Commissioner Kleppner's Draft Consumption Tax Chapter – v2

Chapter 3: Consumption Taxes in Vermont

"From the point of view of government policymakers, a good tax raises a lot of money without causing people to avoid the tax by distorting their spending (or voting) behavior. By that measure, a sales tax is a very good tax indeed: a body of research shows that, overall, sales-tax rates are not noticeable enough to consumers to make them change their behavior." – "How Do People Respond to Sales Tax Increases," Baker et al., 2017.

Introduction

Consumption taxes are an important source of revenue in all 50 states and DC. Even states with no sales tax, like New Hampshire, tax some services and impose excise taxes. In Vermont, consumption taxes take the form of the Sales & Use Tax, the Meals & Rooms Tax, and Excise Taxes. For a variety of reasons, both economic theory and tax policy theory approve of consumption taxes. As with the Vermont tax system overall, our goal is to make consumption taxes more fair, more sustainable, and simpler.

For the most part, the sales tax applies only to private consumption – purchases made for government use by the federal, state, and local governments are exempt. However, purchases made for individuals using federal dollars, as when a Medicare patient buys a piece of medical equipment and Medicare pays for it, are eligible for the sales tax. Purchases made *by* tax-exempt non-profits are generally exempt, but when a consumer purchases something *from* a tax-exempt non-profit, it is generally taxable.

Tax theory discourages the application of a sales tax to business inputs, with purchases at wholesale being the most prominent example. The reason for this is straightforward.

Here are the numbers for a company whose business model requires 50% margins.

- In a state without taxes, the company purchases a product at wholesale for $50 and sells it to the consumer for $100.
- If you apply Vermont's 6% sales tax to the consumer purchase, the company buys it for $50, sells it for that same retail price of $100, and the consumer pays $106, including the $6 in tax.

- If you apply the 6% sales tax to both transactions, the company pays $53 for the product at wholesale, and sells it for a retail price of $106 (to maintain their 50% margin target). Then you apply the 6% sales tax to that, and the consumer pays $112.36.

Breaking down the $112.36 that the consumer paid, you see that $50 is the wholesale cost, $53 is the retailer's margin, and $9.36 is tax. Note that of that $9.36 in tax, $3 is tax at the wholesale level that got passed on to the consumer, another $6.18 is the tax the consumer pays on the underlying $103 of wholesale price plus retail margin, and 18 cents is the 6% consumer tax on the 6% wholesale tax, yielding an effective consumer tax rate of 9.09% ($9.36/$103), and an increased cost to the consumer of $12.36 compared to the taxless transaction. The state ends up collection $9.36 more, but the consumer ends up paying $12.36 more.

This effect ("pyramiding") is roundly discouraged by tax theory. It is more efficient for all parties for the state to simply levy a 9.36% sales tax at the consumer level, and exempt the wholesale purchase. The state ends up with the same revenue; the consumer pays $3 less; the wholesaler is relieved entirely of the administrative burden of collecting and remitting sales tax; and retailer is relieved of the burden of paying sales tax on their purchases, and can sell their wares to consumers at a slightly lower price.

We also examined the effect of changes in the sales tax on levels of consumption/access due to price elasticity of demand. In general, consumer-level demand is price inelastic in the range of price changes caused by adjusting sales tax rates. Per research done at the Kellogg School of Business at Northwestern University in 2017, *"(t)he researchers saw no impact on household spending habits four months to a year after a sales-tax increase."*[1] That is particularly true for necessities like health care, groceries, education, residential energy use, and clothing, which are the five biggest categories that are currently exempt from the sales tax in Vermont.

A further mitigating factor is that even if demand did have some price elasticity in the range of changes we are examining, our recommendation to broaden the base and lower the rate would mean that there would be a slight decrease in demand for the 2/3 of consumer transactions that are not currently subject to the sales tax. However, that would be partially offset by the increase in demand for the 1/3 of consumer goods that are currently taxed, as the tax rate for these things would go down.

We will therefore assume that changing the sales tax by a few percentage points will not have a material effect on demand. However, in the accompanying Sales Tax Calculator, we have included two

[1] "How Do People Respond to Sales Tax Increases," Baker et al., 2017.

models, one that does not price elasticity of demand and one that includes it, so you can model different scenarios and gauge for yourself that significance of elasticity of demand. You will see that the inclusion or exclusion of price elasticity of demand does not make a large difference to the results.

A 60% tax, on the other hand, such as the excise tax Vermont levies on cigarettes, does in fact change consumer behavior in the intended manner – it reduces smoking, especially among young people. We therefore include the effects on demand in the analysis of the excise tax.

Vermont's current 6% sales tax exempts some categories of goods and most categories of sales. We now examine the reasons for those exemptions, and we will explore opportunities to make Vermont's sales tax more fair, more sustainable, and simpler by expanding the base and reducing the rate, while at the same time exempting business inputs.

Why Are There Exemptions to the Sales Tax in Vermont?

There are hundreds of categories of goods and services in the United States economy, and states have made very different choices about which ones to tax. Vermont currently taxes consumer purchases of most goods that are not deemed necessities, and exempts necessities like groceries, clothing, home heating, and medical products. Vermont currently exempts most sales of business inputs. Finally, Vermont currently taxes about 40 of the 260 or so services that are taxed by at least one other state (See Appendix 1).

There are six main reasons that some categories of goods and services are exempt in Vermont:

1. To protect low-income Vermonters from the financial burden of paying a tax on necessities, like groceries, clothing, home heating, and health care.
2. To encourage community goods, like education and newspapers. Health care falls into this category as well.
3. Since the sales tax was originally just on goods, many services, like limousine rental and tuxedo rental, are exempt simply because they've always been exempt. Health care also falls into this category.
4. Some categories are exempt because the sales tax is deemed too hard or too complicated to collect, for the seller and/or for the Tax Department. Health care is probably the only category to fall into all four of these categories.
5. Some categories are so small that the costs to collect the tax are greater than the revenue from the tax. This includes "casual sales," one-time events like yard sales.
6. To avoid taxing business inputs.

This leads to three big questions:

1. Are sales tax exemptions an efficient way to protect low-income Vermonters? If not, is there a better way to achieve this goal?
2. Are sales tax exemptions an effective way to promote community goods? If not, is there a better way to achieve this goal?
3. Is the benefit of the historic exclusion of services from the sales tax likely to outweigh the costs of that exclusion as the economy continues to evolve toward more services?

