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The Destructive Impact of a Gross Receipts Tax

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Executive Summary

No state but Washington uses a gross receipts tax (GRT) as a major, broad-based source of income. It has been notably unpopular in those cities and localities where it has been implemented. Even in Washington, there is bipartisan consensus that the GRT has become a seriously destructive factor in the economic life of that state.

Because of the pyramiding effect of a gross receipts tax, Nevada's products and services would be at a competitive disadvantage against those from other states. The tax would encourage businesses to leave Nevada and locate elsewhere.

Because a GRT is payable even when there are no profits, it puts extra negative pressure on startup businesses. Further, even when businesses are operating at a loss, they must pay the tax. Thus a GRT would make Nevada recessions and joblessness harsher than otherwise.

A GRT would operate like a general depressant across the Nevada economy, as virtually all businesses would now have heavier costs. The taxes extracted from the private sector will mean a net reduction in private sector demand for production factors—such as employees. More of the state economy will thus be controlled by Nevada's political class and its favored rent-seekers. A GRT, therefore, would mean more government waste.

It would also require the establishment of a state IRS—as a GRT requires a huge bureaucracy of investigators and auditors to not only enforce a vast volume of rules and regulations but also to deal with a uniquely high rate of taxpayer evasion. In Los Angeles reputable estimates put noncompliance as high as 40 percent of firms obligated to pay the city's GRT.

Revenue estimates coming out of the Governor's Task Force on Tax Policy are almost certainly over-optimistic. Most likely, the actual rate of a Nevada GRT would have to be raised almost immediately—and significantly above the .25 percent task force figure.

But implementing even that would be to put all businesses considering moving into Nevada on notice that the future here is likely to be one of higher corporate taxes—of always-increasing complexity. Nevada's entire economic diversification campaign would be a serious casualty.

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THE DESTRUCTIVE IMPACT OF A GROSS RECEIPTS TAX

The Governor's Task Force on Tax Policy has proposed a gross receipts tax as a major new source of future Nevada state government revenues. The mandate of the task force was to explore all possible sources of revenue, but to *not* analyze expenditures. It was thus a foregone conclusion, based upon government projections, that state government would "need" additional sources of revenue.

The state of Washington in 1935 became the first state to implement a gross receipts tax, calling it a "business and occupation," or "B&O" tax. No other state currently uses a gross receipts tax (GRT) as a major, broad-based source of income. Highly unpopular in those cities and jurisdictions where it has been implemented, the GRT is now faces a bipartisan hostility even within Washington state. There, a major year-long blue-ribbon study has concluded by recognizing that the tax is a seriously destructive factor in the economic life of that state and by recommending that the tax be replaced. Although Nevada proponents of a GRT have asserted that the tax would offer the Silver State greater revenue stability, Washington state—still suffering "sharp fluctuations in revenue"—has not found that to be the case[1].

The gross receipts tax now faces bipartisan hostility even within Washington state.

A. The Impact on Business and Government

The essential nature of a GRT is that it focuses only on receipts and ignores business costs. There are at least five reasons why this should concern policymakers:

- The pyramiding, or multiplier effect of the gross receipts tax on business-to-business sales.
- The negative impact on new business.
- The compound negative impact on firms during recessions and duress.
- The negative drag on production and expansion.
- The heavy costs of collection and noncompliance.

The pyramiding effect of the gross receipts tax

Unlike a sales tax, which is paid only on the ultimate sale, a GRT can be paid several times in the production of a sale to the final user. If "A" sells a component to

[1] See the report of the Washington State Tax Structure Study committee, available on the Web at http://dor.wa.gov/content/WAtaxstudy/wataxstudy.htm .

"B," who includes the component and adds value, and then sells to "C"—who integrates A's and B's contribution into a final product that "C" sells to the ultimate consumer, "D"—then that final product would include four (4) gross receipts taxes. The component supplied by "A" would bear a tax slightly more than 1 percent[2], "B's" work would be about ¾ of 1 percent, and so on.

For this reason, in 1990 when the Nevada Legislative Commission published its major comprehensive study—*A Fiscal Agenda for Nevada*[3]—it was critical of a GRT. As noted in that study, "One drawback here is that if a gross receipts tax were applied to all businesses in the state, considerable 'tax pyramiding' would result." The cumulative effect of the GRT therefore would be to put Nevada's products or services at a competitive disadvantage against similar goods or services from other states.

