

Gross Receipts Taxes in State Government Finances: A Review of Their History and Performance

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Executive Summary

Gross receipts taxes had largely disappeared as an important revenue source for state governments by the later years of the twentieth century, usually after considerable effort by state business groups to eliminate them. Analysts and scholars presumed that these taxes—also known as “turnover taxes”—had forever been replaced with options that made more sense as ways of distributing the cost of government and had less undesirable impact on the taxpaying public, including businesses, and generally lost interest in them. In recent years, however, such broad-base, low-rate taxes have again entered state tax policy discussions. With this re-emergence comes a need for a new analysis of gross receipts taxes to aid policymakers who are unfamiliar with their structure and drawbacks.

This examination of American and European experience with gross receipts taxation has identified several significant conclusions about the tax. These may be summarized:

Broad base: The gross receipts tax base can be broad, broader than the total value of production of the economy, but it lacks any link either to capacity to bear the cost of government services or to the amount of government services

used—the normal standards for assigning tax burdens.

Low rate: Whether a gross receipts tax has a low rate depends on how much revenue the government intends to raise from it. Unlike most taxes, the effective rate of a gross receipts tax is higher than the statutory (or advertised) rate. A broad-base, low-rate gross receipts tax is unlikely to contribute a major share of tax revenue to a modern state government.

Stable revenue: A gross receipts tax appears to be roughly as stable as a retail sales tax. Its variations do not contribute to the overall stability of total state revenue because its fluctuations follow generally the same pattern as other major taxes.

Economic neutrality: A gross receipts tax interferes with private market decisions. Its pyramiding creates a haphazard pattern of incentives and disincentives for business operations. Most significantly, it establishes artificial incentive for vertical integration and discriminates against contracting work with independent suppliers and the advantages of scale and specialization that production by independent firms can bring.

Competitiveness: A gross receipts tax interferes with the capacity of individuals and businesses to compete with those in other states and other parts of the world. The tax embedded in prices grows as the share of a production chain within the state increases, so there is incentive to purchase business inputs from outside the state. It discourages capital investment by adding to the cost of factories, machinery, and equipment, and the disincentive increases as more of those capital goods are produced in the taxing state. This tax structure does not promote the growth and development of the state.

Fairness: A gross receipts tax does not treat equally situated businesses the same. Firms with the same net income will face radically different effective tax rates on that income, depending on their profit margins. Low-margin firms will be at great disadvantage relative to higher-margin firms, regardless of their overall profitability. Many new and expanding firms have low margins (or even are initially unprofitable) and the gross receipts tax reduces the chance that these firms will survive. This also is not consistent with a climate for growth and development.

Transparency: A gross receipts tax is a stealth tax with its true burden hidden from taxpayers. Hiding the cost of government is inconsistent with efficient and responsive provision of government services and contrary to the fundamentals of democratic government.

There is no sensible case for gross receipts taxation. The old turnover taxes—typically adopted as desperation measures in fiscal crisis—were replaced with taxes that created fewer economic problems. They do not belong in any program of tax reform.

Introduction

Gross receipts taxes had largely disappeared as an important revenue source for state governments by the last decade of the twentieth century, usually after considerable effort by state business groups to eliminate the tax. In recent years, however, such broad-base, low-rate taxes have again been discussed as an element of state revenue reform. The earlier American (and international) experience with these

taxes appears to have been forgotten, as well as the fundamental principles of tax policy that they violate. Indeed, little analysis has been done on these taxes in recent years, probably because analysts and scholars presumed that gross receipts taxes had forever been replaced with options that better distributed the cost of government and had less undesirable impact on the taxpaying public, including American businesses. The re-emergence of these taxes creates a need for a new analysis of gross receipts taxes to aid policymakers who are unfamiliar with their structure and drawbacks.

Gross Receipts Taxation and the Proper Treatment of Businesses in a Tax System

A gross receipts tax, also called a “turnover tax,” is a tax on receipts of a business. The tax is levied every time a product “turns over” (or changes owners) in the chain of production and distribution from resource extraction to the eventual customer. These taxes are not income taxes because the tax applies to business receipts, not business profits (there is no allowance for the costs encountered by the business in generating those receipts); thus, they do not tax according to the affluence of the business and its owners. The tax is not a retail sales tax, even though some retail sales taxes are legally defined as taxes on gross receipts. In contrast to retail sales taxes, the gross receipts taxes have no mechanism to limit application of the taxes to retail transactions, are not accompanied by compensating use taxes on purchases made out of state, lack a mechanism to exclude from the taxable gross base any tax added to the purchase price by merchants, and lack the commodity exemptions that characterize retail sales taxes; thus, they are not taxes on household consumption.¹ And the taxes are not proxy charges for government services provided to the business because there is no link between the services received by the business and gross receipts of the business. Often they are proposed as a tax on the “privilege” of doing business, somewhat related to the sense of a poll tax on the privilege of existing in a jurisdiction and about equally defensible.

These are general taxes on gross receipts of all

¹ A number of state retail sales taxes are legally gross receipts taxes with incidence legally on the vendor, including taxes in Arizona, California, Connecticut, Hawaii, Kentucky, Michigan, Nevada, New Mexico, North Dakota, South Dakota, Tennessee, and Wisconsin. [John F. Due and John L. Mikesell, *Sales Taxation, State and Local Structure and Administration* (Washington, D. C.: Urban Institute, 1994) and Research Institute of America, *2006 Guide to Sales and Use Taxes* (New York: RIA, 2005)] They may or may not have legal language about shifting to the customer, but that is irrelevant to what happens with the burden. These are all retail sales taxes, not gross receipts taxes, because they have the basic retail sales tax features outlined here. Some believe consumption to be the best single index for distribution of the cost of government. Nicholas Kaldor expresses the idea as follows: with consumption taxation, “...each individual [measures tax capacity] for himself when, in the light of all his present circumstances and future prospects, he decides on the scale of his personal living expenses. Thus a tax based on actual spending rates each individual’s spending capacity according to the yardstick which he applies to himself.” Nicholas Kaldor, *An Expenditure Tax* (London: Allen and Unwin, 1955), 47

businesses—sellers of both goods and services—without allowance for costs of the business or for receipts from sales made to other businesses. Although the actual incidence of a gross receipts tax depends on market conditions, under most circumstances the tax is likely to be reflected in product prices as it flows to the final customer. And the final price is likely to reflect the gross receipts tax added at each point that the product and the inputs used to make the product changed hands in the distribution flow. This is even the case when the tax is legally a business privilege tax.

Gross receipts taxation is an element in a perpetual tax policy puzzle: the proper treatment of businesses in a tax system.² To require payment of tax by business entities is convenient because economic activity is more concentrated in businesses than in households and because businesses are generally more familiar with the requirements of financial record-keeping and reporting than the average household. Collecting taxes from business is thus administratively economical and convenient. It appears reasonable because private businesses are the source of economic prosperity in a market economy and the government must seek financial support from the places that have resources available. It is politically attractive because placing a tax on business appears to relieve the fiscal burden from households—where the voters are. And it is logical for businesses to pay for the public services that allow them to protect their operations, to prosper financially, and to grow.

