Policy Brief
01/19/2009

The Business Equipment Tax in Context

During this time of economic downturn and revenue uncertainty, the 61st Legislature must make many tough decisions regarding spending priorities, and any proposals for further decreasing revenue (i.e. cutting taxes) at this time must be carefully scrutinized. One of the only new tax cuts being seriously considered by both Republicans and Democrats is a reduction in the business equipment tax. Unfortunately, the policy is as ill-advised as it is politically popular. The effective tax rate on business equipment has already been reduced dramatically over the last decade; further decreases during an economic downturn will mean decreased revenue to the state and reduced funding for other spending priorities or tax cuts that could have a greater impact on both average Montana families and the economy.

Key Points

- The total market value of business equipment in Montana increased by 66% from 1994 to 2007. State and local revenue derived from business equipment taxes decreased by 20% over the same time period.
- From 1994 to 2007, the effective tax rate on business equipment has fallen by over 50%, from 2.98% to 1.45%.
- During the same time period, residential homeowners have seen an increase in the share of property taxes they pay to fund state and local governments, from 38% in 1994 to 49% in 2007.
- Additional reductions to the business equipment tax will further increase the property tax obligations of homeowners and will decrease our collective ability to invest in other more stimulative policy priorities.

What is the Business Equipment Tax?

The business equipment tax is a property tax paid on the value of personal property used in business. Examples of business equipment can include kitchen equipment, tractors, construction equipment, tools, copiers, and even cash registers. Under current law, businesses with equipment valued at less than $20,000 do not have to pay business equipment taxes.

Business equipment is just one type of property taxed in Montana. In all, Montana has 14 different "classes" of taxable property. Business equipment is referred to as "Class 8" property.

