Tax Principles and the Gross Receipts tax: Some thoughts

William A. Testa
Federal Reserve Bank of Chicago
April 4, 2007

Business Taxation: Principles

- Who Pays?
  - Ability to pay
  - Exportability
  - Benefit basis (user fee)

- The case for a General Business Activity Tax (BAT) as a benchmark. That means taxing value added by “origin” as:
  - “Good government” that is transparent and value-enhancing

- Neutrality (efficiency)
  - Ease of revenue collection
  - Distortions by type of business/form of organization
  - Replacement of more distorting alternatives
  - Economic growth effects

RECAP

Who pays?

- Ability to pay (soak the rich
- "Tax exporting or free lunch"
- Benefit principle broadly defined
- The long run incidence of business taxes cannot be demonstrated to be progressive
- There are few real opportunities to export taxes
- Business entities use public services; they should pay taxes--on that basis

The case for business taxation and the benefit principle (BAT)

- Taxes may well be passed along in prices of goods, but this is as it should be, just as labor and other factor costs are passed along. Businesses choose to use public services in its production. The taxes reflect “real” costs and location.
  - Note: Business’ argument against BAT and GRT that “I pay even when I make no profits is not valid
- Otherwise, misperceptions to voters that public services are free or cheaper than they really are, which likely distorts government spending and debt etc.

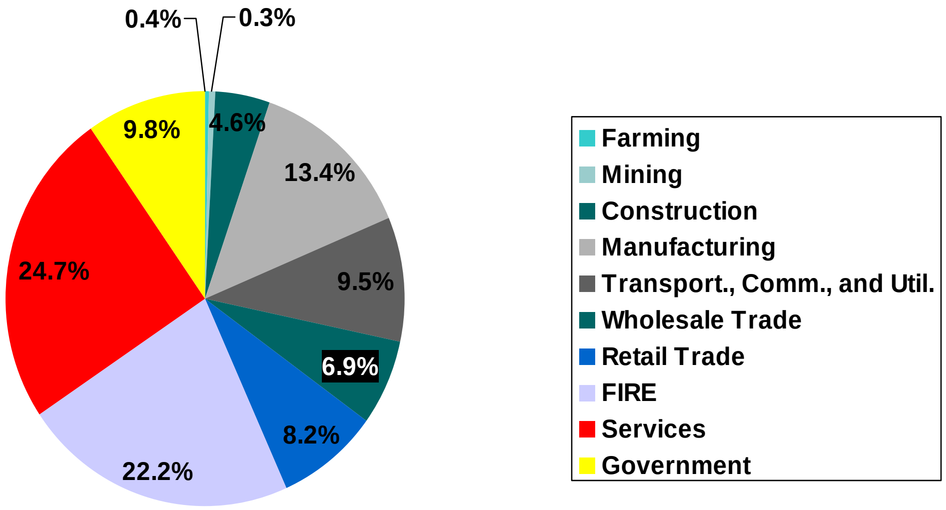
- BAT largely avoids “distortions” or biases by type of business, and avoids pyramiding

- Proportionate taxation implies no detrimental effects on business location or investment because gov’t services become a “factor of production”…..it can even stimulate development!
  - Sets up an active value-creating dialog between government and business concerning what services and who pays for them
  - Currently, business taxes far exceed government services to businesses….aggravating abuse of tax abatements and corruption of existing business tax code

What about general tax principles? Neutrality

- Benefit principle of business taxation implies “origin-based” tax on general business activity

- “general business activity” = “value added”



2005 Annual Gross State Product in Illinois, $562 b.

The BAT and fundamental differences with the proposed GRT: "Con"

- Ability to pay? Much like most "import" taxes, much of burden shifted forward in consumer prices (and hidden)
- No pyramiding or double taxation with BAT
- GRT biased toward imports versus local production
- GRT should NOT exempt export-based sales (per the Illinois proposal)…
  - thus began the corruption of the Michigan VAT
- No particular reason to exclude "small" business on equity or efficiency grounds….(and some businesses will "sub-divide" to avoid the tax)

