective educators and administrators from accountability — not allowing parents, for example, an adequate range of educational choices.

Cynically, the state teachers union — through its lobbying and financial support of legislative candidates dedicated to protecting the *status quo* — has long been the biggest obstacle to the educational reforms that would improve student achievement in the state. While Gov. Brian Sandoval pushed aggressively during the 2011 Legislative Session for an education-reform agenda offering greater opportunities to students, the teachers union has disingenuously used children as political leverage to misinform the public through television and other advertisements claiming Sandoval is “destroying our schools.”¹¹

How would any new revenue from the margin tax be spent?

The unions' initiative will ask lawmakers to place margin-tax revenue within the state's Distributive School Account, with the presumption that these funds will then be distributed to school districts and boost K-12 spending across the state. However, lawmakers will be free to use the new money on anything they like — including the creation of new programs having nothing to do with education.

That's because they will be able to offset the new DSA revenue by directing fewer general fund dollars into the Distributive School Account — leaving that money available for other items.

How does the margin tax work?

The unions' initiative defines the “taxable margin” — the tax base against which businesses would pay a 2 percent levy — as either 1) 70 percent of total revenue, 2) total revenue minus the cost of goods sold, or 3) total revenue minus the cost of employee compensation. Firms would be permitted to choose which of these exemptions to apply to their tax filings, with the expectation that most firms will choose the exemption which offers the lowest tax liability.¹²

“Total revenues” are determined after all distributive earnings are disbursed to business owners and shareholders and are based on information contained on a firm's filings with the Internal Revenue Service.¹³

Firms facing a modified-business-tax liability (Nevada's tax on private-sector payroll) would receive a dollar-for-dollar credit against the proposed margin tax.¹⁴ For most firms, the effect of this credit will be to replace the modified business tax with a new, higher, business levy.

Aren't small businesses protected from the margin tax?

The unions claim that their margin tax proposal only targets large businesses and will not affect small, local or start-up businesses. That's because firms making less than \$1 million in total revenue annually are exempt from the tax. However, \$1 million in total *revenue* is a relatively low threshold that is routinely surpassed by "mom-and-pop" retailers, gas stations, liquor stores, etc. Local retailers and small manufacturers, for example, must have large volumes in revenue in order to make even the smallest of profits.

As a result, thousands of small businesses will face a new tax liability under the unions' proposal.

The burden on small businesses, however, will extend far beyond the direct cost of this new tax. That's because the compliance costs of such a complex tax will disproportionately harm small firms. Few small entrepreneurs possess the in-house accounting expertise necessary to navigate the tax — requiring them to hire tax experts at great cost and disadvantaging their companies vis-à-vis larger firms. This has been a recurrent complaint of small-business owners in Texas and a leading reason why Texas lawmakers heard more than 100 bills proposing to amend or repeal the margin tax in 2009 alone.¹⁵

How are struggling businesses affected?

Advocates for the margin tax also appear to misunderstand exactly how their proposal would impact firms operating at a financial loss. Some, including state teachers union president and primary sponsor Lynn Warne, have confused the tax with a corporate income tax, mistakenly believing that firms operating in the red would not face a margin-tax liability.¹⁶

Because the tax is based on revenue and not income, however, all businesses operating at a loss with more than \$1 million in revenue would be forced to pay the margin tax. Take, for example, a restaurant owner who has seen a decline in revenues due to the recession and yet still faces fixed costs for rent, insurance and franchising, plus the costs of food, equipment and employee compensation. He or she might easily find that, over the course of a year, total costs have exceeded total revenues.

While the structure of the margin tax would allow the restaurant owner to deduct a portion of these expenditures from the restaurant's taxable base, he or she would still face a new, 2 percent levy against the remainder of the restaurant's annual revenue even though the restaurant lost money over the course of the year.

Thus, the margin tax would aggravate the closure or bankruptcy of businesses that are already struggling. And not only business owners would be hit: Employees would be dismissed and lose their incomes as well.

Why wouldn't a margin tax help diversify the economy?

