Is There a Role for Gross Receipts Taxation?

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*Is There a Role for Gross Receipts Taxation?**

Abstract *- States are showing renewed interest in using Gross Receipts Taxes (GRTs) as a method for taxing business. This paper discusses the advantages and disadvantages of GRTs along three dimensions—as a stand alone tax against standard tax principles, as a replacement for an existing business tax structure, and finally as a "fill–in" or corrective tax to rebalance a state's tax system. In addition, the paper offers estimates of current state and local tax levies on business relative to estimates of the benefits that business receives through public services. The paper concludes that the GRT is not a first best option, and that an origin–based value added tax would be a preferred business tax structure.*

INTRODUCTION

There has been an unexpected proliferation of states adopting the gross receipts tax (GRT) and other business activities taxes in recent years. States last embraced GRTs during the Great Depression when existing tax bases failed to produce enough revenue to keep key government services functioning. Today, the need for revenue again drives states to expand taxes collected from business. State and local governments have recently faced tumultuous times, going from fiscal feast (the boom of the1990s) to famine (the 2001 recession). But perhaps unlike the GRTs, enacted out of desperation at the time of the Great Depression, states today are also likely to turn to new business taxes for reasons beyond revenue replacement, including the promotion of economic development and the reform of highly flawed and biased tax systems. In some instances, states have expediently turned to such taxes in response to judicial opinions criticizing current state fiscal systems.

GRTs are not being enacted in the principled vacuum of an ideal world and, thus, cannot be evaluated entirely from such a standpoint. Still, fundamental principles of tax policy offer important guidance, especially since GRTs are little known and less understood, yet sometimes injected into a heated policy debate concerning the direction of a state's fiscal system. GRTs must also be carefully considered in relation to what they are replacing, if anything. Here, economic prin-

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ciples are once again helpful in examining the trade–offs among alternative revenue vehicles. In either case, examination of the GRT against time–tested principles is of further merit because these "GRTs" come in many shapes and sizes. Accordingly, the economic effects of their bells and whistles are often difficult to discern without knowing what to look for.

This paper suggests a tri–partite approach to understanding and evaluating GRT proposals. All three approaches start from the basic principles of equity and efficiency. But the weights on these principles and associated sub–principles vary according to the size and motivation of the proposed tax—that is, whether the GRT is proposed as a major revenue cornerstone or as a complementary piece of a general and multi–faceted tax structure.

The first approach is to consider a GRT on its own stand–alone merits, using the standard evaluative criteria (and sub–criteria) of equity and efficiency. Here, the alleged horrors raised by economists about the GRT are largely justified, although there are possible modifications to the GRT that may make it acceptable. The second approach evaluates a GRT as a general pervasive bulwark of a state's general *business* taxation—as a replacement or full revenue partner beside the dwindling corporate income tax (CIT) as well as local property taxation of business. In this case, the GRT is considered and contrasted with a proposed ideal general business tax, one based on value added by "origin" and levied in proportion to benefits received.[1] Certain modified versions of the GRT may approach this ideal in its structure. Even so, a caution is raised in adopting a GRT since most states already overtax business entities in relation to the benefits principle of taxation. A third approach is to consider the GRT as a corrective "fill–in" to plug into an otherwise unbalanced tax structure.

WHAT ARE GRTs?

We generally think of a GRT as an ad valorem levy against the gross revenues of a business operating within a state's boundaries. GRT and other activities taxes are distinguished from state (corporate) income taxes first because they often apply to all forms of business organization other than the limited liability corporation,[2] with some even bringing nonprofit organizations into their scope. Since fast–growing service industries, especially business services, have tended to eschew corporate form in favor of partnerships, GRTs also tend to broaden tax coverage across the spectrum of industry sectors as well. Second, unlike most CITs, the basis of taxation of activities taxes goes beyond profits and returns on capital investment to reach activity covering the gamut of productive activity.

In this breadth, however, GRTs can generate pernicious tax coverage, reaching far beyond the value added of activities that takes place within the geography of the taxing state, and reaching the same productive activity several times over. The latter is usually referred to as "tax pyramiding" in that goods or services are

[1] Taxation "by destination" is the contrasting concept, meaning that the basis of taxation is the sales or use destination of the good or service.

[2] A recent trend in state taxation has been to subject pass–through entities such as limited liability companies (LLCs) and limited partnerships to taxation by decoupling from federal IRS standards for reporting. For example, Florida and Georgia decouple for the purpose of their sales tax, Illinois decouples for the personal property replacement income tax, and Kentucky imposes the income tax on all limited liability entities. For more detail, see "Recent Trends in the State Taxation of Pass–Through Entities," Bradley, Arant, Rose & White, LLP, *State and Local Tax Bulletin,* December 16, 2005. http://www.bradleyarant.com/pdf/SALT_Bulletin_12_16_2005.pdf.

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sometimes taxed one or more times during the production process and then once again upon final sale to consumers.

GRTs or "business activities taxes" under this general rubric have been fashioned in many ways. Table 1 lists GRT–type taxes along with characteristics relating to their tax base, extent of pyramiding and geographic reach.

EVALUATING THE STAND–ALONE MERITS OF A GRT AGAINST STANDARD TAX PRINCIPLES

One of the outward attractions of the GRT to policymakers is that it can be designed to have two features that are viewed very favorably in the tax literature—a broad base and a low rate. If the tax base is the gross receipts of all businesses (regardless of their structure—S corp, C corp, partnership or other), the tax base is very broad and captures the revenues raised by all forms of business activity in the state. The very breadth of the tax base allows the application of a low nominal rate. For example in the Ohio version of a GRT, the rate is only 0.26 percent. In addition, in theory, GRT tax administration costs are likely lower than corporate income taxes since its taxable base is easier to identify and calculate, thereby

TABLE 1
CHARACTERISTICS OF STATE GRT–TYPE TAXES

State YEAR Enacted/Killed	Description of Tax Base	Accommodation to Ease Pyramiding	Treatment of Interstate Exports and Imports
Washington 1933	Gross sales, gross income or value of products produced in state	Tax rate modification	No distinction
New Hampshire 1993	Value added—sum of payroll, interest, dividends	No pyramiding	No distinction; components apportioned largely by origin (payroll and property)
Michigan 2007	Gross receipts minus business purchases	Inputs of business purchases subtracted	Import taxation: Apportionment of tax base of multi–state businesses based on sales by destination
Ohio 2005	Gross receipts	Moderate tax rate adjustments	Exports exempted; imports widely subject to tax through extensive nexus
Illinois 2007 proposed	Gross receipts	Tax rate modification	No distinction
New Mexico 1966	Gross receipts	Nonsystematic removal of business–to–business transactions over time	Services performed out of state not taxed
Texas 2006	"Gross margin" option of receipts minus compensation or two alternative bases	3 alternative base—minimum of: 1. Revenues minus cost of goods sold 2. Revenue minus labor compensation 3. 70% of total revenue Also: Tax rate modification	No distinction