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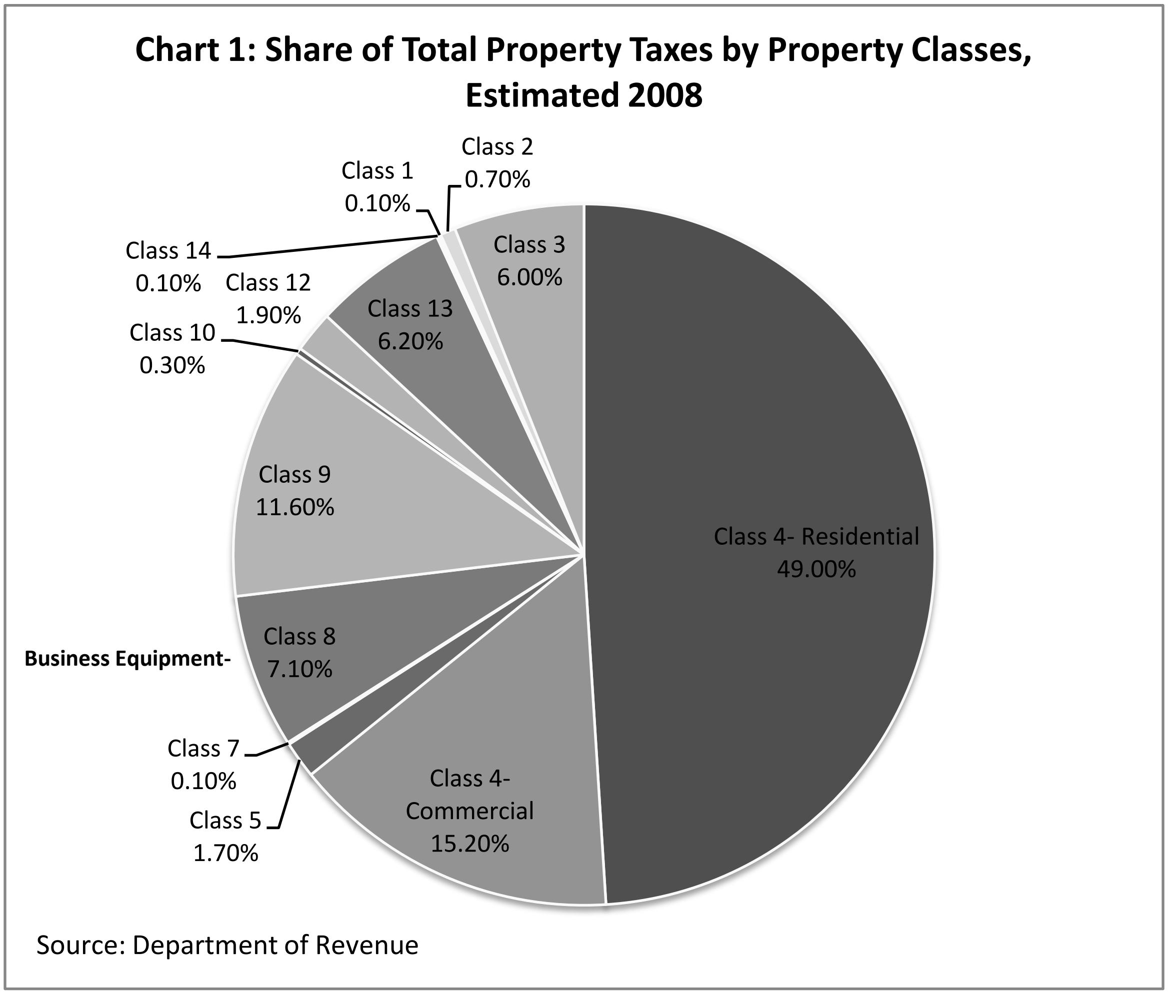
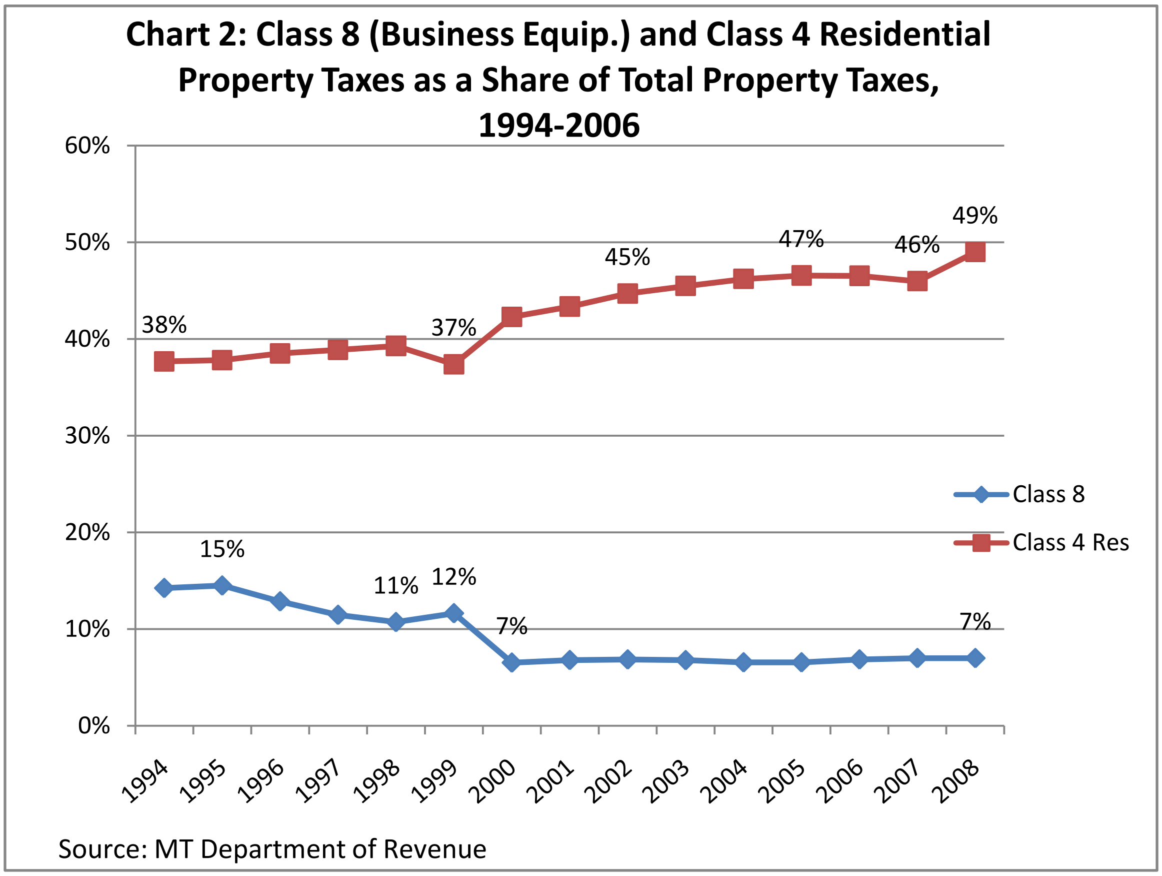
Business Equipment Taxes are a Small Portion of all Property Taxes Collected in Montana