Margin-tax advocates have claimed that another broad-based business tax is required if Nevada's entrepreneurs are to diversify the state's economy. However, new business models are *less* — not *more* — likely to emerge in Nevada if the state exacts a new penalty against the entrepreneurs who create these businesses. A margin tax would reduce the incentive for economic diversification.

Any advocate of the margin tax who also claims to support greater diversification is either economically illiterate or intentionally deceitful.

Don't other states impose higher business taxes?

Some commentators have pointed to business tax rates as high as 8 percent in neighboring California in order to justify their support of the margin tax initiative.¹⁷ This is an apples-to-oranges comparison, however.

California's business tax, along with those of most other states, is a corporate income tax — it's a levy against only the profits made by businesses during the course of a year. The proposed margin tax would be assessed against total revenues — meaning the tax base is much larger and would include even those firms that make no profit or operate at a financial loss.

How would the state collect the margin tax?

In order to administer the proposed margin tax, the Nevada Department of Taxation would need to expand into a state version of the federal Internal Revenue Service. That's because the department would need to acquire the personnel to process and audit margin-tax filings.

Any firm doing business in Nevada would be required to submit annually to the state tax department information about its total revenues, bad debts, foreign royalties or foreign dividends, net distributive income and allowable federal deductions. In addition, the firm would need to select which of the three deductions it will claim from its margin-tax liability and submit financial documentation to support these claims.¹⁸

If a firm chooses to deduct for employee compensation, then official payroll records and records supporting other compensation expenditures, such as employer-provided health or life insurance, must also be provided. Firms choosing to deduct for "cost of goods sold" will need to submit documentation for all investments in factories or machinery, the cost of raw materials or intermediate goods, rents, depreciation, etc.

Any firm that operates across state lines would be required to apportion these figures based on the percentage of the firm's activities that occurs within the borders of the State of Nevada.¹⁹

No firm would be allowed to change its accounting practices for the purposes of its margin-tax filing more frequently than once every four years without the express written consent of the state tax department.²⁰

In order to finance the initial expansion of the state tax department that would be required to administer the margin tax, the unions propose to raise the existing modified-business-tax rate paid by

financial institutions within the state from 2.0 percent to 2.24 percent and earmark this revenue for said expansion.²¹

Is it true that there are privacy concerns with the margin tax?

Yes, language contained in the unions' proposal would require the state tax department to publicly post on its website all margin-tax filings within the state.²² As a result, potentially sensitive information regarding a firm's financial health, investments, ownership status or partnership arrangements would become public information that can be immediately accessed by a firm's corporate rivals, competitors or even political opponents.

Included on these filings would be a substantial subset of information from federal tax filings that firms are permitted to submit confidentially to the IRS. The unions' proposal would subvert this federal confidentiality and make this subset of information publicly accessible.

How would the margin tax impact the hospitality industry?

The unions' proposal exempts gaming from the margin-tax liability.²³ (A gross-receipts tax is already assessed on gaming revenue, with the rate dependent on the type of gaming license and the size of the establishment.) However, Nevada's hospitality industry will still face new tax liabilities.

All revenue accruing to hotel or casino operators through some venue other than table games or slot play would be subject to the margin tax. This includes hotel stays, live entertainment and any restaurants, retail venues or other rental spaces. Indeed, the margin tax would be an additional tax levy on top of current levies against these activities such as the live entertainment, room and sales taxes.

The impact of this new tax liability on Nevada's largest industry will result in some combination of higher prices for consumers and diminished wages or job opportunities for resort-industry workers.

How would the margin tax impact the mining industry?

Miners would receive no credit against their margin-tax liability for the taxes paid through the existing net proceeds of minerals tax, according to the unions' proposal. This means that the margin tax would be a new, additional levy on top of those already assessed against mining firms.