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reducing compliance burdens.[3] Finally, a GRT may improve revenue stability, particularly for states where corporate income tax revenues have proven to be highly volatile. A recent analysis by Mikesell (2007) suggests that the GRT, while significantly less volatile than a corporate income tax, has roughly the same stability as a retail sales tax. Further, an estimate of the short–run elasticity of Washington States GRT (the Business and Occupation Tax) found that the elasticity of the base was 1.4, which was essentially the same as the states retail sales tax (Washington State Tax Structure Committee, 2002, 122). However, in the case of Washington, the same study found that the revenue stabilizing benefits of the GRT might be muted given that the tax appears to move in sync with the retail sales tax and other major tax bases. As such, it does not appear to promote overall revenue stability over the business cycle.

Given these apparent virtues, why wouldn't all states want to adopt a GRT? Mikesell (2007) provides a thorough analysis of the shortcomings of the tax and finds ample reason to suggest why it is not a favorite of tax economists. The most significant flaws identified are a lack of transparency, the inappropriateness of using the gross receipts base to measure economic activity, and perhaps its greatest flaw—tax pyramiding.

First, the base of the tax—gross receipts—is an inappropriate guide for assessing the economic presence of a firm in a given state. Geographically, receipts have little to do with the venue of production, especially as value and supply chains are widening out world wide. This disassociation between nexus and tax liability makes the GRT tax liability capricious and potentially distortive to decisions concerning investment and location. In particular, considered as an implicit user charge to firms that should relate to the firm's usage of in–state public services or the costs it imposes on the state, this flaw of the GRT is significant. Depending on the nature of the business, for example, high–volume/low–margin businesses versus low–volume/high–margin businesses, the level of gross receipts produced by a firm will have little relationship to the services it consumes from government. One way in which this flaw has been ameliorated is by setting a myriad of differing tax rates to reflect differences in businesses' ratios of value added to gross receipts. For example, since retail operations tend to purchase large amounts of inputs and, thus, have relatively low value added in relation to sales, their tax rates are lower under several GRTs. In Washington State, the tax rate for retail enterprises is 0.47 percent, while the average for all industries is 0.61 percent. In Texas, the new "Margin Tax" has a 0.5 percent statutory rate for retail and wholesale trade, while all other businesses have a one percent rate. In this approach, the administrative complexity of the GRT increases, thereby reducing one of its primary advantages—namely low cost of administration.

[3] The Washington State Tax Structure Committee (2002, 50, Appendix C–18) study identified the collection costs for the Department of Revenue for major tax sources for 1996. The study finds that the average cost per $100 of revenue collected for all state taxes was $0.63. Local taxes (collected at the state level) were higher at $0.70. Of the major tax bases, Washington's GRT (the Business and Occupation tax) does not seem to offer significantly lower costs of collection:

State Taxes	**Cost per $100 Collected**
—Retail Sales	$0.27
—Business and Occupation (GRT)	$0.75
—Public Utility	$1.18
Local Taxes	
—Sales and Use	$0.76

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Another structural problem with the GRT is its application to the evolving structure of U.S. firms. Over past decades, U.S. firms have become increasingly specialized and vertically disintegrated, largely in response to enhanced communication and information technologies. Assuming that this trend in vertical disintegration is productivity–enhancing, a tax structure that discourages it would tend to be growth–depressing. Since the GRT acts as a "turnover" tax, with liability accruing each time a good or service is bought or sold, a final good whose value is achieved across many intermediary transactions will tend to have an outsized GRT tax liability. The more atomized is the industry–wide value chain, the greater is the tax liability. Importantly, then, GRT biases U.S. businesses toward vertical integration at a time when it is straining in the other direction in response to advances in supply–chain innovation and technology. This bias extends the GRT's capricious liability across industries to firm organization, and creates a tax bias against small specialized firms.

Another neutrality concern with a GRT is its treatment of imports and exports. Motivated by a desire to achieve economic growth *via* export promotion, some states exempt firm receipts derived from any goods or services exported out of state. For example, the state of Ohio excludes such receipts from the tax base. Evaluating the merits of such export exclusion requires a perspective on the particular tax base that the GRT is targeting. As a stand–in for the retail sales tax, export exclusion from a GRT seems justified; a tax on consumption is destination based and, thus, would and does exclude exports. However, as a tax on business activity, there is no particular reason to exclude exports and every reason to favor neutrality instead. Namely, favoring exports only pushes a state's economy towards industries in which it is not naturally advantaged. Moreover, if the GRT is intended to function as a user charge or fee for state and local government services provided to industry, there is similarly no reason to give a free ride to export–oriented industries.

From a neutrality standpoint, the tendency of a GRT to pyramid is perhaps its most obvious and capricious flaw. While this tax pyramiding could be remedied by exempting the sale of intermediate goods and services from the GRT, this would significantly reduce the revenue–raising capacity of the tax and increase its complexity. In addition it would run the risk of having the GRT tax rate increase significantly, thus jeopardizing (or rather, exposing) one of the primary justifications that helps market the GRT as nondistortive in the first place—a broad base and a low rate.[4] A recent study measured the extent of pyramiding under the GRT in Washington State (Washington State Tax Structure Committee, 2002, 112, Table 9–7). The study found that on average the Washington GRT pyramided 2.5 times with significant variation by industry type, ranging from 6.7 times for Food Manufacturing and Petroleum and Refining to 1.4 times for computing and data services. Tax pyramiding also increases the effective tax rate of the Business and Occupation Tax (Washington's GRT), making it higher than the statutory rate. The difference becomes even more apparent when an effective tax rate is calculated based on value added. While the statewide average Business and Occupation tax rate is 0.61 percent, on a value–added

[4] The policy justification that a GRT is a good tax because it allows for broad–based and low–rate taxation is somewhat illusory. Given tax pyramiding, the effective rate can be much higher than the statutory rate depending on the nature of the business. Furthermore, states with a long history of the tax, such as New Mexico, tend to narrow the base (often by selectively eliminating some of the pyramiding effects), thereby having to compensate by raising the rate. After time, the base is no longer broad and the higher rate further distorts the tax structure.

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basis the effective tax rate jumps to 1.53 percent (Washington State Tax Structure Committee, 2002, 41, Table 1).