We will examine each question in turn in the following sections.

Are Sales Tax Exemptions an Efficient Way to Protect Low-Income Vermonters?

For purposes of this report, we define low-income Vermonters as those living in households with income of less than 200% of the federal poverty level. By that definition, about 28% of Vermonters are low-income. (See Appendix 2).

Health care, groceries, home energy, education, clothing, and car repair services account for about 90% of the private consumer spending that is currently exempt from the sales tax in Vermont (See Appendix 3). Health care is the most complicated case, and the only one with multiple reasons for exemption, so we will examine health care in separate section below.

Starting with groceries: according to the US Bureau of Labor Statistics, low-income Vermonters spend about 17.7% of Vermont's total private spend on groceries[2]. That means that right now, by exempting groceries from the 6% sales tax, Vermont is giving up about $126.1 million in sales tax revenue to provide $22.3 million in relief to low-income Vermonters.

To be clear, we are not recommending a 6% sales tax on groceries. Our recommendations are laid out below. At this point, our goal is simply to think through whether or not exempting groceries is an efficient way to protect low-income Vermonters from a sales tax of any level on groceries.

If Vermont levied the 6% sales tax on groceries, collected the $126.1 million in taxes, and refunded that $22.3 million in grocery sales tax collected from low-income Vermonters, there would be no harm to low-income Vermonters. Conservatively assuming a 15% cost to administer a rebate program, the state would have an additional $100 million which it could put toward lowering the sales tax rate and/or increasing spending, in whatever ratio the legislature decided was appropriate.

[2] https://www.bls.gov/cex/2019/aggregate/decile.pdf -- state-level data not available, assumes Vermont mirrors national data.

As noted in Chapter 1 of this report, we would encourage a comprehensive review of income, benefits, and taxes by income level in order to eliminate disproportionate loss of benefits as income increases ("benefit cliffs"), rather than looking at each element of support for low-income Vermonters in isolation. That being said, Vermont currently provides food support to low-income Vermonters through 3SquaresVT and Vermont WIC, which programs could provide part of the mechanism for rebating low-income Vermonters' grocery sales tax to them.

"States frequently exempt consumer goods, such as clothing and groceries, but these ***blanket exemptions are ineffective ways to lessen the regressive nature of sales taxes****. . . If states are still concerned about the somewhat regressive nature of sales taxes,* ***several policy options are more effective tools than blanket exemptions****. Grocery tax credits, expanded Earned Income Tax Credits, or an increased standard deduction in an income tax would provide assistance without introducing the same degree of economic distortions."* – TaxFoundation.org (bolding ours)

When you look at the other big categories of private consumer spending that are currently exempt from the sales tax, you find the same pattern. Using 6% as an example, in home energy consumption, the state is foregoing roughly $42.1 million in revenue[3] to protect low-income Vermonters from an $7.9 million expense. As with groceries, as part of a comprehensive review of the income, benefits, and taxes in low-income households, we note that Vermont already has a mechanism for providing support to low-income Vermonters' residential energy purchases in the Low-Income Heating Assistance Program (LIHEAP). If you extend the sales tax to residential energy, the state could collect the $42.1 million in tax revenue, and distribute $7.9 million back to low-income Vermonters through the LIHEAP program, and end up (again assuming a 15% administration cost) with $33 million per year for increasing spending and/or decreasing the rate.

Low-income Vermonters spend about 14.7% of the total private dollars spent on education[4], so again, using 6% as an example, the state is foregoing $59.1 million in revenue to protect low-income Vermonters from $8.7 million in sales tax burden. Clothing and automobile repair follow the same pattern.

In general, we conclude that exempting broad categories of necessities is not an efficient way to protect low-income Vermonters from the financial burden of paying a sales tax on necessities,

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[3] Vermont Tax Expenditures 2019 Biennial Report, 2019.

[4] https://www.bls.gov/cex/2019/aggregate/decile.pdf -- state-level data not available, assumes Vermont mirrors national data.

and that better mechanisms exist or can be developed, even at a 15% cost of administration, that will hold low-income Vermonters harmless, and increase Vermont's capacity to raise revenue and/or decrease the sales tax rate.

Are Sales Tax Exemptions an Effective Way to Promote Community Goods?

"A body of research shows that, overall, sales-tax rates are not noticeable enough to consumers to make them change their behavior. In other words, we tend to adopt an attitude of "it is what it is" about sales tax—even when the rates go up—and just get on with the business of purchasing what we need." – "How Do People Respond to Sales Tax Increases," Baker et al., 2017.

What is true of rates going up is equally true of rates doing down. A 6% sales tax is not enough to discourage consumer behavior, and exemption from a 6% sales tax is not enough encourage consumer behavior.

The list of community goods that Vermont tries to encourage with sales tax exemptions includes two big items: health care and education. As noted above, we will examine health care separately.

Education in this context includes only private spending on education – private payments for K12 and private payments for college. This includes both public and private insitutions. Total private education spending in Vermont in 2019 was $984.6 billion.[5] Low-income Vermonters spent about 14.7% of that.[6] There are several important barriers for low-income Vermonters to accessing education:

"Higher education in Vermont—for both two and four-year colleges—consistently ranks as the most expensive in the nation, while simultaneously offering the lowest state funding, according to a 2019 report from the College Board[7] *. . . For the 80% of CCV students who are enrolled part-time, supporting students outside of the classroom is a major issue. . . The lack of access to a car or daycare for their child can really derail a great student from completing their classes."*
-- Burlingtonfreepress.com 1/20/2020

In light of these issues, the presence or absence of a sales tax would not appear to be a significant factor in accessing education. Expanding higher education in Vermont might be better achieved through larger-scale subsidies or refunds of the tuition for low-income and middle-income Vermonters,

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[5] Bureau of Economic Analysis, https://apps.bea.gov/iTable/iTable.cfm?reqid=70&step=1&isuri=1&acrdn=4#reqid=70&step=1&isuri=1
[6] Consumer Expenditure Survey, Table 1110, "Deciles of income before taxes: Annual expenditure means, shares, standard errors, and coefficients of variation," 2019. https://www.bls.gov/cex/tables.htm#annual
[7] https://research.collegeboard.org/pdf/trends-college-pricing-2019-full-report.pdf

combined with services like transportation, remote learning, and childcare for students for whom those things are a barrier. If college tuition is $40,000, and we add a (say) 3.5% sales tax to that, the price of that tuition goes up to $41,400. The problem is not the $1400 in sales tax, it's the $40,000 in tuition.