But those guiding concepts are less robust than they might seem. Businesses never represent the final resting place of the tax burden, but rather serve as a conduit of the tax burden to households, either through higher prices paid for goods and services sold by businesses, through lower returns received from the sale of services or other resources to those businesses, or through reduced net returns to business owners. A business will adjust to taxes imposed on it, and those adjustments will increase the tax burden on households; there is nowhere else for it to go. This reality complicates the design of appropriate taxation of businesses. Rather than designing policy to tax business, a more useful approach is to recognize the role of business as a conduit to households and to structure taxes accordingly.

In particular, the policy issues involve designing tax structures that do the least harm to the productive operation of the market economy, that allow households to understand with a fair degree of accu-

racy how high a tax burden they are bearing, that require businesses to pay for government services that they directly and explicitly consume, and that cause ultimate tax burdens to be sensibly distributed among households. Analysis of gross receipts taxation needs to be done within the policy context of efficient, equitable, and transparent transfer of resources from private to public use, not in a context of deter-

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mining the proper share of total taxes a business ought to pay. The issues to consider are how business taxes are transmitted to households, and how to mitigate the adverse economic and social impacts from that transference.

One point about business taxation cannot be overlooked: as a matter of economic efficiency, if a business uses a government service, it should pay for that service. Thomas Pogue clearly summarizes the logic: "...the most compelling *economic reason* [for business taxation] is to charge businesses for costs they generate but would otherwise not take into account in deciding what, where, and how to produce. This can be termed the *social cost* rationale, because the object is to confront producers with the full cost to society of the inputs they use in producing goods and services. Under this rationale, business taxes are a means of internalizing the costs of otherwise unpriced inputs used in production."³ That policy will induce businesses to take account of the resources required to produce government services, to treat them as economic and not free goods, and to be judicious in their use. But gross receipts taxes do not serve that purpose.

² Some states levy gross receipts taxes on certain types of businesses, like public utilities. These are much narrower in coverage than the taxes considered here.

³ Thomas F. Pogue, "Principles of Business Taxation: How and Why Should Businesses Be Taxed?" in W. Bartley Hildreth and James A. Richardson, eds., *Handbook on Taxation* (New York: Marcel Dekker, 1999), p. 192.

Gross Receipts Taxation as an Element in Tax Systems

Gross receipts taxes have a long history, dating back to the thirteenth century in Europe and to the mid-nineteenth century in the United States. This history provides a useful framework in which to analyze their current role in the tax system and their economic and political effects. The taxes became important in France and Germany in the post World War I year, and the Nazis exported them to the countries they intended to annex (Austria, Luxemburg, and the Netherlands).⁴ They continued as important revenue sources in Europe until replaced by national value-added taxes in the 1960s and 1970s.

The earliest American taxes based on sales receipts were business occupation taxes on total sales, purchases, or receipts, which developed during the nineteenth century in mid-Atlantic states (Pennsylvania, Virginia, Connecticut, and Delaware) as replacements for lump-sum occupational taxes. They were fractional rate taxes with multiple rates classified by type of business and were intended to be charges for the privilege of doing business. (Of course, governmental intent does not actually determine who bears the ultimate burden of any tax.) They were usually adopted as license taxes, but had a component calculated as a percentage of gross receipts beyond the lump-sum payment. These taxes were levied at very low rates, yielded minimal revenue, and had high administrative costs as a percentage of revenue collected (as much as 15 percent of collections in Pennsylvania and 7 percent in Connecticut).⁵

Gross receipts taxes became more serious instruments of state finance in the late 1920s and 1930s with adoptions in West Virginia, Mississippi, Georgia, Indiana, Delaware, and Washington, generally enacted to help with the collapse of state finances during the Great Depression and to reduce property taxes burdens (the primary source of state

revenue up to that point). In 2005, Ohio adopted such a tax, even as all other states but Delaware and Washington had repealed theirs.⁶ Hence, there is a body of experience for reference as states consider whether adopting a new gross receipts tax would constitute real tax reform.

The Arguments for Gross Receipts Taxation

Proponents of state gross receipts taxes argue that they are low-rate, broad-based, and stable revenue sources. These are the same basic arguments that were made for such taxes in the 1930s, even though the economic conditions of the early twenty-first century hardly compare with those of the Great Depression. The following was written in 1939 but could well have been written by current gross receipts tax supporters:

Turnover taxes are defended on the grounds that they serve to broaden the tax base, compelling every citizen to bear his share of the cost of government; that they place the tax burden on those who have money to spend; and that they encourage business activity and home ownership by relieving property tax burdens. More compelling than any of these considerations, however, is the fact that turnover taxes are capable of producing large amounts of revenue at relatively low collection costs. Popularity of turnover taxes is due also to the widespread belief that the yield of such taxes is more stable than the yields of most other types of levies.⁷

But there is another political reason for these taxes, clearly described by John Due in his analysis of the European turnover taxes: the fact that they are hidden from the public is a substantial advantage

⁴ The French tax was earlier, but the Spanish *alcavala* is more widely known because Adam Smith suggested that the greater prosperity of Great Britain compared to that in Spain and the generally low state of development of manufacturing in Spain in the eighteenth century was attributable in considerable part to the administrative burden of that tax. [Adam Smith, *Wealth of Nations* (New York: Modern Library, 1937), p. 850.]

⁵ Neil Jacoby, *Retail Sales Taxation* (Chicago: Commerce Clearing House, 1939), p. 34, 51. Gross receipts taxes—in the form of business license taxes that calculated a portion of the license fee according to the entity's gross receipts—were also levied in Alaska and Louisiana. Neither tax produced significant revenue. The former was repealed in 1979 and the latter in 1982.

⁶ Texas also enacted a new business tax in 2006, to become effective in 2008. The tax applies to businesses organized as corporations, limited liability companies, limited partnerships, and business trusts, and not to taxable businesses with less than \$300,000 total revenue per year. The base, "taxable margin," equals the lesser of 70 percent of total revenue or total revenue reduced by either cost of goods sold or compensation expense. The statute creates its own limited definition of cost of goods sold. The tax rate is 1% with a special rate of 0.5% for retailers and wholesalers. This tax is not included here because it is more a badly designed business profits tax, like those that emerged in the newly independent states of the former Soviet Union, than either traditional or newer gross receipts taxes. Gross receipts-based alternative minimum corporate income taxes have recently been adopted in New Jersey (2002, the Alternate Minimum Assessment) and in Kentucky (2005, the Alternate Minimum Calculation). The New Jersey tax was eliminated in 2006. These taxes combine all the problems of minimum income taxation in general—excess compliance and administrative cost, penalization of the unsuccessful business, undesirable incentive impacts, doubtful equity basis—with those of taxation according to gross receipts. A corporate gross income tax was an alternate minimum corporate income tax in Indiana from 1963 (when the gross income tax was converted into a retail sales tax, a personal income tax, and a corporate net income tax) until 2002 (when the corporate gross tax was finally phased out).