The BAT and fundamental differences with the proposed GRT: "Con"

- No pyramiding or double taxation with BAT…with GRT, we don't know the actual extent of pyramiding (mitigated by lower rates)

	Sales vs. Value Added (Illinois, $Mil., 2002)				
Industry	Manufacturing	Construction	Mining	Retail Trade	Wholesale Trade
Sales	188,365	55,309	2,276	131,470	317,467
Value Added	64,952	23,212	1,243	40,441	33,930
Ratio	2.9	2.4	1.8	3.3	9.4

Raising Revenue: A Pro for GRT?

- Raising Revenue to finance public goods

- GRT……in a highly developed economy, we are (technically) little-constrained in choosing among revenue sources (though MI VAT had long legal difficulties)

- If the GRT fails other criteria, no need to choose it

“Pros” for the GRT

- It generally varies with business activity
  - Can it be made into a BAT in disguise?
- The extent that the GRT is partly shifted back onto labor may enhance “ability to pay” in a back-door fashion
- GRT may not have the inherent “capital intensity” bias of existing business taxation ...and yet
  - Unlike Ohio, GRT not clearly replacing a worse alternative (no business sign-off)...as a result, efforts to erode the base may be intense
  - Unlike Ohio, Illinois’ GRT *increases* business taxation so that growth effects are worrisome

Economic effect on growth?

- "To describe every major CEO in Illinois as fat cats is a mistake," Daley said. "They don't have to be here. They can go to Wisconsin. They can go to Indiana. They can go to India. They can go to China.

  "So if you want to beat up businesses, go beat 'em up. And when they leave, just wave to 'em, and they are going to wave back to you."

- If we hypothetically compare state-local business tax collections to “Public services to business” today, business taxes are too high
  - The proposed Illinois GRT would make it more so.

Business taxation is now high vs. BAT

Business Taxes and Expenditures, Fiscal Year 1995			
	Business Taxes ($ millions)	Government Expenditure on Business ($ millions)	Ratio of Taxes/ Expenditures
Illinois	13,012.8	5,504.6	2.36
Indiana	5,257.5	1,592.8	3.30
Iowa	2,906.4	1,272.4	2.28
Michigan	10,696.7	3,916.4	2.73
Minnesota	5,211.1	2,272.0	2.29
Ohio	9,869.7	4,208.1	2.35
Wisconsin	**5,041.5**	**2,671.6**	**1.89**
Midwest	51,995.6	21,516.0	2.42

Source: William H. Oakland and William A. Testa.

Hypothetical Tax Rates for a Single Business Tax Levied on the Basis of Value Added by Origin, Fiscal Year 1995			
	Tax Rate Assuming Current Collections (%)	*Tax Rate Assuming Collections Equal to Current Service Costs (%)*	*Difference*
Illinois	4.4	1.9	2.5
Indiana	4.3	1.3	3.0
Iowa	4.9	2.2	2.8
Michigan	5.2	1.9	3.3
Minnesota	4.9	2.1	2.8
Ohio	4.1	1.8	2.4
Wisconsin	**4.6**	**2.4**	2.2
Midwest	4.5	1.9	2.7

Source: William H. Oakland and William A. Testa

Bottom line? Can we do better?

- Increased spending programs must be evaluated on their own merits….and programmatic reforms have not yet been thoroughly discussed within context of tax hike
- Can we do better? (No discussion yet of alternatives)
- There are pros and cons of a GRT…but
- *My* greatest concern is the negative "business climate" impact
  - The rate is very high (versus Ohio)
  - Taxes are partly shifted in the long run….but "hidden" nature of taxes may aggravate structural inefficiencies.
  - And in the meantime…
  - The precedent set is building on the raising of business fees in previous years without dialog (unlike Ohio)
  - Lessening of business tax distortions remains unclear (unlike Ohio)