

## DRAFT 12.28.2020

### Chapter 7: 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, the Motor Vehicle Purchase and Use Tax, and Excise Taxes. For a variety of reasons, both economic theory and tax policy theory approve of most consumption taxes when applied broadly at a low rate. Our goal is to make the Vermont tax system overall more fair, more sustainable, and simpler, and our recommendations for consumption taxes aim to further those goals in the overall financial picture of Vermonters, and specifically with respect to consumption taxes.

Our most general recommendation to achieve those goals is to broaden Vermont’s sales tax base. As we discuss below, among the 45 states with a sales tax, Vermont’s sales tax base is unusually narrow. Much of what we recommend about broadening Vermont’s sales tax base follows recommendations made by the Blue Ribbon Tax Commission, and we note that two different commissions, separated by ten years and made up of six different Vermonters with very different backgrounds, having together taken testimony from a broad range of Vermonters, have reached the same conclusion and made the same recommendation. Our recommendations would move Vermont into the group of two or three states, including Washington State, New Mexico, and Hawai’i, with the broadest sales tax bases in the nation.

We recognize ~~the fact~~ that in terms of tax policy, being in the middle of the pack of states provides a sense of safety. ~~The legislature is insulated from accusations of taking dangerously extreme measures.~~ It’s less likely that Vermont will go very wrong if the state is doing things that are working in a good number of other states. There are, however, areas in which Vermont prides itself in being ~~at the leading edge~~ in a small minority, or even standing alone: Vermonters are proud of being one of the lowest-crime states in the country; Vermonters are proud of being one of only a very few states with no billboards; and in tax policy, Vermonters can be justly proud that Vermont is one of two or three states

that are leading the way in using the state tax code to reduce inequality: We see very little risk to Vermont's reputation or economy in being among the few states with the broadest sales tax base, and much benefit in terms of the fairness and stability of our sales tax system. We also feel that having one of the lowest sales tax rates in the country poses no risk and provides both economic and reputational advantages.

The sales tax was created as a tax on tangible personal property (TPP), which by definition did not include services. Over the years, all 45 states with a sales tax have expanded it to include some services, although often with the questionable somewhat convoluted justifications that about how a particular service, like ski rental, is a substitute for a purchase, like buying skis. In addition to all the categories left out of the tax by definition, there are others that are specifically exempted by statute. In Vermont, these include a variety of necessities like groceries, clothing, and home heating oil.

We examine the reasons that some categories of goods and services are either exempt or excluded from the sales tax, and weigh the logic and the evidence as to whether those reasons ~~ey~~ are compelling or not.

We also examine the hurdles to expanding the sales tax base, including the likely concerns from people in businesses that do not currently collect sales taxes and, from low-income Vermonters and advocates for low-income Vermonters, and including we also consider various technical and administrative challenges.

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 (subject to some limits), but when a consumer purchases something from a tax-exempt non-profit, it is generally taxable.

Since ~~As~~ health care makes up about a third of the consumer-level economic activity in Vermont, we examine the current taxes on health care and whether there is a way to simplify and broaden them without restricting Vermonters' access to health care.

Finally, we examine the question of what mix of lowering rates and increasing revenue Vermont should pursue based on a broader sales tax base, and conclude that after protecting low-income Vermonters and administrative costs, essentially all of the gain should be put toward lowering the rates.

**Value-Added Taxes, ~~and Transaction Taxes, and Gross Receipts Taxes: Threewe Things We Do NOT Recommend~~**

Globally, the value-added tax (“ad-valorem” or “VAT”) is the most common form of consumption tax, used in over 160 countries including all European countries, Canada, Australia, Japan, India, China, and almost all the countries in Latin America.<sup>1</sup> A VAT is collected at each step of the production process, from raw materials to consumer, but is not charged on the value of the product, but only on the value that is added at each step of the process. If you imagine Vermont with a 6% VAT, an ice cream company buys cream from a farmer for \$2/lb. The farmer collects \$2.12, and sends 12 cents to the state. The ice cream company then sells a pint of ice cream to the local grocery store for \$3, and collects \$3.18, but, having already paid 12 cents in VAT, only sends 6 cents to the state. The grocery store sells the pint of ice cream to you for \$5, collects \$5.30, of which it sends 12 cents to the state. The end result is the same as a 6% sales tax – you, the consumer, pay 6%, or 30 cents, on your \$5 purchase of ice cream, and the state collects 6%, or 30 cents, on that pint.