“because it lessens opposition to the tax and thus makes it politically possible to obtain a high yield.”⁸ Because the customer sees none of the tax embedded at each exchange in the production and distribution process, not even the final retail exchange, the customer is entirely unaware of the tax, thus permitting the government to finance this portion of its operations in an entirely stealthy manner.

Turnover taxes were particularly important for Germany and France in the aftermath of World War I, a conflict that destroyed their fiscal systems. As Haig and Shoup observed, “The morale of taxpayers was at a low ebb, and taxes ‘hidden’ in prices, collected through relatively convenient business channels, and to be paid ultimately by the consumer in small bits day by day were apparently more attractive than an increase in rates of already existing taxes.”⁹ They were an element of fiscal pragmatism: compared to more complicated revenue sources, these gross receipts taxes had the advantage of generating revenue in those difficult economic conditions. They could yield substantial revenue at relatively low statutory rates. They continued even in the years after World War II because the countries saw no other feasible source to finance their operations.

How well do the arguments for gross receipts taxes stand up in the current economic environment? The political utility of stealth taxation violates concepts of democratic governance, and the other arguments are far less compelling than they might initially appear.

LOW RATE

The rate of any tax depends on how much revenue is to be raised. Rates for gross receipts taxes will be much higher if the state intends to make the tax a major contributor to its revenue portfolio, as was the case with the now-repealed taxes in West Virginia and Indiana, and as is the case with the existing tax in Washington State.¹⁰ Any tax can be low-rate if revenue expectations are low; this is not a

unique or necessary feature of a gross receipts tax.

Some examples of turnover taxes in various states can shed light on the revenue impact of these taxes.

West Virginia

The 1921 West Virginia gross sales tax was the first state gross receipts tax to yield fiscally significant revenue. The tax produced more than half of all state tax revenue from 1922 to 1925 and more than one-third through 1930, initially at rates ranging from 0.20 percent to 0.40 percent, depending on business category, but increased in 1925.¹¹ This tax was finally repealed in the late 1980s, after much effort by businesses in the state. By 1986, the Business and Occupation Tax had 26 different classifications of taxable activities, with legal rates ranging from 0.24 percent for wholesaling to 7.77 percent for natural gas production (rates had been somewhat higher in the early years of that decade), and produced 26.2 percent of state tax revenue.¹² Tax yields were concentrated in a few business categories: in fiscal year 1968, 30 percent of total yield was collected from the “manufacturing, compounding, or preparing of products” class and 65 percent of yield came from just four classes (manufacturing, coal production, contracting, and retailing).¹³

Delaware

When the Delaware gross receipts tax was enacted in 1913, its modest rates yielded modest revenue. In recent years, the yield has changed—via changes in rates and basis for calculating the tax—in response to a need to close state fiscal deficits. The tax produced an average of 4.00 percent of state tax revenue in the 1970 – 1975 period, steadily increased to average 8.01 percent in the 1980 – 1995 period, and steadily declined to produce 5.95 percent in the 2000 – 2005 period, the result of structural changes made in the tax in accord with fiscal need.¹⁴ The tax yielded 6.1 percent of state general fund revenue in fiscal year 2005¹⁵ To generate as much revenue as that same

⁷ Bryant Putney, “Turnover Taxes in the United States,” *Editorial Research Reports* (Congressional Quarterly), February 2, 1939, p. 83.

⁸ John F. Due, *Sales Taxation* (Urbana, Illinois: University of Illinois Press, 1957): 58.

⁹ Robert Murray Haig et al., *The Sales Tax in the American States* (New York: Columbia University Press, 1934): 5. Other European countries levied sales taxes that did not have the full multi-stage application of these turnover taxes.

¹⁰ The effective rate of a gross receipts tax will, of course, be higher than the advertised rate because the tax applies at multiple points in the production/distribution process.

¹¹ Jacoby, *op. cit.*, 59.

¹² U. S. Bureau of Census, *State Tax Collections in 1987* (Washington, D.C.: U.S. Government Printing Office, 1988).

¹³ Vance Q. Alvis, “Turnover Taxation in West Virginia,” *West Virginia University Legislative Fiscal Studies, State Tax Study Staff Papers* 1 (September 1970), p. 23.

¹⁴ Delaware Department of Finance Fiscal Notebook [http://www.state.de.us/finance/publications/fiscal_notebook_05/Section02/Section2.pdf]

¹⁵ Delaware Department of Finance Fiscal Notebook, *op. cit.*

state's individual income tax (which produced about five times as much revenue for the state, 30.7 percent of the total), for instance, would require much higher gross receipts tax rates.¹⁶ Tax rates presently range from 0.077 percent (farm machinery retailers and commercial feed dealers) to 1.536 percent (lessees), according to type of business activity.

Washington

The Washington State Business and Occupation Tax (1933 – present) applies at rates ranging from 0.275 to 1.5 percent, depending on the category of business. In fiscal year 2005, it produced \$2,269.1 million for the state, 16.4 percent of total state tax revenue, behind only the retail sales and use tax (\$6,620.2 million) in yield.¹⁷ The state levies neither individual nor corporate income taxes, so the opportunities for alternative revenue are limited.

Indiana

The Indiana Gross Income Tax (1933 – 1962), the broadest transaction tax ever levied in the United States, was a turnover tax plus an income tax: a tax on gross receipts of wholesale sales (including manufacturing, mining, farming, etc.), display advertising, retail sales, and laundry and dry cleaning sales, on wages, salary, and other labor income, property income of all types, sales of services, and sales of property. The tax was the largest single source of state tax revenue from 1936 until its restructuring in 1963, producing 83.7 percent of total state tax revenue in 1962.¹⁸ In that year, it was replaced with a conventional retail sales tax, a personal income tax, and a corporate income tax. The gross income tax remained as a corporate minimum tax. In 1965, when it was collected only from corporations whose calculated net income tax liabilities were lower than their gross tax liabilities (generally the less profitable and loss-making firms and firms with considerable multi-state activity whose total net income was reduced by apportionment), the tax produced 17.3 percent of state tax revenue. The share diminished over time, as other tax rates increased and the statu-

tory rate for the corporate gross tax was phased downward. By 1991, its yield had fallen to 5.4 percent of the total.¹⁹ This last remnant of the tax was finally repealed in 2002.

Ohio

Ohio enacted a gross receipts tax on all commercial activity from July 1, 2005, phasing in from a rate of 0.06 percent to an eventual rate of 0.26 percent after March 2009. The tax is on pace to yield around \$600 million in fiscal year 2007, compared with a forecast of total state tax revenue of \$19.4 billion for the year. When the rate is fully phased in, it is expected to yield \$1.55 billion—only 8 percent of even fiscal year 2007 total tax expectations—and that amount will certainly be higher by the 2010 full-phase-in date.²⁰ Even when fully operational, the tax is not structured to be a major revenue producer for the state.

Neither of the Depression-era turnover taxes in Mississippi and Georgia produced significant revenue and both were levied only for a couple of years. The Mississippi tax was transformed into the first retail sales tax in the United States through an increased rate on retail sales, exclusion of pre-retail sales from taxation, and an allowance for vendors to exclude tax collected from purchasers from their own gross tax base.

