

---

The Gross Receipts Tax: A New Approach to Business Taxation?

Author(s): Thomas F. Pogue

Source: *National Tax Journal*, December, 2007, Vol. 60, No. 4 (December, 2007), pp. 799-819

Published by: National Tax Association

Stable URL: <https://www.jstor.org/stable/41790620>

---

JSTOR is a not-for-profit service that helps scholars, researchers, and students discover, use, and build upon a wide range of content in a trusted digital archive. We use information technology and tools to increase productivity and facilitate new forms of scholarship. For more information about JSTOR, please contact [support@jstor.org](mailto:support@jstor.org).

Your use of the JSTOR archive indicates your acceptance of the Terms & Conditions of Use, available at <https://about.jstor.org/terms>



is collaborating with JSTOR to digitize, preserve and extend access to *National Tax Journal*

JSTOR

# The Gross Receipts Tax: A New Approach to Business Taxation?

**Abstract** - Despite their well-understood shortcomings, gross-receipts-based taxes (GRTs) have been recently enacted or considered in a number of states, reflecting a perceived need for an alternative approach to business taxation. To determine how well a GRT meets this need, this paper addresses several questions. What principles should guide choice among taxes collected from businesses? How does the GRT stack up not only against these principles, but also against existing and other feasible taxes? How do the newly enacted GRTs compare to the taxes they replace? Are there better replacement taxes than the GRT? The conclusion: GRTs are at best second-best.

## INTRODUCTION

In its most general form, the base of a gross receipts tax (GRT) is the dollar value of receipts from sale of goods and services, with no omission of categories of sales and no allowance for costs incurred by sellers. All businesses within a taxing jurisdiction report the value of their receipts and apply a tax rate to those receipts to determine the amount of tax owed. Current and proposed GRTs are not this general, as they omit categories of receipts, tax categories at differential rates, and make various *ad hoc* adjustments for costs.

The shortcomings of the GRT are well understood. As Mikesell (2007a, 1) succinctly states, "it (the GRT) 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." Reflecting this criticism among others, state-level use of the GRT declined through the second half of the twentieth century, to the point that by 2002 only Delaware, New Mexico, and Washington levied significant gross receipts taxes. And the New Mexico tax is best regarded as a broad-based sales tax.

However, rather than continuing to fade away, since 2002 some form of GRT has been enacted in New Jersey, Kentucky, Ohio, and Texas, and modified GRTs have recently been considered in Illinois, Maine, and Montana. Michigan's just-enacted (2007) replacement for its single business tax has a GRT component. The New Jersey tax was short-lived, expiring in 2006. These new GRTs have been enacted in part as replacements for existing taxes and in part as sources of additional revenue.

---

**Thomas F. Pogue**

Department of  
Economics, University  
of Iowa, Iowa City, IA  
52242-1994

**National Tax Journal**  
Vol. LX, No. 4  
December 2007

This resurgence in the use of and interest in GRTs raises the question of why this tax, long denigrated by economists, is being considered again by state legislatures. To address this question, I first consider several more fundamental questions. What principles should guide choice among taxes collected from businesses? How does the GRT stack up not only against these principles, but also against existing and other feasible taxes? How do the newly enacted GRTs compare to the taxes they replace? Are there better replacement taxes than the GRT?

### BUSINESS TAX PRINCIPLES

Since income from economic activity ultimately accrues to individuals, the burden of taxes collected from businesses necessarily falls on individuals. Businesses have no tax-paying capability independent of the persons who are their owners, customers, employees and suppliers. In short, business taxes are indirect taxes on persons.

What does it mean then to label a tax as a "business tax"? Does it mean that the burden of the tax falls fully on the owners of businesses—on suppliers of capital? Does it mean that the tax has some other specified incidence? If so, to label a tax we would have to know its incidence with fair precision. Or, does it simply mean that the tax is *collected* from businesses? In this paper, I use the term in this second sense.

So why not collect all taxes from persons? Why collect any taxes from businesses? There are two reasons for doing so. The first and most compelling reason is that economic efficiency cannot be achieved without taxing businesses for the costs of their activities that they would otherwise ignore. I term these the *social costs* of business activity (Pogue, 1998). These are external costs, such as production-generated air and water pollution. And they are the costs that governments

incur in providing services and facilities used by businesses—transportation infrastructure, police and fire protection, the court system required to enforce contracts and property rights, etc. The term "social cost" is sometimes used to refer only to external costs and not the costs of government services. However, I include both categories of cost because both are borne by society at large unless government acts to internalize them.

Economic efficiency requires that businesses face taxes (or government mandated charges and fees) that accurately reflect the social costs of their activities, just as market prices reflect the costs of other inputs. When such taxes and charges fall short of social costs, businesses are subsidized. Efficiency also requires that businesses be taxed uniformly, so that relative prices are not changed, *unless tax differentials can be linked to differences in social costs*. However, if businesses do differ in their social costs, whether external costs or costs that government incurs on their behalf, efficiency requires differential taxes. In that case, efficient taxes may alter relative prices, and in doing so appear to lack neutrality unless one recognizes their role in offsetting social costs. I will follow the tax policy literature and use the terms "efficiency" and "neutrality" interchangeably, recognizing, however, that neutral taxes may affect relative prices.

Imposing taxes to offset businesses' social costs may lead to higher product and service prices and/or lower payments for labor, capital, and natural resources than would otherwise be the case. Output, employment, and/or profits may fall in some sectors (those with relatively high social costs), while rising in others. Some businesses may fail. But these outcomes are not an argument against taxing or otherwise charging businesses for the social costs of their activities. Higher output prices and/or lower input prices are necessary consequences of internalizing social costs. So too is the realignment of

production from sectors with relatively high social costs to those with relatively low costs.

Taxing businesses to cover social costs, as defined above, encompasses the *benefit* rationale for taxing businesses. But the benefit rationale, which calls for taxing businesses to cover the costs of government services, is often treated separately (Oakland and Testa, 1996 and 2000; Bird, 2003; McLure, 2005). As noted above, I have not done so because the policy objective is to internalize costs that businesses would otherwise ignore, whether those costs are external costs or the costs of government services. Of course, the taxes and charges required to internalize external costs will likely differ from those that best account for the costs of government services that benefit businesses.

The second reason for taxing businesses is that compliance and administrative costs may be lower when taxes are collected from businesses. Important examples are collecting payroll and wage taxes from employers instead of employees, and collecting retail sales taxes from sellers instead of buyers. Taxes collected from businesses for this reason are not commonly regarded as business taxes.

A need for revenue is not a reason for taxing businesses, nor is the mistaken belief that taxes on businesses do not burden individuals. Apart from taxing to offset social costs, one might argue that a corporation income tax (CIT) is needed to tax retained earnings as they accrue, in which case the tax functions as a withholding tax on individual shareholder income. However, a state-level CIT is a poor tool for this purpose because many shareholders of the corporations in any given state are likely to reside outside that state. More generally, a tax on business income or property may be seen as a partial remedy for deficiencies in existing personal income and consumption taxes. But the ideal remedy for such deficiencies is to reform direct taxes; attempting

to tax personal income and consumption with indirect business taxes is clearly a second-best strategy.

### *Implications of the Social Cost Rationale*

What are the main implications of applying the social cost rationale for taxing business?

Taxation should not be conditional on income, and it should not be restricted to profitable businesses. Unprofitable businesses benefit from government services and generate social costs. An income tax is, therefore, an inappropriate means of taxing business. Further, fairness in business taxation does not imply that businesses with equal income should pay equal taxes.