There are a number of smaller categories of community goods that are exempt from sales tax in Vermont as well: newspapers; admission to school sporting events; membership services from environmental, human rights, social, civic, and business organizations; sports instruction; other amusement and recreation industries; and others.

We do not in any way dispute that these things are good for the community and deserve Vermont's support. We simply do not believe that a sales tax exemption is an effective way to support, encourage, or expand them. We do believe that exempting these activities, while not providing meaningful support to the activity, does create complexity, unfairness, and instability in Vermont's tax system, and those negative consequences outweigh the extremely limited benefit the exemptions provide.

We conclude that exempting community goods from the sales tax is not an effective way to expand them, and that if the legislature does indeed wish to support, expand, and encourage these and other community goods, it should analyze the barriers to expansion, and address them head-on with appropriate means and mechanisms. We caution the legislature to avoid assuming that the sales tax exemption provides enough support so that nothing further need be done to expand Vermonters' access to these community goods.

Does the exclusion of services from the sales tax still make sense?

The General Assembly concludes that structural deficiencies in Vermont's current revenue and budgeting structure, combined with a change in the State economy from an economy based on goods to an economy based on services, requires and examination and rethinking of Vermont's current sales tax base. – Sales Tax on Services Study, VT Dept of Taxes, 2015.

Per the study cited above, services were initially excluded from the sales tax in the 1930s because goods "constituted a large portion of household consumption, wealthier people bought more of them, and they were easier to quantify. Also, it was widely believed at that time that taxing a service would be like taxing the jobs associated with that service, and jobs were already scarce in that era."

In principle, excluding some services from the sales tax raises an issue of fairness, as it puts Vermonters who don't happen to use that service at a disadvantage, and it also puts individuals and companies who happen to produce something that is taxable at a disadvantage. As we have noted, the exclusion or inclusion of any service in the sales tax does not meaningfully change demand, so this fairness issue is more one of principle than practice.

However, more serious consequences of exempting most services from the sales tax are that doing so makes sales tax revenue less stable and less sustainable, makes the tax system more complicated, and forces the state to impose a higher tax rate to achieve the revenue goal.

We conclude that there is nothing inherent in the service sector that justifies a blanket exemption from the sales tax, and that the widespread exclusion of services adds complexity, unfairness, and instability to Vermont's tax system and inflates Vermont's sales tax rate.

Health Care and the Sales Tax

Vermonters use a variety of health care services and goods:

- Visits (in person or via telemedicine) to the doctor's office, the dentist, the psychotherapist, the chiropractor, etc.
- Ambulatory service centers and outpatient hospital services.
- Stays at hospitals and nursing homes
- Intermediate care facility, home health, and nursing services
- Services of managed care organizations
- Lab and x-ray services
- Emergency ambulance services

Health care goods

- Prescription and non-prescription medications
- Prescription and non-prescription medical devices

We generally think of health care as exempt from the sales tax, but in fact all the categories above in red are already subject to a sales tax in Vermont, albeit one that is imposed as a gross receipts tax and called a provider tax (See Appendix 3).

The provider tax has a unique feature in that Vermont and other states use revenue from the provider tax to help pay for Medicaid, and those provider tax dollars spent on Medicaid trigger the release of federal Medicaid dollars to the state. Per federal regulations, provider tax dollars cannot make up more than 25% of total state Medicaid spending, and at $169 million in provider taxes, Vermont is around

that level[8]. "Beyond Medicaid, states have the policy option to tax most types of providers and services and to designate or earmark the revenue for any state purpose."[9]
We note also that as it now stands, the provider tax is not leveled at all on some categories of health care, and it is leveled at different rates (between 3.3% and 6%) on the various categories on which it is levied. On prescriptions, it is not levied at a rate at all, but at a fixed dollar amount of 10 cents per prescription. All of this inconsistency adds complexity and reduces fairness, and the partial application of the provider tax to health care reduces stability and increases rates.

Every state except Alaska currently imposes provider taxes on at least some categories of health care. Beyond provider taxes, many states also impose a sales tax on some health care transactions. Of the 45 states with a sales tax, plus the District of Columbia:

- Four states (Delaware, Hawai'i, New Mexico, and Washington State) currently apply a sales tax or a gross receipts tax to physicians' and dentists' work[10].
- Thirty-seven states impose the sales tax on non-prescription drugs (See Appendix 1).
- One state (Illinois) currently applies a (1%) sales tax to prescription drugs.
- Thirty-two states apply the sales tax to non-prescription medical devices.[11]
- Nine states apply the sales tax to medical devices regardless of whether they are prescription or non-prescription.[12]

As noted above, there are four possible reasons that part of health care is exempt from the sales tax in Vermont: to protect low-income Vermonters; to promote health care; because it's seen as too complicated; and because it's always been exempt. We will examine the first three of those reasons in turn.

The Effect of Taxing Health Care on Low-Income Vermonters

Currently, low-income Vermonters are insulated from the cost of health care in a number of ways. For those living below 138% of the federal poverty level, the Medicaid program provides access to health care with very little in the way of out-of-pocket costs. For those between 138% and 200% of the federal poverty level, the ACA provides meaningful subsidies for insurance premiums and caps on out-of-

[8] "Provider Taxes Overview," Lanweil and Carbee, JFO and OLC, 2017, and LJFO SCHRM 2019 Revenue breakdown
[9] https://www.ncsl.org/research/health/health-provider-and-industry-state-taxes-and-fees.aspx
[10] Delaware and Washington by way of a gross receipts tax -- Federation of Tax Administrators 2017 State Sales Tax Survey (https://www.taxadmin.org/sales-taxation-of-services, data included as Appendix 1)
[11] https://salestaxhelp.com/states-tax-medical-devices
[12] Ibid.

pocket spending. The state also supports low-income Vermonters with Dr. Dynosaur (kids and pregnant women), long-term care assistance, and prescription drug assistance.[13]

Per the previously observed pattern, if the sole reason to exempt health care is to protect low-income Vermonters, and we assume as an illustration an expansion of our current 6% sales tax to the untaxed portion of health care, Vermont is foregoing $182.1 million dollars in tax revenue to protect low-income Vermonters from $9.3 million in cost.[14] We believe the above-described mechanisms for supporting low-income Vermonters' health care could be adapted to ensure that low-income Vermonters do not experience any increase in their costs for health care due to an expansion and unification of the sales tax on health care (with the usual caveat that we recommend a comprehensive analysis of the financial situation of low-income Vermonters).

