State Tax Policy Takes a Wrong Turn: The Spread of Margin and Gross Receipts Taxes

Alan D. Viard, AEI
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Fall and rise of turnover taxes

- Pure turnover taxes apply to full gross receipts at each stage of production
- Condemned by public finance textbooks
- Replaced in Europe by VATs, which apply only to value added at each stage
- Reemergence in U.S. states, including Texas
  - Pure turnover ("gross receipts") taxes
  - Modified turnover ("margin") taxes allow some deductions, such as wages or cost of goods sold

Example

- Four firms in production chain in labor-only economy
  - Miner sells \$250 item to manufacturer
  - Manufacturer sells \$500 item to wholesaler
  - Wholesaler sells \$750 item to retailer
  - Retailer sells \$1000 item to consumer
- Turnover tax base 2500 (250+500+750+1000)
- VAT base 1000 (250+250+250+250) – 1 percent turnover tax would raise same revenue as 2.5 percent VAT

Margin and gross receipts taxes

- Delaware manufacturers & merchants tax
  - Enacted 1913, 2.01 percent top rate
- Washington business & occupation (B&O) tax
  - Enacted 1933, 1.8 percent top rate
- New Jersey alternative minimum assessment
  - Enacted 2002, 0.8 percent top rate
  - Option to deduct cost of goods sold
  - Expired, except for out-of-state companies, in 2006

Margin and gross receipts taxes

- Kentucky alternative minimum computation
  - Enacted 2005, 0.75 percent top rate
  - Option to deduct cost of goods sold
  - Repealed, except for LLCs, in 2006
- Ohio commercial activities tax (CAT)
  - Enacted 2005, 0.26 percent top rate
- Texas margin tax
  - Enacted 2006, 1.0 percent top rate
  - Options to deduct wages or cost of goods sold

Nevada voters reject margin tax

- Margin tax modeled after Texas, but with 2 percent rate, earmarked for schools
- Sponsored by Nevada State Education Association, opposed by businesses, AFL-CIO, members of both parties, newspapers
- Heavy spending on both sides, but opponents outspent supporters four to one
- Early polls favorable, but rejected 79-21

Economic overview

- Turnover taxes highly distortionary
  - Uneven taxation of production chain
  - Uneven taxation of labor
  - Heavy and uneven taxation of capital
  - Low statutory tax rate is mirage
- VATs much less distortionary
  - Uniform taxation of production chain and labor
  - Zero taxation of capital
- Margin taxes ease some turnover-tax distortions, but add new distortions

Uneven taxation of production chain

- Incentive for vertical integration – lower tax on goods for which integration easier
- In example, tax base is $2500 if four firms are separate, $1750 if retailer and wholesaler integrate, $1000 if all four integrate
- VAT neutral with respect to organization of production chain

Uneven taxation of labor

- Upstream labor taxed more heavily than downstream labor
- In example, 1 percent turnover tax effectively taxes retail labor at 1 percent, wholesale labor at 2 percent, manufacturing labor at 3 percent, mining labor at 4 percent
- 2.5 percent VAT would effectively tax all labor at 2.5 percent – same average rate, without disparities

Heavy, uneven taxation of capital

- Tax effects of reducing current consumption, increasing current investment, and using capital to increase future consumption
  - Reduced tax on current consumption
  - Increased tax on future consumption – offsets first effect in present discounted value
  - Tax on current gross investment
- Third effect absent for VAT, resulting in zero effective tax on capital

Heavy, uneven taxation of capital

- Modifying example, if capital's production chain similar to consumer good's chain, then 1 percent turnover tax equivalent to negative 2.5 percent investment tax credit
- ETR on capital income higher for short-lived capital (Bradford-Harberger result in reverse)
  - Assume 4 percent required after-tax return
  - ETR is 2.5 percent on zero-depreciation capital
  - 8.75 percent on 10-percent-depreciation capital
  - 15 percent on 20-percent-depreciation capital

Modifying pure turnover tax

- Margin taxes, in Texas and elsewhere, allow *some* business expenses to be deducted from gross receipts
- Step in right direction, BUT not necessarily an improvement (second-best theory)
- Deductions can introduce new distortions and complexity, especially if firms given choice

History of Texas margin tax

- Recommended by tax reform commission
- Enacted at 2006 special legislative session as new form of franchise tax, replacing income-based form
- Intended to finance education, after earlier school finance plan struck down
- Texas Supreme Court upheld tax against various constitutional challenges in November 2011, October 2012

Texas margin tax revenue

- Revenue lower than initially predicted
- 2008: $4.5 billion (3.8 percent of total)
- 2009: $4.3 billion (4.0 percent)
- 2010: $3.9 billion (3.0 percent)
- 2011: $3.9 billion (3.1 percent)
- 2012: $4.6 billion (3.2 percent)
- 2013: $4.8 billion (3.8 percent)
- 2014: $4.8 billion (3.4 percent)

Tax is lowest of four options

- 0.6825 percent of gross receipts
- 0.975 percent of gross receipts, above $1 million deduction
- 0.975 percent of gross receipts minus employee compensation
- 0.975 percent of gross receipts minus cost of goods sold (COGS)
- Cut in half for wholesale, retail firms

Additional features

- Credits allowed for research, historic structures, etc.
- Firms below $10 million of gross receipts have option to pay 0.575 percent of receipts, with no credits
- Applies to noncorporate firms that have limited liability protection
- Multi-state firms apportion by gross receipts

Effects of the tax options

- First two of the four options, and the option for firms below $10 million, are pure turnover taxes
- COGS deduction available only to some firms
- Compensation deduction magnifies turnover tax's distortions
- Use of different options by different firms creates further disparities and incentives for spinoffs

COGS deduction

- Many wage payments and many purchases from other firms can be deducted, approaching tax on net capital income
- But, COGS deduction available only to firms that sell *goods*, not those that sell services
- And, not all expenses qualify as COGS
- Texas COGS definition differs from federal income tax's definition, which serves completely different purpose

Compensation deduction

- In example, compensation deduction shrinks base from 2500 to 1500 (0+250+500+750)
- 1.67 percent tax rate needed to raise same revenue as 1 percent pure turnover tax
- *Greater* distortion of production chain than under pure turnover tax
  - Tax base would shrink to zero if all firms integrated
  - Tax base would shrink to 750 if retailer and wholesaler integrated

Compensation deduction

- *Greater* disparity of tax rates on labor (with same average burden)
  - Effectively exempts retail labor
  - Taxes wholesale labor at 1.67 percent
  - Taxes manufacturing labor at 3.33 percent
  - Taxes mining labor at 5 percent
- Tax burden on capital roughly unchanged

Conclusion

- Pure turnover taxes are flawed, as tax economists have long known
- Margin taxes offer little or no improvement over turnover taxes