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Vertical integration

The one means available to Nevada businesses to avoid the GRT's pyramiding effect would be vertical integration. If a firm can acquire another firm or firms crucial to its business process through either merger or acquisition, then the individual units of the larger firm would now "trade" internally with each other and not be subject to the tax. Thus a tax policy that favors taxation of gross receipts encourages, other things equal, the creation of large firms and discourages the existence of small and medium-sized firms.

The negative impact on new business

New businesses tend to have losses or minimal profits. Because a gross receipts tax is payable even when there are no profits, such a tax puts negative pressure on startup businesses. Washington state is reported to currently lead America in the proportion of new startup businesses that fail.

An exemption for firms with gross receipts under $350,000—suggested by the task force—is no doubt better than nothing. But the tax will remain a major disincentive for major business expansion in Nevada.

Washington state has found, to its great distress, that a gross receipts tax is a strong incentive for local businesses that are successful to move away—out of Washington and into neighboring states—or to so move portions of a firm. One pertinent example is Microsoft's licensing division, now located in Reno. Another, in the news last year, was the departure of Boeing's corporate headquarters from the Puget Sound area[4].

The compound negative impact on firms during recession and duress

Because a gross receipts tax eats into business capital when losses are incurred, businesses would "pull in their horns" even more than usual when losing money. Thus the impact of a GRT would be to make recessions even deeper and more pronounced in Nevada than such slumps otherwise would be.

[2] (1.0025) (1.0025) (1.0025) (1.0025) = 1.0103756.

[3] Also commonly known in political vernacular as "the Price-Waterhouse report." *A Fiscal Agenda for Nevada*, Robert D. Ebel, editor, 1990, p. 624.

Washington state's experience with the pyramiding effect of the gross receipts tax—according to that state's tax structure study committee—is that it has not been economically neutral and has been a major factor in making Washington businesses, and the state itself, uncompetitive.

[4] Boeing, the state's long-time number-one employer, had, over a score of years, time and again given state politicians fair warning. But as often happens in such circumstances, the message was never really received until too late.

The compound negative impact of the GRT is another reason why Washington state today has a bipartisan consensus that its state gross receipts tax has become a seriously destructive factor in the economic life of that state.

The negative drag on production and expansion

In traditional economic theory, a reduction in a firm's gross revenues without any reduction in costs is a signal to reduce the output of goods and services. Such a tendency to reduce output will also, implicitly, tend to reduce the firm's demand for factors of production—such as Nevada employees and Nevada office space. In short, the arrival of a gross receipts tax in Nevada will tend to signal to businesses to look elsewhere for superior business locations.

Heavy collection and non-compliance costs

Public and private collection costs

A gross receipts tax requires a large bureaucracy of many government employees. While the Governor's Task Force recommends a single "1/4 of 1 percent fits all," Washington state has many different tiers of rates to address the basic reality that different industries have different profit margins. For example, a supermarket's margin is low and a pharmaceutical giant's margin[5] can be quite high. Already, even task force proponents of a Nevada GRT have been lobbying each other for exemptions and modifications for their own industries. Yet this just scratches the surface. A huge volume of rules and regulations are required to implement Washington state's GRT; the code implementing the tax in Washington is reported to be comparable to the entirety of the Nevada Revised Statutes. The rules, for example, must not only specify procedures of administrative tribunals, but arm those tribunals for arguments about whether a good or service is exempt in "category x" or "category y," or whether a transaction is exempt by virtue of interstate elements, etc.

A GRT rivals an income tax in terms of its requirements for bureaucracy, manpower, rules and regulations and expensive infrastructure (e.g., computer systems). It is NPRI's understanding, based upon the little public information that is currently available, that the State of Nevada would be required to build any such GRT system literally from the ground up. This of course raises questions concerning the estimated costs of associated computer systems, computer operations, auditing operations, etc. In total the formal structure of a GRT system does not appear to differ substantially from the extensive— and expensive—new infrastructure the state would be required to install to establish a formal business income tax. Based on the State of Nevada's historically inefficient record when installing and successfully implementing vast new computer systems—e.g., NOMAD, e.g., DMV—the outlook is not promising. But a conservative estimate of the costs of getting such a system up and running could easily be $50 million or more.

Nevada is not accustomed to an "income-tax-like" bureaucracy, and one can argue that establishing it would be inefficient compared to expanding levies on existing sources of revenue. But even under optimistic projections of efficient implementation of a GRT, the annual cost of collection is high and should be deducted from the projected revenue.