In the end, we come to the same conclusion about health care that we did about the other exempt categories of necessities: **exempting health care is not an efficient way to protect low-income Vermonters from the cost of a sales tax on health care.**

Does Exempting Health Care from the Sales Tax Increase Vermonters' Access?

As far as maintaining the exemption to expand access to health care as a public good, Rand analysis of the available data[15] suggests that the price elasticity of demand for health care is -.17, which is to say, demand is very inelastic. This is even more true for low-income households, since Medicaid, state programs, and the ACA provide them with lower levels of cost-sharing, and "studies consistently find lower levels of demand elasticity at lower levels of cost-sharing."[16]

This means that a 3.5% tax on health care goods and services, even if it were passed on entirely to the consumer, would result in a reduction of health care utilization of less than six tenths of one percent. Again, the issue with access to health care isn't the 3.5%, it's the 100%.

Is Health Care Too Complicated to Subject to the Sales Tax?

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[13] https://info.healthconnect.vermont.gov/Medicaid, https://www.greenmountaincare.org/ , https://www.greenmountaincare.org/health-plans/long-term-care

[14] Low-income spending on health care is complicated by the state and federal assistance. However, good estimates of how much of their own money low-income Vermonters actually spend on health care are available: https://www.kff.org/other/state-indicator/distribution-by-fpl/?dataView=0&currentTimeframe=0&sortModel=%7B%22colId%22:%22Location%22,%22sort%22:%22asc%22%7D and https://www.rand.org/content/dam/rand/pubs/research_reports/RR900/RR901/RAND_RR901.pdf

[15] "The Elasticity of Demand for Health Care," RAND, 2005.

[16] Ibid.

One of the main complexities in Vermont's health care system is just how many parties are involved in paying for Vermonters' health care:

- The federal government through Medicaid, Medicare, Tri-care, subsidies provided by the ACA, and the federal government's portion of federal employees' health care expenses.
- Patients and the parents of patients up to age 26, through premiums, deductibles, co-pays, co-insurance, and payments for non-covered medical expenses.
- Organizations that provide health insurance to their employees and their employees' families, through premiums and contributions to HSA-like mechanisms for reimbursing employee out-of-pocket expenses.
- Private insurance companies, through their portion of patient expenses.
- The state government through the state portion of Medicaid; state programs to assist low-income Vermonters with health care costs; and the state's portion of state employees' health care expenses.
- Local governments, including local school systems through the local governments' part of insurance premiums and out-of-pocket health care costs for town employees and teachers and other school system employees.
- Hospitals who are required by federal law to provide emergency health care to all, regardless of ability to pay. To offset the costs of services for which the patient cannot pay, the hospitals are forced to increase charges to private insurance companies. To cover those increases, private insurance companies do two things: increase the premiums that organizations and individuals pay; and reduce coverage by increasing patients' out-of-pocket expenses.

However, as noted above, even when the federal or state governments are paying, if they are paying for goods or services for an individual, those transactions are eligible for a sales tax. Hawai'i's excise tax on health care services applies to doctors and dentists and includes amounts received from patients and health insurance companies.[17] Michigan specifically taxes medical services when provided by Medicaid managed care organizations,[18] and Ohio also makes special provision for applying the sales tax to medical services received through a "Medicaid health insuring corporation."[19]

Providers in Vermont already bill patients and all the other payers, and as the other payers already bill patients, **we do not foresee particular additional complexity in collecting or remitting the sales tax on health care transactions.**

[17] https://salestaxhelp.com/medical-services-taxable
[18] Ibid.
[19] Ibid.

Since we believe a sales tax can be applied to health care without harming low-income Vermonters, and without limiting Vermonters' access to health care, and without undue complexity, and since we see meaningful benefits for Vermonters in terms of a lower sales tax rate and a simpler and more fair tax system, and since we see benefits to the state government in terms of a more stable and sustainable revenue stream and a simpler tax code, we recommend replacing Vermont's partial and inconsistent provider tax with a consistent sales tax on all consumer health care transactions.

We believe that Vermont could use part of the sales tax on health care to fund the portion of Medicaid currently funded with the provider tax, and trigger the release of the same federal dollars to Vermont. If not, our alternate recommendation is to apply the sales tax to all the parts of health care that are not currently subject to the provider tax, and to work to bring the various rates and systems of provider tax into harmony with the sales tax rate.

We acknowledge the complexity of holding low-income Vermonters harmless given the number of ways their health care is paid for, and given the fact that people tend to move multiple times in and out of Medicaid as their income fluctuates. We refer back to our overarching recommendation in Chapter 1 regarding low-income Vermonters and the tax code, and recommend that a sales tax on health care be included in the total income/benefits/tax solution.