State and local property taxes collected in Montana make up approximately 13% of our total state and local revenue.[1] Taxes paid by homeowners on residential property make up almost half of all those property taxes paid in the state. (Residences are classified as "Class 4- Residential Property.") In comparison, taxes paid on Class 8 business equipment make up just over 7% of all property taxes collected (See Chart 1).



[1] State & Local Government Finance Data Query System. http://www.taxpolicycenter.org/slf-dqs/pages.cfm. The Urban Institute-Brookings Institution Tax Policy Center. Data from U.S. Census Bureau, Annual Survey of State and Local Government Finances, Government Finances, Volume 4, and Census of Governments (2006). Date of Access: (17-Jan-09 07:09 PM)

State and local revenue derived from business equipment taxes decreased by 20% from 1994 to 2007 (from $90 million to $72 million). Business equipment taxes have also decreased as a share of total property taxes paid, from 15% of all property taxes in 1995 to 7% of property taxes in 2008. During the same time period, the share of property taxes paid by Class 4 residential homeowners has increased from 38% to 49% (Chart 2). In other words, over the last 15 years, homeowners in Montana have seen their property tax obligation grow in relation to owners of business equipment. This trend has occurred despite the fact that the total market value of business equipment in Montana has increased dramatically- by 66%- over the same time period (from $3 billion in 1994 to almost $5 billion in 2007) (Chart 3).