It is a maxim of tax policy that, other things being equal, low tax rates are preferable to high rates: economic distortions increase as effective tax rates rise, and any inequities among taxpayers are magnified by higher rates. But this assumes that the tax produces meaningful revenue. Collection of any tax involves both compliance costs for the taxpayer and administrative costs to the revenue agency, and many of these costs are independent of the amount of revenue generated by the tax. A low-rate tax that produces modest revenue may have very high compliance and administrative costs relative to that revenue. In such circumstances, the appropriate revenue policy is to eliminate the low-rate tax entirely

¹⁶ Because high rates have a negative effect on the size of the base, it is not clear what gross receipts tax would be sufficient to generate that amount of revenue. Base effects may, in fact, be so severe that that revenue total may be impossible from the tax.

¹⁷ Washington Department of Revenue, "Summary of Washington State Tax Collections, Fiscal Years 2004 and 2005." [http://dor.wa.gov/Docs/Reports/2005/Tax_Statistics_2005/Table1.xls]

¹⁸ Bureau of Census, *Census of Governments: 1962*. Vol. IV, No. 4, *Compendium of Government Finances*. (Washington, D.C.: U.S. Government Printing Office, 1964), p. 90.

¹⁹ Bureau of Census, *State Government Tax Collections* (Washington, D.C.: U.S. Government Printing Office, various years).

²⁰ Dennis J. Willard, "Ohio Tax Reaps More Than Expected," *CentreDaily.com*, November 27, 2006 [<http://www.centredaily.com/mld/centredaily/news/nation/16106239.htm>] and State of Ohio, *Executive Budget, Fiscal Years 2006 and 2007*. Columbus, Ohio: Office of Management and Budget, 2005.

and raise that modest revenue from a more productive source. Another maxim of tax policy is that no rate/no tax is even better than a low rate. A low rate is a desirable objective for tax policy, but only if the tax in question produces meaningful revenue.

An unspoken but certainly important element in the preference for low statutory rates, at least in regard to this particular tax, is the political reality that the citizenry might not notice the tax. And citizens who do not notice a tax are less likely to object, regardless of the tax's attributes or of how wastefully proceeds of that tax are spent. A tax whose impact is on businesses and whose legal rate is low will not generate the public discussion of a tax whose impact is more apparent. While such a strategy of obscuring the cost of government is at odds with normal conceptions of representative democracy, it cannot be denied that it is part of modern fiscal politics.

BROAD BASE

A gross receipts tax applies on each business transaction.²¹ It encompasses the entire market production of the state and includes intermediate transactions leading up to the final product. The base is thus larger than the gross state product because it includes both the final value of product and the value of transactions leading up to that final production. Suppose, for example, that a company manufactures and sells an automobile. The value of that automobile would be measured as part of the gross state product. A turnover tax would apply to those gross receipts. However, that tax would also apply when tire manufacturers sold tires to the company to install on the automobile, when steel manufacturers sold sheet steel to be fabricated into the body of the car, when utilities sold power and water to the automobile manufacturer and to the tire maker, and so on.²² Hence, it is apparent that the gross receipts or turnover base exceeds the value of final production (or gross product) of the state. The gross receipts base is broad. But is it reasonable to have an annual tax on a flow whose base is larger than the sum of economic production in the state?

The following data illustrate the irrationality of such a large base.

Washington

The total base of the Washington State Business and Occupation tax, the most significant gross receipts tax remaining in the United States, was \$474,813.8 million in calendar year 2005. Washington gross state product in that year was only \$268,502 million.²³ The tax base is 177 percent of the total economic product of the state because of taxation of intermediate transactions in the flow of production. Only the flow of not-previously-taxed finished goods into the state and the flow of taxed unfinished goods out of the state keep the base-to-product ratio from being even greater.

Indiana

The fiscal details of the Indiana gross income tax similarly show the impact of taxing the same economic flow at multiple stages of production. In 1962, total gross income reported for the tax was \$32,818 million: \$20,481.7 million taxed at 0.375

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percent (mostly the gross receipts component of the tax) and \$12,336.2 million taxed at 1.5 percent (mostly the personal income component, but also including receipts from the sale of services). Exclusions reduced the taxable total to \$24,773 million.²⁴ This compares with state personal income in that year of \$11,343 million, retail trade of around

²¹ It may even include gross receipts of service providers, even providers of professional services, which states are reluctant to include in their retail sales tax bases. Also, the taxes may include some receipts of non-profit entities otherwise outside both retail sales and income taxes.

²² If the automobile company owned the tire company, for instance, no tax would apply to the acquisition of the tires. Thus, the vertically integrated firm would have an advantage over its competitors.

²³ Washington State Department of Revenue, *Quarterly Business Review: Calendar Year 2005* (Olympia: Washington State Department of Revenue, 2006) and U. S. Bureau of Economic Analysis, *Western States Led Economic Growth in 2005* (BEA 06 - 23) [<http://www.bea.gov/bea/newsrelarchive/2006/gsp0606.pdf>]

²⁴ Charles F. Bonser, "Analysis of Major Business Taxes Levied by Indiana," in Charles F. Bonser, et. al., *Business Taxation in Indiana* (Indianapolis, Indiana: Commission on State Tax and Financing Policy, 1966), p. 23.

\$6,216 million, and gross state product of roughly \$15,000 million.²⁵ The gross receipts base was around 137 percent of total production in the state. Economic activity in the state was clearly taxed multiple times during production, with the result that effective tax rates on consumer purchases were much higher than the statutory rates.

A broad base does not by itself make a tax a good choice. A poll tax and a flat tax on all business entities would, for example, be broad-base taxes but there is no reason to believe that either would be a good choice for raising significant revenues. Coverage of an economically sensible base should be as broad as possible, without exemptions or special provisions that create inequities and distortions. Broad coverage of a reasonable base, not broad coverage alone, is the accepted standard.

In some discussions, it is suggested that such a broad tax presents a way to make everyone pay for the government services they receive.²⁶ But the gross receipts tax represents a poor means for dividing the cost of government according to benefits from government. As the Washington State Tax Study observes, the "benefits received" basis for taxation "...is most relevant when a tax is levied specifically for the purpose of providing a particular government service to a specific group of taxpayers... [It is] impractical for much of government spending because the 'benefits' received cannot be determined for each taxpayer."²⁷ The gross receipts of a business are associated with no particular governmental service and differences in gross receipts are not a useful measure of whether the business has consumed greater or lesser amounts of government services. Gross receipts taxation fails to make sense as a way of dividing the cost of providing government services.

REVENUE STABILITY

Another virtue attributed to the gross receipts tax is stability; its revenue is not subject to the fluctuations of other state tax bases.²⁸ Whether gross receipts taxes are actually more stable has not been given much attention, certainly not recently.

