POLICY brief

Washington Research Council

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Two New Reports on Business Taxes

BRIEFLY

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Two reports came out this month that illuminate the unique tax structure faced by Washington businesses. The first report is by Robert Cline, Tom Neubig, and Andrew Phillips of Ernst & Young LLP, prepared for the Council on State Taxation (COST). This study is a nationwide analysis of business tax burdens. They find that Washington businesses are among the most highly taxed in the nation.

The second report discusses the use of gross receipts taxes such as Washington's business and occupation (B&O) tax and was done by John Mikesell, one of the nation's top academic experts on state and local taxation, for the Tax Foundation and COST.

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The COST Rankings

Last year, Robert Cline and colleagues calculate, businesses paid $14.2 billion in state and local taxes in Washington. Of this, $4.1 billion was sales and use taxes on business purchases; $3.4 billion was property tax, $2.5 billion was B&O tax, $2 billion was specific gross receipts and excise taxes, $1.5 billion was unemployment insurance tax, and $0.7 billion was other taxes and license fees.

Cline and colleagues calculate the effective tax rate on business as the ratio of state and local business taxes to private sector gross state product (GSP). They estimate that the effective tax rate on Washington businesses was 6.2 percent in FY2006. This is the 8th highest effective tax rate in the nation. The average effective tax rate across the country was 5.1 percent, ranging from 3.7 percent in Washington D.C to 10.9 percent in Wyoming.

Washington also ranks among the top states for business's share of state and local taxes, with businesses responsible for 52.9 percent of the total state and local tax burden compared to a national average of 44.9 percent. While this is actually down from 54 percent in 2002, Washington's business tax share ranking is unchanged at 10th highest in the nation.

Of the seven states with no personal income tax, only Alaska and Wyoming had higher business tax rates as a percent of GSP. In both cases the high tax rates are the result of severance taxes on mineral extraction and are not taxes on mobile capital.

The good news is while Washington business taxes are high, they are not increasing quite as fast as other states. State and local business tax revenues have increased by $3.4 billion since 2002; an increase of 31.4 per-

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State Business Tax Rankings

FY 2006

	Business Share		Effective Tax Rate	
	Percent	Rank	Percent	Rank
Alaska	82.1	1	9.8	2
Wyoming	77.0	2	10.8	1
South Dakota	64.0	3	5.4	19
Texas	63.1	4	5.6	16
North Dakota	61.5	5	7.3	3
Louisiana	60.6	6	6.0	11
New Hampshire	56.9	7	5.1	24
New Mexico	56.5	8	6.2	8
Delaware	53.5	9	3.9	46
Washington	**52.9**	**10**	**6.2**	**8**
West Virginia	52.2	11	7.2	4
Tennessee	51.7	12	4.6	36
Montana	50.9	13	6.3	7
Oklahoma	49.5	14	5.6	16
Arizona	49.4	15	5.2	22
Kansas	48.6	16	5.8	13
Mississippi	48.3	17	6.1	10
Florida	47.8	18	5.4	19
Illinois	47.7	19	5.3	21
Nebraska	47.4	20	5.7	15
Nevada	47.4	20	4.7	32
Iowa	46.6	22	4.6	36
Rhode Island	46.0	23	5.8	13
Vermont	45.8	24	6.5	6
Indiana	45.6	25	4.9	28
Maine	45.6	25	6.6	5
Kentucky	44.7	27	4.9	28
Colorado	44.4	28	4.2	42
Alabama	44.2	29	4.3	41
New York	43.0	30	5.9	12
Minnesota	42.5	31	5.1	24
Pennsylvania	42.5	31	5.0	26
California	42.3	33	5.2	22
South Carolina	42.1	34	4.8	30
Michigan	41.9	35	4.7	32
Georgia	41.3	36	4.2	42
Missouri	41.3	36	4.1	45
Idaho	41.2	38	4.6	36
Arkansas	40.9	39	4.7	32
Ohio	40.3	40	4.7	32
Wisconsin	39.3	41	5.0	26
Massachusetts	38.7	42	4.4	40
New Jersey	38.4	43	4.8	30
Hawaii	38.0	44	5.6	16
Utah	38.0	44	4.2	42
Virginia	37.8	46	3.9	46
North Carolina	37.4	47	3.9	46
Maryland	36.1	48	4.6	36
Oregon	36.1	48	3.9	46
Connecticut	34.3	50	3.9	46
Dist. of Columbia	43.9	-	3.7	-
U.S.	44.9	-	5.1	-

Source: Ernst and Young

cent. This is relatively low compared to other states. Washington ranks 37th for the increase in total state and local government tax revenues collected between FY2002 and FY2006 and ranks 43rd for the percent increase in business tax revenues collected during the same period.

Businesses in Washington paid 52.5 percent of the additional state and local taxes collected from FY2002 to FY 2006. This seems to be a national trend with businesses responsible for an average of 49 percent of state and local tax revenue growth nationally.