But this requirement—that profitability not be a factor in determining businesses' tax liabilities—is not easily or widely accepted by legislators and businesses. Consequently, the contrary belief that profits, especially the lack thereof, should be considered in assessing business taxes has likely deterred use of state-level value added taxes, which Oakland and Testa (1996), among others, see as the best means of charging businesses for general government services. And businesses' objections to paying the Michigan Single Business Tax even when they were unprofitable likely contributed to its termination at the end of 2006 and its replacement by the newly enacted Michigan Business Tax.

Personal income and consumption taxes are not appropriate charges for social costs, which are attributable to business activity, not income or residency of persons.

As a charge for general government services, a business tax should apply to all forms of production regardless of how organized. In particular, non-profit, not-for-profit, and charitable businesses and organizations should be taxed in the same manner as for-profit enterprises.

Likewise, government enterprises—water supply, power, sewage collection and treatment, parking—should be taxed in same manner as private businesses. Failing to do so subsidizes these entities.

Even if businesses engaged in activities regarded as socially beneficial are deemed worthy of subsidy, it is unlikely that the appropriate subsidy is measured by their social costs—by either the external costs they generate or the cost of government services provided to them. Nevertheless, such businesses often face lower taxes and fees than other businesses. And they may be exempted from regulations and fees aimed at curtailing external costs. Although subsidizing in this manner is often an appealing policy, a better approach would be direct subsidies based on explicit estimates of the external benefits generated by the businesses.

If the social costs generated by businesses are proportional to some broad measure of economic activity, such as value added, then a tax on that measure is appropriate. Oakland and Testa (1996; 2000), Testa and Mattoon (2007) and Bird (2003, 708–9) have argued that the costs of general government services are indeed roughly proportional to value added, and for that reason they have advocated an income-based value added tax (VAT) to tax businesses for government services. To illustrate, for the 50 states and the District of Columbia, Testa and Mattoon (2007) estimated that government expenditures on businesses averaged about two percent of value added in 2005. Correspondingly, the VAT tax rate to cover such costs would have averaged two percent, but actual state-local business taxes were estimated to range from three to five percent of value added. Limiting taxes on businesses to the amount required to cover costs of government services would, therefore, by their estimates significantly reduce business taxes—in many states by more than 50 percent.

But use of government services as well as external costs are in fact likely to vary relative to value added, across industries and even among individual firms in an industry. So levying a VAT to cover the cost of general government services to business would only be a partial solution to the problem of taxing businesses for the social costs of their activities. The ideal would be a system of taxes, charges and fees specific to each industry and even to firms within an industry. Having said this, a VAT based on the cost of government-supplied services to businesses would certainly be a step in the right direction, and may be a reasonable approximation to the ideal system.

Taxation should not depend on whether businesses are producing for export or for the domestic market. Businesses whose activities entail the same social costs should face the same tax regardless of whether they are producing for export or for a state's domestic market. This point is sometimes not understood by those who criticize the GRT. See, for example, Chamberlain and Fleenor (2006, 9) who state, "... well designed state tax systems should tax imports on the same basis as domestically produced goods, and they should exempt all exports from taxation ...."

Interstate allocation of a business tax base should be determined by where social costs are generated—primarily where resources are used to produce products and services. This implies apportionment of receipts on an origin rather than a destination basis, which removes the nexus issues raised in *Quill*. In particular, the complexities arising in taxing internet sales for purposes of a retail sales tax (RST) do not arise in taxing businesses for costs generated. Businesses involved in internet sales should be taxed where resources are employed to execute those sales. In contrast, an RST aimed at taxing consumption of residents should be apportioned on a destination basis. Apportionment should,

therefore, depend on the purpose of a tax, and failure to specify this purpose can lead to misunderstandings and unnecessary complications.

Proponents of economic development call for *competitive* taxation, or even subsidy, of mobile producers. And they oppose taxation of exports even though export industries use government services and may generate external costs. Taxing businesses according to the social cost rationale, therefore, conflicts with what are widely perceived as appropriate tax policies for promoting economic growth. However, that does not mean businesses should be subsidized by setting taxes below social costs in an effort to promote economic development. As I explain elsewhere (Pogue, 1998, 99), subsidizing businesses in this manner may benefit some of a state's residents—mainly owners of land and other in-place resources that are in greater demand as the economy expands. But it cannot benefit a state's residents *as a group* except in the unlikely event that a sufficient share of the taxes required to pay for governmentally supplied inputs can be exported to non-residents. That is, the aggregate income of a state's residents usually cannot be increased by taxing businesses at less than the social costs they generate, even if doing so appears to promote economic development.

#### THE GRT AS A BUSINESS TAX (WEIGHING BUSINESS TAX OPTIONS)

How does the GRT measure up against the business tax principles outlined above? The answer, in short, is that a GRT is not an ideal offset to the social costs of business activities. But the same is true for other broad-base taxes in common use—the RST and the CIT. Consequently, what is needed is an analysis of how the

GRT compares to other taxes in satisfying those principles.

Recent critiques of the GRT—McLure (2005a, 2005b), Mikesell (2007a, 2007b), and Chamberlain and Fleenor (2006)—do not focus on such comparisons. Instead, they restate long-standing criticisms of general GRTs based on standard principles of taxation—economic neutrality, competitiveness, fairness, and transparency.<sup>1</sup> Mikesell (2007b) also provides a brief history of gross receipts taxation, beginning with a tax levied in France in 1292. I first review these criticisms and then turn to the question of how the GRT compares to other broad-base taxes.

#### *Criticisms of GRTs*

The chief criticism of the GRT is that it violates the principle of economic neutrality. A GRT implemented without deductions or exemptions for business-to-business sales generates, through the process of pyramiding, differentials in the effective tax rate on final sales. These differentials depend on the number of taxable intermediate sales in the production/distribution process, and whether value added occurs early or late in that process. For a given number of intermediate sales, the effective tax rate is greater the earlier value is added because the tax on any given amount of value pyramids through more stages the earlier the value is added. Such tax-rate differentials are inefficient or non-neutral because they distort relative prices and alter resource allocation decisions.

Although this criticism is valid, the GRT's non-neutrality arises not because it generates tax-rate differentials *per se*; instead it is non-neutral because such differentials *do not accurately reflect differences in social costs*. As explained above, tax differentials are required to correctly

---

<sup>1</sup> Although competitiveness is often listed as separate from efficiency as a concern of economic policy, McLure (2005a) explains that competitiveness is not an "independent goal, separate from economic neutrality."

adjust for differences in social costs, and when they do so, they are not inefficient (non-neutral).

How serious is pyramiding? Tax rate differentials have been estimated for New Mexico and Washington. For New Mexico, the estimated tax rates due to pyramiding range from 0.31 percent (educational services) to 2.68 percent (manufacturing) and average 1.35 percent, giving a maximum differential of 1.33 percentage points (2.68 – 1.35). Added to New Mexico's five percent statutory tax rate, these tax differentials imply an effective state GRT rate averaging 6.35 percent and ranging from 5.31 percent to 7.68 percent (New Mexico Tax Research Institute, 2005). In the case of Washington, estimated pyramiding tax rates range from 0.8 percent (retail trade) to 3.2 percent (electric, gas and other utilities) and average 1.5 percent (Chamberlain and Fleenor, 2006, 5). So the maximum differential is 1.7 percentage points (3.2 – 1.7). Note that it is tax-rate differentials that lead to inefficiency by creating artificial differences in the costs of products and services. If tax rates due to pyramiding are the same in all sectors, then pyramiding causes no cost distortions among taxed sectors.<sup>2</sup> The variation in pyramiding tax rates estimated for New Mexico and Washington is not large compared to existing within-state and between-state differences in statutory sales tax rates. That is, pyramiding does not appear to have generated tax rate differences for major industrial sectors that are outliers,<sup>3</sup> although Mikesell (2007a, 10) terms this variation in effective tax rates substantial.