From the consumer’s point of view, there is no difference between a sales tax and a VAT. From the point of view of the businesses involved in the supply chain, a VAT is more burdensome to administer, although this is somewhat offset by the fact that businesses are relieved of the burden of determining whether a customer is a consumer or a business. From the government’s point of view, the revenue raised is the same, but the VAT has two advantages – it’s harder to evade, and the government receives the revenue in multiple payments over time instead of one payment at end of the process, when the consumer makes the purchase. Because the US has a somewhat unusual system of taxing authorities at the federal, state, and local levels, it does not seem that the VAT is viable in the United States. A VAT can only work at the federal level, so you either take away the states’ ability to levy a sales tax and do a national VAT instead, or you layer a national VAT on top of a sales tax, which leads to double taxation of sales.<sup>2</sup> “A VAT, however, requires a national entity to operate the system of remittances and credits because of interstate transactions. Therefore, it would be exceedingly difficult, if not impossible, for a state on its own to implement a VAT.”<sup>3</sup>

We therefore do not recommend consideration of a VAT for Vermont to replace the sales tax.

~~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~~

<sup>1</sup> International Monetary Fund, <https://www.imf.org/external/np/fad/tpaf/pages/vat.htm>

<sup>2</sup> Graham Campbell, Memo on Transaction Tax Details, May 21, 2018.

<sup>3</sup> Ibid.

~~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 (subject to some limits), but when a consumer purchases something from a tax-exempt non-profit, it is generally taxable.~~

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

As an example, take 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 collecting \$9.36 more, but the consumer ends up paying \$12.36 more.

This effect ("pyramiding" or "cascading") 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.

For the same reason, we do not recommend a gross receipts tax. While a small handful of states impose a gross receipts tax, these taxes typically apply to business-to-business (“B2B”) transactions as well as consumer purchases (“B2C”), and therefore cause the same pyramiding as a transaction tax.

### **The Effects of Adding, Increasing, Removing, or Decreasing the Sales Tax**

We also examined the effect of changes in the sales tax on levels of consumption and/or access due to price elasticity of demand, which is to say, how much demand or access decreases/increases in response to an increase/decrease in the sales tax. 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.”*<sup>4</sup> There is some evidence that in the month prior to a sales tax increase, consumers stockpile goods, so demand goes up in the month prior and then down in the months after, but once that stockpile is worked off, demand goes back to where it was prior to the tax increase. Presumably, the opposite is also true –in the month ahead of an announced decrease in the sales tax, people may purchase less, waiting for the tax to go down. It is also important to note that price elasticity of demand varies based on household income – lower-income households are more likely to reduce their purchases in response to a small price increase than are higher-income households. Price elasticity of demand also varies based on the magnitude of the change in price. While a 5% price increase may cause a 3% decrease in demand (price elasticity of demand of -.6), a 50% price increase may cause a 40% decrease in demand (price elasticity of -.8).

Demand is particularly inelastic 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. As is often the case, health care is unique in that “demand,” which is to say, how much people buy, is often determined not by the consumer/patient, but by the doctor. A further factor distorting “demand” in health care is the fact that often neither doctor nor patient knows or much cares how much a particular treatment costs. Both of these phenomena are likely to be important factors in the inelasticity of health care “demand.” We reiterate our recommendation from Chapter 5 that we make recommend structural changes to the Vermont’s programs for low-income Vermonters to ensure that the changes we are recommending do not reduce access to any of these necessities for them.

~~Another further mitigating~~ factor decreasing the net effect of the changes we are recommending is that even if demand did have some price response 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

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<sup>4</sup> “How Do People Respond to Sales Tax Increases,” Baker et al., 2017.

decrease in demand for the roughly 50% of purchases of goods and services that are not currently subject to the sales tax. ~~However but~~ that would be partially offset by the increase in demand for the 50% 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 ([online at XXX](#)), we have included four calculations: for both holding low-income Vermonters harmless from the application of the sales tax to categories currently not taxed and making no provision to do so, we model scenarios with both price elasticity of demand and no elasticity. You will see that the inclusion or exclusion of price elasticity of demand does not make a large difference to the results, while holding low-income Vermonters harmless does make a meaningful difference.

~~In contrast with the changes of a few percent that we are contemplating here, 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 are therefore mindful of the effects on demand in the analysis of the excise tax.

Vermont's current 6% sales tax exempts or excludes some categories of goods and most categories of ~~service~~ates. 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 most necessities like groceries, clothing, home heating, and medical products. Vermont currently exempts most sales of business inputs. Finally, Vermont currently taxes about ~~45~~<sup>60</sup> of the ~~260~~ or so services that are taxed by at least one other state (See Appendices ~~7-1 and 7-2~~<sup>7-1 and 7-2</sup>).