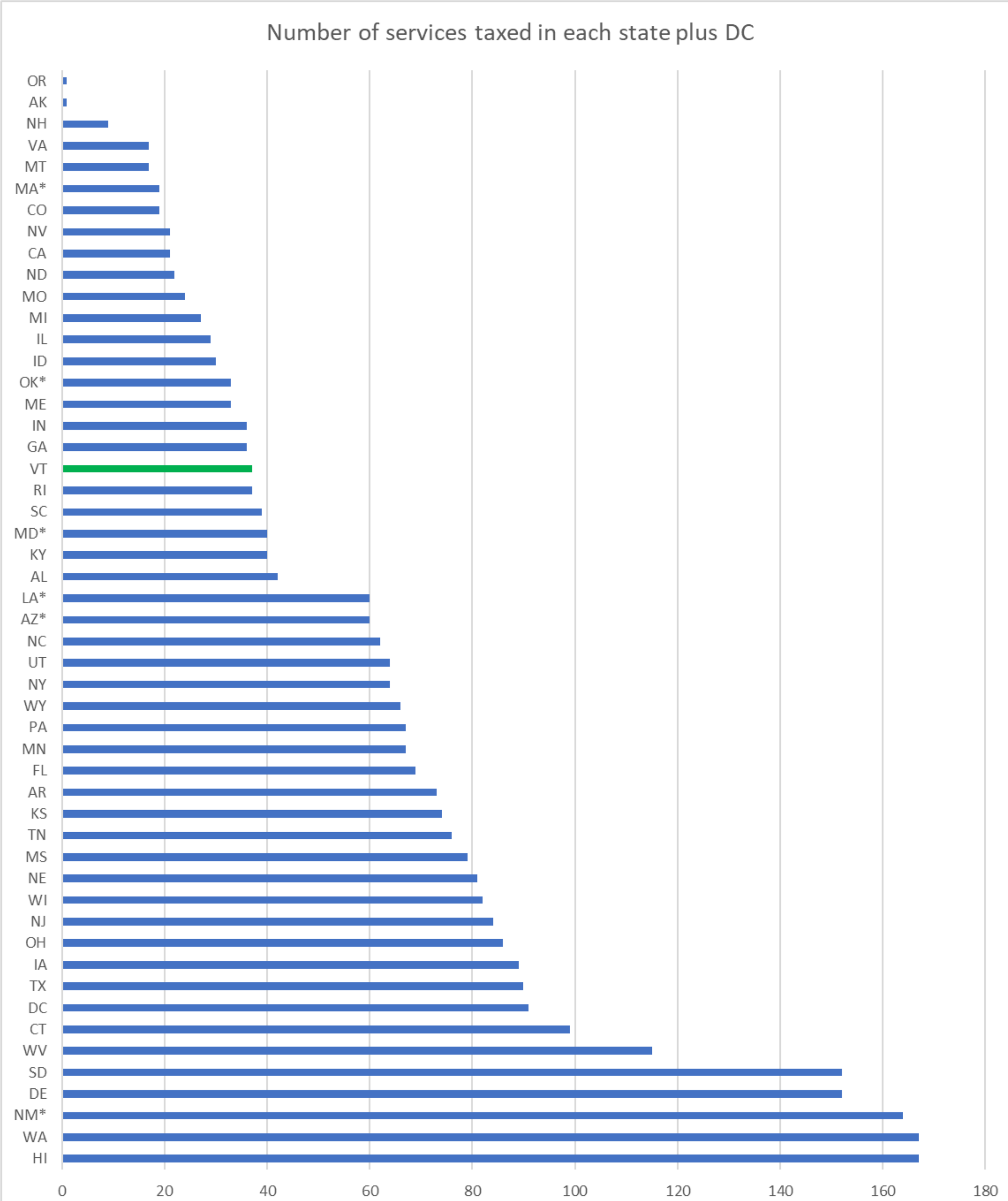
Further Considerations on Expanding the Sales Tax Base

Meaningful (sales tax) base broadening (is) a worthwhile endeavor, as base expansion allows for greater tax neutrality and revenue stability, and can be paired with more targeted relief for low-income households. – TaxFoundation.org

We conclude that there are no good reasons to exempt any categories of goods and services from the sales tax. We further note that there are some affirmative reasons to include as many categories as possible.

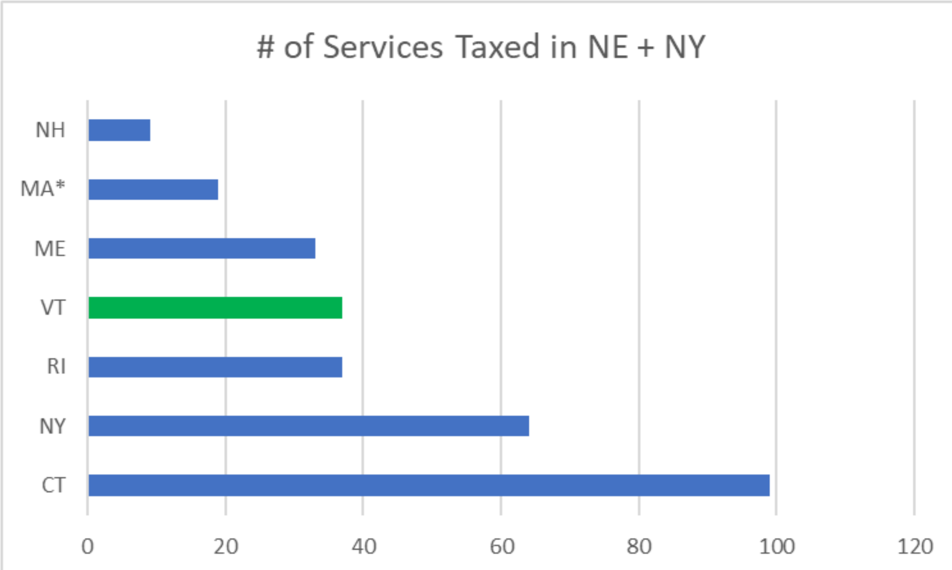
Historically, the sales tax has been applied mostly to goods purchased in person, and as the economy evolves toward more services and more online transactions, it is important to the goals of fairness and sustainability that the tax structure shift with it.

By some measures, Vermont has a fairly narrow sales tax base. If you look just at the number of services Vermont taxes, you see that Vermont is on the lower end of the spectrum.



From VT Dept of Taxes, updated with 2017 data from the FTA study

If you take the same look at New York and New England, you see that Vermont is middle of the pack.



From VT Dept of Taxes, updated with 2017 data from the FTA study

Among the top five states in terms of tourism as a percent of the total state economy, Vermont has by far the narrowest sales tax base and collects the least in terms of sales tax as a percent of total state and local government revenue.

Vermont: A Tourism-dependent Outlier

- Vermont is one of only five states in which the Accommodations and Food Services sector accounts for over 4% of Gross State Product.
- The other four states all rank in the top 10 for widest state sales tax breadth. Vermont ranks 42nd (fourth to last among states with statewide sales tax).
- General Sales Tax accounts for over a third of state and local tax collections in three of the states, a fifth in Maine, but only 10% in Vermont.

Tourism-dependent states tend to lean more heavily on sales taxes in order to alleviate the tax burden on state residents.

	Accommodation and Food Services as % of GSP	Acc. and Food Services Rank	State Sales Tax Breadth	Breadth Rank	State & Local General Sales Tax Collections per Capita	Sales Tax Collect. Rank	General Sales Tax as % of State & Local Tax Collections
Nevada	11.9%	1	54%	4	$ 1,846	4	41%
Hawaii	8.4%	2	105%	1	$ 2,431	2	37%
Vermont	4.8%	3	25%	42	$ 627	45	10%
Maine	4.1%	4	44%	8	$ 1,080	27	20%
Florida	4.1%	5	43%	9	$ 1,323	16	36%

Source: GSP Share from U.S. BEA. Tax collections from Tax Foundation Facts and Figures 2020.