A test can be conducted with the Washington Business and Occupation Tax. In Table 1, relevant data are presented for the Business and Occupation Tax, the Washington retail sales tax, and, for comparison with major taxes not levied by Washington state, the Oregon individual and corporate income taxes. Washington and Oregon, as neighbors, would generally be subject to approximately the same economic environment, so this presents a reasonable test of the stability of the gross receipts tax compared to these other major taxes. The data are for the reported bases of the Business and Occupation and retail sales taxes (total gross receipts and gross retail sales), total adjusted gross income reported for the individual income tax in Oregon, and reported Oregon corporate net income tax collections (the total base of the corporate tax was not available, but there have been no statutory rate changes over the years examined here). These data for 1995 through 2005 can be examined to establish the degree of stability inherent in each of the taxes. The summary statistics in Table 1 shed light on the extent to which a gross receipts tax base in practice is more stable than other significant taxes.

The average change in the gross receipts tax base was 5.3% over the period of analysis. That is slightly below the average change for the retail sales tax base and somewhat above that for the individual and corporate income taxes. There is not much difference between the four bases in terms of annual rates of change.

The standard deviation measures how spread out the percentage change numbers are or, in other words, whether the annual change percentages are always about the same (considerable stability in the rate of change) or whether there is considerable variability. In this comparison, the gross receipts base is not quite as stable as the retail sales base (0.0461 versus 0.0387), more stable than the individual income tax base, and very much more stable than the corporate income tax. The greater stability of the retail sales tax base may be due to this tax's exclusion of business purchases, particularly purchases of production infrastructure, to a greater extent than the gross receipts base, and such purchases are themselves quite sensitive to economic change and the state of the economy.

Table 1 also presents the highest and lowest annual change percentage for each tax in the period

Table 1
Stability Characteristics of State Tax Bases, 1995 - 2005

	Washington Business and Occupation Tax Base	Washington Retail Sales Tax Base	Oregon Adjusted Gross Income	Oregon Corporate Income Tax Revenue
Annual Change (mean)	5.28%	5.89%	-5.09%	4.96%
Standard Deviation	0.0461	0.0387	0.0537	0.2655
Highest Change	10.87%	9.79%	11.70%	41.90%
Lowest Change	-3.23%	1.00%	-4.50%	39.20%
Correlation with B&O Base	-	0.8802	0.9192	0.8947

Note: Oregon Adjusted Gross Income for 1995 - 2004 only.

Source: Washington Department of Revenue, *Quarterly Business Review, A Compilation of Statistics on Gross Income, Taxable Retail Sales and Accrued Tax Liability as Reported by Washington State Excise Taxpayers* (various years) [<http://dor.wa.gov/content/statistics/>]; Oregon Department of Revenue, *Oregon Personal Income Tax Statistics* (various years) [<http://www.oregon.gov/DOR/STATS/index.shtml>]; and U.S. Bureau of Census, *State Tax Collections* (various years) [<http://www.census.gov/govs/www/statetax.html>]

examined. The breadth of swing (highest change minus lowest change) is greatest for the corporate income tax, by a huge margin, and lowest for the retail sales tax. The swing for the gross receipts tax is slightly less than for the individual income tax but more than for the retail sales tax.

An unstable revenue source can add to the stability of the total revenue portfolio if its instability works to counteract the instability of other sources. This happens if change in the source is negatively correlated with change in other sources. However, this does not appear to be the case for the gross receipts base. It is positively correlated with the retail sales base and also with the two Oregon income taxes (again working under the assumption that what happens in Oregon is a good reflection of what would happen with a comparable base in Washington).

On the basis of Washington's evidence, the gross receipts tax appears to be slightly less stable than the retail sales tax but more stable than taxes on corporate profits or individual income. The variation in the gross receipts tax would not appear to contribute to the overall stability of a state tax system.

Problems with Gross Receipts Taxation

A gross receipts tax violates accepted principles of sound business taxation. In particular, it creates problems in terms of economic neutrality, competitiveness, fairness, and transparency.

ECONOMIC NEUTRALITY

A tax (and a tax system) should raise revenue in a way that has minimal effect on economic choices made by individuals and businesses. It ought not interfere with the functioning of the competitive market as it allocates resources to the betterment of society. When taxes distort decisions, the result is a higher cost of getting goods and services to the public than would otherwise be necessary and lower

potential living standards for the citizenry than would otherwise be attainable. A tax that distorts the functioning of the market is a loss for everyone; any special advantage from the distortion is less than the loss incurred by the rest of the economy. Politicians and government officials are far less capable of allocating resources than is the allocative mechanism of the private market.

The pyramiding effect of general gross receipts taxes creates the primary non-neutral element of these taxes. As the tax applies to goods and services sold by one company to another, those taxes paid constitute a production cost to the purchasing company. The tax is paid several times as a product moves to the final consumer, and the amount of tax depends on the number of exchanges in the production chain.

A firm can gain advantage by merging with its suppliers, thus eliminating an exchange in the production chain at which the tax applies. This creates an artificial incentive for vertical integration, favoring larger enterprises over their smaller competitors. This is problematic. As John Due maintains, "The fundamental objection to the turnover tax is its severe discrimination against nonintegrated production and distribution systems."²⁹ A firm that is not economically integrated will find it difficult to shift the tax because of competition from integrated firms. A small business that purchases its inventory from distributors will have even more difficulty competing with large firms that handle inventory internally or purchase directly from manufacturers. And product from out-of-state will be advantaged compared to product produced within the state because of gross receipts tax that has been embedded in the cost during the chain of production. The more fabrication is done out of state, the greater the cost advantage will be.

Unfortunately, vertical integration means that even the largest firms must handle a variety of dissimilar tasks, losing the advantages of economies of

²⁵ U.S. Department of Commerce, Bureau of Economic Analysis [<http://www.bea.gov>] and U. S. Bureau of Census, *Census of Business 1963: Vol. 2, Retail Trade — Area Statistics, Part 2, Indiana to New York* (Washington, D.C.: U.S. Government Printing Office, 1966), p. 16-5. The gross state product is approximate, based on the ratio of state personal income to gross state product in the two preceding years, because gross state product estimates are not available for 1962. Retail trade is also approximate, based on linear interpolation between Census data for 1958 and 1963.

²⁶ The base of a gross receipts tax may be constructed so that it is not, in fact, broad in impact. Exemption thresholds for payment of tax in Delaware have been designed so that the tax impact is concentrated in a few large firms: 82 percent of businesses in the state fall below the threshold and 85 percent of collections come from only 800 companies. [Al Mascitti, "Contrary to GOP, Gross Receipts Tax Not Really Ailing Small Businesses," *News Journal (Wilmington, Delaware)*, June 12, 2005: p. 18.]

²⁷ Washington State Tax Structure Study Committee, *Tax Alternatives for Washington State* (November 2002) [http://dor.wa.gov/content/statistics/wataxstudy/Final_Report.htm], p. 4.

²⁸ Of course, a completely stable tax base—one that is unchanged from year to year—would not be desirable. Therefore, the objective is a sort of dynamic stability or a pattern of consistent growth over the years.

²⁹ John F. Due, *Government Finance: An Economic Analysis* Revised edition. (Homewood, Illinois: Richard D. Irwin, 1959), p. 322.

scale and specialization that contracting with independent firms can provide. This reduces the ability of firms to compete with firms from other states and other countries. The gross receipts tax lesson: outsource as little as possible, but if outsourcing is to be done, do it with out-of-state firms.