It is also true that the exemptions to Vermont's sales tax have been enacted over many decades by many different legislatures, and the original intent of each exemption is not always clear. However, there appear to be ~~are~~ six main reasons that some categories of goods and services are exempt or excluded 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 public 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. Along with its other categories, 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 and education are probably the only two sectors to fall into all four of these categories.
5. Some categories are so small that the administrative burden 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, and if not, is there a better way to achieve this goal?
2. Are sales tax exemptions an effective way to promote public goods, and 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 in the lowest four deciles of household income. This very roughly corresponds to households making less than 80% of the median income<sup>5</sup>, which is the definition used by HUD, USDA, and Vermont's Agency of Commerce and Community Development in its housing needs assessment. This definition is broader than some other measures, as it equates very roughly to between 250% and 300% of the federal poverty line<sup>6</sup>, so it yields higher and more conservative estimates of the costs of protecting low-income Vermonters than other measures would. While we define low-income Vermonters as those in the lower 40% of the income distribution for purposes of discussion and illustration, please note our recommendation in Chapter 5+ for an analysis of the total financial picture of households ranging from the lowest household incomes up to 400% of the federal poverty line and a policy initiative to eliminate

<sup>5</sup> <https://www.census.gov/quickfacts/VT>.

<sup>6</sup> [https://www.healthvermont.gov/sites/default/files/documents/pdf/VHHIS\\_Report\\_2018.pdf](https://www.healthvermont.gov/sites/default/files/documents/pdf/VHHIS_Report_2018.pdf), Appendix B, p. 51.

benefits cliffs for people moving up through those income levels and to insulate them from additional burden based on our proposed changes to Vermont’s tax structure:

For reference, median household income in Vermont is around \$62,000<sup>7</sup>, and the federal poverty level for a family of three is \$21,720<sup>8</sup>, so for a family of three, 80% of median household income is around \$49,600, 250% of the federal poverty line is \$54,300, and the 40<sup>th</sup> percentile of household income in Vermont is around \$49,900<sup>9</sup>.

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Health care, groceries, home energy, education, clothing, and car repair services account for about ~~85.90%~~ of the private consumer spending that is currently not included in the sales tax in Vermont (See Appendix ~~7-3XXXX~~). Health care is the largest sector, and is the most complicated case, and the one with the most reasons for exclusion, 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 27.8% of Vermont’s total private spend on groceries<sup>10</sup>. 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<sup>11</sup> to provide \$35.1 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 \$35.1 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 \$85.8 million which it could put toward lowering the sales tax rate and/or increasing spending, in whatever ratio the legislature decided was appropriate.

As noted in Chapter 5+ 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

<sup>7</sup> <https://www.census.gov/quickfacts/VT>.

<sup>8</sup> <https://aspe.hhs.gov/poverty-guidelines>

<sup>9</sup> <https://data.census.gov/cedsci/table?g=0400000US50&tid=ACSDP5Y2019.DP03>

<sup>10</sup> <https://www.bls.gov/cex/2019/aggregate/decile.pdf> -- state-level data not available, assumes Vermont mirrors national data.

<sup>11</sup> Vermont Tax Expenditures 2019 Biennial Report, 2019.



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 grocery sales tax payments to the lower end of the low-income spectrum, with a new mechanism required for remitting sales tax payments to people in the higher end of the low-income spectrum.

*“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 one looks at the other big categories of private consumer spending that are currently exempt from the sales tax, one finds the same pattern. Using 6% as an example, in home energy consumption, the state is foregoing roughly \$42.1 million in revenue<sup>12</sup> to protect low-income Vermonters from an \$13.2 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 \$13.2 million back to low-income Vermonters through the LIHEAP program, and end up (again assuming a 15% administration cost) with \$26.9 million per year for increasing spending and/or decreasing the rate.

Low-income Vermonters spend about 17.4% of the total private dollars spent on education<sup>13</sup>, so again, using 6% as an example, the state is foregoing \$59.1 million in revenue to protect low-income Vermonters from \$10.3 million in sales tax burden.<sup>14</sup> 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, and that better**

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<sup>12</sup> Vermont Tax Expenditures 2019 Biennial Report, 2019.

<sup>13</sup> <https://www.bls.gov/cex/2019/aggregate/decile.pdf> -- state-level data not available, assumes Vermont mirrors national data.

<sup>14</sup> 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> . See also <https://accd.vermont.gov/sites/accdnew/files/documents/DED/CEDS/CEDS2020FullReport.pdf> .