Pyramiding generates revenue that must be offset if the pyramiding is eliminated. This can be done by increasing the GRT tax rate, increasing other taxes, and/or reducing spending. But each of these actions will likely have adverse efficiency effects. So a decision to reduce pyramiding often entails a choice among second-best alternatives. In this choice, the inefficiencies associated with pyramiding may be preferable to those that would follow from changing taxes and spending to offset the revenue loss. There is a similar trade-off on the equity dimension: pyramiding generates differentials in effective tax rates that create horizontal and vertical inequities based on consumption patterns. But the adjustments in taxes and spending made to eliminate pyramiding may also have adverse equity effects. So once again deciding whether to eliminate pyramiding entails choice among second-best alternatives.<sup>4</sup>

Gross receipts taxation is criticized for weakening the ability of domestic businesses to compete with out-of-state businesses if the tax applies to export sales.<sup>5</sup> Even if export sales are excluded from the GRT base, competitiveness may be affected because in-state sales of intermediate products and services to exporters are taxed. Competitiveness may be also affected even when imports are subject to a compensating tax if out-of-state producers are not similarly subject to a multiple-stage GRT. However, the problem is not that export-producing businesses are taxed, since, as explained above, *all* businesses should be taxed to offset their social costs. The problem is that a GRT is

<sup>2</sup> Of course, the average rate differential due to pyramiding adds to the cost difference between taxed and non-taxed sectors.

<sup>3</sup> The estimated differences in effective tax rates for New Mexico are small even though pyramiding accounts for 32 percent of GRT revenue (New Mexico Tax Research Institute, 2005, 7). Pyramiding could, of course, generate larger differences in effective tax rates in some sub-sectors.

<sup>4</sup> In the case of New Mexico, it is fair to say that legislators are aware of these trade-offs, and they have decided to move gradually in eliminating the GRT on business-to-business transactions. An often-expressed view is that the New Mexico GRT as it existed in 1966 compares favorably to the current GRT because of its greater revenue yield, even though pyramiding was surely more serious in the 1966 version.

<sup>5</sup> Mikesell (2007a, 11–12) discusses in some detail the effect of gross receipts taxation on competitiveness.

a poor proxy for such costs. And in the case of imports, there is a problem only if competing states are subsidizing their producers by failing to levy taxes sufficient to cover social costs.<sup>6</sup> Furthermore, any tax levied by a state may affect competitiveness of its domestic businesses. In particular, corporation income taxes may become embedded in the costs of export producing businesses, and retail sales taxes are subject to pyramiding. So the relevant question is how a gross receipts tax compares to other taxes in its effect on competitiveness. That question cannot be answered simply by looking at the characteristics of the GRT.

Another standard criticism is that GRTs discriminate against new investment and capital-intensive industries unless sales of investment goods (capital goods and inventories) are eliminated from the tax base. In particular, compounding of the GRT may add to the prices of capital goods purchased from in-state suppliers, which could deter domestic investment. Since purchases of labor are not subject to such compounding, the GRT is biased against capital-intensive industries. Also, because the gross receipts tax rate compounds as production moves through multiple stages, a GRT provides an artificial incentive for vertical integration and penalizes sectors that are not integrated, while creating a tax bias against small firms that might otherwise provide services or other inputs to larger enterprises.

McLure (2005b, 214) and Mikesell (2007a, 13), among others, argue that the GRT is unfair because it imposes different taxes on similarly situated businesses, consumers and workers; it is horizontally inequitable. And it does not take account of ability to pay, to the point that the tax may cause some business to fail. But these criticisms would not apply if the

GRT collected from each business were to reflect accurately the social costs of its activities. In that case, the tax's effects on prices, incomes, and resource allocation, whether adverse for some parties or not, would simply be the consequence of fully internalizing production and distribution costs.

In short, the key shortcoming of the GRT *as a business tax* is that it does not reflect social costs. If the tax were to reflect social costs fairly accurately, then the standard criticisms of gross receipts taxation would not apply. A corollary is that when comparing gross receipts taxation with other approaches to taxing businesses, the key question is which tax best reflects the social costs of business operations.

Finally, to put these criticisms in perspective, we need estimates of the efficiency loss (excess burden) attributable to pyramiding. That is, while pyramiding of a GRT undoubtedly generates tax-rate differentials that may distort resource-allocation decisions, we do not know how such decisions are in fact altered in response to a low-rate GRT. Similarly, we do not have evidence on how industry structure has been affected by the GRT's incentive for vertical integration. And we do not know how the efficiency losses implicit in a GRT compare to efficiency losses of existing taxes that it might replace or supplement. We cannot answer questions such as "How does the efficiency loss of a low-rate GRT compare to the loss of an RST that fails to tax most services?"

#### *Comparison with other Taxes*

Neither the GRT nor any other broad-base tax can serve as an ideal charge for the external costs of businesses' activities. Taxes levied as a charge for external costs will necessarily be industry specific, if not

---

<sup>6</sup> Such does not appear to be the case. Recent estimates by Testa and Mattoon (2007) show business taxes exceeding the cost of government services to business *in all states* even when 25 percent of state-local education expenditures are treated as expenditures on behalf of businesses. When education expenditures are fully allocated to households, business taxes exceed spending on behalf of business by a factor of two or more in every state.



firm specific. For example, a carbon tax, widely discussed as a means of reducing carbon dioxide emissions, will vary by firm and industry. Therefore, the GRT must be compared to other taxes as a charge for the cost of *general government services and facilities* used by businesses, such as transportation infrastructure and the court system.

Oakland and Testa (1996, 11) make such comparisons and conclude that an origin-based VAT dominates other broad-base taxes—RST, CIT, GRT—as a charge for government services utilized by businesses.<sup>7</sup> For this purpose, a VAT should apply to production of capital as well as consumption goods because businesses producing capital goods make use of government services just like other businesses, i.e., it should be an income-based VAT. Further, the VAT should apply to value added by government and non-profit sectors.

Although dominated by an income-based VAT, but not necessarily a consumption-based VAT, a GRT seems likely to dominate corporate income and franchise taxes for several reasons. First, all businesses benefit from general government services, regardless of their profitability and regardless of their organizational form. And all businesses would pay a standard GRT, in contrast to the CIT which taxes only profitable businesses organized as corporations. In particular, a GRT would tax businesses in the rapidly growing service sectors that are often organized in a form that escapes corporation income taxation. Second, a GRT would be easier to administer and comply with than a CIT. Sourcing, in

particular, would be less complicated with a GRT, which can source each business' receipts to the state in which its products or services are produced.<sup>8</sup> In contrast, with a CIT, multi-state corporations must apportion net income by formula since there is no unambiguous way to determine where each dollar of net income was earned. Third, a GRT leaves fewer opportunities for tax planning since, in its most general form, it applies to all receipts of all businesses in a state regardless of where products and services they sell are delivered or used. Also, accounting to determine taxable receipts is less complicated and costly than accounting to measure taxable income. Fourth, GRT revenue is more stable than CIT revenue. Fifth, because the GRT base is much larger than the CIT base, the tax rate required for given revenue is lower for the GRT than for the CIT. A lower tax rate may mean either more or less excess burden from collecting revenue, depending on the distortions generated by pyramiding. The decisions to impose a GRT in Kentucky, Ohio and Texas were likely based in part on these reasons for preferring a GRT to corporate income and franchise taxes.

Although a GRT is commonly criticized for lacking transparency and generating differentials in effective tax rates on final products, the same criticisms apply to corporation income taxes. So neither tax is clearly preferable to the other on these grounds.