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Similarly, among the top five states in terms of retail as a % of the total state economy, Vermont has by far the narrowest sales tax base and collects the least in terms of sales tax as a percent of total state and local government revenue.

Vermont: An Outlier Among States with Large Retail Trade

- Vermont is one of only five states in which Retail Trade accounts for over 8% of Gross State Product.
- General Sales Tax accounts for 20-46% of state and local tax collections in the other four states, but only 10% in Vermont

Likewise, states with economies dependent on retail trade tend to lean more heavily on sales taxes for state revenue.

	Retail Trade as % of GSP	Retail Rank	State Sales Tax Breadth	Breadth Rank	State & Local General Sales Tax Collections per Capita	Sales Collections Rank	General Sales Tax as % of State & Local Tax Collections
Washington	9.0%	1	39%	16	$2,476	1	46%
Maine	8.8%	2	44%	8	$1,080	27	20%
Mississippi	8.7%	3	46%	6	$1,180	20	32%
Idaho	8.3%	4	40%	14	$ 984	33	26%
Vermont	8.2%	5	25%	42	$ 627	45	10%

Source: GSP Share from U.S. BEA. Tax collections from Tax Foundation Facts and Figures 2020.`

Additionally, of the 45 states that have a sales tax, plus Washington DC, Vermont is one of only seven states that exempt all three of groceries, clothing, and prescription drugs.

Tax theory suggests that as a general rule, a broad base is better than a narrow base. There are at least three reasons for this:

1. The broader the base, the more stable and sustainable the tax revenue, as any particular category or industry makes up a smaller part of the tax base, and growth or decline in that category or industry has a smaller effect on overall tax revenue, and more chance of being offset by a different industry moving in the opposite direction.
2. A narrow tax base implies judgements and discretionary choices about what should or should not be exempt. Sometimes intentionally, sometimes inadvertently, these choices necessarily advantage some consumers over others, and advantage some businesses and non-profits over others, calling the fairness of these taxes into question, regardless of the nobility of their goals.
3. The broader the base, the more choices policy makers have for the mix of increasing revenue and decreasing tax rates.

The Vermont tax code has some odd inconsistencies: for instance, Vermont deems transportation a necessity, so the state exempts automobile repair services, but taxes the purchase of automobiles. Vermont exempts the purchase of home heating, but taxes the purchase of the home.

With Vermont's sixty or so exemptions from the sales tax, Vermont also has issues of unfairness and complexity. You usually think of tax fairness from the point of view of the person paying the tax, and from that point of view, Vermont's patchwork of taxable and non-taxable purchases inadvertently favors people who happen to consume more of the non-taxables and handicaps people who happen to consume more taxables. It is also valuable to look at fairness from the point of view of the people producing the goods: it is unfair to tax the work of people whose labor creates goods, but not to tax the work of people whose work produces services.

By trying to use the sales tax as a tool to encourage community goods, and exemptions from the sales tax for necessities as a tool to protect low-income Vermonters, the legislature puts itself in the position of having to decide what's necessary, and what's good, and what's not. Food is a necessity; is soda? Is candy? Does the legislature really want to be in the business of making judgements about what's necessary if it doesn't have to? Clothing is necessary; is a $50 hat? A $500 pair of boots? A kidney transplant is necessary – is a fourth round of chemo? How about cosmetic surgery? How about cosmetic surgery to correct a deformity that is causing meaningful emotional distress to the patient? Whatever the legislature decides is necessary will necessarily be subjective and somewhat arbitrary, and distortive. Taxing clothing above $150, for instance, will cause some consumers to buy the $145 dress they like less, and not get the $154 dress they like more, since the $154 dress with a 6% sales tax becomes $163.25, and somewhat insignificant 6% difference between $145 and $154 becomes a more meaningful 12.6% difference.

Vermont's current system also puts state revenue at risk, as the economy can evolve away from taxable categories, like gasoline, and toward untaxed categories, like home electricity used to charge electric cars.

We note that the Blue Ribbon Tax Commission Recommendations 2A and 2B recommended expanding the sales tax to include "all consumer-purchased services with limited exceptions for certain health and education services and business-to-business service transactions," and all consumer purchases of goods, "retaining only the exemptions for food and prescription drugs." As we have seen, we see no compelling reason to exempt consumer purchases of health care, education, food, or prescription drugs.

<u>Because we find no compelling reason to exempt any form of consumer activity from the Vermont sales tax, and in view of the advantages for fairness, simplicity, and sustainability, we recommend that Vermont's sales tax base be expanded to include all consumer purchases of goods and services, and to exclude all business inputs (see Appendix 2).</u>

<u>If Vermont Expands the Tax Base, What Should The Legislature Do with the Money?</u>

When you expand the base, you have to decide how much of the additional revenue you are going to spend, how much you are going to rebate to low-income Vermonters, and how much you are going to put toward lowering the tax rate.

In approximate numbers, if you apply the sales tax to all consumer-level purchases, assuming that you apply the sales tax to all consumer health care and repeal the provider tax:

1A. With the current 6% sales tax, making no accommodation to protect low-income Vermonters, you would add $549.3 million in sales tax revenue to the current sales tax revenue of $389.3 million.

1B. With the same assumptions, but rebating to low-income Vermonters the full among collected from them, and assuming a 15% cost to administer the rebate program, a 6% sales tax will raise an additional $467.3 million.

2A. If you choose to make this change revenue-neutral, and use the broadening of the tax base to reduce the tax rate, making no accommodation for low-income Vermonters, you can lower the rate to 3.0%.

2B. In the revenue-neutral scenario, if you hold low-income Vermonters harmless, you can lower the sales tax rate to 3.2%.

We have reviewed the suggestion that a 3.0% sales tax on necessities would not cause any significant harm to low-income Vermonters, due to programs already in place and due to inelasticity of demand. On balance, we believe that ensuring the well-being of all Vermonters is so important that the legislature should exercise an abundance of caution, and we therefore do not recommend adding a tax to any category without an affirmative way to keep low-income Vermonters whole.

If you expand the sales tax to all consumer purchases, and you ensure that low-income Vermonters will not bear any new financial burden, the last question we examine in this section is how much of the additional revenue Vermont should allocate to new spending, and how much Vermont should allocate to lowering the sales tax rate.