**mechanisms exist or can be developed that even at a 15% cost of administration, will hold low-income Vermonters harmless, and increase Vermont’s capacity to raise revenue and/or decrease the sales tax rate.** Again, it is not our recommendation that refund mechanisms be developed for each category of goods and services to which we extend the sales tax. Instead, we refer to our recommendation in Chapter 5+ that the legislature look at the full financial picture for low-income Vermonters including income, transfers, and taxes in the context of our recommendations, and adjust the programs that support low-income Vermonters accordingly.

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### **Are Sales Tax Exemptions an Effective Way to Promote Public 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 going 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 public goods that Vermont tries to encourage and/or make more affordable 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 institutions. Total private education spending in Vermont in 2019 was \$984.6 billion.<sup>15</sup> Low-income Vermonters spent about 17.4% of that.<sup>16</sup> 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<sup>17</sup>. . . 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.”*

<sup>15</sup> 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>

<sup>16</sup> 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>

<sup>17</sup> <https://research.collegeboard.org/pdf/trends-college-pricing-2019-full-report.pdf>

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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, 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) 3.76% sales tax to that, the price of that tuition goes up to \$41,440. Combining several estimates of price elasticity of demand for higher education<sup>18</sup> to arrive at .6, that \$14840 increase might reduce access to education by 2.2%, whereas the inflation adjusted growth in public college tuition over the last 20 years of 65%<sup>19</sup> has probably reduced access by almost 40%. The problem is not the \$14840 in sales tax, it's the \$40,000 in tuition.

There are a number of smaller categories of public 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 causes the rate to be higher than it would otherwise be, and those negative consequences outweigh the very limited benefit the exemptions provide.

**We conclude that exempting public goods from the sales tax is not an effective way to expand those goods**, and that if the legislature does indeed wish to support, expand, and encourage these and other public goods, an approach may be to analyze the barriers to expansion, and address them head-on with appropriate means and mechanisms. We ~~caution the legislature so not believe~~ that the sales tax exemption, either alone or in combination with other measures, does not provide Vermonters with meaningful access to these public goods.

We recognize the very important public policy role that taxes in general play in encouraging public goods and discouraging public bads. As noted, the excise tax on cigarettes continues to be an effective

<sup>18</sup> <https://www.reed.edu/economics/parker/f10/201/cases/elasticity.html>

<sup>19</sup> <https://usafacts.org/articles/college-tuition-has-increased-but-whats-the-actual-cost/#:~:text=After%20adjusting%20for%20inflation%2C%20the,%25%2C%20respectively%2C%20since%202000.>

tool to discourage smoking, especially among young people, and has played a significant role in reducing suffering and premature death, improving health, and reducing health care costs for Vermonters. The data suggest, however, that because the sales tax has a relatively low rate, and therefore changes to the sales tax are on the order of a few percent, it is not among the more effective taxation tools for discouraging or encouraging behavior.

**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 an examination and rethinking of Vermont's current sales tax base. —Sales Tax on Services Study, VT Dept of Taxes Act 57 of 2015, Sec. 94, 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 any given revenue goal. These problems will become more pronounced as the portion of the economy represented by services continues to grow. While a crisis like COVID leads to a vast reduction in some service sectors associated with tourism, the broader the base, the less likely a particular crisis is to have a disproportionate negative effect. If we only taxed services, COVID would have been far more damaging to state revenues than it has been and if we taxed groceries, as we recommend, COVID would have been much less damaging to state revenues.

**We conclude that there is nothing inherent in the service sector that justifies a blanket exclusion 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. As with goods, our recommendation explicitly exempts the purchase of services by businesses.

**The Human Hurdles to Expanding the Sales Tax to New Goods and Services**

The experience of the past has shown that any industry that has not been included in the sales tax will view the prospect of their new inclusion in the sales tax with concern. Their objections cluster around losing sales, and around the administrative burden of collecting and remitting the sales tax.

We see several ways in which the legislature can address these concerns: first, making the expansion as close to universal as possible makes it more difficult for any one industry to argue that it should be exempt or excluded. Second, you can present the data that show that sales in a sector do not, in fact, decline when they go from being exempt from the sales tax to included in the sales tax. Finally, we note that the burden of collecting and remitting the sales tax has decreased a great deal due to the advances in sales tax software.

We expect that you will hear some passionate and emotional testimony from people asking you to continue to exempt or exclude their business or their industry from the sales tax. Some of this testimony will include dire predictions about the effects on Vermont businesses, and on the economic competitiveness with other states. We would recommend that your consideration of these concerns be married to a consideration of any supporting data. We note that while Hawai'i is in a unique position in the middle of the ocean, Washington State, for instance, is similar to Vermont in that shares a border with Canada and fairly rural borders with a couple of US states, and Washington State does not seem to have suffered from its broad tax base.

