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The Right Prescription for Mississippi

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In early 2008, Mississippi Governor Haley Barbour announced the creation of the Mississippi Tax Study Commission, which is tasked with preparing a comprehensive study of the state's tax system and recommending suggested improvements. The Commission, which brings together members with a wide range of business, legal, academic, and legislative expertise, has been instructed to prepare a report of its findings by September 2008.

The Mississippi Tax Study Commission has released [its draft report of recommendations](#), and has begun voting on final recommendations. There is both good and not-so-good in the list of proposals.

The Good

- *Eliminate the franchise tax.* The report proposes, as a long-term goal, phasing the tax out over five years. This economically damaging part of Mississippi's tax code (imposing a \$2.50 levy for every \$1,000 in capital that is held, invested, or employed by a business) hits firms even when they are not profitable, and the burden of calculating it prevents Mississippi from attracting multi-state and multi-national corporations. Because many of Mississippi's neighbors still levy this tax, it would provide a regional comparative advantage. Its abolition would give Mississippi a boost, even if the revenue were made up elsewhere.
- *Flatten Corporate Tax Rates.* The report recommends eliminating two corporate tax brackets and taxing all corporate income at the top rate of 5 percent (the same top rate as individual income taxes), and exempting the first \$10,000 of taxable income. Keeping the rates the same reduces the incentive to shift income between the two systems, and sticking with one rate reduces complexity. Arguments for progressive rates, whatever their merit in the individual income tax context, are illogical in the corporate income tax context. The

Commission and the Legislature may consider expanding this flattening and exemption expansion to the individual income tax as well.

- *Conform the State Tax Code to the Federal Tax Code for Depreciation Purposes.* Not "decoupling" from federal tax calculation rules reduces administrative burdens on corporations. Instead of having to calculate taxable income twice under two systems, Mississippi companies would need to do so only once. Oft-repeated claims about revenue losses from conforming are grossly exaggerated.
- *Eliminate Unconstitutional Capital Gains Exemption for In-State Companies.* Mississippi currently exempts capital gains from taxation if the sale is derived from an in-state company. This is unconstitutional, and either of the Commission's proposals (to tax gains at a lower 3 percent rate) is a good legal steps. It would also make Mississippi the only state to tax capital gains at a lower rate than wages, which would be a bold experiment worth watching.
- *Reduce the Tangibles and Intangibles Taxes.* The Commission proposes a \$20,000 exemption to the taxes on personal property, which is essentially a tax on inputs. Intangibles taxes harm multi-state companies and holding companies.
- *Rejecting a State Lottery.* The Commission admirably avoids the siren call of a lottery, which is one of the most regressive and hidden forms of taxation.
- *Studying Long-Term Consideration of Phasing Out the Individual or Corporate Income Tax.* Eliminating a major tax, if done properly, signifies a determination to attract investment and reduce tax burdens.
- *Improve Transparency and Appeals Processes.* The Commission has excellent recommendations for expanding availability of budget and tax information and eliminating the conflicts of interest in the existing tax appeals process. Revenue officials should be accountable to elected officials. A good tax system requires informed taxpayers who understand how taxes are assessed, collected, and complied with. It should be clear to taxpayers who and what is being taxed, and how tax burdens affect them and the economy. Information about Mississippi's budget, including revenue estimates, expenditure categories, and the cost of tax incentives is often difficult or impossible to locate or is out of date. Improving budget transparency can enable Mississippi's citizens and potential out-of-state employers to be informed and able to make accurate business and voting decisions.

The Not-So-Good

- *Eliminate some unused tax credits and continually review others.* The report proposes eliminating four rarely used tax credits and establishing sunset dates on the remaining ones, but keeps the state in the business of picking economic winners and losers. State lawmakers, trying to be mindful of their states' business tax climates, are often tempted to lure businesses with lucrative tax incentives and subsidies instead of pursuing broad-based tax reform. Mississippi offers at least 16 major corporate income tax credits, each with application processes and bureaucratic red tape. A booklet produced by Mississippi's State Tax Commission, listing available credits, runs 98 pages long. While officials roll out the

red carpet for new businesses, existing in-state employers are taken for granted and are stuck paying higher taxes. A far more effective approach is to systematically improve the business tax climate for the long term so as to improve the state's competitiveness, by repealing all incentives and subsidies. The tax code would thus be used just for raising revenue, not for changing economic behavior.