A study of the New Mexico GRT by the New Mexico Tax Research Institute (2005) found that the extent of pyramiding, and its economic impact, was limited because of a pattern of exemptions that has given specific industries pyramiding relief over the years. The study calculated a pyramiding tax rate (measured as taxes paid from pyramided sales as a percentage of gross state product (GSP) generated by specific industries) and found that the "pyramiding tax rate" was 1.35 percent for all private industries. The hardest–hit industries were manufacturing and transportation and warehousing at 2.68 percent and 2.66 percent, respectively. This represents the "excess" tax paid related to pyramiding above the five percent statewide gross receipts tax rate.

In most cases the application of remedies to correct possible distortions to the GRT essentially turns the tax into a haphazard form of either a sales tax or a value added tax (VAT). The question must be asked that if this were the policy intent, why not adopt those tax structures in the first place? The most likely reason is that the GRT provides a politically more palatable option for evolving toward these more preferred tax structures. In some instances, it appears to be easier to market a GRT to the public than these other tax forms, or there are difficult legal or constitutional constraints that are circumvented with the use of GRT.[5]

However, these marketing merits of the GRT come with some trade–offs. It would be difficult to argue that the GRT is a transparent tax. In the first place, as is the case with most business taxes, the incidence of the tax is hard to determine. While legally the tax is placed on the business entity, economic theory suggests that the tax is likely to be either passed backward onto labor in the form of reduced wages or decreased hiring, or forward onto consumers in the form of a hidden sales tax. In either case, neither labor nor consumers will likely be aware that they are actually paying the tax. In addition because of the potential for tax pyramiding, the actual distortion is likely to be significantly greater than the nominal tax rate for the GRT might suggest.

The combination of these flaws makes it difficult to argue that a GRT should be the first option any state considers in choosing a new general tax. Yet, states are gravitating toward the tax. Is it possible that the GRT can be an appropriate choice when fiscal issues, problems with the existing state economic structure and political constraints are taken into account?

THE GRT AS A PRIMARY STATE BUSINESS TAX

Part of the attraction of a GRT may lie in the fact that few states can boast that their current business tax structure is even close to well–conceived. States that rely on corporate income taxes find that many businesses are exempt or escape taxation and that the tax is often biased against capital intensive firms, especially those in the manufacturing sector. Part of Ohio's motivation to adopt a GRT was the desire to end personal property taxation on business that was seen as detrimental to the state's extensive but fragile manufacturing base. In proposing a GRT for Illinois, Governor Blagojevich suggested that even firms that should be subject to the state's corporate income tax escaped the tax altogether through tax planning

[5] In fact many states that have adopted alternatives to traditional corporate income taxes have been careful to avoid naming the new tax structure in a transparent way. Michigan's failed VAT was called the Single Business Tax. Washington's long–time GRT is called the Business and Occupation Tax and the new Ohio GRT is referred to as the Commercial Activities Tax.

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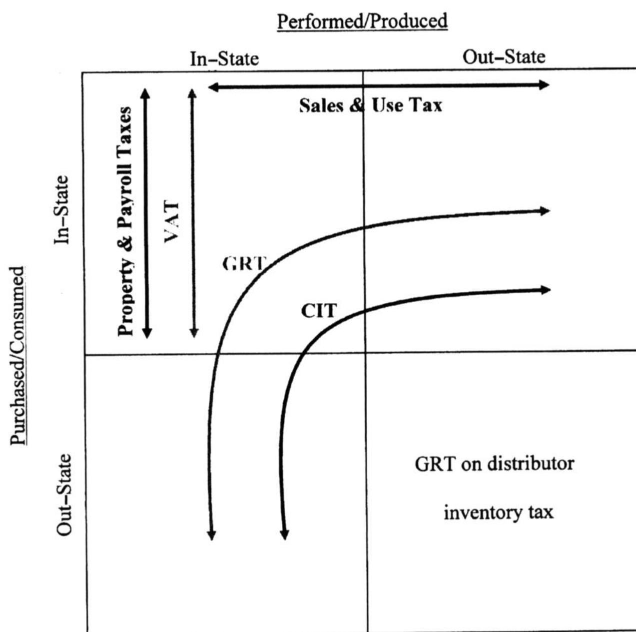
and loopholes. In this context, can the GRT be a better fit or correct inequities in the existing primary business tax structures? What is the economic incidence of the GRT versus other major business taxes? Finally, if the GRT is not a good choice for a primary business tax, what would be better?

GRTs have taken on many different forms as they have been adopted by various states. What may appear at first blush to be a tightly defined concept actually takes on various forms in practice. In consequence, critiques of particular "GRTs" often do not resonate, as they otherwise might, in discussions that take place across state boundaries.

This can be seen by an appeal to the origin–destination dichotomy that continues to be a critical issue in tax analysis. The issue is whether the intent of taxation is to assess liability at the point of consumption or the point of production. This distinction has become increasingly important as economies have become more open, buying and selling goods and services from other locales. The GRT, as adopted in practice in various forms, takes on characteristics of both origin and destination. A good or service can be produced (performed) either at home or abroad, and can be consumed (used or sold) either at home or abroad. This leads to four possible categories of GRTs, with varying economic effects, illustrated in Figure 1.

At heart, the GRT usually falls partially in the upper–left quadrant as an origin–based or business activities tax. Goods or services produced at home and sold at home are usually taxed in several and various stages of production and sale. This portion of the GRT taxes value added by origin. This strong origin orientation suggests that it is similar to local property taxation of business property, though it is broader in taxing production activity related to labor inputs and it is redundant in the possible multiple taxation of

Figure 1. GRT—What Is It? (origin vs. destination features)



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intermediate input usage. In its origin character, it aligns with the principle of taxing social costs attendant to business activity (Pogue, 2007). And to the extent that "business income" of multi–state companies under a CIT is captured by formula apportionment of the firms' national activities base by in–state sales, payroll, and labor compensation factors, the CIT and GRT are both origin based. In fact, the GRT's taxable base is broader and far less confined to social costs attendant to capital usage only, as is inherent in both the property and corporate income taxes.

Consider now those goods and services (or value added thereof) produced at home but purchased abroad (or out of state) as indicated in the lower–left quadrant of Figure 1. In this instance, the origin basis (and attendant benefit tax or social cost feature) of taxation is often lost. The state of Ohio exempts gross receipts of such exports from their taxable base. Here, the GRT–like vehicle acts like an RST or a CIT that is apportioned by sales at destination, for example. Again, the taxable base of the GRT is broader than the CIT, but the distortions due to arbitrarily subsidizing out–of–state sales are identical. The deadweight loss may be seen in considering two states located side by side with the same export–excluding GRT tax structures. At worst, production is (needlessly) driven to the over–the–border state to avoid the tax, but at the cost of (1) ignoring comparative advantages in production, (2) adding transportation costs, and (3) failing to internalize the social costs of public services consumed by business production in the home state.