Summary of Categories Not Currently Subject to Sales Tax, Potential Sales Tax, and Level of Protection Required for Low-Income Vermonters

<u>Current untaxed category</u>	<u>Total consumer activity in Vermont by category</u>	<u>% of total activity by low-income Vermonters</u>	<u>Total tax revenue at a 3.6% sales tax</u>	<u>Portion of total tax revenue that would come from low-income Vermonters</u>
<u>Education</u>	<u>\$984,600,000</u>	<u>17.4%</u>	<u>\$35,445,600</u>	<u>\$6,167,534</u>
<u>Automotive services</u>	<u>\$316,000,000</u>	<u>22.9%</u>	<u>\$11,376,000</u>	<u>\$2,605,104</u>
<u>Services not related to personal property</u>	<u>\$283,333,000</u>	<u>21.1%</u>	<u>\$10,199,988</u>	<u>\$2,152,197</u>
<u>Professional services</u>	<u>\$143,333,000</u>	<u>21.1%</u>	<u>\$5,159,988</u>	<u>\$1,088,757</u>
<u>Related to personal property besides cars</u>	<u>\$133,333,000</u>	<u>21.1%</u>	<u>\$4,799,988</u>	<u>\$1,012,797</u>

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Hair, Skin, & Nails	\$125,000,000	23.3%	\$4,500,000	\$1,048,500
Veterinary services	\$83,333,000	21.1%	\$2,999,988	\$632,997
Household Services	\$75,000,000	19.7%	\$2,700,000	\$531,900
Funeral	\$25,000,000	21.1%	\$900,000	\$189,900
Travel	\$16,667,000	21.1%	\$600,012	\$126,603
Groceries	\$2,102,500,000	27.8%	\$75,690,000	\$21,041,820
Residential energy	\$702,500,000	31.4%	\$25,290,000	\$7,941,060
Clothing	\$503,333,000	21.7%	\$18,119,988	\$3,932,037
Newspapers	\$39,833,000	27.0%	\$1,433,988	\$387,177
Sales of mobile/modular homes	\$5,000,000	100%	\$180,000	\$180,000

Sources for category values: 2019 Vermont Tax Expenditure Report; 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>;

<https://accd.vermont.gov/sites/accdnew/files/documents/DED/CEDS/CEDS2020FullReport.pdf>.

Sources for portion of spending by low-income Vermonters: Table 1110. Deciles of income before taxes: Shares of annual aggregate expenditures and sources of income, Consumer Expenditure Survey, 2018, Bureau of Labor Statistics

(<https://www.bls.gov/cex/2018/aggregate/decile.pdf>). State-level data not available, so we assumed that the distribution of spending across income deciles in Vermont matched that of the United States.

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## **Health Care, the Sales Tax, Provider Taxes, the Insurance Premium Tax, and Health Insurance Claims**

### **Assessments**

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

We generally think of health care as exempt from taxes, but in fact all the categories above in *green italics* are already subject to something like a sales tax in Vermont via the provider tax. Further, all health care services listed above which are covered by private insurance are taxed. Every time an insurance company receives a premium payment from a Vermonter, the insurance company pays a 2% tax on that revenue, and every time a Vermonter submits a valid claim, the insurance company pays a

claims assessment of 0.999% on that claim. These two taxes on insurance companies get factored into the premiums that Vermonters pay.

The provider tax is imposed on most categories as a net patient revenue tax, which is a gross receipts tax minus contractual discounts/refunds that providers give to payers; charity care; and bad debt. This makes provider taxes functionally similar to a gross receipts tax, which outside of health care is the functional equivalent of a sales tax, as a gross receipts tax on a business gets passed on to consumers via higher prices. ~~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<sup>20</sup>;~~
- ~~• 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.<sup>21</sup>~~
- Nine states apply the sales tax to medical devices regardless of whether they are prescription or non-prescription.<sup>22</sup>

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#### The Effect of Applying the Sales Tax to 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 400% of the federal poverty level who do not receive health insurance through their employer, the Affordable Care Act (“ACA”) provides meaningful subsidies for insurance premiums and caps on out-of-pocket spending. For those between 200% and 300% of the FPL, Vermont provides assistance as well. The state also supports low-income Vermonters with Dr. Dynasaur (kids and pregnant women), long-term care assistance, and prescription drug assistance.<sup>23</sup>

One complication in health care is that Medicaid patients typically have no or very low co-pays. However, Medicaid and other programs for low-income Vermonters often have fixed payment levels for particular services, and if a provider adds a sales tax to a bill that's already at the maximum