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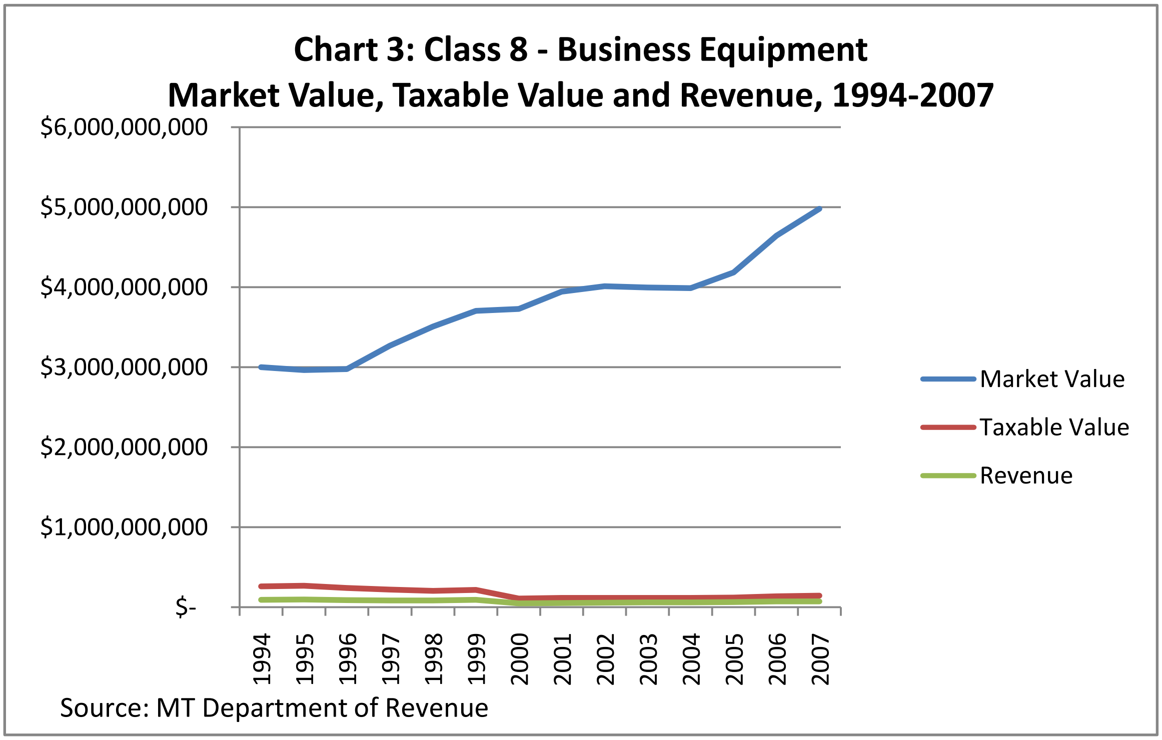
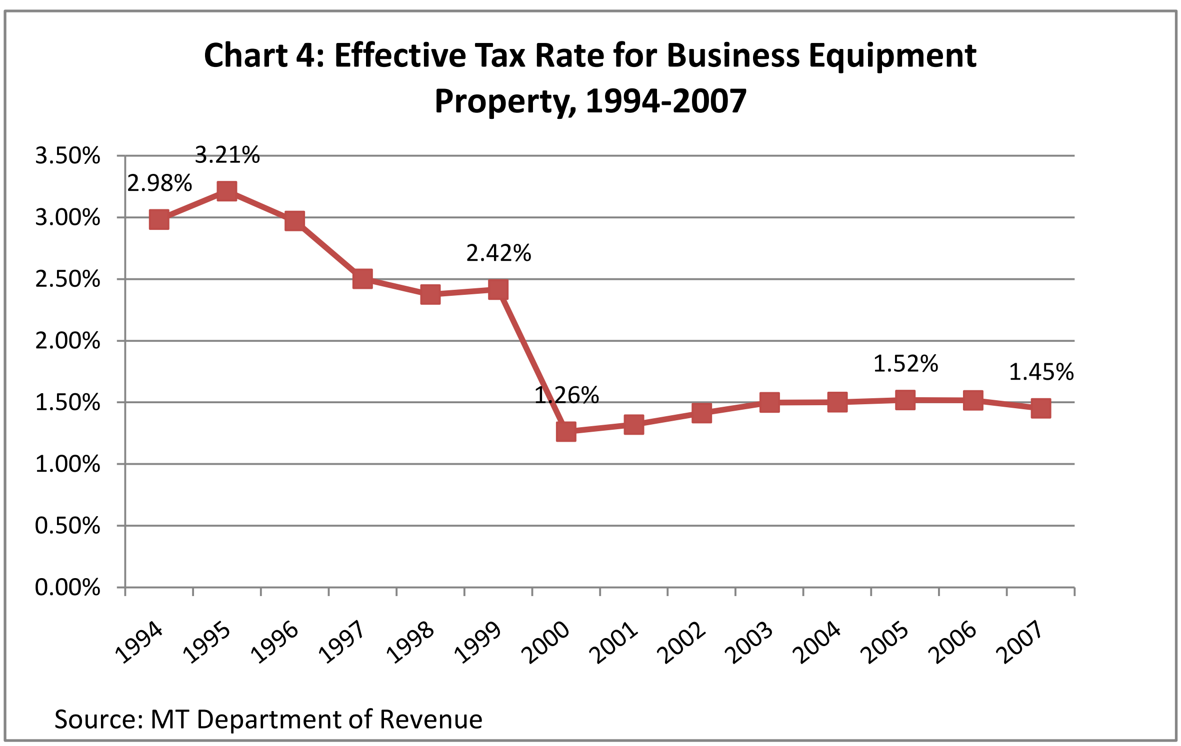


Another way to express this trend is through the concept of "effective tax rate." The effective tax rate on a piece of property is the share of the market value of the property that is paid in taxes. From 1994 to 2007 the effective tax rate on business equipment has fallen by over 50%, from 2.98% to 1.45% (Chart 4).



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What Explains the Decline in Business Equipment Revenue, Share of Total Property Tax Revenue, and Tax Rates?

The business equipment tax has been reduced through a series of policy decisions made by the Montana Legislature. Until 1989, the tax rate for business equipment was 11%.

> **Key Terms**
> A **tax rate** is a rate set by the Legislature for each class of property. The tax rate is applied to the market value to determine the **taxable value** of the property.