If each state were a closed economy, an RST that 1) taxes all final sales, *including sales of capital goods*, and 2) does not tax intermediate sales would be equivalent to a tax on all value added.<sup>9</sup> These condi-

<sup>7</sup> A VAT also dominates a GRT as a general revenue source, which is likely a major reason why European GRTs, widespread in the 1950s and 1960s, have since been replaced by VATs.

<sup>8</sup> A GRT is not completely free of apportionment issues. In particular, providing interstate transportation and communication services necessarily entails resource use in two or more states. Consequently, sales of such services must be apportioned among states. An origin-based formula, e.g., payroll and property, would be consistent with the business tax principles stated above, but allocating on the basis of sales would not.

<sup>9</sup> If there are no exports from or imports to a state, then all production is sold within the state. The value of final sales of all goods and services, including capital goods and additions to inventory, equals total value added. And a tax on all final sales is equivalent to a tax on value added. Of course, if the sales tax is restricted to consumer goods and services while the VAT is not so restricted, then the two taxes are no longer equivalent.

tions are not met in today's economy—an RST does not include capital goods by definition—but if they were, an RST would dominate a GRT as a business tax. Otherwise, a GRT could be preferable to a new RST. And a GRT could be preferable to increasing the rate of an existing RST. A GRT would not uniformly tax all value added. But neither do existing retail sales taxes, which omit capital goods and many services from the base and often tax intermediate sales. As a charge for government services, receipts from sales of products and services should be taxed where production occurs, which would be the case with a standard GRT but not with the typical destination-based RST. In short, both taxes are imperfect as a charge for government services. There is no “first best” option here. The option with the lower efficiency loss would be the “second best” option for raising revenue, and that could well be the GRT.

States may find it easier to tax service-providing businesses, especially providers of professional services, and government and non-profit enterprises by enacting a GRT than by expanding the existing sales, franchise, or income tax bases to include such entities.

A GRT generates efficiency losses because it taxes intermediate sales. How an existing GRT, whether long in place or newly imposed, stacks up against alternatives, therefore, depends on the extent to which intermediate sales are taxed. A GRT improves in comparison to other taxes as intermediate sales are removed from its base. Because of the distortions and perceived unfairness of taxing intermediate sales, the business community will likely push for exemptions, deductions, and credits that reduce taxation of intermediate sales. A GRT may, therefore, evolve over time to become a more satisfactory means of taxing businesses for general government services; it may become a closer approximation of a consumption VAT.

Although removing intermediate sales from the GRT base reduces efficiency losses, it also increases compliance and administration costs. This is the same trade-off that comes into play in choosing between a GRT and a VAT. A similar trade-off arises when choosing between a GRT and expanding the RST base to include services. The newly imposed GRTs in Kentucky, Ohio and Texas may reflect judgments about this latter trade-off. But it may also have been politically easier to impose taxes on services via a new GRT than to do so by explicitly adding them to the RST base.

#### EVALUATION OF EXISTING GRTS

This section briefly describes existing GRTs and evaluates their suitability as business taxes. Also see Mikesell (2007a and 2007b), Sutton, Ford, Yesnowitz, and Hopkins (2006) and Chamberlain and Fleenor (2006) for information about these taxes.

##### *Long Standing Taxes*

Among the states that first imposed a GRT during the Great Depression, only New Mexico and Washington continue to do so. The only other long-standing GRT is the Delaware tax, enacted in 1913. Some states and localities also levy GRTs on particular business sectors, but our concern in this paper is broad-base taxes.

The Delaware, New Mexico and Washington taxes are not fully general. None applies the same tax rate to all transactions at all stages of production, and all exempt specified categories of transactions. Delaware and Washington do not tax entities with gross receipts below specified thresholds, but New Mexico has no such exemption. The Delaware thresholds are sufficiently high that the tax is concentrated on the largest businesses in the state, especially retailers. The Delaware and Washington taxes are

broader than the New Mexico tax in that they do not allow deductions for cost of goods sold, while the New Mexico tax, like the typical RST, does not apply to receipts from sale of products and services that are to be resold or become an integral part of a final product.

Delaware and Washington apply differential rates across industry sectors.<sup>10</sup> New Mexico imposes a uniform state-level rate (five percent) and allows county and city add-ons that push the 2008 combined state-local rate above eight percent in some localities. The rate differentials in Delaware and Washington do not appear to be aimed at reducing pyramiding, which would call for reduced or zero rates on business-to-business transactions. In contrast, New Mexico reduces pyramiding by exempting sales-for-resale and some other intermediate purchases.<sup>11</sup> These adjustments, of course, move the New Mexico GRT toward a consumption-based VAT.

None of the taxes entails apportionment of receipts of multi-state firms. The Washington tax applies to receipts from sales of products and services by Washington businesses regardless of whether buyers are in-state or out-of-state. The New Mexico tax functions as a destination-based sales tax: receipts from sales to out-of-state buyers are not taxed, and purchases from out-of-state sellers are subject to a compensating tax. The latter is not fully enforced. The Delaware tax applies to the receipts from sales of products and services by Delaware businesses, including sales to out-of-state buyers.

The New Mexico tax base includes a broader range of receipts than the Washington and Delaware taxes, as well as most

state retail sales taxes. It taxes 1) receipts of US government contractors, 2) receipts from sales of intangibles, services, and leases to local governments, non-profits, and some Indian tribes, 3) governments' receipts from sales, such as water, sewer, and tickets for university athletic events, and 4) franchise fees. As explained above, taxes on government and non-profit sectors are appropriate since they use government supplied services.

### *New GRT-Type Taxes*

Ohio, Texas, and Kentucky have recently enacted taxes that have modified GRT bases. These taxes reflect dissatisfaction with existing taxes, especially corporate income and franchise taxes, which are seen as volatile and unfair taxes with slow or declining revenue growth. They represent a trend away from income taxes based on the federal definition of income. The new GRT-type taxes are seen as preferable to corporate income taxes for reasons noted above. Fox, Luna and Murray (2007) conclude, "Movement to gross receipts taxation in place of corporate income taxation is perhaps the most significant change in business tax policy in recent years."

As they enacted these taxes, legislators were often trying to achieve conflicting objectives. In particular they tried to favor in-state businesses, promote economic development, limit tax increases relative to current law, and limit variation in taxes relative to income. Consequently, the language of the legislation is complicated and will require interpretation by tax practitioners and ultimately the courts. These taxes will be costly to administer and comply with.

<sup>10</sup> Washington rates range from 0.138 to 1.6 percent with retailing taxed at 0.471 percent and manufacturing and wholesaling at 0.484 percent. Delaware rates range from 0.096 to 1.92 percent. See Chamberlain and Fleenor (2006) and Mikesell (2007a) for more detail on rates.

<sup>11</sup> New Mexico Tax Research Institute (2005) estimates that about 35 percent of the potential "pyramiding" revenue—revenue from taxing business-to-business transactions—is eliminated by various exemptions, deductions, and credits.

### Ohio Commercial Activities Tax

The Ohio Commercial Activities Tax (CAT) is a business privilege tax enacted along with a phaseout of the Ohio franchise and personal property taxes and a decrease in personal income tax rates. These changes are phased in through FY 2010.<sup>12</sup> Revenues from the CAT are expected to be enough to replace the personal property tax and a small portion of the franchise tax. So the tax package is not revenue neutral.

In developing the CAT, Ohio legislators were not trying to implement the business tax principles defined in this paper. Instead, one important goal was to improve the Ohio business climate, which called for lower taxes on domestic producers, especially manufacturers, and no tax on exports. A related concern was that the rapidly growing service sectors were lightly taxed in comparison to manufacturing. And the franchise tax was thought to be subject to excessive tax planning.

