March 29, 2007

The Hidden Tax for Sm(all) Business in Governor Blagojevich's Gross Receipts Tax

by Chris Atkins

Fiscal Fact No. 81

I. Introduction

Illinois Governor Rod Blagojevich is asking small businesses in Illinois to believe that his gross receipts tax (GRT) proposal will not impact their operations or their bottom line. Indeed, the Governor claims that small businesses will be "exempt" from the tax because the first $1 million in gross receipts will not be taxable.[1] What the Governor is not telling Illinois businesses, however, is that the GRT will impose a stealth tax increase on all businesses--big and small--through an increase in the price of the goods and services they buy.

In turn, these businesses will likely recoup the cost of this hidden tax by:

- Raising the price of the goods and services they sell;
- Purchasing their inputs from out-of-state sellers, or;
- Integrating with other businesses to avoid the GRT altogether

If businesses are unable to shift the hidden tax by these methods, they will have to do one or all of the following:

- Lower wage payments to workers;
- Save less money;
- Make fewer new investments, or;
- Lower the rate of return on their existing investments

Each of these possible responses by business owners would have negative economic consequences for every Illinois citizen who would end up bearing the true economic burden of this hidden tax.

It is perhaps no irony that the largest tax increase this decade[2] would largely be hidden from unsuspecting Illinois citizens and business owners. This *Fiscal Fact* will show that, unless the people of Illinois (small business owners in particular) examine this tax proposal closely, they might end up supporting a GRT under the mistaken assumption that it will have no impact on their economic well-being.

II. The Hidden Tax for a Hypothetical Small Manufacturer

The chief economic flaw with GRTs is tax pyramiding.[3] Tax pyramiding refers to the effect caused by the GRT's imposition at each stage of the production process. Pyramiding causes higher tax rates to apply to products that move through a longer production stage, which raises prices for those products and causes economic distortion of investment decisions.

The example in Table 1 shows how the tax pyramiding inherent in Governor Blagojevich's GRT proposal can impose a hidden tax on a hypothetical small manufacturer. This tax is hidden because, in this example, the tax pyramiding imbeds it in the price of the inputs the small manufacturer buys from other firms. For the purposes of this example we assume that the GRT pyramids five or six times before our small manufacturer purchases its goods and equipment, which is equal to the level of pyramiding for some manufacturers in Washington State due to that state's gross receipts tax.[4]

Table 1. How Gov. Blagojevich's Plan Imposes a $10,000 Hidden Tax on a Hypothetical Small Manufacturer

Current System				**Governor's Proposal**			
Inputs	**Quantity**	**Price**	**Total**	**Inputs***	**Quantity**	**Price**	**Total**
Goods - Parts	24,000	$5.00	$120,000	Goods - Parts[a]	24,000	$5.08	$121,812
Goods - Parts	4,000	$40.00	$160,000	Goods - Parts[b]	4,000	$40.60	$162,416
Goods - Parts	295	$500.00	$147,500	Goods - Parts[c]	295	$508.82	$150,102
Goods - Equipment	100	$1,000.00	$100,000	Goods - Equipment[d]	100	$1,015.10	$101,510
Goods - Equipment	320	$250.00	$80,000	Goods - Equipment[e]	320	$253.78	$81,208
Services - Utilities	1	$22,500.00	$22,500	Services - Utilities[f]	1	$22,905.00	$22,905
Services - Accounting	1	$10,000.00	$10,000	Services - Accounting[f]	1	$10,180.00	$10,180
Services - Legal	1	$5,000.00	$5,000	Services - Legal[f]	1	$5,090.00	$5,090
Services - Telecommunications	1	$5,000.00	$5,000	Services - Telecommunications[f]	1	$5,090.00	$5,090
Total Purchases			$650,000	Total Purchases			$660,313
				"Hidden Tax" Increase			**$10,313**

*This example assumes that the GRT at each stage of production is fully shifted forward to this small manufacturer, as many economists believe.

a) Assumes that the good has gone through 5 stages of production until purchased, that the first firm in the production chain sold the product for $1 each, that $1 of value is added at each stage of production and that the gross receipts tax is fully shifted forward to buyers at each stage.