- In 1989, the tax rate on business equipment was reduced from 11% to 9% in a Legislative Special Session Amendment.
- In 1995, the 54th Legislature passed legislation to further reduce the tax rate on business equipment by one percentage point for each of the next three years, from 9% in 1995 to 6% in 1998.
- In 1999, the 56th Legislature further reduced the tax rate on business equipment from 6% to 3%. The Legislature also created an exemption to the business equipment tax for businesses with less than $5,000 in business equipment.
- In 2005, the 59th Legislature raised the exemption for the business equipment tax from $5,000 to $20,000. In other words, businesses with less than $20,000 in business equipment were not subject to the tax.

The following table displays the total effect of the reductions in the business equipment tax since 1995 for businesses with equipment valued at $1 million, $100,000, $25,000 and $15,000 respectively.

	Market Value $1,000,000	**Market Value $100,000**	**Market Value $25,000**	**Market Value $15,000**
1994				
Tax rate	9%	9%	9%	9%
Taxable value	$90,000	$9,000	$2,250	$1,350
Average mill*	345.22	345.22	345.22	345.22
Taxes owed	$31,069.80	$3,106.98	$776.75	$466.05
2007				
Tax rate	3%	3%	3%	0 (exempted)
Taxable value	$30,000	$3,000	$750	0
Average mill*	503.81	503.81	503.81	0
Taxes owed	$15,114.30	$1,511.43	$377.86	0
Difference in Taxes Owed 1994-2007	$15,955.50	$1,595.55	$398.89	$466.05

*Source: Montana Department of Revenue

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Further Reducing the Business Equipment Tax Will Decrease Revenue for the State and Increases the Property Taxes Paid by Homeowners.

> **Key Term**
>
> A **mill levy** is a tax rate per thousand dollars of taxable value of property. State and local mill levies are applied to the taxable value of property to determine the amount of property taxes owed. For example, the 6 mill levy that helps pay the cost of our university operations is applied to the taxable value of property at a rate of 6/1000, .006, or.6%. In total, the state imposes five different mill levies totaling 101 mills.[1]
>
> In addition to the state mills, local cities and counties apply mill levies to the property within their jurisdiction to help fund local government functions. In 2008, an average of 538 mills was applied to all classes of property in the state.

Further reductions to the business equipment tax will reduce the amount of revenue deposited into the state's general fund for our collective spending priorities. The effect of the reductions on local governments is more complicated. Property taxes fund both state and local governments. In fact, 83% of all property taxes collected in Montana go toward the expenses of local governments, most significantly the expenses associated with educting our children.

When the taxable value in a local jurisdiction decreases, that jurisdiction can raise its mill levies in order to maintain last year's revenue plus one-half of the average rate of inflation for the past three years. If the taxable value of business equipment is reduced in local jurisdictions by either reducing the tax rate on business equipment or by reducing the number of businesses required to pay the tax, the local jurisdictions are likely to raise their mill levies in order to compensate for that decline in taxable value. The increased mill levies are then applied to the remaining property in the jurisdictions, most significantly to Class 4 residential property.[2] As a result, local revenue remains constant but the obligation to support local government functions, such as education and public safety, shift to homeowners and other property owners. In order to avoid such a shift, the state would need to reimburse local governments for the lost business equipment tax, resulting in a further reduction to the state general fund.

Reducing the Business Equipment Tax is Bad Fiscal Policy during an Economic Downturn

Montana state and local governments rely on our property taxes to invest in the common goods that make our communities strong, prosperous, and secure. Property taxes are one of the ways that we combine resources, through government, to get things done that we can't do as individuals: educate our children, build and maintain transportation infrastructure, provide police and fire protection, keep our air and water clean, promote public health, and maintain a social safety net. Individuals and businesses alike benefit from the strong infrastructure, communities, and workforce built with our shared investments.

Montana, unlike the federal government, can not fund government programs during an economic downturn through deficit spending, which is prohibited by our state Constitution. Rather, as revenue decreases, government spending must also decrease. Reducing taxes further decreases our ability to invest in our common goods and services.