GROSS RECEIPTS TAXES

One reason for the high tax burden placed on business in Washington is the B&O tax. This is a truly unique aspect of the Washington tax system and is the most significant gross receipts tax remaining in the nation.

John Mikesell is the author of a new report on gross receipts taxes. This tax also known as a “turn over tax”, is a tax levied every time a product “turns over” or changes hands. Unlike an income tax the gross receipts tax is not levied on the profits from a sale because no allowances are made for the input or other operating expenses.

The rationale for a gross receipts tax is that it places the tax burden on those who have money to spend, it provides a wide tax base, low collection costs and reduces the property tax burden. The Washington B&O tax also appears to be more stable than either corporate or personal income taxes but less stable than the retail sales tax. They are also politically popular because the tax is embedded in the cost of the product at each step and so is almost entirely hidden from consumers. This may be politically convenient for law makers but it also violates a key democratic principal: that a tax system should be transparent so tax payers can see the cost of government.

Under the B&O tax, firms with the same net income face substantially different tax rates depending on their profit margin. A firm with a lower profit margin faces a higher effective tax rate than a firm with a higher profit margin. Thus the tax burden bears little relation to the affluence of the business or the businesses ability to pay the tax. It also provides an incentive for industries to vertically integrate or to purchase inputs from out of state purveyors and discriminates against specialization and contracting with independent suppliers.

Washington’s B&O tax generated $2.3 billion in tax revenue for the state in 2005 or 16 percent of total state tax revenues. Tax rates range from 0.275 to 1.5 percent depending on the type of business. The B&O tax base for 2005 was $474.8 billion while GSP was only $268.5 billion. This makes the tax base 177 percent of private sector economic activity due to the pyramiding effect of taxation on intermediate goods.

Mikesell cites the Washington State Tax Structure Study, which found that on average the B&O tax pyramids 2.5 times during the production process but can vary from 1.5 to 6 times depending on the industry. The tax paid relative to the value added can vary substantially across industries making the effective tax rate often 250 percent of the statutory rate. This system creates a random set of incentives and disincentives that severely impede the efficient flow of capital to industries that yield the highest economic returns.

The report concludes:

> This examination of American and European experiences with gross receipts taxation has identified several significant conclusions about the tax in modern fiscal systems. These may be summarized:
>
> **Broad base:** The gross receipts tax base is broader than the total value of economic production. However, breadth itself is not a meaningful standard for evaluating a tax. The base is not logical as an indicator of either capacity to bear the cost of government or consumption of government services.
>
> **Low rate:** Statutory gross receipts tax rates may be low, but not necessarily. Whether the legal rate is high or low depends on how much revenue the government intends to raise. Even with its broad base, a low rate on gross receipts is unlikely to contribute a major share of revenue to a modern state government. Low-rate, low-yield taxes often have high administrative and compliance costs relative to the amount of revenue generated.
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> **Stable Revenue:** A gross receipts tax appears to be roughly as stable as a retail sales tax. Its variations do not add overall stability of total state revenue because its fluctuations follow generally the same pattern as other major taxes.
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> **Economic neutrality:** A gross receipts tax distorts private market decisions. Its pyramiding creates a haphazard pattern of incentives and disincentives for business operations. It creates artificial incentive for vertical integration and discriminates against contracting work with independent suppliers and the advantages of scale and specialization that production by independent firms can bring.
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> **Competitiveness:** A gross receipts tax interferes with the capacity of individuals and business to compete with those in other states and other parts of the world. The tax embedded in prices grows as the share of production within the state increases, so there is incentive to purchase business inputs from outside the state. And businesses must deal with the embedded gross receipts tax when they sell to out-of-state customers. Possibly most significantly, the tax discourages capital investment by adding to the cost of factories, machinery, and equipment, with the extent of disincentive dependent on how much of those capital goods are produced in the state. This tax structure does not promote growth and development of the state.
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> **Fairness:** A gross receipts tax does not treat equally situated businesses the same. Firms with the same net income will face radically

different effective tax rates on that income, and low-margin firms will be at a great disadvantage. Many new and expanding firms have low profit margins (or even are initially unprofitable) and the gross receipts tax reduces the chance that these firms will survive. This also is not consistent with a climate for growth and development.

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

It is sometimes suggested that gross receipts taxes allow simple compliance and administration; the concept of the tax is clear, and there is no need for the many deductions and adjustments required for a tax on profits. But the inherent inequities and disincentives of this simple tax create a demand for complications—for relief of industries in trouble or unable to shift the tax, or for relief of in-state businesses through differential rates, exemptions, and special treatment for certain economic activities. The response to these problems dissolves the simplicity and creates a new set of complications unique to the gross receipts tax. An illogical base cannot be insulated from the practical need for corrections to repair the effects of its fundamental defects. The problems become greater when revenue demands made on the tax are increased.

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

References

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