b) Assumes the good has gone through 5 stages of production until purchased, that the first firm in the production chain sold the product for $8 each, that $8 of value is added at each stage of production and that the gross receipts tax is fully shifted forward to buyers at each stage.
c) Assumes the good has gone through 6 stages of production until purchased, that the first firm in the production chain sold the service for $83.33 each, that $83.33 of value is added at each stage of production and that the gross receipts tax is fully shifted forward to buyers at each stage.
d) Assumes the equipment has gone through 5 stages of production until purchases, that the first firm in the production chain sold the equipment for $200, that $200 of value is added at each state of production and that the gross receipts tax is fully shifted forward to buyers at each stage.
e) Assumes the equipment has gone through 5 stages of production until purchases, that the first firm in the production chain sold the equipment for $50, that $50 of value is added at each state of production and that the gross receipts tax is fully shifted forward to buyers at each stage.
f) Assumes no pyramiding in the service and that the gross receipts tax on the service is fully shifted forward to the buyer.

To see the full impact of the $10,000 hidden tax increase on this small manufacturer we have to understand its impact on net profit after taxes. Table 2 presents the net profit calculation under the current system and under the Governor's proposed GRT.

Table 2. How the GRT's Hidden Tax Increase Reduces Net Profits by $5,000

Net Profit Calculation under Current System		**Net Profit Calculation under Governor's Plan**	
Gross receipts[a]	**$1,000,000**	**Gross receipts**[a]	$1,000,000
Less Total Costs	$931,510	Less exemption	$1,000,000
Purchases	$650,000		
Labor	$260,510		
Facilities	$21,000		
Equals Taxable Income (gross receipts less total costs)[b]	$68,490	Equals Taxable gross receipts (gross receipts less exemption)	$0
Tax Rate	7.30%	Tax Rate	0.50%
Less Tax Liability (taxable income * tax rate)	**$5,000**	**Less Tax Liability (taxable gross receipts * tax rate)**	$0
		Less Total Costs	$941,823
		Purchases	$660,313
		Labor	$260,510
		Facilities	$21,000
Equals Net Profit	**$63,490**	**Equals Net Profit**	**$58,177**
Reduction in net profit under Governor's plan: ($5,314)			

a) Assumes 5000 products sold to Illinois consumers at $200 each.
b) Assumes all taxable income is apportioned to Illinois.

Note that in this example the small manufacturer's net profit falls by over $5,000 under the Governor's plan even though its tax liability went from $5,000 under the corporate income tax to $0 under the GRT. This results from the $10,313 increase in the price of its inputs due to the pyramiding nature of the gross receipts tax. If the small manufacturer focuses exclusively on how the GRT impacts its tax liability, it will completely overlook how this hidden tax impacts its net profit.[5]

III. The Economic Incidence of the GRTs Hidden Tax

The small manufacturer will deal with the $5,000 reduction in net profits in one of two ways: first, it could increase the price of its goods; second, it could shift its purchases to out-of-state suppliers. If the market will not bear a price increase or a shift to out-of-state suppliers, the small manufacturer will either "eat" the loss by saving less, making fewer new investments, or distributing fewer dividends to shareholders, or it could lower its wage payments to workers (see Table 3).[6]

Table 3. Who Bears the Burden of the Hidden Tax?

Small Manufacturer's Most Likely Options for Recouping $5,000 Reduction in Net Profit			
Business Passes Taxes on to Consumer	**Current System**	**Governor's Proposal**	**Difference**
Net Profit	$63,490	$58,177	($5,314)
Quantity Sold	200	200	0.00
Price Charged for Product	$200	$201.06	$1.06
Impact on Average Consumer	Pays $1.06 more at the cash register[a]		
Business Buys Goods from Out-of-State Suppliers	**Governor's Plan**	**If Purchased Out of State[b]**	**Total Price Difference**
Input Costs			
Goods-Parts	$121,812	$120,600	($1,212)
Goods-Parts	$162,416	$160,800	($1,616)
Goods-Parts	$150,102	$148,238	($1,865)
Goods-Equipment	$101,510	$100,500	($1,010)
Goods-Equipment	$81,208	$80,400	($808)
Total Cost for Goods and Equipment	$617,048	$610,538	($6,511)
Change in net profit			$1,197
Impact on Average Citizen	Job loss as Illinois suppliers lose market share, fewer new jobs, general decline in Illinois economic growth		
Small Manufacturer's Less Likely Options for Recouping $5,000 Reduction in Net Profit			
Business "Eats" the Tax	**Current System**	**Governor's Proposal**	**Difference**
Net Profit	$63,490	$58,177	($5,314)
New investment	$21,163	$19,392	($1,771)
Distributions to shareholders	$21,163	$19,392	($1,771)
Savings	$21,163	$19,392	($1,771)
Impact on Average Citizen	Fewer new jobs, lower rate of return on retirement savings, higher interest rates for mortgages, car loans, etc.		
Business Passes Tax on to Wage Earners	**Current System**	**Governor's Proposal**	**Difference**
Net profit	$63,490	$58,177	($5,314)
Wages	$260,510	$255,196	($5,314)
Workers	8	8	0.00
Average Yearly Wage	$32,564	$31,900	($664)
Impact on Average Citizen	Paycheck goes down by $664 per year		