There are significant unmet needs in Vermont toward which additional revenue could be allocated, including adapting our infrastructure for the changes in weather expected from climate change.

There are also significant benefits to a meaningful lowering of the Vermont sales tax rate:

- Vermonters pay a low, uniform sales tax rate, making things more fair for all Vermonters, and reducing the distortions in economic behavior created by a higher rate imposed inconsistently.
- If you hold low-income Vermonters harmless, they will be better off, as they will not bear any increased costs for things that are currently not taxed, and, as with all Vermonters, the tax they pay on things that are currently taxed will go down.
- Vermont businesses benefit from fairer system that treats every business's output the same. Vermont businesses also benefit from a simpler tax code. We do note that the administrative burden on businesses with consumer sales that do not currently charge sales tax will increase, and the many businesses who provide services to consumers and to other businesses will have the burden of keeping their sales to consumers (taxable) separate from their sales to other businesses (not taxable). We note that one of us works at a small manufacturing company that sells both to consumers and to other businesses, and does not have any difficulty in charging sales tax to consumers and exempting sales to other businesses.
- The Vermont government benefits from a more stable and sustainable Vermont tax base, and a simpler tax code that is easier to administer.
- The Vermont economy benefits from an increased competitive advantage on sales tax relative to New York (4%) and Massachusetts (6.25%) and an advantage compared to every other state with a sales tax except Delaware and Colorado, and a decreased competitive disadvantage relative to New Hampshire and the four other non-sales-tax states.

We therefore recommend that the revenue from expanding Vermont's sales tax base be used first to hold low-income Vermonters harmless, and that most of the remainder be used to lower the sales tax rate, with the smallest part used to fund additional spending. Specifically, we recommend applying a 3.5% sales tax to all consumer purchases of goods and services, creating mechanisms to make this change neutral for low-income Vermonters, and deploying the additional $45 million to tackle some of the current unmet needs and anticipated future needs that we have identified.

We would suggest that it is much easier to expand the base to include everything than it is to expand the base to include almost everything. If there is a single exception, there will be pressure from industries/companies/sectors and their lobbyists to give them an exemption as well. This is misguided, since as we've noted, a sales tax exemption does not encourage any significant amount of additional activity, but, as you all know, sometimes people are misguided.

This change will make the sales tax more fair, more sustainable, and simpler; it will do no harm to low-income Vermonters; and it will make Vermont's sales tax third-lowest among the 45 sales-tax states and DC, after Delaware (gross receipts tax) and Colorado (2.9% sales tax).

Meals Tax

There are currently eight exemptions to the Vermont Meals tax, Vermont taxes restaurant meals, and we are proposing to tax groceries, but the notion of taxing meals prepared at home is almost nonsensical, and four of the eight exemptions to the Meals tax are simply to avoid taxing meals prepared at a person's "home," even if it's a temporary home, including retirement communities, summer camps, hospitals, convalescent and nursing homes, and schools. We support these exemptions.

Two of the remaining four exemptions to the Meals tax exist to allow non-profits to use as much of the money they raise from selling meals as possible toward their mission, whether they sell the meals on their premises or at fairs/picnics etc. The statute specifically requires 100% of the income from selling these meals to be used for the non-profit's mission. We support these exemptions as well.

The seventh exemption to the Meals tax is for meals provided to people who work in restaurants and hotels during their shift. The total dollar value of this benefit is relatively small, the hassle of keeping track of the value of the meals consumed by staff when their working is high, so we do not see any justification for ending this exemption, and support it's continuation.

The final exemption from the Meals tax is for grocery-type items furnished for take-out, including "whole pies, cakes, and loaves of bread, single-serving baker items sold in quantities of three or more, deli and candy sales by weight, whole uncooked pizzas, and larger containers of ice cream, salad dressing, sauces, cider, or milk."[20] Since we are recommending that the sales tax be extended to groceries, **we recommend ending this exemption and including these items in the 3.5% sales tax**.

Rooms Tax

[20] Vermont Tax Expenditures 2019 Biennial Report, 2019.

The Vermont Rooms tax is intended to tax the act of staying somewhere for fun. It is not intended to tax anyone's long-term accommodation. Of the six exemptions to the Rooms tax, four are designed to avoid taxing people's residences: those exemptions are for rooms at a retirement community; in a hospital, sanatorium, convalescent home, nursing home, or assisted living facility; student housing; and summer camp accommodations. We support continuing these exemptions.

The fifth exemption to the Rooms tax is for rooms rented on the premises of a non-profit. As with the exemption to the Meals tax, the purpose of this exemption is to allow the non-profit to further their public-service mission. While data is not available on how much money this is, it is hard to imagine it is a meaningful amount of money, and we support continuing this exemption

The final exemption to the Rooms tax is rooms provided employees of hotels and restaurants as part of their jobs. We believe that housing is a such a significant benefit that this should included in the employee's income. We therefore support the exemption from the Rooms tax, and **recommend that housing provided to an employee as part of their job be included in their taxable income.**

Excise Taxes

This Commission took no testimony on the Excise tax, and as noted, we believe it is generally working as intended, and is applied to appropriate categories as appropriate rates.

As discussed further below in the section on long-term structural changes to our economy, climate, and society, we expect that over the next 20 years, gasoline use will drop dramatically. We note that California has just passed a law banning the sale of new gas-powered passenger cars as of 2035, following in the footsteps of several European countries with similar legislation. We also observe more and more electric cars on Vermont's roads, and expect that Vermont's newly formed Climate Council will work to accelerate the transition to clean transportation, whether or not Vermont joins the regional Transportation Climate Initiative.

As a result, one of the big sources of revenue for the transportation fund is likely to dry up. There are also issues of fairness – right now, people driving gas-powered cars are paying for the roads that people driving electric cars are using for free.

We therefore recommend an annual excise tax on electric cars, to be paid as part of the annual registration process, set to be equal to the average that Vermonters pay in gasoline excise taxes.

We hope these recommendations regarding Vermont's consumption taxes will further the goals of making both Vermont's consumption taxes and Vermont's overall tax system fairer, simpler, and more sustainable over the next 20 years.