As a state VAT, Michigan's Single Business Tax (SBT) (1976–2007) adhered to its origin feature in part.[6] However, it apportioned the SBT tax base of multistate companies such as Ford and GM by sales destination. Practically, such a tax feature impacted (smaller) in–state companies including parts suppliers and small retailers. This feature contributed to its unpopularity with small business and ultimately to its elimination. The recently enacted Michigan Business Tax base is bifurcated into (1) a CIT–type tax, and (2) a modified GRT that in some ways mimics a VAT by origin. Under both of these taxes, the bases of multi–state companies are apportioned by the proportion of sales in state, converting this element of the tax into a destination–based assessment.

So–called GRTs also tend to tax imports into the state to varying degrees. Ohio has perhaps gone furthest in this regard with its controversial "bright line" nexus definitions. The proposed Illinois GRT will likely follow suit. Out–of–state producers must have only very minimal nexus such as "actively promoting sales in the state" to have their gross receipts be taxable under Ohio's Commercial Activities Tax (CAT). Note that enforcement of such taxes in practice may differ significantly from the letter of the law.

Such taxation of "imports" into states most obviously runs afoul of the "user charge" or "social cost" principle of business taxation. And if the state believes that in taxing imports they are exporting tax burdens to non–residents, they are likely mistaken. For the most part, individual states do not have sufficient size or market power to influence the producer price of goods and services sold into the state. So, such import taxes likely work to raise prices of imported goods. And from an efficiency standpoint, this feature of the tax unnecessarily discourages export activity by home–state producers that purchase inputs from out of state.

For a state's resident retail consumers, the taxation of imports under a GRT becomes an added retail levy and should be considered with other existing levies

[6] The SBT offered several alternatives to calculate liability. Note also that the SBT allowed deduction of expenditures on machinery and equipment, which somewhat narrowed its basis from current production activity.

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on retail sales in evaluating a state's tax structure balance. As shown in Figure 1, the GRT is typically like the retail sales tax, taxing both sales produced at home and purchased from abroad. In some sense, then, this version of the GRT becomes, like the retail tax, a tax on the "consumption" of a state's residents. Accordingly, in looking at the GRT's interaction with the extant retail sales tax of a state, the GRT may either contribute to neutrality or distort the base further. It is constitutionally difficult for some states, such as Illinois, to expand their retail sales tax base to retail services as might be recommended on neutrality grounds and to increase the elasticity of the tax base over time. Illinois' governor suggested as much in his 2007 GRT proposal. However, justifying the GRT on these grounds may come at high cost, since retail goods may already be highly taxed and because intermediate (business) sales become ensnared in the same tax structure. However, one justification for including such business–to–business sales in the taxable base in Illinois was that many such business service firms were said to be (increasingly) exempted from the state's CIT through partnership and other forms of business organization and since those same partners paid personal income taxes at Illinois' low flat rate of three percent.

Perhaps the most egregious deviation from an origin–based form of GRT relates to its application to firms such as out–of–state distributors who may neither "sell into" the state in any meaningful way nor generate much "social cost" or use of government services in the state (lower–right quadrant). For example, distributors of high–value but easily transportable goods might fall into this category. As under the hated "inventory" form of the property tax, examples where activities are driven from a state are not difficult to imagine under a GRT. States such as Washington and New Mexico tend to have lower effective tax rates for wholesale distributors for such reasons. Still, for such firms having high–value goods in transit but low margins and value added, such a tax would be highly punitive and would ultimately distort decisions regarding the location of economic activity.

Overall, many so–called GRTs share a peculiar feature with other ill–conceived business taxes. That is, its proponents do not know what they want it to be, it is often levied with expediency in mind, its principles are not well defined, and it is manifested in many guises. As a result, the various guises of the GRT result in numerous economic distortions of prices, resource allocation, and the location of production. Moreover, these distortions are amplified to varying degrees by its pyramiding feature, which also plays havoc with the choice of organizational form that businesses may select along the spectrum of vertical integration.

If the GRT (and most current forms of state business taxation) are far from the ideal primary business tax, what would work better? As argued by Ebel and Papke (1967), Cline (1988), Oakland and Testa (1996) and others, an income–based VAT by origin offers the most compelling direction for a broad–based business tax in that it more accurately reflects the economic presence and activity of a firm in the state. Given that the tax is based on the value added by the firm, it more closely aligns with business services consumed and considerations of spillover cost. So too, in addition to avoiding tax liability that is capriciously based on turnover and the form of industrial organization, an origin–based VAT does not bias by mode of production—e.g., it is neutral with respect to capital–intensive and labor–intensive firms. This compares favorably to today's dominant business taxes—property, sales, and CIT—which are biased in taxing capital usage in production. There are several variants in constructing a value–added tax base. The so–called consumption method is the most favorable in its treatment of

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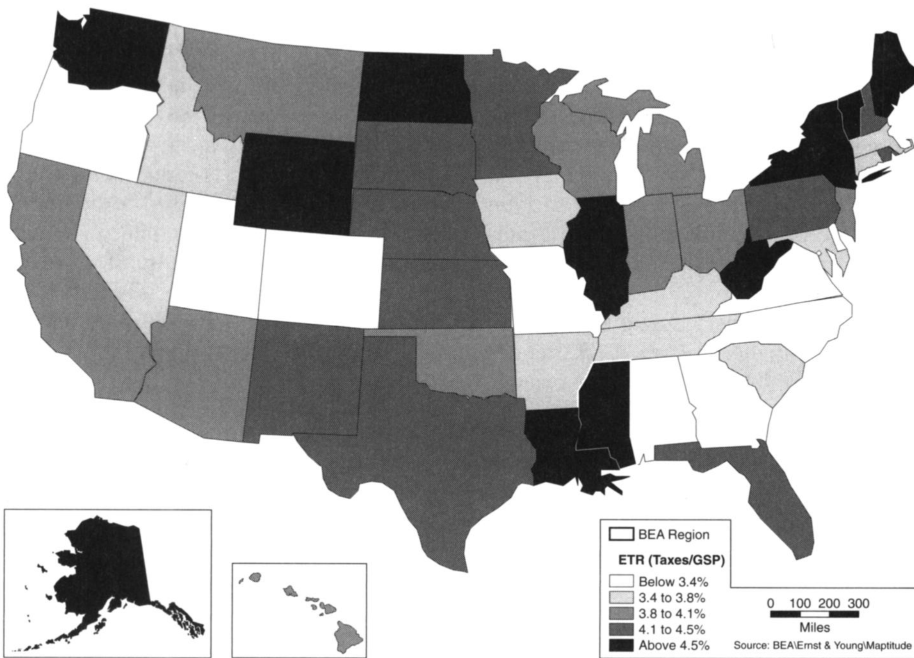
capital usage in production, as it allows deductions for current spending on capital goods from the base.[7]