The following examples of turnover taxes in various jurisdictions illustrate these distortions.

Washington

The Washington State Tax Study found that the Business and Occupation Tax pyramided an average of 2.5 times in the product flow, but some products pyramid 1.5 times while others pyramid as many as five or six times.³⁰ As a result, the effective tax rate—tax paid relative to value added by a business—varied substantially from industry to industry. That creates a haphazard pattern of incentives and disincentives that impedes the flow of capital to activities yielding the best economic return and therefore dampens the state's economic development prospects. The effective rate averages 250 percent of the advertised one, and businesses have a considerable incentive to arrange their operations to avoid the tax.

France

France adopted its commodity transfer tax in 1920 with a rate of 1 percent plus 0.1 percent for distribution to local governments and “made all those who habitually or occasionally sold articles of commerce or articles manufactured by themselves, even though no profit should arise, subject to the tax.”³¹ The government clearly understood that commodities would be taxed more than once as they moved through the production and distribution chain, initially assuming for revenue estimates that a commodity would experience five such exchanges. Manipulations to avoid taxable transactions between suppliers or producers were common: “...dealers in some way manage to become commission merchants and brokers, and direct encouragement is

given to the formation of large units out of smaller ones in such a way as to prevent the application of the tax.”³² This distortion of market decisions operated to the detriment of the national economy and added unnecessary costs to the operation of businesses. Problems and distortions from the tax were apparent to all, but they were accepted because no better way was seen to raise the revenue in the post World War I era.

Germany

The German turnover tax showed how the cumulative burden of the tax varied according to the number of transactions between production and final sale and the relative content of labor versus materials in product price. A study done in 1952 showed the effective tax rates on selected commodities to range from 3.2 percent for electricity to 12.5 percent on linen bedspreads, a finding even more interesting because electricity was legally exempt from the tax.³³ The tax on pre-retail transactions built a varying tax burden that was not related to any governmental intent—and was invisible to the public. The low statutory rate pyramided into a much higher effective tax rate, and the taxpayer had no way of knowing what the actual rate was.

The problems are clear. First, the cumulative burden of the tax varies across products according to the number of transactions the product has gone through from production to final sale. Each exchange in the production and distribution channel is taxed, so the more exchanges, the higher the accumulated turnover tax burden. Effective tax rates and burdens on those purchasing products will not depend on the intent of the government but on a series of factors that include the number of transactions involved in getting the product to market and the relative content of labor versus materials in the price of the final product. Second, the taxes artificially encourage economic integration and discourage outsourcing to small busi-

³⁰ Washington State Tax Study, *op. cit.*, p. 24.

³¹ *Ibid.*, p. 172.

³² William Raymond Green, *The Theory and Practice of Modern Taxation* (New York: Commerce Clearing House, 1938), p. 177. There was advantage to being a middleman without taking title to the goods and hence avoiding the tax. This was the source of much administrative complexity. (Carl Shoup, “The Sales Tax in France—Simplicity?” *Bulletin of the National Tax Association*, XVI (October 1930), 16 – 17.

³³ IFO-Institut für Wirtschaftsforschung, *Untersuchungen zur Grossen Steuerreform* (Munich: 1953), p. 109 cited in John F. Due, *Sales Taxation* (Urbana, Illinois: University of Illinois Press, 1957), p. 60.

³⁴ Germany attempted for a time to balance competition between vertically integrated and non-integrated firms by trying to tax internal transfers and, for a time, through lower wholesale rates, but operation of the tax became extremely complicated.

³⁵ Charles E. McLure, Jr., “How—and How Not—to Tax Business,” *State Tax Notes* 36 (April 4, 2005), 31 – 32.

³⁶ Data for 2002 to 2003 from Office of Advocacy, U.S. Small Business Administration [http://www.sba.gov/advo/research/dyn_stmsa03.pdf] and from U.S. Bureau of Census [<http://censtats.census.gov/cgi-bin/usac/usacomp.pl>].

nesses. Because purchases of inputs or services from outside the business would be subject to turnover taxation while transfers of services within units of the business would not, the system establishes a bias toward economic integration. When a firm purchases a supplier or a producer purchases a distribution enterprise, the tax component of the final product price declines, to the competitive advantage of that business.³⁴

A low legal rate becomes a much higher effective rate as a product moves through the production and distribution chain to the final customer. And both households and businesses have an economic incentive to avoid higher effective rates, making choices that work to the detriment of economic development, growth, and progress. A tax whose effective rate depends on the length of the chain from production to final consumer cannot be judged appropriate for any market economy. Charles McLure summarizes: "The taxation of business inputs violates the principle of economic neutrality by discriminating against businesses and industries that must incur these costs and by encouraging self-supply, even when that is not the most efficient way to obtain an otherwise taxed product. By increasing costs, taxing business inputs makes [the state's] producers less competitive in both export and local markets."³⁵

COMPETITIVENESS

A state's tax system should not interfere with the capacity of individuals and businesses to compete for business with entities in other states and throughout the world. Even small rate differences are important in competitive decisions. Embedding gross receipts tax in the prices charged by state producers when those producers purchase materials, inventory, services, and other inputs from within the state makes it more difficult for state producers to compete with firms from other states that do not face such taxes. A tax that encourages businesses to look to out-of-state suppliers is not conducive to a strong economy. And the small margins created by even low-rate taxes matter. For example, the Ohio Commercial Activity Tax was revised before it had been in operation for even a year to exclude from taxation the receipts from tangible personal property delivered into the state for shipment outside the state through "qualified distribution centers." Without this provision, it was feared that Ohio distribution businesses would be at a competitive disadvantage. The provision adds complexity to an otherwise simple tax.

The gross receipts tax presents a special problem for capital-intensive industries. Such firms purchase their factories, machinery, equipment, fixtures, etc.,

from other businesses. Self-supply is seldom an option for significant capital assets. Therefore, the cost of purchasing production and distribution infrastructure is increased by the application of the gross receipts tax and by the gross receipts tax that has been embedded in the purchase price through exchanges in the chain of production that created that equipment. The more of this chain that has taken place within the state, the greater the inflation of the cost of the equipment. Indeed, the tax discriminates against the use of capital in the production process: it must be paid on capital when it is produced but not on labor, so it encourages substi-

It is unclear why any state would want, first, to discourage capital investment by its businesses and, second, to discourage production of capital equipment within its borders. This is not a good strategy for a state's economic growth and development.

tution of labor for capital in the production process. It is unclear why any state would want, first, to discourage capital investment by its businesses and, second, to discourage production of capital equipment within its borders. This is not a good strategy for a state's economic growth and development.