Appendix 1: See spreadsheet “Appendix 1”

Appendix 2: See spreadsheet “Appendix 2”

Appendix 3: 2018 % of Vermont Population Living Under 200% of the Federal Poverty Line

Vermont County or State	Population Under 200% FPL (All Ages)	Population (All Ages)	Percent of Population Under 200% FPL (All Ages)	Reliability
Addison County	7714	34003	22.69	5.1496
Bennington County	10776	34482	31.25	5.7352
Caledonia County	9934	29294	33.91	5.4338
Chittenden County	38157	152414	25.04	3.5722
Essex County	2368	6197	38.21	6.7272
Franklin County	10571	48544	21.78	6.2217
Grand Isle County	1291	6922	18.65	8.7827
Lamoille County	7941	24668	32.19	5.8676
Orange County	8237	28364	29.04	4.5401
Orleans County	9576	26061	36.74	4.0753
Rutland County	16182	57156	28.31	4.0785
Washington County	15008	56211	26.7	4.559
Windham County	13390	41529	32.24	4.5053
Windsor County	14968	54489	27.47	4.7154
Vermont	166113	600334	27.67	1.4365
United States	100490740	314943184	31.91	0.1548

Source: https://vermontinsights.org/population-all-ages-living-in-households-under-the-200-federal-poverty-level-in-vermont/

Appendix 4: Vermont's Provider Tax

Of the 19 Federal Classes of Health Care Services,	
Vermont Levies a Provider Tax on	**Vermont Does Not Levy a Provider Tax on**
Inpatient hospital services	Physicians' services
Outpatient hospital services	Ambulatory service centers
Nursing facility services	Nursing services
Emergency ambulance services	Podiatric services
Services of intermediate care facilities	Dental services
Home health care services	Services of managed care organizations
Outpatient prescription drugs	Laboratory and x-ray services
	Therapist services
	Psychological services
	Optometric services
	Chiropractic services
	Other health care items/services for which the state has enacted a licensing or certification fee

Source: "Provider Taxes Overview," Langweil & Carbee, JFO and OLC, January 26, 2017

Health care subject to provider tax	2017 rate	2017 tax	2017 implied revenue
Hospitals	6%	$142,286,414	$2,371,440,233
Nursing Homes	6%	$15,039,003	$250,650,050
Home Health	3.63%	$4,793,713	$132,058,209
Intermediate Care Facilities	5.90%	$73,708	$1,249,288
Pharmacy	*	$780,000	$514,800,000
Ambulance	3.30%	$1,200,000	$36,363,636
Total			$3,306,561,417

*10 cents/script at BCBSVT's average of $66/prescription

Source: "Provider Taxes Overview," Langweil & Carbee, JFO and OLC, January 26, 2017

Appendix 5: Incidence of Health Care Spending in Vermont

Table 4.1. Nominal Incidence of Total Spending on Health by Vermont Residents, 2012 and 2017

	Spending Amount (Millions)	
	2012	2017
Employer market	**$1,690**	**$2,034**
Employee premium contributions	$395	$478
Retiree premium contributions	$12	$18
Vermont employer premium contributions for Vermont residents	$1,188	$1,431
<50 workers	$284	$287
50–99 workers	$65	$76
100–499 workers	$205	$248
500+ workers	$634	$820
Out-of-state employer premium contributions for Vermont residents	$95	$107
Medicare	**$1,074**	**$1,440**
Federal Medicare spending	$873	$1,166
Medicare premium contributions	$189	$256
Medicare supplemental policies	$12	$18
Medicaid/CHIP/VHAP	**$1,246**	**$1,661**
Federal Medicaid spending	$717	$1,033
State Medicaid spending	$518	$623
Medicaid premium contributions	$11	$4
Non-group/Catamount/Exchange	**$85**	**$359**
Individual market premium contributions	$58	$221
Federal private insurance subsidies	$15	$127
State private insurance subsidies	$11	$10
Out-of-pocket	**$720**	**$944**
Insured	$686	$937
Uninsured	$34	$7
Other	**$270**	**$373**
Federal military spending	$55	$62
TRICARE premium contributions	$1	$1
Other federal spending	$138	$214
Other state spending	$76	$96
TOTAL	**$5,084**	**$6,810**

NOTES: Other federal and state spending includes DVHA appropriations, disproportionate share hospital (DSH) payments, and non-Medicaid health-related appropriations. Medicaid premium contributions are VHAP and CHIP premiums. Individual market premium contributions are non-group, Catamount, and Exchange premiums

Source: RAND, "The Economic Incidence of Health Care Spending in Vermont," 2015.

https://www.rand.org/content/dam/rand/pubs/research_reports/RR900/RR901/RAND_RR901.pdf

Appendix 6: Vermont Sales Tax Expenditures

Expenditures and Estimates from 2019 Report	FY 2016 estimated	FY 2017 estimated	FY 2020 estimated	Estimated 2020 sales
Sales of food	117,260,000	117,030,000	126,150,000	$2,102,500,000
Medical products	60,730,000	64,300,000	75,500,000	$1,258,333,333
Energy purchases for a residence	37,800,000	39,920,000	42,150,000	$702,500,000
Clothing and footwear	28,000,000	28,800,000	30,200,000	$503,333,333
Agricultural inputs	18,560,000	18,900,000	20,380,000	$339,666,667
Veterinary supplies	3,890,000	4,230,000	5,020,000	$83,666,667
Energy purchases for farming	4,230,000	4,310,000	4,640,000	$77,333,333
Agricultural machinery/equipment	2,490,000	2,510,000	2,640,000	$44,000,000
Admission to nonprofit museums	2,400,000	2,400,000	2,600,000	$43,333,333
Newspapers	2,940,000	2,820,000	2,390,000	$39,833,333
Fuels for railroads/off-road uses	1,990,000	2,240,000	2,310,000	$38,500,000
Property in net metering system	2,790,000	1,430,000	2,290,000	$38,166,667
Funeral charges	1,900,000	1,900,000	2,000,000	$33,333,333
Rentals of washing facilities	1,100,000	1,100,000	1,200,000	$20,000,000
Sales of films to movie theaters	800,000	800,000	900,000	$15,000,000
Sales of mobile homes/modular housing	200,000	200,000	300,000	$5,000,000
Railroad rolling stock/depreciable parts	200,000	200,000	200,000	$3,333,333
TOTAL	**287,280,000**	**293,090,000**	**320,870,000**	
Total consumer			**$281,290,000**	
Total consumer goods				$234,540,000
Total consumer services				$46,750,000