a) A price increase that was fully absorbed by the consumer (i.e. consumers continued to demand the same quantity at the higher price) would, of course, increase the gross receipts

of the business and also increase GRT liability.
b) One level of pyramiding would still apply to the goods purchased out of state and it is assumed this is fully passed forward to the small manufacturer.

In all four cases-which, with one exception noted below, represent the total universe of how this small business would react to this $5,000 loss if it wants to remain in business--real people in Illinois end up paying a real economic cost for the impact of the GRT even though it did not raise the tax liability of this particular small manufacturer. Of course, the people who pay this economic cost will likely not understand that the GRT is causing them to pay higher interest rates, higher prices, or lose wages or jobs, which is exactly why the GRT imposes a hidden tax.

There is one final way that this small manufacturer could respond to the GRT in order to eliminate the $5,000 loss: integration. If this small manufacturer merged with (or was purchased by) the firms that it buys from, the GRT would not apply and the loss would be eliminated. Thus, GRTs create artificial incentives for firms to amalgamate that, in effect, discriminate against small business ownership in favor of larger business structures that can reduce the negative impact of the pyramiding of the GRT.

In many cases this strategy would represent the most efficient way for the small manufacturer to respond to the increase in the price of business inputs caused by the imposition of the GRT. Indeed, Illinois firms that are already vertically integrated will have a major advantage in this respect.

IV. Conclusion

While Governor Blagojevich's GRT proposal would increase taxes substantially the GRT itself would largely hide this tax increase from the people of Illinois. Business owners, in particular, should be on guard that the GRT would negatively impact them even if it does not increase their tax liability. Small businesses should understand that the GRT would increase the price of their inputs even if they fall under the $1 million cap which exempts them from the tax. In turn, they will have to pass that cost on to consumers, their workers, or "eat" the hidden tax themselves by foregoing potential investment opportunities.

Footnotes

1. *See* Press Release, "Governor Blagojevich continues his fight for middle class families in his Fiscal Year 2008 Budget Address," (March 7, 2007) located at http://www.illinois.gov/PressReleases/ShowPressRelease.cfm?SubjectID=3&RecNum=5759.

2. *See* Jonathan Williams, "Governor Blagojevich's Gross Receipts Tax Plan Represents Largest State Tax Increase This Decade," *Tax Foundation Fiscal Fact* (March 19, 2007).

3. *See* Andrew Chamberlain and Patrick Fleenor, "Tax Pyramiding: The Economic Consequences of Gross Receipts Taxes," *Tax Foundation Special Report* No. 147 (December 2006). Other commentators have identified additional flaws with gross receipts taxes. *See* John Mikesell, *Gross Receipts Taxes in State Government Finances: A Review of Their History and Performance*, Tax Foundation and Council on State Taxation (January 2007).

4. *See Tax Alternatives for Washington State: A Report to the Legislature Vol. I*, p. 24, Washington State Tax Structure Study Committee (November 2002).

5. This is true for all firms, not just those that fall under the $1 million exemption. Those over the exemption, however, will likely face an increase in tax liability in addition to higher input costs.

6. Note that in Table 1 we assumed that the GRT was fully shifted forward at each stage of production. We have relaxed this assumption in the case of our small manufacturer to show the full panoply of options that businesses have when determining how they are going to absorb the cost of taxation. In reality, each firm in each stage of production prior to the purchase of inputs by the small manufacturer would have the same options for absorbing the GRT that our hypothetical small manufacturer has in Table 3.

Tax Foundation
2001 L Street NW Suite 1050
Washington, DC 20036
Ph: (202) 464-6200
Fax: (202) 464-6201
www.taxfoundation.org