The distortion problems may be most severe for new and expanding businesses. Businesses that are just starting operations often operate at a loss or with only low profits. A tax that is driven by a business' gross receipts, rather than its economic capacity, makes it difficult for the business to survive, to become profitable, and to grow. Some evidence of this problem can be seen in enterprise data from Washington, where the Business and Occupation Tax applies to gross receipts rather than to profits of the firm. Data from the U.S. Small Business Administration show total business establishment births and small business establishment births, both measured as shares of total business establishments, to be 8.9 percent and 16.3 percent, respectively, above the national average. But total and small business death rates exceed the national average by 8.9 percent and 14.1 percent.³⁶ The Business and Occupation

Tax is not likely the sole cause of this unfortunate pattern, but it certainly makes a contribution.

The European countries levying turnover taxes were keenly concerned about their impact on international competitiveness. With the turnover tax, exports were disadvantaged because of the tax embedded in the price of products offered for the international market, and imports were advantaged because there was no multi-stage turnover tax included in offered prices (except for any turnover tax imposed by the country of origin). In essence, the turnover tax discouraged exports and encouraged imports, to the detriment of domestic production and employment. This problem became more critical for businesses as European countries moved toward greater economic integration and more open borders for international trade in the 1950s and 1960s. When France innovated the value-added tax, a tax that could remove tax from the prices of traded goods, countries rather quickly substituted it for the turnover taxes. The economic distortions were less with the new tax: it did not harm international competitive positions, it did not artificially encourage vertical integration, and it could produce large amounts of revenue.³⁷ When France demonstrated that such a tax could successfully be collected, it was no surprise that European countries moved to replace their turnover taxes with such a tax.

Businesses have created strategies to minimize the competitive impact of the tax, incurring some extra costs with the strategies, but at less cost than the amount of tax saved. These strategies are a natural outcome of the need for businesses to remain competitive. Recent experiences are most apparent in Washington and West Virginia.

Two strategies identified by a Washington State tax study show how the gross receipts tax induced some businesses to change their organizational structure:³⁸

A Washington State manufacturer creates an out-of-state subsidiary to legally be the primary manufacturer. The subsidiary imports goods into Washington and contracts with the Washington entity as a processor to complete the manufacture of the goods. The manufacturer pays tax on the contract payments it receives as the processor, rather than on the value of the goods produced.

A Washington wholesaler establishes itself as the purchasing agent in dealings with its customers. The agent purchases goods from manufacturers and transfers them to retailers in exchange for a commission. The wholesaler (purchasing agent) owes tax on the commission, rather than on the value of the goods the retailer receives.

Similar manipulations of business practices were apparent as businesses worked to minimize the West Virginia tax:

The business and occupation tax applied "to the entire amount of the general contract and then again to the dollar value of sub-contracts let by the general contractor. If sub-contracts are made by the initial sub-contractor, at each successive stage the entire dollar amount of all these sub-contracts is taxed. The total tax liability in such circumstances could readily add up to a rate of 10 or 12 percent on some portions of the original general contract. This duplication of the tax base results in a prohibitive total tax burden. The total tax paid by contractors on a given general contract can be reduced by various devices, including the avoidance of sub-contracts and excluding from the contract price the materials used in performing a contract. Sub-contracts may be eliminated by having the firm which lets the contract enter directly into separate contracts with each subcontractor, so that the dollar amount of the general contract is only for the work actually performed by the general contractor. The value of materials used by the contractor is excluded from the contract, such materials being purchased by the firm which lets the contract. This device is more easily employed by larger firms, which can take advantage of quantity discounts, than by the smaller firms."³⁹

The examples have in common the objective of reducing the amount of Business and Occupation Tax owed, not of improving business operations. There will be extra costs in the business arrangement but those costs are less than the amount of tax

³⁷ A turnover tax was an important revenue source for the Soviet Union also. The tax levied highly differentiated, product-specific tax rates, making it more like a large system of selective excises than a general gross receipts tax and certainly maximizing its economic distortions, dislocations, and inequities. But the Soviet system was not terribly concerned about interference with market choices.

³⁸ Washington State Tax Study, p. 113.

³⁹ Vance Quentin Alvis, "The West Virginia Gross Sales Tax," *West Virginia University Business and Economic Studies*, 7 (June 1960), pp. 70 - 71.

saved. The gross receipts tax manages to distort economic practices, to cause businesses to contract in a more awkward and expensive fashion, and to create bias against smaller firms.

FAIRNESS

A first concern in establishing the fairness of a tax is to determine whether the tax base makes logical sense for dividing the cost of government services. The two generally accepted standards are ability to pay and benefits received. According to the first measure, economic entities that have more ability to afford the cost of government services should pay more for those services. Gross receipts measures scale of operations but, in contrast to measures of profitability, fails to tell much about relative capacity to bear that cost. Entities with high gross receipts may be on the steps of bankruptcy court—or already there—while small firms may be entirely successful, just as some large entities may be profitable and some small ones may be abject failures. Gross receipts by itself is not an acceptable guide for the affluence and economic ability of an entity. This provides a partial explanation of why the Washington Business and Occupation Tax and a number of earlier gross receipts taxes applied different tax rates for different types of business activity. But political clout and ease of shifting the tax forward in higher prices shaped the rate patterns as much as likely affluence—and, within business types, there are usually both successful and unsuccessful individual businesses, meaning that the gross receipts tax remains a poor tool for taxing according to ability to bear the cost of government.

The fairness issue emerges across businesses as well, where it is an accepted principle of tax policy that equally situated businesses should be treated equally by the tax system. Different sorts of business are treated in distinctly different fashion by the gross receipts tax. The tax bears particularly hard on low-margin, high-turnover businesses in competitive industries. Such firms are less likely to be able to include the gross receipts tax in their prices and are more likely to have to absorb the tax out of their profits. But they are operating on a low margin and, accordingly, the tax threatens their survival. As businesses fail, margins in those industries will increase for the remaining firms, but that provides little comfort to the owners of businesses that have not survived. Low-profit margin firms face economic challenges under the best of circumstances and a gross receipts tax makes their challenges even more difficult. During recessions, firms are more likely to face marginal profitability and greater customer resistance to prices that cover the gross receipts tax.

Table 2

Median Effective Tax Rates for Major Industries, Washington State Business and Occupation Tax, 1984

Major Industry Class	Lowest in Class	Highest in Class
Agriculture, Forestry, Fishing, and Mining	5.8% (no subclasses)	
Contracting	7.2% (heavy roads)	10.7% (plumbing and heating)
Manufacturing	3.1% (petroleum)	24.9% (aluminum)
Transportation	1.3% (water)	4.8% (trucking)
Utilities	2.7% (communications)	10.0% (electric, water, gas)
Wholesale	10.2% (other durables; hardware, plumbing)	25.0% (petroleum)
Retail	2.4% (real estate)	38.2% (auto dealers)
Service	0.0% (hotel, motel)	21.7% (other services)

Source: Robert P. Strauss, "A Study of Alternate Tax Structures for the State of Washington," Center for Public Financial Management, Carnegie Mellon University, July 15, 1987.

A tax that applies without regard to profitability is likely to cause more firms to go out of business in those circumstances.