Cost of collection is also a burden on business taxpayers. It would require a new class of record keeping, forms, etc. that would constitute an administrative hardship on all businesses and can be a severe drain on small businesses whether or not below the proposed $350,000 cap. Even aside from the costs of accountants and tax

Already, even task force *proponents* of a Nevada GRT have been lobbying each other for exemptions and modifications to benefit their own industries.

[5] Or, in Nevada, that of a gaming corporation.

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lawyers, the private sector would find the GRT a substantial burden on top of the actual tax dollars paid.

The proposed exemption of businesses grossing less than $350,000 is clearly politically expedient. It even has a practical intent: to avoid the high-margin collection costs involved in pursuing taxes that even at best would never exceed $875 per company per year.

Nevertheless, businesses grossing less than $350,000 annually are not the large employers paying high salaries that Nevada should be primarily cultivating. The Silver State is a natural prospective home for large, national employers of highly paid workers—especially those in intangible industries such as finance, intellectual property, investment management and the creative side of high tech. These firms can locate themselves wherever the lifestyle and the tax climate are attractive.

The possibility of attracting such firms was the primary motivation of the Nevada Legislature in 1999 when it passed SCR-19 and devoted much effort during the next interim session to the strategic goal of readying Nevada to become "The Delaware of the West." For high state officials to now even be speaking of a GRT suggests a notable inability to maintain long-term focus.

Should the state go ahead and implement even a ¼ of 1 percent GRT, it would truly put the camel's nose under the tent: All businesses considering moving into Nevada would be put on notice that the future here is likely to be one of higher corporate taxes of always-increasing complexity.

The costs of non-compliance

In addition to the administrative expenses inherent in the gross receipts tax, it also presents a significant problem of noncompliance—i.e., taxpayer evasion. Everywhere the tax has been instituted in a comprehensive way[6] it has elicited fierce resentment. Not only Washington state but the City of Philadelphia has found the tax a major source of business hostility—even more so than other, heavier, taxes. In Los Angeles, Dave Naney, a senior tax manager for Arthur Andersen LLP, estimates 40 percent of firms legally obligated to pay that city's gross receipts tax fail to do so[7]. In Nevada—a state to a large degree populated by tax-hating immigrants from high-tax states—one can be assured that non-compliance will soon become not only common but a mark of cachet.

Such high evasion rates will inevitably drive up administrative enforcement costs while reducing the "gross receipts" from the GRT.

This in turn means that the revenue estimates coming out of the Governor's Task Force on Tax Policy are almost certainly significantly over-optimistic. It further entails that almost immediately the actual rate of a Nevada GRT would have to be raised above the .25 percent hypothesized by the task force.

Though it is admittedly speculative, there is a risk of social disruption. Nevada's population is largely self-selected in reference to issues of taxes and personal freedom. Attempting to impose such a complex and disliked tax on such a population is a recipe for non-compliance as well as significant civil disobedience. The issues of taxes and personal freedom have been constitutive in the de facto social compact of the statewide community.

Bottom Line: A gross receipts tax would mean a whole new set of *significant* problems facing the State of Nevada.

[6] As opposed, for example, to being levied only upon, for example, the municipal or state power-generation utility.

[7] The more conservative estimate of the city clerk is as high as 30 percent, according to the California Taxpayers Association.

B. The Impact on Nevada Working People

The gross receipts tax put forward by the Governor's Task Force on Tax Policy as a revenue solution for the state of Nevada would often function like an income tax on Nevadans.

Legally, the measure could evade Nevada's constitutional ban on personal income taxes. Practically speaking, however, the GRT would operate like a general depressant across the state economy, since virtually all businesses would now have heavier costs[8]. In addition, if the tax successfully extracts $227 million[9] from the private sector, that will mean a net reduction by that amount in the private sector's demand[10] for production factors—such as employees, contract services, goods, rental space, etc. In this fashion also, any large new business tax in the Silver State will function as a tax on the actual incomes of Nevadans. This personal dimension of the tax, however, will usually be largely invisible—exerting its impact through the promotion that is no longer available, the new job that is not offered, the bid for office space that is no longer forthcoming and the investment opportunities that no longer exist.