[2] In 2004, the Montana Legislature Tax Reform Study Committee estimated that 60% of the lost revenue from eliminating the business equipment tax would be shifted to Class 4 residential and commercial properties. A copy of the Committee's full report is at http://mt.gov/revenue/legislativeinformation/taxreform.asp.

Cutting the business equipment tax during an economic downturn could be particularly devestating to Montana families. State revenue tends to decline during a downturn at the same time that demand for government services tends to increase. As incomes decrease and unemployment rises, taxes collected on individual and corporate incomes decrease. At the same time, more of our neighbors must rely on government supports such as Unemployment Insurance, Temporary Assistance to Needy Families (TANF), the Children's Health Insurance Program, and Medicaid. Further cutting the business equipment tax now will result in less revenue for the programs and supports we most need during an economic downturn.

Reducing the Business Equipment Tax is not an Effective Way to Stimulate the Economy

In addition, less revenue to the state necessarily means less government spending when the economy most needs government spending. One of the basic tenets of economic policy is that money circulating through the economy – buying goods, paying salaries, generating jobs – is needed to move out of a recession. This is true whether the money is from a big corporation, a small mom-and-pop operation or state and local governments. Governments pay salaries, buy goods and services, and generate jobs, which can be particularly important during a recession, when individuals and businesses are spending and investing less in the economy. Further reduction of the business equipment tax will result in either a reduction in this important source of demand for goods and services or in an increase in other state taxes.

"Recent history should remind states of what happens when they go too far in cutting taxes. When the last recession hit in 2001, states that had been cutting taxes the most — Colorado, Michigan, and New Jersey, for example — had bigger budget problems, and bigger economic problems, than other states. Five years after the last recession ended, the 16 states that cut taxes the most in the years leading into the 2001 downturn still lagged behind their more responsible counterparts, creating jobs at half the rate of the other states and experiencing slower income growth."

-Center on Budget and Policy Priorities, "Fiscal Stimulus at the State Level?" February, 2008 at http://www.cbpp.org/2-29-08sfp.pdf

Certain narrowly targeted tax cuts may stimulate the economy if they are directed at low-income households who will spend all of the extra income resulting from the cut. However, tax cuts for higher-income households or businesses are more likely to harm the economy during a downturn than help. Higher-income households do not spend every dollar of additional income. Instead they will save and invest some. How businesses will spend additional money available from tax cuts is difficult to predict. It may go to workers (higher wages), owners (profits) or customers (price cuts). For companies that operate in more than one state, there is no guarantee that the additional funds will go to Montana workers, owners or customers. Nor is it known how likely the workers, owners or customers are to spend the additional money. Tax cuts to low-income households and government spending are the most direct, effective ways to stimulate the economy during a recession.

Proponents of business equipment tax cuts refer to the policy as stimulutive. Underlying this claim is an assumption that reductions in the tax will encourage businesses to invest in more business equipment. Contray to that assumption, analysis by the Montana Department of Revenue indicates that the reductions in tax rates for business equipment occuring since 1995 have had no significant impact on the investment in new business equipment. This finding in Montana is backed up by a national study that looked at the "stimulative" effect of corporate tax cuts in states during the 1990s. The Center on Budget and Policy Priorities found that, "Contrary to the promises of tax-cut proponents, the tax cuts failed to improve those states' fiscal and economic health, particularly after the U.S. economy ran into trouble in 2001. In fact, the big tax-cutting states generally faced larger fiscal problems, and have had worse economic performance, than other states that were more cautious about tax cuts."[3]

Montana Does Not Need to Lower Business Equipment Taxes in Order to be Competitive.

Proponents of reductions to the business equipment tax in Montana often argue that the reduction is necessary in order for Montana to be competitive in attracting businesses to the state. As numerous national studies have already shown, Montana already has competitive corporate tax rates. To give just one example, the relatively conservative Tax Foundation rates Montana as having the sixth best business tax climate among the fifty states.[4]

More importantly, tax rates are only one of many factors businesses consider when deciding where to locate and/or expand. More determinative are factors such as the skills and education of the workforce, quality of education, energy costs, transportation systems, health care costs, and cultural and

Quotes by Business Leaders Regarding Tax Cuts

"Any company that makes a decision as to where they are going to be based on the tax rate is a company that won't be around very long. If you're down to that incremental margin, you don't have a business.