The problem is apparent in effective rates from the Washington Business and Occupation Tax. Table 2 presents median effective tax rates for representative firms in major industry classes and subclasses in 1984. The rates, calculated as Business and Occupation Tax paid as a percent of the firm's net income, vary widely across industries and across firms within major industry class. The table shows only the extreme class variations, but there are significant other disparities. For example, groceries faced an effective rate of 18.6 percent while eating and drinking establishments faced a rate of only 7.4 percent. It is difficult to see this range in effective rates and not conclude that the tax is unfair in its treatment of businesses. Firms with high turnover in relation to profits face higher effective rates than do those with high profits relative to turnover, and that pattern has nothing to do with the capacity of a firm to bear the cost of government nor does it have anything to do with the cost of providing government services to a firm. It is simply a reflection of unfair and inefficient tax policy.

Another inequity is in regard to the balance between firms serving in-state and out-of-state markets. The Ohio Commercial Activity Tax provides an illustration of the effect. Gross receipts from sales made out of state by an Ohio company are exempt from the tax; gross receipts from sales of exactly the same items made in-state are fully taxable. Therefore, two firms of equivalent economic size and profitability, one with most of its operations serving an out-of-state market and one with most of its operations serving the Ohio market, would face significantly different commercial activity tax bills and different effective tax rates. There is no standard

of taxation that would support such variation and inequity in tax rates.

Finally, a gross receipts tax will place a tax burden on exempt entities. Even though state gross receipts taxes often (but not always) excuse non-profit organizations from paying tax on their receipts, they still must bear the burden of the tax that is embedded in their purchases. To the extent that they purchase from suppliers who have been subject to the tax, they will bear the tax embedded in the price of the product or service. Even if the purchaser or item being purchased is given tax-exempt status, prices paid will include gross receipts tax elements from earlier stages of the production and distribution process. The pyramiding nature of the tax makes the impact unavoidable.

TRANSPARENCY

The Washington State Tax Study observes: "People should know when they pay taxes and how much they pay. A good tax system is designed to ensure that the tax burdens on residents are clear and evident."⁴⁰ How are citizens to make reasonable decisions about government services if they do not know how much those services cost and who will be expected to pay for them? Transparency in taxation is a bedrock of democratic choice. Unfortunately, the extent to which lawmakers subscribe to this principle is less certain because, while provision of government services is politically popular, the levy of taxes is not. This problem is particularly serious in regard to questions of taxation of business entities.

A gross receipts tax violates transparency in two important ways. First, the tax may be imposed on a business but its burden will be borne by a household—as consumer, as owner of production inputs (including labor), or as business owner. It is not easy to identify which households end up bearing the burden. Richard Bird appropriately sums up the situation: "...it is not always clear exactly which people—owners, workers, or consumers—end up paying business taxes, but somebody definitely will pay. Hiding who really pays the bills is not a good way to ensure accountable public sector decisions."⁴¹

The second violation of transparency involves the pyramiding of tax imposed on pre-retail purchases in the production chain. The tax imposed on pre-retail transactions will be embedded in the production cost at each stage of the production chain, serving to raise the price paid in following transactions. When the final consumer purchases the prod-

uct, its price reflects several pyramided layers of gross receipts tax, and it is impossible to know to what extent taxes increased the price. The final purchaser cannot know how much tax is actually reflected in the price, even if the customer understands what the tax rate is on the final transaction. The household bearing the burden of the tax does not know the amount of that burden, a clear violation of fiscal transparency and an impediment to informed decisionmaking about government operations. With most taxes, exemptions, deductions, and other provisions cause the effective tax rate to be lower than the statutory (or advertised) tax rate. The gross receipts tax is different: pyramiding makes the effective rate higher than the statutory rate.

Conclusion

This examination of American and European experiences with gross receipts taxation has identified several significant conclusions about the tax in modern fiscal systems. These may be summarized:

Broad base: The gross receipts tax base is broader than the total value of economic production. However, breadth itself is not a meaningful standard for evaluating a tax. The base is not logical as an indicator of either capacity to bear the cost of government or consumption of government services.

Low rate: Statutory gross receipts tax rates may be low, but not necessarily. Whether the legal rate is high or low depends on how much revenue the government intends to raise. Even with its broad base, a low rate on gross receipts is unlikely to contribute a major share of revenue to a modern state government. Low-rate, low-yield taxes often have high administrative and compliance costs relative to the amount of revenue generated.

Stable Revenue: A gross receipts tax appears to be roughly as stable as a retail sales tax. Its variations do not add overall stability of total state revenue because its fluctuations follow generally the same pattern as other major taxes.

Economic neutrality: A gross receipts tax distorts private market decisions. Its pyramiding creates a haphazard pattern of incentives and disincentives for business operations. It creates artificial incentive for vertical integration and discriminates against

⁴⁰ Washington State Tax Structure Study Committee, *op. cit.*, p. 5.

⁴¹ Richard M. Bird, "A New Look at Local Business Taxes," *Tax Notes International*, 30 (May 19, 2003), p. 695.

contracting work with independent suppliers and the advantages of scale and specialization that production by independent firms can bring.

Competitiveness: A gross receipts tax interferes with the capacity of individuals and business to compete with those in other states and other parts of the world. The tax embedded in prices grows as the share of production within the state increases, so there is incentive to purchase business inputs from outside the state. And businesses must deal with the embedded gross receipts tax when they sell to out-of-state customers. Possibly most significantly, the tax discourages capital investment by adding to the cost of factories, machinery, and equipment, with the extent of disincentive dependent on how much of those capital goods are produced in the state. This tax structure does not promote growth and development of the state.

Fairness: A gross receipts tax does not treat equally situated businesses the same. Firms with the same net income will face radically different effective tax rates on that income, and low-margin firms will be at a great disadvantage. Many new and expanding firms have low profit margins (or even are initially unprofitable) and the gross receipts tax reduces the chance that these firms will survive. This also is not consistent with a climate for growth and development.

Transparency: A gross receipts tax is a stealth tax, with its true burden concealed from the public. The public does not see the tax because it is legally imposed on businesses and they have no way of seeing the pyramiding that converts a low legal rate into a much higher effective rate. Hiding the cost of government does not lead to efficient and responsive provision of government services and is entirely contrary to the fundamentals of democratic government.

It is sometimes suggested that gross receipts taxes allow simple compliance and administration; the concept of the tax is clear, and there is no need for the many deductions and adjustments required for a tax on profits. But the inherent inequities and disincentives of this simple tax create a demand for com-

Many new and expanding firms have low profit margins (or even are initially unprofitable) and the gross receipts tax reduces the chance that these firms will survive.

plications—for relief of industries in trouble or unable to shift the tax, or for relief of in-state businesses through differential rates, exemptions, and special treatment for certain economic activities. The response to these problems dissolves the simplicity and creates a new set of complications unique to the gross receipts tax. An illogical base cannot be insulated from the practical need for corrections to repair the effects of its fundamental defects. The problems become greater when revenue demands made on the tax are increased.

No sensible case can be made for imposing gross receipts taxes in the modern economic environment. The old turnover taxes, typically adopted as desperation measures in fiscal crisis, were replaced with taxes that created fewer economic problems. Gross receipts taxes should never be seen as an element of positive tax reform. They were abandoned for good reason.



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