TALKING TAXES

Broad-Based Gross Receipts Taxes: A Worthwhile Alternative?

States currently face a number of fiscal challenges, ranging from unresolved structural deficits, to underlying flaws in their existing tax systems, to the demands posed by ambitious initiatives such as improved access to health care. In response, some policymakers are casting about for new alternatives for generating revenue that do not seem to require visible or difficult changes in law. One such alternative that has gained in popularity in the past few years is a broad-based gross receipts tax.

This policy brief describes how broad-based gross receipts taxes typically function, reviews the advantages and disadvantages of this form of taxation, and details the states that use such taxes.

How Does a Broad-Based Gross Receipts Tax Work?

A gross receipts tax (GRT) is essentially another type of sales tax. The main difference between a traditional sales tax and a GRT is that the former generally applies only to retail sales, while the latter applies to the sales made by companies at every stage of the production process. In other words, a GRT is a sales tax that applies to more types of transactions.

Take, for instance, the production and the purchase of a dining room chair under each of these two types of taxes. Under a retail sales tax (assuming that exemptions are in place for business purchases for use in production), only the purchase of the chair by the consumer is taxed, with the amount of sales tax explicitly stated on the consumer's sales slip. Under a GRT, the lumber that forms the basis of the chair, the machines that shape that lumber into legs, back and seat, the sale of the assembled chair from manufacturer to wholesaler, the sale of that chair from wholesaler to retailer, and the sale of that chair from retailer to consumer are all subject to taxation. These multiple impositions of the GRT are incorporated either partially or entirely into the final purchase price of the chair, usually without any explanation on the consumer's bill of sale.

In both theory and practice, the statutory tax rates associated with a GRT are relatively low. For example, Washington state's version of a broad-based gross receipts tax sets rates on businesses that range from 0.138 percent to 1.5 percent, depending on the type of economic activity in which the businesses are engaged.

Advantages of Broad-Based Gross Receipts Taxes

Broad-based gross receipts taxes may enjoy some advantages over other types of taxes:

- ***GRTs can expand the base of economic activity subject to taxation.*** Because they are not based on income, GRTs may not be as vulnerable to the same sort of avoidance schemes that have eroded corporate income tax bases. GRTs may also be able to cover some out-of-state businesses and some in-state sectors that corporate income taxes can not reach. GRTs are not impervious to manipulation, though – experience from Washington and Ohio, two states that employ GRTs, shows that some industries have been able to lobby for statutory exemptions from this form of taxation.
- ***GRTs may be a comparatively stable source of revenue.*** Given their relatively broad economic bases, GRTs may yield revenue streams that vary less from year to year than taxes predicated on income, which can fluctuate considerably over time.

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Broad-based gross receipts taxes may hold some appeal for policymakers unable or unwilling to address long-standing problems with their existing tax systems. Yet, given the shortcomings associated with this form of taxation, policymakers should nevertheless strive to implement more productive approaches for meeting the fiscal challenges before them.

Of note, policymakers can realize the advantages commonly associated with GRTs by using them as "backstops" within their existing corporate income taxes; that is, GRTs could serve as alternative minimum taxes, with businesses paying the higher of their GRT or corporate income tax liabilities.

Disadvantages of Broad-Based Gross Receipts Taxes

Broad-based gross receipts taxes suffer from a number of major shortcomings:

- ***GRTs hit low-income taxpayers the hardest***. Like any sales tax, GRTs are regressive, as poorer taxpayers often must spend everything they earn just to get by, whereas wealthier taxpayers only need to devote a fraction of their incomes to consumption.
- ***GRTs are not sensitive to a business's ability to pay***. Businesses that fail to turn a profit would still face a GRT; businesses that are engaged in high-volume, low-profit-margin activities would be adversely affected as well. Conversely, businesses with very high profit margins could pay lower taxes under a GRT than under a corporate income tax.
- ***GRTs lead to severe pyramiding problems***. Since a GRT applies not just to retail sales but to all stages of the production process, it may be levied on itself multiple times. For instance, the GRT paid on the raw materials going into a particular product will later be subject to GRT when the finished product is sold to a wholesaler. One examination of Washington's gross receipts tax found that it pyramids 2.5 times on average.
- ***GRTs tend to be hidden from taxpayers***. As GRTs are generally imbedded, to some degree, in the price of goods and services that consumers buy, they are far less visible than other forms of taxation. This lack of transparency may lead taxpayers to focus greater attention – and ire – on other forms of taxation, with predictable results.
- ***GRTs may distort economic decision-making***. Given the pyramiding problems associated with GRTs, they hold the potential to discriminate against in-state suppliers (since purchasing from out-of-state suppliers may allow businesses to avoid a GRT) or to create artificial incentives for vertical integration (as integration would reduce the number of times in a given production process that a GRT would be imposed).

Broad-Based Gross Receipts Taxes: Still Relatively Rare

At the close of the 1990s, only Delaware and Washington imposed comprehensive gross receipts taxes. Since that time, however, three states have levied such a tax. Two – New Jersey (on a temporary basis from 2002 to 2006) and Kentucky (in 2005) – incorporated gross receipts taxes into their corporate income taxes as a means of calculating an alternative minimum tax, while a third – Ohio (in 2005) – scrapped both its corporate income tax and its personal property tax in favor of a gross receipts tax. More recently, the Governors of Michigan and Illinois have proposed replacing the principal business taxes in their respective states with versions of a gross receipts tax.

Gross Receipts Taxes: All That Glitters Is Not Gold

Broad-based gross receipts taxes may hold some appeal for policymakers unable or unwilling to address long-standing problems with their existing tax systems. Yet, given the shortcomings associated with this form of taxation, policymakers should nevertheless strive to implement more productive approaches for meeting the fiscal challenges before them. Rather than abandoning their corporate income taxes, they should strengthen them: by adopting combined reporting to combat avoidance, by repealing failed incentives like single-sales factor apportionment, or by limiting overly generous net operating loss carry-forwards or carry-backs.

To find out more about this issue, contact ITEP at (202) 299-1066.