<sup>20</sup> 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)

<sup>21</sup> <https://salestaxhelp.com/states-tax-medical-devices>

<sup>22</sup> *Ibid.*

<sup>23</sup> <https://info.healthconnect.vermont.gov/Medicaid>, <https://www.greenmountaincare.org/>, <https://www.greenmountaincare.org/health-plans/long-term-care>

reimbursement rate, payment of the full sales tax is likely to fall entirely onto the patient, potentially increasing their co-pay by multiples. It is not clear that the prohibition on balance billing would apply to a sales tax for Medicaid patients. As the additional sales tax might present an insurmountable financial barrier to some Vermonters, we cannot recommend a sales tax on health care without finding a mechanism to protect low-income Vermonters from this burden.

Beyond provider taxes, many states do 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<sup>24</sup>.
- 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.<sup>25</sup>
- Nine states apply the sales tax to medical devices regardless of whether they are prescription or non-prescription.<sup>26</sup>

We examined the possibility of creating a mechanism by which charges for Medicaid would be exempt from the sales tax. While the states cited above apply a sales tax to some health care expenditures, as we worked through the practical implications of trying to apply a uniform sales tax across all patient-level health care expenditures, such a policy, it became clear to us that such a system to exempt Medicaid charges from the sales tax rapidly becomes unreasonably complicated and burdensome. Vermont's dual drives toward universal primary care and paying providers based on outcomes add further dimensions of complexity to this question.

**We believe that the importance of keeping access to health care as free from barriers as possible, combined with the complexity of how health care for low-income Vermonters is paid for, means that it is not practical to apply the sales tax to health care,** either in place of the provider tax or only on those categories of health care that are not subject to the provider tax.

<sup>24</sup> 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)

<sup>25</sup> <https://salestaxhelp.com/states-tax-medical-devices>

<sup>26</sup> Ibid.



Health care makes up about 18.8% of Vermont’s total economic activity<sup>27</sup>, and about a third of Vermont’s consumer activity, so although health care is not amenable to the sales tax, any analysis of consumption taxes in Vermont that ignores health care is incomplete. We therefore include the provider taxes in our analysis of consumption taxes, and note that every state except Alaska imposes provider taxes.

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 [matching \(at various rates\)](#) federal Medicaid dollars to the state. “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.”<sup>28</sup>

As noted above, outside of health care, a gross receipts tax gets passed on to consumers via higher prices. In health care, however, there are a variety of ways that providers support the expense of the tax: some providers can charge patients more and some cannot; some providers can charge insurance companies more, and some cannot. The options available to hospitals are different from those available to independent practitioners.

We note also that as it now stands, the provider tax in Vermont is not levied at all on some categories of health care, and it is levied 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, which on average ends up being about 0.15%. All of this inconsistency adds complexity. It probably also reduces fairness, although again, health care pricing and net revenue are affected by so many factors that the underlying “sales” numbers are inconsistent to begin with. Further, the partial application of the provider tax to health care reduces stability of the tax revenue and increases rates compared to a system in which the provider tax was applied equally to all health care providers.

As noted above, there are four possible reasons that part of health care is exempt from the 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 now examine the first three of those reasons as they apply to expanding the provider tax.

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<sup>27</sup>[https://gmcboard.vermont.gov/sites/gmcb/files/Misc/2018\\_VT\\_Health\\_Care\\_Expenditure\\_Analysis\\_Final\\_%20July\\_%202020.pdf](https://gmcboard.vermont.gov/sites/gmcb/files/Misc/2018_VT_Health_Care_Expenditure_Analysis_Final_%20July_%202020.pdf)

<sup>28</sup><https://www.ncsl.org/research/health/health-provider-and-industry-state-taxes-and-fees.aspx>

### Do the Current Categorical Exemptions from the Provider Tax Increase Vermonters', and Particularly Low-Income Vermonters' Access to Health Care?

As far as maintaining the partial provider tax exemption to expand access to health care as a public good, RAND analysis of the available data<sup>29</sup> 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 who receive health care through federal and state programs, 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.”<sup>30</sup> This is in addition to health care’s particular distortions of the “purchase” decision, described above.

This means that a 3.76% provider tax on those categories of health care goods and services that are currently exempt, even if it were passed on entirely to the consumer, would result in a reduction of health care utilization in those categories of less than seven tenths of one percent. If you harmonize the provider tax rates across all provider classes, the increase in the tax in half the health care areas will be partially offset by decreases in the tax in some of the other areas.