Figure 2 estimates for all of the states the hypothetical tax rates that would be necessary to replace all state–local business taxes with a single flat rate tax on value added by origin. To construct the tax rate, total tax collections for a state's local and state government are used, as reported by the latest Ernst and Young study of U.S. business taxation (Cline, Neubig, and Philips, 2007), aggregating the effects of property taxation of business property, the portions of the sales tax representing taxes paid on business–to–business sales, business income and activities taxes, unemployment insurance taxes, and selective sales taxes on industry sectors and on purchases of business inputs in production. The tax base of the denominator is reported GSP for each state as reported by the Bureau of Economic Analysis. Since state GSP is a net production concept (except for its inclusion of depreciation) and is defined as production taking place within the geographic boundaries in each state, it is generally equivalent by definition to value added by origin in each state.[8]

By this measure, a general origin–based VAT with rates ranging from three to five percent across states could conceptually displace the entirety of state and local business taxes as they are often labeled today. This may sound high. Yet, state and (largely) local property tax collections comprise approximately a 37 percent share of business tax collections. In some respects, levies on property may

Figure 2. 2005 State and Local Business Taxes



[7] For a discussion of VAT–type taxes and construction of tax bases, see Kenyon (1996).

[8] The GSP tax base is broader than what one might enact in practice since GSP also includes the value added of government and nonprofit sectors.

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fall somewhat outside the scope of what might be considered general business taxation, as local property taxation of business property may already represent an implicit user charge for local public services provided to business property, especially police, fire, and roads for goods transportation. To the contrary, even at the local level, some have argued that value added should be adopted as the basis of taxation to replace local taxation of tangible personal property of business, in part because this property tax biases against capital usage and because assessment practices are highly inaccurate (Papke, 2000).

Similarly, unemployment insurance taxes, which comprise a 3.1 percent share of business tax collections, should presumably be left off the table because they may be considered to be an existing "user charge" that need not be considered in general business taxation. Accordingly, after such adjustments, a general broad–based value added tax in the neighborhood of two percent would generate business tax collections equal to those of the remaining taxes.[9]

In attempting to mitigate the pyramiding inherent in GRTs, some states have modified or fashioned their existing GRTs to reflect more closely this more ideal VAT structure. Some states have adopted modified tax rate structures for their GRTs to reflect varying general value added by industry type. Similarly, states that use the subtraction method (New Mexico and Michigan) for intermediate sales in calculating their gross receipts base move the tax base closer to a value added structure. The construction of the New Hampshire Business Enterprise Tax (BET) and Michigan's former SBT also approach VAT–like tax base composition; however, by not subtracting capital expenditures, the BET basis of taxation is broader than Michigan's former "consumption–based" VAT.[10]

Further, as a replacement tax for a CIT (whose share of total tax revenues is often dwindling) and to augment a retail sales tax (where the lack of service taxation limits its revenue potential), a value–added–type tax (by origin) is preferable by design. The revenue elasticities of these taxes have been faltering over time in accordance with fundamental shifts in the economy away from goods production and consumption and away from the corporate form of business organization. The alternative tax base of value added is little affected by such shifts. The tax base grows along with the general economy because it is, by definition, the economy.

So too, as championed by Pogue (in this issue) and others, the only solid justifications for any type of business taxation are (1) to correct distorted prices that arise because of spillover costs, such as pollution, (2) to recoup the costs of services provided to business entities (user charges) and (3) to take advantage of collection/administrative savings that arise if businesses are the point of collection in a rational scheme of tax collection designed to minimize transaction costs. As discussed by Oakland and Testa (1996), the origin–based VAT addresses

[9] Value added taxes may be constructed with a tax base comprised of either consumption or income. Here, we refer largely to the income type, which approximates the national accounting concept of net national product or its equivalent net national income. Such a tax base would be levied on the total income earned in the process of production within a state, and would, therefore, not bias capital–intensive versus labor–intensive production and income. In contrast, a "consumption–based" VAT is constructed as equivalent to the taxation of current household consumption of goods and services. In practice, most states' VAT tax bases, e.g., Michigan's former SBT, are closer to the consumption basis. By subtracting or deducting gross investment from the taxable base, a VAT excludes income earned in the production of capital goods, thereby arriving at a consumption basis. For a discussion of VAT–type taxes and construction of tax bases, see Kenyon (1996).

[10] The State of Michigan's new Modified GRT also permits such deductions.

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the collecting of revenues to recompense the costs of business services and it goes further. It sets up an implicit market and cooperative relationship between government and business entities. Under such a system, business services provided by governments act as an additional factor of production, thereby creating value with full recompense. In this scenario, a benefit–based "business tax" becomes pro growth and development and is indeed required for efficiency in resource allocation to the public sector.

While this is a useful paradigm in designing a general business tax, it remains to be determined what level of taxation is appropriate. An origin–based tax on value added may be closest to ideal, but the question of what rate to impose remains. As we will demonstrate, the sum total of what are commonly called business taxes today would exceed what would be collected under a general tax on business as guided by the benefits principle. For this reason, GRTs—even if fashioned to approach (resemble) an origin–based VAT—should not generally augment existing state budgets, but should rather replace inferior revenue sources.

THE BENEFITS PRINCIPLE AS A GUIDE TO CONSTRUCTING AN APPROPRIATE BUSINESS TAX—HOW DOES THE GRT FIT?

When it comes to taxing business, much state policy focuses on having a tax structure that encourages firms to locate and expand their operations within the state. While economic development is not the only objective of business tax policy—fairness, economic efficiency, simplicity in administration and compliance and sound revenue growth are also frequent objectives—the desire to attract and retain business and capital investment is clearly at the top of the list when it comes to business tax design. Accordingly, we propose that a general business tax functions best when the tax bears some relationship to the benefits a firm receives from government services—the so–called benefits principle.

