

Scott Hodge: Thank you for tuning in. I'm Scott Hodge, President of the Tax Foundation. Joining me today for our weekly Tax Policy Podcast is Professor John Mikesell, who is Professor of Public Finance and Policy Analysis at Indiana University, specializing in state and local government finance, and sales and property taxation.

Professor Mikesell also serves as Editor-in-Chief of *Public Budgeting and Finance*, which is the journal of the American Association for Budget and Program Analysis and the Association for Budgeting and Financial Management; and of course, regular readers of *State Tax Notes* will notice his frequent articles in *State Tax Notes*, which are a big hit here at the Tax Foundation.

Professor Mikesell, thanks for joining me.

John Mikesell: Well, I'm glad to be talking with you.

Scott Hodge: Well, one of the interesting trends that we're seeing in recent times is so-called tax reform across the states, in which states are moving away from their typical tax policies of income taxes and so forth, and moving back to gross receipts taxes, which were kind of a Depression-era tax, as I understand it. And just a few years ago, I think only Washington State had a broad-based gross receipts tax; but now others are doing it – Ohio, Texas, etc. What's the trend here? Why is this becoming such a popular new tax?

John Mikesell: That really is a bit of a puzzle to me. My first and flip response is that a lot of people weren't paying attention when those taxes were discussed in their public finance classes. Anyone who has read anything about the old West Virginia Business and Occupation Tax, or the Indiana gross income tax, or the old European turnover taxes knows that these are just simply terrible taxes in terms of competitiveness, in terms of economic development, in terms of encouraging investment, and all those sorts of things.

So given that they don't make sense from a policy standpoint, I say, well, maybe it's politics, and that means these are taxes that get hidden. They're reported as being taxes on business, but we all know that they're going to end up most likely as taxes embedded in prices that consumers pay. It's just that they're a very much hidden kind of a tax.

Scott Hodge: Now, one of the principles of tax policy, though, is that a tax should have a low rate on a broad base; and certainly, from that very narrow definition, gross receipts taxes seem to be a winner.

- John Mikesell:* Yes.
- Scott Hodge:* But there are other things that have to be taken into consideration. Is that right?
- John Mikesell:* Yes. Low-rate and broad-base are only a part of the picture. The rest of the picture is a broad base that is sensible.
- Scott Hodge:* (Laughter) Invisible.
- John Mikesell:* Gross receipts is not sensible. I mean, consumption – household consumption – is a sensible base. Individual income is a sensible base. Real property is a sensible base.
- But the gross receipts of a business – well, that’s not linked to the affluence of a business. It’s not linked to the benefits that the business receives. It just isn’t a reasonable sort of a standard to tie the cost of government to.
- Scott Hodge:* Can you just give me some basics on how these work, and, in particular, how a gross receipts tax can be – I don’t know – unfair, I guess? Especially when times get bad, and businesses aren’t doing so well.
- John Mikesell:* Well, when businesses aren’t doing so well, they’re still having gross receipts, but they may not be having any profitability, and some businesses will have reasonably good margins, some businesses will not – will have very small margins. And the gross receipts tax has a great capacity of punishing the low-margin businesses.
- Scott Hodge:* But advocates would say it’s a very stable tax, and certainly governments need stability – especially when times get rough.
- John Mikesell:* Well, they behave pretty much like a retail sales tax. They’re not quite as stable because they go even further into taxing business purchases than does a classical state sales tax in the U.S.
- And if you look at the correlation of the gross receipts base with other revenues coming into the state government, they’re highly correlated. So adding a gross receipts tax is not going to add any stability to overall finances. It’s going to just continue behaving the way that the state finances have been behaving before.
- Scott Hodge:* That’s interesting. And when you look at these, do you find that any particular industries or sectors are more affected than others?

John Mikesell: Well, sectors that have low margins probably are most harmed. They probably are working in more competitive industries. They don't have quite as easy a capacity to include the gross receipts tax in their prices, which – of course – is our normal presumption with such taxes. And if they're unable to do that, then it's going to come out of their profits.

Scott Hodge: So grocers, retailers –

John Mikesell: You got it.

Scott Hodge: Or anybody with a low margin. Now I suppose that's the reason why many states, such as Washington State, have multiple rate structures for different industries, in order to counter that effect.

John Mikesell: That's exactly right. Even lawmakers understand that this sort of flat rate is going to have differing kinds of burdens across industries, so they try to bring in rate variation to try to deal with that.

But of course, that blows the simplicity in the tax completely out of the water. It opens up the possibility of business strategizing to try to get their particular activity classified in the lowest rate category they possibly can, because there are always judgment calls about what sector the business is in.

Scott Hodge: And one of the arguments that advocates make is that this is an opportunity, or this is a type of tax, that can help them export their tax burden. How does that stack up? Is that right?

John Mikesell: Well, there are a couple problems with that. One is if their state has got this gross receipts tax embedded in the prices of the items that are being produced by their businesses, they're clearly reducing the competitiveness of their own particular state's industries. Other states are not facing this kind of a burden, and so those kinds of businesses are going to be put at economic disadvantage.

And of course, because the tax applies at every transfer in the production and distribution stage, you've given the businesses in your state a very clear incentive to buy as much of their inputs – their raw materials, their production machinery, and so on – from out-of-state suppliers, because those out-of-state suppliers don't have to worry about having gross receipts tax embedded in the prices that they charge.

Scott Hodge: Now that's interesting. Have you seen evidence of where a gross receipts tax may have led to vertical integration in order to overcome some of those issues?

John Mikesell: Well, back in the days when West Virginia had its Business and Occupation Tax, that was clearly something that was going on all the time, and businesses were structuring contractual relationships to make it appear that they had integration when they really were separate contractors. And of course, that was a standard problem in all of the European turnover taxes before they converted to value-added taxes.

Scott Hodge: Interesting.

Now I'd like to finish up sort of on a broader picture, looking at getting your thoughts on the clash, if you will, of modern economy and old tax systems, in particular, like the corporate income tax, sales taxes, etc. From your perspective, what can states do to sort of modernize their tax code and make it more adaptable, or coexistent, with a changing economy?

John Mikesell: In some respects, states are trapped within a system that the federal government gives them, in terms of the retail sales tax. The remote vendor registration issue just simply cannot be corrected by state policies alone. They're going to have to get Congress to revise the physical presence standard.

But if that gets done, then the retail sales tax is clearly a viable and useful revenue source, particularly if states continue with the expanding the tax to include household purchases of services, and continue their very glacial movement toward getting business purchases out of the base.

Individual income taxes, particularly so long as the federal government continues to levy an individual income tax, are an avenue of some decent revenue for states.

Corporate income taxes are dying a deserved and slow death, and that's a tax that is disappearing, and deserves to disappear. It's a conduit of tax-burdened individuals, and states ought to just forget about the conduit and tax individuals.

Scott Hodge: Well, it's unfortunate that a tax that seems to be suffering such a slow death is costing both the economy and businesses so much to comply with.

John Mikesell: Oh, yes. That's right, and to figure out ways to reduce the burden. State legislatures are complicit in the process, trying to figure out ways to tax somebody else's corporation while they protect their own corporation. The direct approach of just getting rid of the corporate income tax at the state level is the direction that makes the most sense.

Scott Hodge: Well, Professor, this has been very interesting. I appreciate your insights on this, and we're going to continue to monitor these developments in the coming year; and we're anxious to see a report that you have coming, and we'll be publishing here in the next few months.

John Mikesell: Yes, I'm looking forward to seeing it as well. *(Laughter)*

Scott Hodge: *(Laughter)* Thank you very much for joining us.

John Mikesell: Okay, great.

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