### Are there Undue Complexities in Extending the Provider Tax to All Provider Categories?

One of the main complexities in the United States’ health care system is just how many parties are involved in paying for Vermonters’ health care:

- The federal government through Medicaid, Medicare, TRICARE, subsidies provided by the ACA, and the federal government’s portion of federal employees’ health care expenses.
- Individuals and families with private insurance, through premiums, deductibles, co-pays, co-insurance, and payments for non-covered medical expenses.
- Employers 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, or through direct payments of claims
- 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.

<sup>29</sup> “The Elasticity of Demand for Health Care,” RAND, 2005.

<sup>30</sup> Ibid.

- Hospitals, which pay for all or part of the care for several groups of patients: emergency care patients, regardless of ability to pay; Medicaid patients, for which they are reimbursed only part of the cost of care; and patients who simply don't pay their bills. To offset the costs of that portion of services for which the hospital doesn't get paid, 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.

~~Hawaii's excise tax on health care services applies to doctors and dentists and includes amounts received from patients and health insurance companies,<sup>31</sup> and Michigan specifically taxes medical services when provided by Medicaid managed care organizations.<sup>32</sup>~~

Vermont health care providers and legislators have done a great deal of work over the years on expanding the provider tax, including investigations into including some of the categories that are currently outside the provider tax system. We have studied the PHPG VT Health Care Related Tax Study Report (2012). We acknowledge the barriers that exist now or existed in the past, including reporting and administrative barriers and resistance from particular provider categories. We note the fact that many providers, like dental practices, do not routinely produce annual financial statements, and that there would be some cost to each practice to begin to track the inputs to the Net Patient Revenue calculation. This issue also affects independent physician practices, chiropractors, and other practitioners whose finances are not currently regulated by the State. It is also true that to administer, monitor, and collect provider taxes from these health care sectors will require resources and potentially new regulatory authority for some State entity. We do not see any of the concerns, costs, or hurdles as outweighing the benefits to fairness, sustainability, and simplicity that expanding the provider tax to all categories of providers will create.

We are sensitive to the concerns that imposing a provider tax on physicians' practices and on dental practices may make it harder to attract young physicians and dentists to Vermont, and the consequent concern that fewer doctors and dentists practicing in the state will in fact be a significant barrier to access.

However, we note that there is a decline in primary care physicians and dentists now, and since they are currently not included in the provider tax, there are clearly other causes of this decline. We recommend

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<sup>31</sup> <https://salestaxhelp.com/medical-services-taxable>

<sup>32</sup> ~~ibid.~~

that the legislature identify those causes and address them. We also note that the imposition of the provider tax has not led to a decrease in providers in those categories in which it has been imposed.

Another factor is the relative number of Medicaid patients that each category of provider treats. Those with higher Medicaid patient populations generally get higher reimbursement rates when the provider tax is imposed on them, while those with lower Medicaid patient populations pay the provider tax, but see a smaller offset from increased Medicaid reimbursement rates.

The recent cases of dentists and emergency ambulance service providers gives us an illustrative contrast. The legislature studied the prospect of extending the provider tax to dental practices. That effort foundered on three snags: first, dental practices don't typically produce audited financial statements, so calculating and monitoring Net Patient Revenue would be difficult; second, many dental practices have few or no Medicaid patients, so increased Medicaid reimbursement rates are of limited value to them; and finally, dentists can support well-organized and well-funded lobbying campaigns.

On the other hand, the effort to extend the provider tax to emergency ambulance services was successful, and indeed had the support of emergency ambulance service providers. Like the dentists, the ambulance services did not typically produce audited financials. Unlike the dentists, the ambulance services all serve a meaningful number of Medicaid patients. By applying a provider tax to emergency ambulance services, the State was able to increase the Medicaid reimbursement rate, and the ambulance services ended up with more revenue.

As increasing Medicaid reimbursements is not a great benefit to those providers who don't treat Medicaid patients, ~~a~~ a different approach to securing provider support may be 1) to decide at the outset that all provider classes will be included, so there is no in-or-out decision to be made, and no reason for a provider class to lobby to be in the "out" group; 2) to provide hard numbers in terms of what the inclusion of all provider classes means for how low the provider tax rate will be, and indeed how much lower the state sales tax will be.

As the example of the emergency ambulance service providers shows, implementing adequate financial record-keeping and reporting is not particularly difficult or expensive.