The primary advantage to using the benefits principle to develop a state and local tax system is that it sets prices correctly to an approximate extent—reflecting real resource *value* of government services provided—with all the attendant advantages of market–like interactions. Using this principle, general business taxation would be proportionate to expenditure on the related value of the government services in production. Such a tax is neutral with regard to economic effects and distortions, since it neither offers unfair subsidies to businesses nor overcharges business for benefits that they do not receive. At the same time, benefit taxation of businesses also improves public choice among households in choosing public services, since taxpayers will pay the real and transparent resource cost of government services directed to households; in particular, they avoid underestimating the true cost of government services because of illusory cross–subsidies from so–called business taxes—illusory because most business tax burdens are currently paid by households, if not immediately on their imposition, then over time as economic adjustment are made in response to the taxes. In recognizing that "business" taxes are not actually subsidizing household services, such as education and health care, households and their representatives will more carefully evaluate the costs and benefits of government services.

Following Oakland and Testa (1996), it is important to recognize that business organizations *do use* costly government services, including police, fire protection, roadways, and legal protections. Having businesses pay for such services, then, is not only fair, but also efficient in several respects. In particular, the attendant communication and negotiation between

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government and business in agreeing on public services and attendant taxation that underlies the benefit principle leads to enhanced productivity and cost effectiveness in business and government operation.

In paying state and local governments for their public services, businesses will be motivated to articulate their service needs to these governments, just as customers do with service providers in market situations. In turn, this will promote growth and development in states and localities. The resulting negotiation and conversation between governments and businesses will help identify those essential roads, bridges, and property protections that make businesses more productive. So too the process of haggling over the price and cost of government services to businesses will tend to keep governments cost efficient. In this, it is important to recognize that such a tax–expenditure system would address and include in practice only the very general types of public expenditures for which explicit individual user charges are difficult to implement. Otherwise, individual user charges would be preferable as opposed to general taxation as better targeted toward the recovery of specific resource costs. Indeed, specific inclusion of billable items under the general business tax rubric would lead to firm–by–firm negotiation and ultimate erosion of the general business tax base.

In the same vein, use of the benefits principle in a system of general business taxation may also lessen the oft–criticized use of selective tax breaks to specific business firms. State and local government mistakenly turn to selective tax abatements in part because current business taxes are often excessive and disassociated with benefits received. For this reason, governments may often be correct in granting tax abatements that reduce taxes that are excessive relative to benefits received. However, such a system is overly complex, capricious, and opaque to the voting public. Consequently, such selective incentives then become subject to abuse by elected officials who may, for example, unduly use them to attract "headline" or "showcase" firm relocations for their re–election advantages alone. Ultimately from the business perspective, such *ad hoc* tax policy may add to a general uncertainty with respect to future liabilities to be paid by firms and households alike. Rather, an ongoing adherence to general benefits–based business taxation sends a superior signal to investors indicating a locale's stable fiscal climate, as businesses can expect tax liabilities in accordance with services provided—no more, no less. And perhaps more importantly, the message is one of government that is attuned to the future service needs of businesses, which may someday be changing in character in a highly uncertain market environment. Of course, all systems are subject to erosion by special interests over time. But one based on a well–articulated principle will likely offer more protection over time in this regard.

Does today's overall state–local taxation of business roughly correspond to the benefits principle? Using a methodology for assigning the benefits from government services to businesses versus households that has been developed in Oakland and Testa (1996),[11] a strong case can be made that a general benefits–based tax system would need to levy a smaller amount of revenue from business entities as compared to what are today called "business taxes." In Figure 3, estimates of public ser-

[11] This method uses expenditure data by detailed category from the Governments Division of the Bureau of the Census. Both state and local expenditures are examined to avoid differences in functional responsibilities between state and local governments across states. Using reasonable assumptions, expenditures are parsed to households versus the business sector. Federal government grant monies by function are netted out, as are user charges for specific government services.

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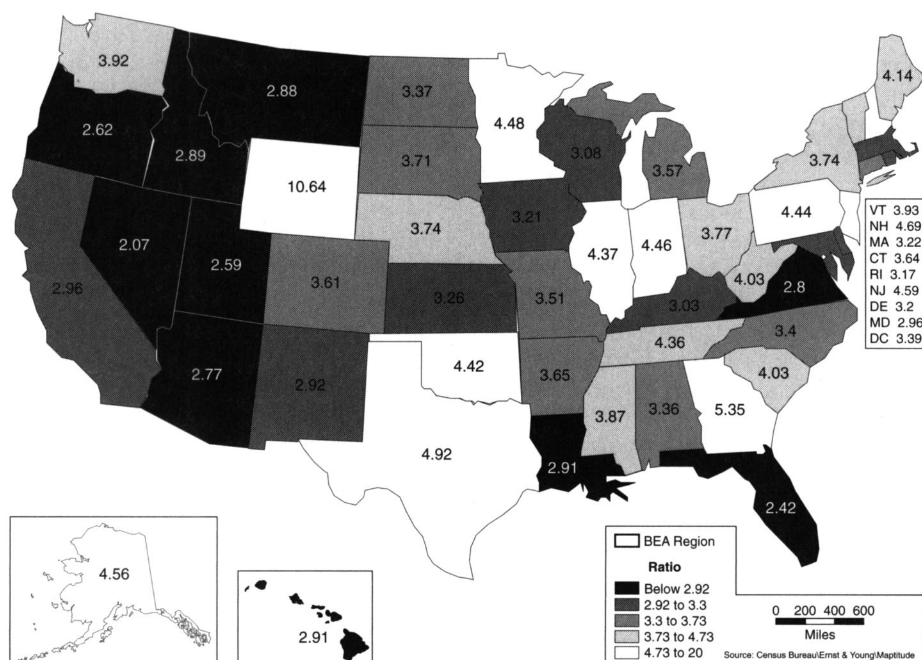
Figure 3. 2005 State–Local Business Taxes versus Estimated Public Expenditures Benefitting Business Entitles



vices to business are constructed for each state from data reported by the Bureau of the Census' Governments Division. The allocation is somewhat subjective in parsing each expenditure category to households versus business. Some allocations are obvious, such as port facilities to the business sector, and recreation, health and welfare to households. In other allocations, we believe to err in over–allocation to business. Services where allocation is not possible, such as transportation and public (property) safety, are split evenly between households and business.[12] Overhead services such as judicial and public administration are parsed according to the final business versus household shares of public services.

Figure 3 maps the ratio of such business expenditures to commonly identified business taxes in the U.S. Most ratios of taxes to business services are well above a parity ratio of one, with a median value of 3.57 in the state of Michigan.

In our estimates, publicly funded education is allocated entirely to the household sector. For the most part, the benefits of educational attainment accrue to workers in competitive labor markets where workers are compensated for their productivity. Moreover, in the public–choice arena, we believe that households would prefer to direct the public–education curricula and related processes and would not prefer that business entities do so in their self–interest. However, as exceptions, it is also true that community colleges are increasingly training adults for firm–specific skills that likely accrue to firms themselves rather

[12] Property might be another reasonable way to allocate services to business versus households. This would tend to skew services further toward the household side.