-New York City Mayor, and billionaire founder of the Bloomberg L.P., Michael Bloomberg. Quoted in John Tierney, "The Big City: An Outsider Comes Inside to Run Things," *New York Times*, November 8, 2001.

The industries that I think about the most, information technology and biological industries, they are far more sensitive to the quality of talent in a location than they are to the tax policies. If you say, ok, where in the United States did jobs around information technology grow up disproportionately? Well, California would be number one, and not because they have the most friendly tax policies, compared to other states. . . It really is this issue about the R&D environment being positive and the great talent being there. And the state being a place where talent really enjoys coming there and working there and raising their kids in that location. . . . So there's some very specific issues, but if you took one, that when you step back and had to look at it that kind of trumps all others, it absolutely is K-12 education and university education.

-Bill Gates, interview before the 2005 annual meeting of the National Conference of State Legislatures, August 17, 2005.

[F]rankly what we`re really looking for is a well-educated, strong labor force. You know, that`s really what matters -- what matters to us because when we choose a plant location, we expect to be there for a few decades or more. . .Quality of the work force, educational attainment of the work force, technical skills of the work force.

-Charlie Rose Show interview with A.G. Lafley, President and CEO, Proctor and Gamble, April 23, 2008.

[3] Center on Budget and Policy Priorities, "Tax Cuts and Continued Consequences: States That Cut Taxes the Most During the 1990s Still Lag Behind," December 2006, at http://www.cbpp.org/12-19-06sfp.pdf.

[4] Tax Foundation, "2009 State Business Tax Climate Index," October 2008 at http://www.taxfoundation.org/news/show/22658.html.

recreational amenities.[5] When Montana prioritizes tax cuts as the method of attracting businesses, we decrease state revenue and concomitantly our collective ability to fund other common goods that influence business decisions.

More useful report cards base their assessment of business climates and economic performance on a far broader range of factors such as school quality, transportation and health care - not just tax cuts. The Center for Economic Development's (CFED) "Development Report Card for the States" grades states for economic performance and business vitality, among other things. This report card assesses if a state's economy generates a widely-shared and sustainable standard of living. The report card gives Montana C’s and D’s, finding that, “Montana continues to struggle to provide a good standard of living for its residents, to make the state a good place to do business, and to build toward future economic success. . . . [T]he state excels at human capital development and employment growth, but low performance around wages, innovation, financial resources, and resource efficiency results in mediocre grades across the board.”[6]

A complete look at Montana’s business climate will assess the whole picture - not just whether tax cuts have been prioritized. Montana ranks at the top of business tax climate lists and yet the state's economic performance and economic well-being of its citizens continues to lag.

[5] Lynch, Robert G. 2004 "Rethinking Growth Strategies: How State and Local Taxes and Services Affect Economic Development" Economic Policy Institute.
[6] Center for Economic Development, “Development Report Card for the States,” 2007, at http://www.cfed.org/focus.m?parentid=34&siteid=2346&id=2346

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Appendix A
List of Property Classes in Montana

Property Class	Description	Percent Share of Total Property Tax Rev.
1	Net proceeds of mines and mining claims except coal and metal	.01%
2	Gross proceeds of metal mines	1.2%
3	Agricultural land Non-productive patented mining claims Non-qualified agricultural land	6.42%
4	Residential, commercial, industrial lands and improvements, incl. improvements on agricultural lands One acre homesteads on agricultural, forest, and non-qualified land Mobile/manufactured homes Golf courses	64.89%
5	Air and water pollution control equipment Independent and rural electric telephone cooperatives Real and personal property of "new industries" Machinery and equipment used in electrolytic reduction facilities Real and personal property of research and development firms Real and personal property used in the production of gasohol	1.5%
7	Non-centrally assessed utilities	.01%
8	Business equipment (a business with less than $20,000 in equipment is exempt)	6.92%
9	All property of pipelines and the non-electric generating property of electric utilities	11.94%
10	Forestland	.3%
12	All property of railroads and airlines	2.01%
13	All property of telecommunication utilities and the electric generating property of electric utilities	4.81%
14	Renewable energy production & transmission property	.01%
15	Carbon dioxide/qualifying liquid pipeline	
16	High voltage DC converter property	

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