Of the newly enacted GRTs, the CAT has the broadest base and most closely approximates a standard GRT. The base of the CAT is broadly defined to include, with a few exceptions, all receipts from sale of products and services to an Ohio buyer.<sup>13</sup> One important exception is receipts from sale of products to qualified distribution centers that will ultimately ship the products to out-of-state buyers. The CAT base includes receipts from sales of tobacco products, motor fuel, and alcoholic beverages, but it does not include the excise

taxes on those products that may show up in the price the buyer sees.<sup>14</sup> Receipts from sales in Ohio are taxed regardless of where a business is located—even if a business is located elsewhere and only selling in Ohio—provided minimal nexus standards (discussed below) are met. There is no deduction for cost of goods sold or other expenses.

Receipts from export sales by Ohio-based businesses are not taxed. Thus, it is thought the tax will be advantageous for Ohio economic development. This tax advantage for exporters could be eroded somewhat by the CAT on exporters' purchases from Ohio suppliers. Also aimed at protecting in-state producers is a "use" tax requiring Ohio businesses to include in taxable gross receipts the value of property they transfer into Ohio within one year after they purchase the property outside Ohio. It is unclear whether this provision will be enforced.<sup>15</sup>

The tax applies to taxpayers with taxable gross receipts exceeding \$150,000. It is a flat \$150 for businesses with receipts between \$150,000 and \$1,000,000. Receipts in excess of \$1,000,000 were taxed at a rate of 0.06 percent in the first year (2005); this rate increases to 0.26 percent when the tax is fully phased in (FY 2010). The rate can increase without legislative action if revenues do not reach assigned targets.

The CAT applies to most business entities, including sole proprietorships and pass-through entities. In contrast, the franchise tax applies mainly to C corporations and a few other business

---

<sup>12</sup> The franchise tax being replaced is based on a taxpayer's net income or net worth, whichever gives the larger tax. A minimum tax also applies.

<sup>13</sup> Unlike the Texas tax discussed below, the Ohio tax base does not include some components of income—dividends, capital gains, and most interest. But the CAT base does include rents and royalties and interest on installment sales.

<sup>14</sup> For example, if gasoline sells for \$3 per gallon of which \$0.5 is state and federal gasoline taxes, then \$2.50 goes into the CAT base.

<sup>15</sup> Weighing against enforcement is the exception defined in Ohio Revenue Code 5751.013 to the effect that property brought into OH within one year after it is received outside OH by a person or group is *not included* in taxable gross receipts if the tax commissioner ascertains that the property's receipt outside OH and its subsequent transfer into OH was not intended to avoid in whole the CAT.

forms. The CAT excludes businesses that are subject to specialized taxes—financial institutions, insurance companies, utilities. It also excludes non-profits and governmental entities.

The CAT sources each transaction on the basis of destination, as is done with a sales tax, rather than applying formula apportionment as is done with franchise and corporation income taxes. It sources receipts from sale of services to the location where the purchaser of services ultimately uses or receives the benefit of the services, not where the services are performed. Therefore, receipts from sale of services to out-of-state buyers are not taxed. And services provided to Ohio businesses by out-of-state businesses could be taxed by both Ohio and the state in which the services were performed.

Product sales are sourced to the location of ultimate delivery; sales of product to an Ohio business are not taxed if the ultimate destination of the product is out of state.

Nexus is determined by “bright line presence,” which occurs if a business is domiciled in Ohio or at any time during a calendar year has \$50,000 of property in Ohio, \$50,000 of payroll in Ohio, taxable gross receipts of \$500,000 in Ohio, or 25 percent of total property, total payroll, or total gross receipts in Ohio. The CAT nexus standard assumes that the Quill requirement for physical presence does not apply, an assumption that will likely be tested in the courts. A finding that this nexus standard is constitutional will have important implications for sales taxation.<sup>16</sup>

Commonly owned businesses—more than 50 percent common ownership—must file a single return as either a “combined group” or a “consolidated elected group.” If they elect to file as a combined

group, the group must include all related entities with Ohio nexus. And the CAT base is the aggregated gross receipts of all companies in the group, *including intra-group transactions*. To exclude intra-group transactions from the CAT base, commonly owned businesses must file as a consolidated elected group. To do so, they must meet a number of conditions, the most important of which is that all commonly owned businesses must be included in the consolidated elected group *even if they do not have nexus in Ohio*. So commonly owned businesses face a trade off: 1) file as a combined group and be taxed on intra-group transactions or 2) file as a consolidated elected group and escape taxes on intra-group transactions but face taxes on receipts of group members that do not have nexus in Ohio. These combined reporting requirements are aimed at preventing creation of multiple entities to take advantage of the \$1 million threshold that must be exceeded before a business has to pay more than the \$150 minimum. They also deter businesses from using combined reporting to eliminate transactions among affiliates from the tax base, unless they are willing to pay the price of including receipts of group members that do not have Ohio nexus.<sup>17</sup>

The Ohio legislature tried to legislate tax incidence by including a provision in the legislation that explicitly prohibits passing the tax through to buyers. Taxpayers cannot invoice the CAT separately, but the tax is nevertheless included in the price for purposes of Ohio’s sales and use taxes. Of course, this provision will not prevent forward shifting of the tax, but it does show that the tax is intended to be a charge on production, or that legislators just wanted the tax to be hidden. Another

<sup>16</sup> See Gall and Kulwicki (2006) and Kulwicki (2006) for more discussion of this point.

<sup>17</sup> Different concerns govern combined reporting for corporate income taxation. With a corporation income tax, commonly owned companies have an incentive to avoid combined reporting so they can shift profits among companies so as to reduce taxes. As Fox et al. (2007) explain, states are increasingly requiring combined reporting to deter such profit shifting.

likely reason for the “no invoicing” restriction is that legislators were concerned that the CAT would be subject to constitutional challenge if is viewed as a sales tax applying in part to food and motor fuel.<sup>18</sup>

Several features of the CAT may be contested. It taxes businesses having “bright line presence” in Ohio, including out-of-state companies with sales in Ohio but no physical presence. It taxes receipts from sale of services to Ohio customers even if those services were performed in other states. It imposes a use tax on commodities bought out of state and later brought into Ohio. And it attempts to tax businesses in a commonly owned group even if they do not have nexus in Ohio.

How well does the CAT follow business tax principles? On the plus side, the CAT taxes Ohio businesses more uniformly than the taxes it replaces (franchise and tangible personal property). In particular, there was concern among legislators that existing taxes fell too heavily on the manufacturing sector and too lightly on the expanding service sector. It taxes unprofitable as well as profitable businesses; it taxes more organizational forms of business than the franchise tax, which applied mainly to corporations.

On the negative side, there is first pyramiding. The tax is very low rate, so tax rate differentials generated by pyramiding are likely to be small. Second, contrary to business tax principles, the tax is sourced on a destination rather than an origin basis. It taxes receipts from sales of products and services sold to Ohio buyers by out of state firms, while leaving untaxed

the receipts from selling products and services to out-of-state buyers. It does not apply to non-profits and government enterprises.

#### Texas Margin Tax

The Texas “taxable margin tax” (TMT) was enacted in 2006 as part of a restructuring of Texas’ taxes triggered by a Texas Supreme Court decision, which held that the state-imposed caps on local property taxes for school maintenance and operation were unconstitutional because they effectively converted the tax into an unconstitutional state-wide property tax.<sup>19</sup> Additional 2007 legislation modified the tax and clarified many of its provisions. The TMT replaces the Texas franchise tax, which was effectively a corporate income tax with an asset-based minimum tax. Revenues will also be used to increase state aid to schools and thereby reduce reliance on property taxes to finance public schools.