Considered from this perspective, the people who will pay a gross receipts tax, should it be passed into law, are 1) virtually every Nevadan who earns a wage or salary, 2) Nevadans who own land and rent it out, and 3) Nevadans who save and invest. While the flow through the state economy of the new truncation of demand will be highly particularized and complex, one can still say that, everything equal, all, by and large, will have their incomes reduced. What would have otherwise found its way to them as disposable income will have instead become state income, to be disposed of by Nevada's political class and its favored rent-seekers.

Many people assume the answer to "who pays?" is simply whoever the government says has to collect and send in the tax. The issue, however, is not who pays the tax immediately, but who pays it in the long run.

Other people think the immediate taxpayer can simply raise his selling price to cover the tax and shift the tax forward onto buyers. Commonly these people believe this is what happens with sales and excise taxes. Given the family resemblance

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[8] Even if a firm has gross receipts below the tax threshold —supposedly $350,000 annually—it will most likely have new accounting and paper-work costs in order to be able to withstand state audits.

[9] This was the estimate as of November 20, 2002 from the Governor's task force regarding projected annual revenue from the GRT.

[10] In the voluntary marketplace, any kind of purchase is a function of prior production (or credit, which is a *pledge* of the same thing). Says' Law—that supply creates its own demand—operates. To put it in colloquial English, "You want some of these here beans? What you got in yer wagon to trade fer 'em?"

But in the relationship between the government and taxpayers, it is different. There is no reciprocal necessity that the government in fact *will* provide anything of genuine value. All we have, essentially, is *hopes* that it will. While in the private sector we have to produce a salable good or service to be able to enter the marketplace and seek the fruits of someone else's efforts, in government it is quite different. The spending of government officials is enabled by prior acts of automatic state confiscation of citizen wealth, relying on the state's legal monopoly of coercive power. And because government spending originates essentially in coercion, rather than production, it always entails a huge proportion of net cost, or waste, to the larger economy.

between those taxes and the proposed gross receipts tax, these same people would probably assume the same about a gross receipts tax.

The fact is, however, that none of these taxes really get passed forward to the consumer in a free market[11]. The key to this whole process is the way prices actually get set. Non-business people often assume that the prices of goods and services are determined by the costs of production. Not true. What governs the price of a good or service is demand—how much of something is in existence and how much demand there is for it on the market.

Take, for example, the costs of feeding and raising to adulthood a young man born in 1935 in a working-class Mississippi home. It is easy to see that those costs have no relation at all to the prices his services soon commanded in the marketplace—once Elvis Presley began recording and performing. What governed those prices was entirely the demand existing in the market.

It is the same with the goods or services offered by any successful person or firm. Demand makes all the difference. Thus business people pay extremely close attention to how their market responds at different price points. Then they set their prices at the maximum net revenue point.

This means that even before any new tax is imposed here in Nevada, prices are already at their point of maximum net revenue. And since any hike in prices would simply decrease a company's net revenue, business people can't simply slap the state's new "gross receipts" tax on top of current prices and start charging the current price plus the new state tax.

The late University of Nevada Las Vegas economics professor Murray Rothbard wrote about this years ago:

> It should be quite evident that if businesses were able to pass tax increases along to the consumer in the form of higher prices, they would have raised these prices already without waiting for the spur of a tax increase. Businesses do not deliberately peg along at the lowest selling prices they can find[12].

So, by and large, business people running Nevada firms will have no other choice but to eat the tax—in other words, accept it as a cost that reduces the firm's income. Even if a firm chooses to raise its prices, its income will still, other things equal, be a function of the same demand schedule. And if prices were already set at the maximum revenue point before the tax hike, revenue will almost certainly be less.

Thus, all across Nevada, a multitude of businesses that are subject to the tax will immediately become less profitable. But as profit is *buying power*—i.e., demand—effective demand, here in Nevada, will drop for all of the factors that businesses use to produce their goods and services. That means Nevada firms will be less able to pay wages and salaries to employees, less able to pay for office space, less able to pay for investment capital and especially less inclined to expand.

Everything else equal, the income of anyone in the Silver State who sells anything to any Nevada business will take a hit, because less effective demand will exist for whatever he or she sells.

Bottom Line: From the vantage point of average citizens, a gross receipts tax has a negative multiplier effect second only to an overt income tax.

[11] On the other hand, to the extent that an entity—such as a public utility—has been granted the status of a government-enforced monopoly or cartel membership, it will have some state-bestowed pricing power since no other alternative supplier is allowed to compete.

[12] *Power & Market: Government & the Economy,* , 2nd ed. 1977, Kansas City, Kan: (Sheed Andrews and McMeel, Inc.).