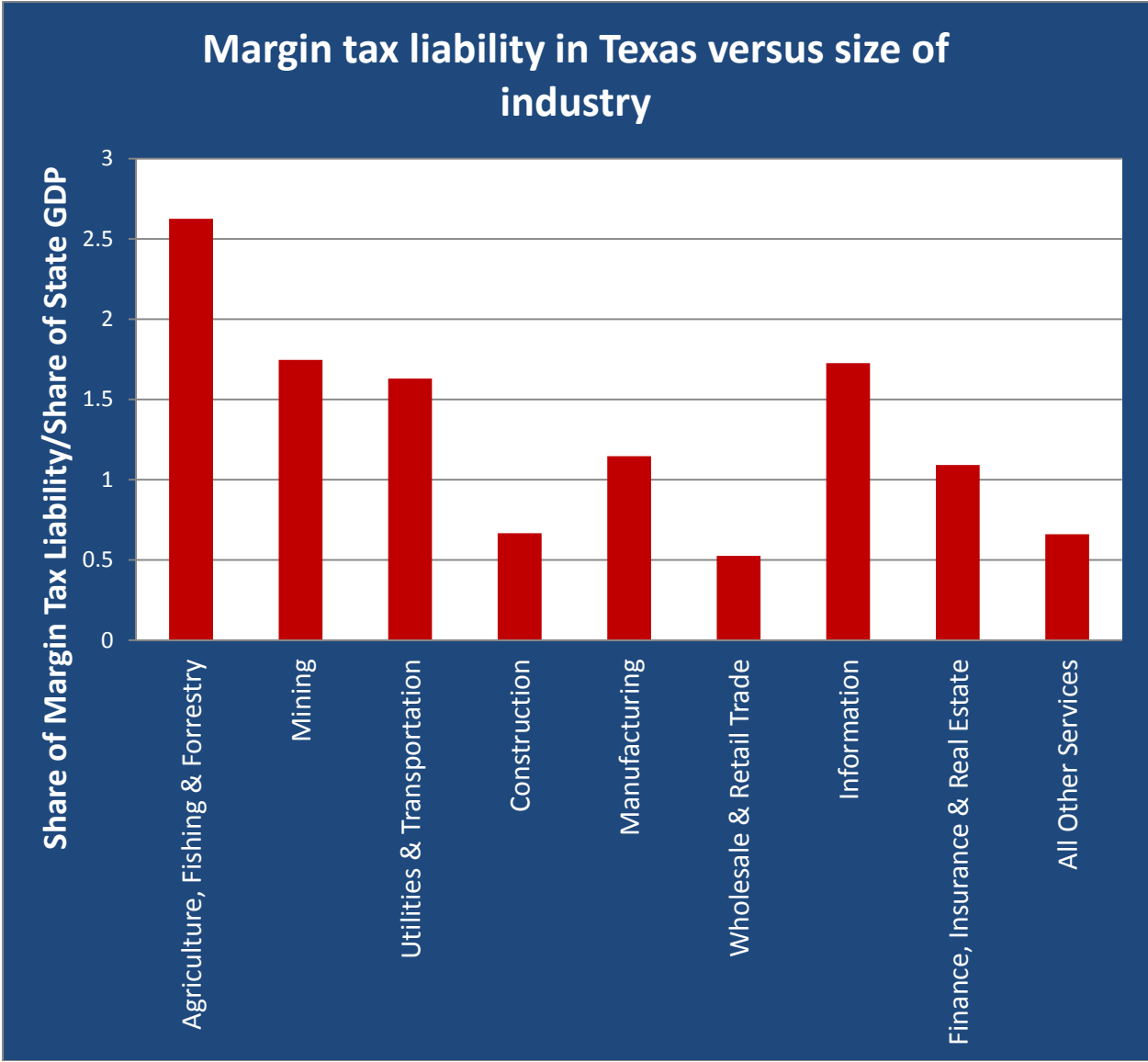
In fact, the unions' language is explicit about subjecting mining proceeds to the tax when it includes, as part of the definition of business income subject to the tax, "each sale of real property located in this State, including royalties from oil, gas or other mineral interests."

How would the margin tax impact industries other than hospitality and mining?