The base of the TMT—the taxable margin—is the least of 1) total revenue minus cost of goods sold, 2) total revenue minus employee compensation and benefits, or 3) 70 percent of total revenue. During its 2007 session, the legislature added the EZ computation option for businesses with \$10 million or less in total revenue. With this option, the TMT functions as a GRT; total revenue with no deductions is taxed at a rate of 0.575 percent.

The definition of total revenue relies heavily on federal tax accounting principles and on references to federal tax forms—form 1120 for corporations and

---

<sup>18</sup> The Franklin County Common Pleas Court recently ruled in favor of the State on the question of whether the CAT is a tax on food. *Ohio Grocers Association, et al. vs. William Wilkins (in his official capacity as Ohio tax Commissioner)*, case no. 06cvh02–2278. In his decision, Judge Bessey wrote: “Similarly, in the case at hand, the Court finds that in contrast to the sales tax, the CAT is calculated on the gross receipts of the business and does not relate to any single consumer or purchaser of food. The Court further finds that the CAT is imposed directly on the business for the privilege of doing business in Ohio, and therefore the incidence of the tax rests upon the business not the consumer. While the tax may ultimately be passed on to the consumers in the form of higher prices, it cannot be directly billed to and paid by the purchaser. As such, *the Court finds that the CAT is significantly different from a sales tax* [italics added]. If the Court were to hold otherwise, the legislature would be unable to impose an excise tax on any aspect of a business that was in the supply chain for any food....”

<sup>19</sup> *Neely v. West Orange-Cove Consolidated Independent School District*.

form 1065 for partnerships. Total revenue for all options is gross receipts plus dividends, interest, rents and royalties, capital gains, and other income; but foreign royalties and dividends and dividends and interest from federal obligations are not included in revenue.

Cost of goods sold includes most of the expenses that would be deductible in computing federal net income, but it omits selling, distribution, advertising costs and expenses for business services. Deducting costs of goods sold reduces pyramiding and improves the tax as a business tax. But there is no economic rationale for deducting employee compensation if we take the VAT as the benchmark for taxing businesses, since compensation is a component of value added. Allowing this deduction appears to be an accommodation to service industries, which have relatively high compensation costs. That is, with the deduction of only cost of goods sold (COGS), service industries would typically be taxed on a higher percentage of their gross receipts than goods-producing industries, which is entirely appropriate if the objective is to tax value added, since value added is a relatively high fraction of gross receipts in service industries. But this was apparently not a politically attractive outcome.

The tax rate for businesses engaged primarily in wholesale or retail trade is 0.5 percent; for all other businesses, the tax rate is one percent. Early estimates by the state comptroller suggest that these rates are too low to generate the revenue expected when the tax was enacted (Testa and Mattoon, 2007). Further, this large tax rate differential will surely increase administration, compliance and enforcement costs. And it is unclear why such a large differential is justified, given that the cost of goods sold can be deducted. Some differential could perhaps be justified on the grounds that these firms have relatively

high selling, advertising and distribution costs, which are not deductible.

The franchise tax applied only to corporations, limited liability companies, savings and loan associations, and banking corporations. In contrast, the TMT applies to virtually all businesses protected by Texas limited liability statutes with total annual revenue exceeding \$300,000.<sup>20</sup> The 2007 Legislature added a scaled discount, ranging from 20 to 80 percent, for businesses with more than \$300,000 and less than \$900,000 in total revenue. The TMT excludes mainly sole proprietorships, general partnerships directly owned by natural persons, and most tax-exempt organizations. Because the TMT applies to forms of business organization that were not taxed by the franchise tax, one response to the tax may be changes in how business operations are organized.

Taxable margin is apportioned using a gross receipts factor. Any amount excluded from total revenue in calculating taxable margin is also excluded from the gross receipts factor for purposes of apportionment. The denominator of the factor is the taxable entity's receipts from sales of tangible personal property and services, from rentals and royalties, and from other business. The numerator of the factor is receipts from business activities performed in Texas, including sales of tangible personal property delivered or shipped to a Texas buyer, services performed in the state, and rentals of property located in the state.

Exports are not taxed and there is no compensating tax on imports such as that imposed by Ohio. And unlike Ohio, services performed out-of-state for in-state buyers are not taxed.

Taxable entities that are part of an affiliated group engaged in a unitary business are required to file a combined report. An affiliated group consists of entities in which a controlling interest, typically

<sup>20</sup> Other states' limited liability statutes are also recognized, for example in the case of trusts.

more than 50 percent, is held by a common owner. Reeder (2006) suggests that transactions included in taxable margin are probably not restricted by P.L. 86-272.

The TMT is a mixture of gross receipts and income taxation. Taxable margin includes dividends, interest, rents and royalties, and capital gains, which would be included in an income tax base but not in a standard GRT base. COGS includes depreciation and depletion as reported on federal tax returns. Taxable margin is, thus, a crude measure of profits, and apportionment and combined reporting requirements for the TMT are similar to those of a corporation income tax. The tax could, therefore, be construed as an income tax. Indeed, Mikesell (2007, note 6) terms the TMT "a badly designed business profits tax." This similarity to an income tax raises the question of whether the TMT is constitutional, since the Texas constitution limits the ability of the Texas Legislature to implement an income tax on individuals or the individual partners of a partnership without voter approval in a statewide referendum. To limit exposure on the constitutional issue, the tax is imposed on entities rather than individuals.

In sum, the TMT departs substantially from the standard GRT. Although it applies not just to corporations but to most forms of business organization, it retains the administrative and compliance problems of corporate income taxation. Allowing taxpayers to choose from a menu of three tax bases creates opportunities for tax avoidance, which may account in part for revenues failing to meet expectations (Testa and Mattoon, 2007). But the potential for avoidance is limited by the fact that for the vast majority of businesses there is really only one

choice, either COGS or compensation. Additionally, all members of a combined group must choose the same deduction. This requirement is intended to prevent businesses from deducting COGS for some member entities and compensation for others. As a business tax, the TMT is superior to the franchise tax that it replaces mainly because it applies to most businesses. But it is clearly inferior to an origin-based VAT, and it is doubtful that it would dominate a standard GRT. The latter would surely be more easily understood, less subject to litigation, and less costly to administer and comply with.<sup>21</sup>

#### Kentucky Alternative Minimum Calculation (AMC)

The Kentucky AMC became effective January 1, 2005. It applies to all corporations doing business in Kentucky where doing business is broadly defined to include owning or leasing property, having one or more employees, deriving income from sources in Kentucky, and directing activities at Kentucky customers for the purpose of selling them goods or services. The AMC applies only to corporations, so it is too narrow to be an effective business tax.

A corporation's tax is the greater of its corporate income tax or its AMC. The AMC is a flat rate 0.095 percent of gross receipts or 0.75 percent of gross profits. Corporations with gross receipts less than three million are exempt. Gross receipts are the numerator of the sales factor used in apportioning corporate income; gross profits are gross receipts minus returns and allowances and cost of goods sold as determined in calculation of federal income tax.

Sourcing of receipts for purposes of the AMC depends on the type of transaction.

---

<sup>21</sup> Past experience suggests that a VAT, a standard GRT and expansion of the RST were not politically viable options. A VAT was suggested and rejected during the 1990s, and a standard GRT and expansion of the RST were soundly rejected in previous legislative sessions. Source: e-mail comments from Karey Barton, who was senior staff person for the commission that drafted the original margins tax law.



