

Gross Receipts Taxes:

A Counterproductive Approach to Addressing Tax Regressivity

In his State of the State address on March 7, Governor Rod Blagojevich declared Illinois' tax system "one of the most regressive ... in the nation" and proposed, as a remedy, replacing the state's existing corporate income tax with a broad-based gross receipts tax. While a broad-based gross receipts tax may have some merits – for instance, it would likely expand the base of economic activity subject to taxation – it is a poor choice for mitigating inequities in the tax code, since it would function much like a sales tax and would thus impose greater burdens on low-income taxpayers.

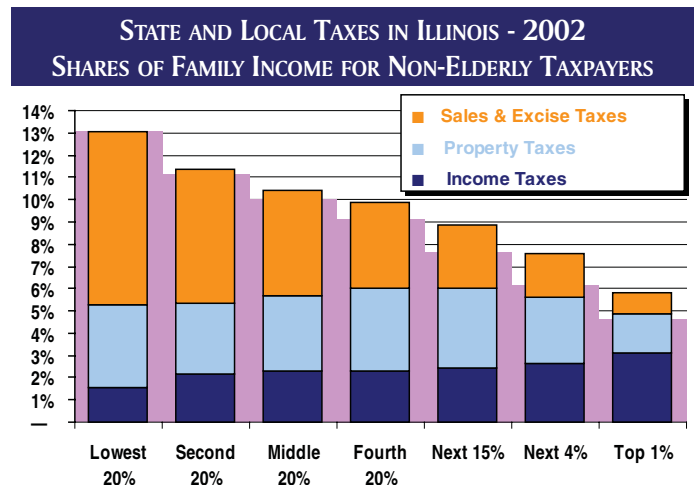
This policy brief reviews the shortcomings in Illinois' current tax system and examines the advantages and disadvantages of a gross receipts tax. A gross receipts tax could be used as an alternative minimum tax that strengthens Illinois' corporate income tax, but policymakers concerned about tax fairness should strengthen tax structures already in place, rather than scrapping them in favor of a gross receipts tax.

Illinois' Tax System: Truly "One of the Most Regressive"

Governor Blagojevich is correct in his diagnosis – Illinois' tax system is truly "one of the most regressive ... in the nation." ITEP's January 2003 study, *Who Pays? A Distributional Analysis of the Tax Systems in All 50 States*, finds that Illinois' tax system is the 6th most regressive in the nation, as the poorest fifth of taxpayers in Illinois pays just over 13 percent of its incomes in taxes on average, while the richest 1 percent pays closer to 5 percent on average (once the federal deductibility of state and local taxes is taken into account). As the figure at right suggests, one of the key factors contributing to the inequitable distribution of taxes in Illinois is its relatively flat personal income tax.

Of the 41 states that levy a personal income tax, Illinois is one of just six that do not use a graduated rate structure and one of only eight that do not offer a standard deduction. Moreover, Illinois' personal income tax rate of 3 percent is the lowest among those states using a single flat rate.

Importantly, Illinois' existing corporate income tax makes a substantial contribution to tax fairness. Corporate income taxes are generally passed through to the individuals who, as shareholders, own corporations; those shareholders, in turn, are concentrated among the very wealthiest of taxpayers. Consequently, unless it is replaced by a more progressive form of taxation, any attempt to repeal Illinois' corporate income tax – as Governor Blagojevich's "Tax Fairness Plan" would ultimately do – would make the state's overall tax system even more unfair than it is today.



A broad-based gross receipts tax may have some merits, but better choices are available – both for mitigating inequities in Illinois’ tax code and for ensuring that it is more reflective of the state’s economy.

Gross Receipts Taxes: Disadvantages Generally Outweigh Advantages

The centerpiece of Governor Blagojevich's “Tax Fairness Plan” is the creation of a gross receipts tax. A gross receipts tax (or GRT) is, in many respects, simply another type of sales tax. The main difference between a traditional sales tax and a GRT is that the former generally applies only to retail sales, while the latter applies to the sales made by companies at every stage of the production process. Among the disadvantages commonly ascribed to GRTs are the following:

- **GRTs hit low-income taxpayers the hardest.** Like any sales tax, GRTs are regressive, as poorer taxpayers often must spend everything they earn just to get by, whereas wealthier taxpayers only need to devote a fraction of their incomes to consumption.
- **GRTs are not sensitive to a business’s ability to pay.** Businesses that fail to turn a profit would still face a GRT; businesses that are engaged in high-volume, low-profit-margin activities would be adversely affected as well. Conversely, businesses with very high profit margins could pay lower taxes under a GRT than under a corporate income tax.
- **GRTs lead to severe pyramiding problems.** Since a GRT applies not just to retail sales but to all stages of the production process, it may be levied on itself multiple times. For instance, the GRT paid on the raw materials going into a particular product will later be subject to GRT when the finished product is sold to a wholesaler. One examination of Washington’s gross receipts tax found that it pyramids 2.5 times on average.
- **GRTs tend to be hidden from taxpayers.** As GRTs are generally imbedded, to some degree, in the price of goods and services that consumers buy, they are far less visible than other forms of taxation. This lack of transparency may lead taxpayers to focus greater attention – and ire – on other forms of taxation, with predictable results.
- **GRTs may distort economic decision-making.** Given the pyramiding problems associated with GRTs, they hold the potential to discriminate against in-state suppliers (since purchasing from out-of-state suppliers may allow businesses to avoid a GRT) or to create artificial incentives for vertical integration (as integration would reduce the number of times in a given production process that a GRT would be imposed).

To be sure, a gross receipts tax may enjoy some advantages over other types of taxes. For instance, it could expand the base of economic activity subject to taxation, potentially covering some out-of-state businesses and some in-state sectors that Illinois’ corporate income tax does not now reach. In addition, given its broader economic base, a GRT may yield a comparatively stable stream of revenue. However, policymakers can realize the advantages commonly associated with a GRT without abandoning the existing corporate income tax. That is, a GRT could serve as an alternative minimum tax – or “backstop” – within Illinois’ corporate income tax, with businesses paying the higher of their GRT or corporate income tax liabilities.

More Productive Approaches to Achieving Tax Fairness Are Available

Governor Blagojevich’s motivation in offering his “Tax Fairness Plan” is commendable, but more productive approaches to achieving tax fairness in Illinois are available. The Governor rightly points to the ability of major corporations to reduce the amount of taxes they owe in Illinois to zero (or less) as a major problem. The solution to this problem is not to scrap the corporate income tax, but to strengthen it – by repealing failed incentives like single-sales factor apportionment or by limiting overly generous net operating loss carry-forwards or carry-backs. The Governor is also justifiably concerned about the level of taxes paid by low- and moderate-income individuals and families in Illinois. Similarly, the solution to this problem is not to create a new and regressive tax, but to improve existing taxes – by instituting a graduated income tax structure or by exempting groceries from the sales tax.

To find out more about this issue, contact ITEP at (202) 299-1066.