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than to individuals as higher wages. For example, in Chicago, the community college system provides specific contract training for utility linemen for the local electricity distribution company as well as food preparation training for a dessert and cheesecake company. So too, some educational research documents social returns to education in reduced crime, which some may argue will partly accrue to the business sector. For these reasons, Table 2 provides sensitivity estimates of the business tax to business service cost ratio under varying assumptions about

TABLE 2
RATIO OF BUSINESS TAXES TO BUSINESS EXPENDITURES (2005)

State	Full Allocation	Plus 10% Education	Plus 25% Education
Alabama	3.36	2.31	1.58
Alaska	4.56	3.52	2.62
Arizona	2.77	2.21	1.70
Arkansas	3.65	2.43	1.62
California	2.96	2.25	1.66
Colorado	3.61	2.68	1.93
Connecticut	3.64	2.77	2.03
Delaware	3.20	2.41	1.77
District of Columbia	2.42	1.99	1.58
Florida	5.35	3.16	1.95
Georgia	2.91	2.30	1.75
Hawaii	2.89	2.11	1.50
Idaho	4.37	3.19	2.27
Illinois	4.46	3.00	2.01
Indiana	3.21	2.36	1.69
Iowa	3.26	2.48	1.83
Kansas	3.03	2.24	1.61
Kentucky	2.91	2.36	1.84
Louisiana	4.14	3.06	2.20
Maine	2.96	2.23	1.63
Maryland	3.22	2.39	1.73
Massachusetts	3.57	2.42	1.64
Michigan	4.48	3.20	2.25
Minnesota	3.87	2.74	1.90
Mississippi	3.51	2.52	1.77
Missouri	2.88	2.24	1.69
Montana	3.74	2.68	1.89
Nebraska	2.07	1.75	1.42
Nevada	4.69	3.29	2.27
New Hampshire	4.59	2.87	1.84
New Jersey	2.92	2.20	1.61
New Mexico	3.74	2.72	1.92
New York	3.40	2.40	1.66
North Carolina	3.37	2.71	2.09
North Dakota	3.77	2.65	1.83
Ohio	4.42	3.05	2.08
Oklahoma	2.62	1.96	1.42
Oregon	4.44	3.04	2.07
Pennsylvania	3.17	2.39	1.75
Rhode Island	4.03	2.59	1.68
South Carolina	3.71	2.88	2.15
South Dakota	4.36	3.29	2.40
Tennessee	4.92	3.40	2.33
Texas	2.59	1.92	1.38
Utah	3.93	2.74	1.89
Vermont	2.80	2.12	1.55
Virginia	3.92	2.96	2.16
Washington	4.03	2.87	2.00
West Virginia	3.08	2.23	1.57
Wisconsin	10.64	6.39	3.99
Wyoming	3.39	2.87	2.33

Source: Ernst & Young\Census Bureau.

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publicly funded education. Alternative estimates allocate ten percent and 25 percent of current state–local spending on education to the business sector. Though these allocations are likely very generous in assuming that education is partly a business service, the ratio of taxes to benefits continues to exceed parity.

Some would argue for business subsidies of education and other household services because such services facilitate firm recruitment of employees and lower the compensation needed to retain them. For the most part, and with some exceptions, attractive public services are more likely to be delivered at reasonable cost in instances where households pay for and make decisions on the levels, characteristics, and quantities of their services.[13]

In updating the results from the Oakland and Testa (1996) study, then, it is clear that state and local business taxes as they are now commonly identified still significantly exceed estimates of the direct benefits businesses receive in government services. Given this finding, business taxes in the form of the GRT should not generally be considered as a large add–on to state–local fiscal systems. As was the case with the Illinois GRT proposal, which would have added $6 billion (three times the level of the state's corporate income tax) to business taxation in that state, significant revenue augmentation via a new GRT would further increase the level of business taxation beyond the benefit level.

THE GRT AS A SPECIAL CASE OR ADD–ON TAX

As the empirical work presented above demonstrates, state tax systems do not generally tax businesses in proportion to benefits received—at least if business taxes are taken at face value as business taxes. Moreover, there is little indication that GRTs would remedy this tendency. However, can a GRT be designed to balance a business tax structure that has deteriorated or become highly biased over time? For example, existing state tax systems tend to be over–reliant on taxing manufacturing and have had a difficult time capturing revenue from service firms that represent a growing share of economic activity. In such cases, might the GRT represent an opportunity to re–balance? In particular, extending sales taxes to services has proven politically unpopular in some states, suggesting that a broad–based GRT might allow the states another avenue for capturing revenues from service firms.[14] Similarly, in states either without a personal income tax (Washington, Texas) or with a very low rate income tax (Illinois), the GRT allows the state to capture revenue from partnerships and other forms of business revenue that face either no or little personal income taxation and are excluded from other business tax bases.

Ohio and Texas are two states that have recently adopted GRTs as new business tax structures in an effort to improve their state's tax structure. Ohio's version of a GRT is called the Commercial Activities Tax (CAT) and can be evaluated as an attempt to replace a significantly worse tax structure. The state's personal property tax on machinery and equipment and inventory placed a burden on manufacturers that seemed hard to justify given the state's desire to maintain its large manufacturing base. Over time, the state had tried to limit the impact of the tangible personal property tax through special treatment, but the importance of

[13] Business organizations are observed to intercede in such decisions in instances where government becomes dysfunctional. However, this is not the optimal state of affairs.

[14] Florida received much attention for its attempt to place a sales tax on advertising and other services. The tax was repealed.

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the tax as a revenue source (particularly for local governments) made it impossible to eliminate it without creating a new tax designed to raise significant revenue. In Ohio, a GRT could be designed in such a manner as to replace the revenue lost from eliminating the personal property tax and to improve tax neutrality across business taxpayers. As adopted, the tax has a low rate (0.26 percent) and a broad base.

Preliminary evidence suggests that Ohio's CAT has performed well from a revenue–raising perspective, as FY06 revenues exceeded the original estimate by 27.5 percent. Even after adjusting revenue estimates upward by 15 percent from FY06 levels, FY07 estimates have exceeded projections. Estimates of the economic impacts of the new tax based on simulations with an input–output model predicted employment gains for the state. FY06 employment in Ohio was reported as increasing by 28,400 (significantly less than one percent of the state's total employment base) over FY05, but attributing this directly to the new tax structure is difficult. From Ohio's perspective, when considered as part of a more comprehensive tax and spending measure, the new CAT may well be better than the state's previous tax structure, particularly considering the previous tax bias against capital investment in a manufacturing–oriented state.