Receipts from sales of tangible personal property are sourced to Kentucky if 1) the property is delivered or shipped to a purchaser in Kentucky other than the U.S. government or 2) the property is shipped from any place in Kentucky and the purchaser is the U.S. government. Receipts from sales of tangible personal property are, thus, sourced on a destination basis, except for sales to the U.S. government, which are sourced on an origin basis. Receipts from providing services, renting property or licensing intangible property are sourced to Kentucky if the activity occurs only in Kentucky or if a greater proportion of activity is in Kentucky than any other state. Receipts from exports of tangible personal property are not taxed except in the case of sales to the federal government; receipts from sales of services to out-of-state buyers are taxed.

#### New Jersey Alternative Minimum Assessment

From 2002 through 2006, New Jersey's Corporate Business Tax (CBT) included an Alternative Minimum Assessment (AMA) calculated on gross receipts or gross profits. Corporations then paid the greater of the CBT or the AMA. S corporations, investment companies, professional organizations, and cooperatives were exempt from the AMA. Gross profits were defined as gross receipts minus cost of goods sold. Cost of goods was federal cost, allocated using factors for allocating corporate income. Gross receipts were sourced on a destination basis for tangible property, where performed (origin basis) for services, and where employed or used for rental and royalty receipts. Thus, gross receipts from export of tangible property were not taxed, while receipts from export of services were. Gross receipts over \$2 million were taxed at graduated rates ranging from 0.1389 to 0.4 percent; gross profits over \$1 million were taxed at rates ranging from 0.2778 to 0.8 percent.

## CONCLUSIONS

The recent interest in and enactment of gross-receipts-based taxes reflects a perceived need, by legislators and tax administrators, for an alternative approach to business taxation. As Fox et al. (2007) explain, there is widespread dissatisfaction with existing corporation income and franchise taxes for several reasons: CITs have become increasingly costly to administer and comply with; revenue is volatile and in some cases (Ohio) declining; corporate income taxes are being avoided through increasingly sophisticated tax planning. Relying on corporation income taxes also means that rapidly growing service sectors are often lightly taxed in comparison to manufacturing, a concern specifically cited in the enactment of the Ohio CAT. States are, therefore, seeing a need for a less complicated tax that applies to more forms of business organization and more sectors of the economy.

Is the GRT such a tax? It is one alternative, but certainly not the best. The well-known criticisms of the gross receipts tax are valid. But more important than the standard criticisms, a GRT is not an ideal business tax because businesses' gross receipts are not well correlated with the social costs of their activities. As Oakland and Testa (1996) explain, an origin-based VAT dominates other broad-base taxes as a means of taxing business. So the states that recently enacted a form of GRT could have done better by enacting a VAT.

#### *Why the Trend to GRTs?*

Why then have these states enacted a form of gross receipts taxation instead of this preferred alternative? Given its poor reputation, what allowed the GRT to jump to the head of the business tax queue? Most obviously, it was political feasibility; but what underlies that feasibility? Any answer is necessarily speculative, but sev-

eral considerations may have influenced decisions to enact a GRT. One is that gross receipts taxation, still in use in some states, is a known quantity in comparison to a VAT. Even in states without a GRT, legislators and tax administrators are familiar with the gross receipts concept because of its use in calculating and allocating other taxes—corporation, franchise and sales. A GRT is likely seen as less difficult and costly to administer than a VAT, and more easily explained to taxpayers. Further, hidden from most taxpayers and having a (misleadingly) low tax rate, a GRT may be seen by both legislators and the public as a relatively minor and innocuous tax. In contrast, increasing other broad-based taxes—sales and personal income—is probably not a viable option because policymakers, seeing a need for a “business” tax, cannot justify what they see as raising taxes on households in order to cut taxes on corporations.

#### *Effect on State Tax Structures*

The recently enacted GRTs in Kentucky, Ohio and Texas depart significantly from the business tax principles set out above. But do they nevertheless improve the tax systems of their respective states?

The Ohio and Texas GRTs are both improvements over the taxes they replace in that they apply to more forms of business organization and tax services more completely. The Ohio tax will be less costly to administer and comply with. But the Texas tax is a GRT–CIT hybrid that retains the compliance and administrative problems of a corporate income tax.

The Kentucky “alternative minimum calculation” based on gross receipts will increase tax payments by some corporations. But it retains all of the problems of the existing CIT, including formula apportionment of gross receipts and gross profits. It adds to compliance and administrative costs by requiring tax calculation for three different bases—gross receipts,

gross profits, and net income. It does nothing to implement the business tax principles set out above. Kentucky would have done better had it just replaced its existing corporation income tax with the tax on gross receipts without allowing an alternative calculation based on gross profits. The same criticisms apply to the “alternative minimum assessment” enacted by New Jersey in 2002 and discontinued in 2006.

All of the new GRTs depart from business tax principles in failing to tax exports, except services produced in state but sold to out-of-state buyers. And they fail to tax all forms of business organization, government enterprises and non-profits in particular. Ohio and Texas tax most private for-profit businesses, but the Kentucky taxes only corporations, as did New Jersey. All may entail excess burdens due to pyramiding, but given low tax rates, those burdens may be small. Both Ohio and Texas have opened the door to legal wrangles over constitutionality.

On balance then, an overall improvement in the state tax system seems most likely in the case of Ohio and less likely in the case of Texas. Although the Kentucky tax may raise revenue, it does nothing to improve the state’s tax structure. Of course, the important bottom line is that all states could have done better had they enacted a low-rate origin-base VAT.

#### *Improving Gross Receipts Taxation*

Although as a business tax a GRT is clearly a second-best option, the trend seems to be toward increased use of gross-receipts-based taxation. So it is worth asking how a GRT can be implemented to reduce its disadvantages. Several suggestions follow.

##### *Business-to-Business Transactions*

On efficiency grounds, the primary criticism of gross receipts taxation is that it taxes business-to-business transactions,

thereby generating both an incentive for vertical integration and differences in effective tax rates that are unrelated to differences in social costs. Therefore, if policymakers have decided to enact a GRT, because of political feasibility or other reasons, they should also consider modifying the tax to reduce taxation of business-to-business transactions. A GRT can be a first step toward a satisfactory business tax if over time business-to-business transactions are removed from the base. Of course, this is a second-best and one might say odd way to eventually implement a VAT; as previously explained, it would be better to start with an income-base VAT.

Business-to-business transactions can be removed through exemption or deduction of receipts from specified transactions. Alternatively, the tax can be imposed on all receipts from all economic activities, with each taxpayer being allowed a credit for tax paid on any purchases it makes in its business operations. The first, *exemption-deduction* route requires that sales of goods and services be identified as either *intermediate* or *final*, with receipts from the former being excluded from the tax base. The legislation making these distinctions is likely to be voluminous, complicated, and subject to legal dispute; that has certainly been the case in New Mexico. The second, *credit* route does not require explicit identification of intermediate goods and business-to-business transactions. Instead, all of each business' receipts are taxed at the GRT rate. But each business also receives a credit for any GRT paid on its purchases of products and services

when calculating its own GRT liability. With each business' tax determined in this manner, the GRT on business-to-business transactions is eliminated, and the GRT on each product or service is determined only by its final sale value. This end result is achieved without the complicated legislation and administration required if a system of exemptions and deductions is used to remove business-to-business transactions from the GRT base.<sup>22</sup>

Another advantage of the credit approach is that it achieves neutrality between in-state and out-of-state sources of business inputs. A business buying a product from an out-of-state source pays no GRT on that purchase. If it buys the same product from an in-state source, the seller of the product collects the GRT, so at that point the in-state source appears more costly. However, when calculating its own GRT liability, the business receives a credit for the GRT paid on its purchase from the in-state source, so the net effect is zero tax on the purchase from the in-state source. The credit approach does not achieve neutrality when the purchases are final products, rather than business inputs. In this case, a compensating tax is necessary for neutrality.