Legislative staff in Texas report that the margin tax there, due to its complex structure of deductions, has disproportionately penalized certain sectors of the economy, including agriculture, mining and information technology.²⁴

Since the margin tax allows firms to deduct for either capital or labor costs, heavily capital-intensive or labor-intensive industries benefit, because they can deduct higher proportions of revenues from their tax base. Law firms, for example, can deduct for labor costs, while retailers can deduct for the cost of goods sold.

Industries that employ more evenly balanced amounts of capital equipment and labor, however — such as agriculture — are unable to deduct such high percentages of revenue. As a result, these industries wind up shouldering a disproportionate share of the margin tax’s burden on the state economy. Farmers in Texas pay a share of the state’s margin-tax collections that is more than two-and-a-half times their share of the state’s gross domestic product.



What does 'tax pyramiding' mean?

One of the most commonly cited concerns with a margin tax and other forms of gross-receipts taxation is that these taxes are levied against firms at every point along the supply chain. Miners extracting silicon, for instance, are subject to the tax. Then the technicians who cut that silicon into wafers are subject to the tax, as well as the technicians who process those wafers into semi-conductors. Again the tax is applied when electrical engineers use those semiconductors to create computer or solar photovoltaic panels. The tax is applied again to the wholesalers, distributors, vendors, installers and maintenance technicians of these components.

Thus, for more complex goods, the tax is amplified, being assessed at each stage of production — a concept known as “tax pyramiding.” This means Nevada would be imposing a higher effective tax rate against more complex goods, driving their manufacturers out of the state and distorting consumer behavior away from these goods. The net result is a tax-induced loss in economic welfare for everyone. For this reason, the Tax Foundation calls gross-receipts taxes “distortive and destructive.” Economists at the Tax Foundation conclude that “there is no sensible case for gross receipts taxation or modified gross receipts taxes such as a Texas-style margin tax.”²⁵

The distortions created by tax pyramiding can be significant and should be avoided in any system of taxation. To avoid this pitfall, NPRI has recommended that the tax base only include end-use consumer transactions.²⁶

Conclusion

The unions' proposed margin tax would be entirely inappropriate for the Silver State. The tax would penalize small and struggling businesses at a time when Nevadans can ill afford it. It would thwart the path to economic diversification. It would tax certain industries more heavily than others and distort consumer behavior. The proposed margin tax would introduce all of these distortions and, yet, would fail to achieve any of the primary objectives of tax reform.

In short, the proposed margin tax is little more than an ill-conceived attempt at a money grab by union operatives.

This recognition is particularly troublesome when one considers that the unions have based their proposal on a flawed premise — that Nevada routinely underfunds its education system. To the contrary, Nevada outspends most of its regional neighbor states, according to statistics from the federal education department. It's true that Nevada lags all of these lower-spending states in student achievement, but this simply shows that Nevada's educational shortcomings result from failed policy designs and not from any shortage of funding.

Disingenuously, one of the sponsors of the margin tax proposal — the state teacher union — has been the primary obstacle to enacting the education policy reforms that would benefit students and, instead, is simply looking to enrich itself with more tax dollars.

What Nevada truly needs is an evidence-based approach to education reform that objectively evaluates which policies have been most successful in other states and seeks to replicate those

reforms here. The reform agenda outlined by Governor Brian Sandoval has been an excellent beginning to this process.

While there is certainly room to consider tax reform, the margin tax proposal fails to satisfy any of its logical objectives. If policymakers are interested in tax reform, they should look elsewhere.²⁷

Endnotes

¹ State of Nevada, Secretary of State, Initiative Petition — Statewide Statutory Measure, “The Education Initiative,” <http://nvsos.gov/Modules/ShowDocument.aspx?documentid=2355>.

² Geoffrey Lawrence, “Texas Margin Tax: Always a Bad Idea,” Nevada Policy Research Institute commentary, <http://www.npri.org/publications/texas-margin-tax-always-a-bad-idea>.

³ Geoffrey Lawrence, “The Power of Choice, Part I,” Nevada Policy Research Institute commentary, <http://www.npri.org/publications/the-power-of-choice-part-i>.