Texas adopted a form of a GRT (called the Margin Tax) in 2006 largely in an effort to comply with a court mandate to improve education funding and because of concerns that the current property tax was becoming an unconstitutional state–wide tax. The tax replaced the existing corporate franchise tax and was enacted to reduce reliance on property taxes to fund schools. While it is called the Margin Tax, this GRT, as in Ohio, is considered to be a franchise tax and places levies of one percent on the gross receipts of most businesses in Texas, with deductions for either labor compensation, cost of goods sold including depreciation, or 30 percent of gross receipts. A special rate of 0.5 percent applies to the receipts of retailers and sole proprietorships, and general partnerships are exempt from the tax.

Unlike Ohio, the revenue performance of the Texas Margin's tax has been disappointing to date. The state's comptroller estimates that receipts are between $500 million and $900 million less than forecast, with state legislators suggesting that the Margin Tax might have loopholes that are hurting its revenue–raising ability (Fikac, 2007).[15]

The states of Washington and New Mexico have had GRTs as primary business tax instruments since the 1930s. In both cases, the states have made numerous changes to the original tax with the most common modification aimed at reducing the tax pyramiding that occurs when intermediate goods and services are taxed prior to final sale. Washington's GRT (called the Business and Occupation Tax) has been in place since 1933 and is measured by gross sales, gross income or the value of products produced in state. No deductions are permitted for cost of materials, wages paid to employees or other operating expenses. The rate varies depending on type of business—1.5 percent on services, 0.5 percent for manufacturing and wholesaling, 0.484 percent on retailing, 0.471 percent on processing of certain agricultural products, and 0.138 percent on travel agents. Only agricultural products and rental real estate are exempt from the tax. In FY2002, the tax accounted for 17 percent of total state tax revenues (roughly $2 billion). While the tax is a productive revenue source and long

[15] The notion that Texas' Margin tax might have loopholes is based on estimated tax reports from large business entities in the state. The estimated tax liability from these filers is below the state comptroller's estimate and may reflect either tax planning or the inability to properly estimate tax liability by taxpayers.

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established, a 2002 tax structure study committee suggested that the Business and Occupation tax should be replaced by a subtraction method value added tax because "... a value added tax eliminates the "pyramiding" effects as goods move through the production chain, thereby addressing the Committee's concerns with economic neutrality and competitiveness (Washington State Tax Structure Committee, 2002, V)."

CONCLUSION: TAX COLLECTIONS FOR A SHIFTING ECONOMY

States continue to struggle with finding a sound conceptual basis in their approach to business taxation. The yields from existing tax systems seem to be eroding. On the consumer–expenditure side, interstate and Internet and mail–order retail sales have contributed to the overall erosion. Consumer spending on physical goods has also given way to spending on services, even while retail sales tax bases remain somewhat focused on goods to the exclusion of rapidly increasing services. In response to these circumstances, it is perhaps not surprising that states have come to redress this erosion. For many services, especially law, financial, and health services, it is often difficult to discern the location of where such services are performed and used. In addition, the legal underpinnings of many retail sales taxes make them difficult to amend to include the emerging service sectors. However, in this respect, the GRT is not well suited to address this erosion. There is a large amount of business–to–business transactions in the base so that tax pyramiding becomes an issue. Here, it would seem instead that the first principle of basing taxation on the "origin basis" in proportion to services consumed would be helpful. For example, New Hampshire's BET model, by which a taxable basis of business activity is constructed by the addition of compensation, interest and dividends paid, suggests that collection and administration of such a value–added–type tax is not unwieldy (Kenyon, 1996). Tax collections are also eroding because the corporate form of organization is waning. Here too, both the GRT and the VAT are universally agreed to be more broad based in their coverage.

Despite CIT erosion and other economic shifts, new business taxes should most commonly replace existing taxes rather than increase revenues. Illinois' 2007 GRT proposal to greatly augment the state's budget stands out as an egregious overstep in this regard. Our analysis strongly suggests that taxes collected as "business taxes" are already too high in relation to government services rendered to business. Rather than selective abatements and exemption–riddled general tax statutes, business growth and development would likely be improved by lower taxes on a broader (but sound) basis.

Tax replacement is also called for because the existing business tax schema in most states is biased against capital inputs and usage–versus–labor inputs. Ohio and Michigan both paid deference to this fact in their recent reforms. Both the VAT and the GRT are more neutral in this regard. However, the VAT has been somewhat more neutral in application since it has tended to be less punitive toward imports into a state (e.g., New Hampshire's BET). In contrast, Ohio's CAT with its "bright line" rules for nexus tends to fall hard on imports, which would especially tend to include imports of capital equipment. To its credit, Michigan's new GRT generally allows expensing of business investment. Capital goods are the most varied and specialized of traded goods, and often have to be transported long distances. A business tax that begins with origin–based "adding up" of inputs to value added would tend to avoid investment–discouraging taxation of capital inputs.

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A fixation on stimulating economic growth has sometimes led states to ill-considered fashioning of many GRT-type taxes. In particular, states such as Michigan and Ohio—those that are highly concerned about the poor performance of their traditional (capital-intensive) economic engines—have exempted exports from the GRT (Ohio) or geographically apportioned the tax base of multi-state businesses using sales by destination (Michigan). Such an approach impedes states from finding their true comparative advantage. The unintended consequence of such non-neutral taxation may be to discourage the development of some unforeseen set of businesses. The Ohio and Michigan examples show that states choosing either GRTs (Ohio) or VATs (Michigan) can get this wrong. But at least by starting with the "adding up" VAT concept (Michigan), the result is somewhat more forgiving. New Hampshire's BET has seemingly constructed the tax correctly in this regard from the outset.

State VATs are often mistakenly thrown in with national VATs in the cauldron of public opinion. National value added taxes are often vilified for lack of transparency (and saliency) and a fear that they lead to expansion of government budgets. Value added national taxation is likened to cascading "hidden taxes" unless special steps are taken to communicate embedded levies. In the aftermath of New Hampshire's BET, observers complained about having been hoodwinked into a "value added" tax. While a national value added tax may suffer from poor saliency when collected in stages with consumption as the target, the opposite is true of a state-level origin-based VAT that is much more transparent. Much like the property tax, the state and local VAT by origin is highly salient, albeit somewhat inexact in relation to the benefits that firms receive from government services. Each business knows its payments. And if that payment becomes explicitly coupled with the business' favorable evaluation of their state services received rendered on their behalf, a state VAT can be expected to make the relationship between government and business more effective and value creating.

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