A third advantage of the credit approach is that some tax is collected on intermediate production that ultimately contributes to the output of entities that may not be taxed on their output, either because they do not sell their output or because their sales are not taxable by law. Such entities include governments, religious and charitable organizations, and non-profit

<sup>22</sup> Neither the credit nor the exemption/deduction approach solves the problem arising when receipts are from sales of "dual-use" goods. These are goods, such as desktop computers, that are used by both businesses and households. Such goods should be taxed as consumer goods when used by households, but they should be tax exempt when used by businesses. One response to this problem would be to have sellers try to determine whether purchases are for business (not taxable) or household (taxable) use. A second approach would be to exempt businesses' purchases of dual-use goods, but require substantiation of their use as business inputs on audit. Zodrow (2004) argues against both of these approaches. He suggests instead that businesses be taxed on all purchases of dual-use goods, but then be allowed to apply for refunds.

and not-for-profit businesses. In contrast, when intermediate transactions are removed from the tax base with exemptions or deductions, no taxes are collected “along the way” to the final stage of production. Further, when sales to such entities are not taxed, there is again some tax collected at intermediate stages with the credit approach, but not with exemptions and deductions.

### Sourcing

Sourcing is often complicated by failure to distinguish the purpose of a tax. If the purpose is to tax the income or consumption of state residents, as when a sales tax is collected from sellers, then the tax should be sourced on a destination basis. However, if the purpose is to tax businesses for costs generated by their activities, then the tax should be sourced on an origin basis. Receipts from sales of services should be assigned to the state where services are performed, not where benefits from services are realized, as Ohio does in the case of business services. Exports should not be exempted; businesses that produce for export generate social costs in the state in which they are located. Imports should not be taxed. States have typically not followed these prescriptions on sourcing, probably out of a desire to favor domestic over out-of-state production; Washington is an exception.

### Apportionment

Apportion according to where sales-generating activities occur—that is, according to the location of labor and property—and not by a formula that attempts to allocate aggregate sales among states.

### Included Transactions

Include receipts from all final sales of products and services including the receipts of non-profits, governments, and government enterprises. Furthermore,

since non-profits and governments do not sell many of the services they provide, some taxes to cover social costs must be collected at earlier stages of production. This can be done by taxing receipts from sales to governments and non-profits. Given the continuing increase in the value of goods and services moving through the non-profit sector, taxing receipts from sales to non-profits, though contrary to common practice, will be increasingly important for efficiency in taxation.

### *Taxation as an Evolutionary Process*

When imposing a new tax, legislators should consider the evolutionary pressures that will determine the long-run outcome of their legislation. *What you legislate is not what you get.* Legislators considering a GRT should, therefore, expect pressures to reduce pyramiding if business-to-business transactions are in the tax base. It will be better to deal comprehensively with such transactions when initially implementing the tax, rather than leaving the door open to *ad hoc* adjustments that play out over time and generate complexity. That is, use the GRT label if it is more acceptable politically than the VAT label, but enact a tax that approximates an income VAT as closely as possible.

Legislators should also expect, and try to head off, pressures for tax breaks driven by the now widely held belief that taxes should be used to promote economic development and gain competitive advantage vis-a-vis other states. Moreover, because tax breaks have become accepted political currency, base-eroding measures favoring particular economic interests may be enacted regardless of their effect on economic development. These latter two pressures are, of course, not unique to the GRT; they are at work eroding the bases of other taxes—income, sales and

property. The inescapable consequence of these base-eroding changes is complexity, which makes tax administration significantly more difficult. The best antidote for such pressures is tax policy analysis grounded in well-understood principles; otherwise, it is difficult to argue against further arbitrary and complicating changes.

### Acknowledgments

I wish to acknowledge and express my gratitude for many helpful suggestions from William Testa and Rick Mattoon (Chicago Federal Reserve Bank), George Zodrow, Fred Church (Deputy Tax Commissioner, Ohio Department of Taxation), Karey Barton (Ryan & Company, Austin, TX), and Jim Nunns (Director of Tax Policy, NM Department of Taxation and Revenue).

### REFERENCES

- Bird, Richard M.  
 "A New Look at Local Business Taxes." *Tax Notes International* 30 (May 19, 2003): 695-728.
- Chamberlain, Andrew, and Patrick Fleenor.  
 "Tax Pyramiding: The Economic Consequences of Gross Receipts Taxes." *Tax Foundation Special Report No. 147* (December, 2006).
- Fox, William F., LeAnn Luna, and Matthew N. Murray.  
 "Emerging Business Tax Policy: More of the Same or Fundamental Change?" *State Tax Notes* 44 (April 10, 2007): 393.
- Gall, Maryann B., and Laura A. Kulwicky.  
 "A Critique of the Nexus Standard for Ohio's New Commercial Activity Tax." *Journal of State Taxation* (March/April, 2006).
- Kulwicky, Laura A.  
 "The Ohio Commercial Activities Tax: Why Out-of-State Businesses Should Sit Up and Take Notice." *State Tax Notes* 41 (July 10, 2006): 113.
- McLure, Charles E. Jr.  
 "How—and How Not—to Tax Business." *State Tax Notes* 36 (April 4, 2005a): 29.
- McLure, Charles E. Jr.  
 "Why Ohio Should Not Introduce a Gross Receipts Tax—Testimony of the Proposed Commercial Activity Tax." *State Tax Notes* 36 (April 18, 2005b).
- Mikesell, John L.  
 "Gross Receipts Taxes in State Government Finances: A Review of Their History and Performance." *Tax Foundation Background Paper No. 53* (January, 2007a).
- Mikesell, John L.  
 "State Gross Receipts Taxes and the Fundamental Principles of Tax Policy." *State Tax Notes* 43 (March 5, 2007b): 615.
- New Mexico Tax Research Institute.  
 "Pyramiding Transactions Taxes in New Mexico: A Report on the Gross Receipts Tax." Albuquerque, New Mexico, September, 2005.
- Oakland, William H., and William A. Testa.  
 "State-Local Business Taxation and the Benefits Principle." *Economic Perspectives (Federal Reserve Bank of Chicago)* 20 No. 1 (January/February, 1996): 2-19.
- Oakland, William H., and William A. Testa.  
 "The Benefit Principle as a Preferred Approach to Taxing Business in the Midwest." *Economic Development Quarterly* 14 No. 2 (May, 2000): 154-64.
- Pogue, Thomas F.  
 "State and Local Business Taxation: Principles and Prospects." In *The Future of State Taxation*, edited by David Brunori, 89-99. Washington: Urban Institute Press, 1998.
- Reeder, Kimberley.  
 "Texas Adopts Broad Tax Reform." *State Tax Notes* 40 (June 12, 2006): 881.
- Sullivan, Martin A.  
 "The Effective Corporate Tax Rate Is Falling." *Tax Notes* (2007).
- Sutton, Giles, Nicholas E. Ford, Jamie C. Yesnowitz, and Chris Hopkins.  
 "The Continuing Evolution of Gross Receipts Taxes." *The State and Local Tax Lawyer* 11 (December, 2006): 37-60.

## Forum on State Gross Receipts Taxes

---

Testa, William H., and Rick Mattoon.

"Is There a Role for Gross Receipts Taxation?" *National Tax Journal* 60 No. 4 (December, 2007): 821–840.

Zodrow, George R.

"Revenue Options for the State of Texas." *State Tax Notes* 34 (December 20, 2004): 799–821.