⁴ Geoffrey Lawrence, “Solutions 2013: A Sourcebook for Nevada Policymakers,” Nevada Policy Research Institute policy study, <http://www.npri.org/publications/solutions-2013>.

⁵ Geoffrey Lawrence, “One Sound State, Once Again: Comprehensive Fiscal Reforms to Again Make Nevada Strong, Prosperous and Free,” Nevada Policy Research Institute policy study, <http://www.npri.org/publications/one-sound-state-once-again>.

⁶ Tax Foundation, “Total Federal Income Tax Compliance Costs, 1990-2015 (Projected),” <http://taxfoundation.org/article/total-federal-income-tax-compliance-costs-1990-2015>.

⁷ U.S. Department of Education, National Center for Education Statistics, Digest of Education Statistics, 2011, Table 192, http://nces.ed.gov/programs/digest/d11/tables/dt11_192.asp.

⁸ *Ibid.* The U.S. Department of Education distinguishes between spending on “current expenditures” and “total expenditures.” “Current expenditures” exclude capital costs and debt repayment and are intended to reflect the ongoing classroom expenditures exclusive of the amortized cost of school construction. “Total expenditures” includes all spending. There is some debate over which metric is more appropriate, but, in either case, Nevada spends more than neighboring states including Arizona, Idaho and Utah.

⁹ U.S. Department of Education, National Center for Education Statistics, Digest of Education Statistics, 2011, Tables 132 and 147, http://nces.ed.gov/programs/digest/d11/tables/dt11_132.asp; http://nces.ed.gov/programs/digest/d11/tables/dt11_147.asp.

¹⁰ U.S. Department of Education, National Center for Education Statistics, Digest of Education Statistics, 2011, Table 113, http://nces.ed.gov/programs/digest/d11/tables/dt11_113.asp.

¹¹ Nevada State Education Association, “Why Don’t You Care About Education?” Video segment available at <http://www.youtube.com/watch?v=7BWn0hNs8Lo>.

¹² *Op cit.*, note 1, Sec. 24.

¹³ *Op cit.*, note 1, Sec. 25.

¹⁴ *Op cit.*, note 1, Sec. 23 (4).

¹⁵ Joseph Henchman, “Nevada May Consider New Business Taxes,” Tax Foundation Fiscal Fact No. 270, <http://taxfoundation.org/article/nevada-may-consider-new-business-taxes>.

¹⁶ See Nevada State Education Association President Lynn Warne’s comments to *Las Vegas Review-Journal*, June 6, 2012, <http://www.lvrj.com/news/conservative-group-initiative-could-tax-money-losing-businesses-157647115.html>; See also, Progressive Leadership Alliance of Nevada Director Bob Fulkerson’s appearance on “The Agenda,” KSNV Las Vegas, June 11, 21012, <http://www.clipsyndicate.com/video/playlist/27033/3549389>.

¹⁷ *Ibid*; See also, Steve Sebelius, “Tax Plan has Miles to Go Before It’s Passed,” *Las Vegas Review-Journal*, June 8, 2012, <http://www.lvrj.com/opinion/tax-plan-has-miles-to-go-before-it-s-passed-158053355.html>.

¹⁸ *Op cit.*, note 1, Sec. 25.

¹⁹ *Op cit.*, note 1, Sec. 29.

²⁰ *Op cit.*, note 1, Sec. 32.

²¹ *Op cit.*, note 1, Sec. 52.

²² *Op cit.*, note 1, Sec. 22.

²³ *Op cit.*, note 1, Sec. 25(6)(b).

²⁴ *Texas Legislature, 79th Legislature, 3rd Called Session, Legislative Budget Board, House Bill 3, Tax/Fee Equity Note, 2006.*

²⁵ *Op cit.*, note 15.

²⁶ *Op cit.*, note 5.

²⁷ *Op cit.*, note 5.

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*The Nevada Policy Research Institute
7130 Placid Street
Las Vegas, Nevada 89119*

*(702) 222-0642 ♦ Fax (702) 227-0927
www.npri.org ♦ office@npri.org*



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