- *Modify but Keep the Inventory Tax.* The Commission should be applauded for recognizing the serious problems caused by the inventory tax. Mississippi is one of just 15 states to levy a tax on the value of a company's inventory, and this tax is especially harmful to large retail stores and other businesses that store large amounts of merchandise. Inventory taxes are highly distortionary because they force companies to make decisions about production that are not entirely based on economic principles, but rather on how to pay the least amount of tax on goods produced. Inventory taxes also create strong incentives for companies to locate inventory in states where they can avoid these harmful taxes. Several states have recently repealed their inventory taxes, and Mississippi should join them. Because many of Mississippi's neighbors levy an inventory tax, its repeal would give Mississippi an advantage over its neighbors that would not go unnoticed by businesses.

Of the Commission's four options, none deal adequately with this harmful tax. The first would replace the inventory tax with [a gross receipts tax, which is even more harmful](#) because it would expand the distortions caused by the inventory tax, not reduce them. The second option would keep the inventory tax but create a tax credit equal to the amounts paid; this is an insufficient solution, since it would maintain the burden of calculating the tax, and less-profitable companies would be unable to take the credit, meaning some distortion would remain. The third option would allow localities to give a partial exemption to manufacturers on finished goods, which is too limited but would at least be a positive interim step. The fourth option is to do nothing.

We recognize that the issue is tricky for the Commission because much of the inventory tax is dedicated to local government, and modification would require recalculation of tax-increment financing districts and bond issues. However these are one-time transition costs; the long-term benefits that would accrue from the elimination of the inventory tax would probably greatly exceed this. The Commission's other proposals, such as allowing local governments to levy sales taxes and expanding the sales tax base, offer revenue-neutral options to such an elimination.

- *Broaden the Sales Tax Base, But Continue Taxing Inputs.* The Commission proposes extending the sales tax to cover a limited list of services. A broad-based sales tax is good because it eliminates preferences for various consumption items. Ideally the sales tax should cover all consumption and exempt all inputs to prevent double taxation. Currently the Mississippi sales tax exempts many services but taxes many inputs. The Commission partly addresses the former (unfortunately by creating a limited list of services, leaving out politically powerful ones instead of comprehensively taxing all services) but worsens the latter.

For example, instead of eliminating the sales tax on manufacturing machinery (Only 15 states impose sales tax on purchases of manufacturing machinery; businesses have been

known to avoid locating facilities or factories in states where the factory's machinery would be subject to state sales tax), the Commission recommends taxing all inputs, albeit at a lower rate (including those by non-profits; [the Clarion-Ledger already has the Girl Scouts responding to this one](#)). Sales taxes on inputs are a hidden tax that distort decisions and increase consumer prices. All inputs should be exempt.

- *Increasing cigarette taxes.* Mississippi should be careful not to rely on cigarette taxes as a long-term source of revenue because it puts the state in the position of relying on a tax on an activity imposed with the justification of reducing the activity. Numerous studies have shown cigarette taxes to be highly regressive, with the poor bearing a disproportionate share of the tax burden. Evasion and compliance costs undermine many of the asserted benefits of such tax increases. Mississippi should avoid heavy reliance on cigarette taxes.
- *Not Studying Long-Term Consideration of Phasing Out the Corporate Income Tax.* The Commission voted to reject a recommendation to study elimination of the corporate income tax. Eliminating a major tax, if done properly, signifies a determination to attract investment and reduce tax burdens. State corporate income taxes have long been declining as a revenue source, and the costs of complying with them have led even liberal scholars to term it "neither efficient nor effective" and "not worth the administrative and compliance costs." Three states have already eliminated it entirely. It is unfortunate that the Commission chose not to recommend studying its eventual elimination.

The best tax system is one with low rates on a broad base, treating all taxpayers equally while minimizing economic distortions. When I testified before the Commission, I expressed the hope that it will work toward such a tax system, which would make Mississippi a more powerful economic performer.

I commend Gov. Haley Barbour and the Commission for taking a comprehensive look at Mississippi's tax system. I hope that the Commission makes proposals that will provide Magnolia State residents with a simple, neutral, transparent and stable tax system.

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