Hawai'i's excise tax on health care services applies to doctors and dentists and includes amounts received from patients and health insurance companies,<sup>33</sup> and Michigan specifically taxes medical services when provided by Medicaid managed care organizations.<sup>34</sup>

Since we believe the provider tax can be extended to the provider categories that are presently exempt 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 consistent provider 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 provider tax on all providers of consumer health care, and using the revenue from the expanded provider tax to harmonize provider tax rates with each other and with the sales tax rate**

As noted on p. 32 of the 2012 PHPG study, "the actual calculation methodology is different for each of the existing assessments, reflecting the State's long-standing value of working collaboratively with the relevant provider classes to implement the assessments in a manner that is acceptable and transparent for the providers, while also being administratively streamlined for both providers and the State." We hope that spirit of cooperation between the providers and the State can continue.

That study also notes (pp 6 & 7) that when extending the provider tax to new categories of provider, there are several important implementation tasks, including:

- Policy development – defining the classes, conferring with CMS, etc
- Potential impact on Section 1115 Waivers
- Administration – updating taxpayer lists, collecting data, collecting the tax
- Staffing – there must be sufficient resources at the responsible State entity to administer the program.

We expect that Vermont will continue to use the provider tax to fund the portion of Medicaid currently funded with the provider tax, and that will trigger the release of the same federal dollars to Vermont. We rely on the current mechanisms for protecting low-income Vermonters from unaffordable health care costs to continue to do so with the categories of health care that will be newly subject to the provider tax. We also refer back to our primary recommendation in Chapter 5+ regarding low-income Vermonters and the tax code.

<sup>33</sup> <https://salestaxhelp.com/medical-services-taxable>

<sup>34</sup> [Ibid.](#)

Therefore, although our preference would be to eliminate the provider tax and apply the sales tax uniformly to all consumer-level transactions, **for reasons of fairness, simplicity, and sustainability, we recommend expanding the provider tax to include those categories of providers not already covered. We further recommend harmonizing the provider tax rates across all categories of providers, and to match the provider tax rate to the sales tax rate.**

We estimate that about \$2,395,322,000 of Vermont health care expenditures are not currently subject to the provider tax.<sup>35</sup> Extending a 3.7% provider tax to this activity would generate about \$88 million, of which about \$8 million would come from low-income Vermonters.<sup>36</sup>

Per best practice, we recommend consultation with CMS before any changes to taxation and assessments on health care.

We also note that any large-scale reforms to health care, up to and including moving to a single-payer system, have the potential to drastically change any current or future health care taxes.

There is one more topic on the subject of taxing health care in Vermont. Vermont imposes an Insurance Premium Tax of 2%, paid by the insurance companies on the premiums they collect, and a claims assessment of 0.999% on every claim that is submitted to a private insurance company.

Hospitals build their budgets based on all their expected expenses and all their expected sources of revenue. They set the rates they charge commercial insurers based on the expenses the hospital hopes to cover with commercial insurance revenue. This typically does not include the provider tax, which the hospital usually plans to cover with Medicaid reimbursements from the state and federal governments. set their rates so as to cover the provider taxes they pay, which means insurance companies set their premiums so as to cover the bills from the hospital, and the claims assessment, and the Insurance Premium Tax. Thus, through their premiums, the consumer pays the premium tax, and the claims assessment, and through the premium and their out-of-pocket/deductible, the consumer pays the provider tax. This means those taxes get paid by a number of payers:

- For consumers with individual insurance:

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<sup>35</sup> LIFO State Health Care Resources Fund 2019 Revenue breakdown, and Green Mountain Care Board's 2018 Vermont Health Care Expenditure Analysis

<sup>36</sup> Table 1110. Deciles of income before taxes: Shares of annual aggregate expenditures and sources of income, Consumer Expenditure Survey, 2018: "Distribution of Total Population By Federal Poverty Level," Kaiser Family Foundation, <https://www.kff.org/other/state-indicator/distribution-by-fpl>

- For consumers who qualify for the ACA’s federal and state premium tax credits, the consumer pays for part of those taxes through their premiums, and the federal and state taxpayers pay for the rest through their taxes.
- For consumers who do not qualify for those tax credits, the consumer pays for the Premium Tax and the claims assessment through their premiums.
- For consumers who get their insurance through their employer, the consumer and the employer together pay the Premium Tax and the claims assessment through their premiums.
- The employees of self-insured companies don’t pay the Premium Tax, but they do pay the claims assessment.

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There is a small problem here with paying taxes on taxes – since the premium includes money for the ~~provider tax and for the~~ claims assessment, taxing the premium in effect is taxing both the money the insurance company collects for its operations and profit, and the money it collects to pass on to the state in claims assessment taxes. ~~We do not see a practical way to avoid the tax-on-tax problem with the provider tax, but the part of the problem represented by the claims assessment can~~ This could be solved by allowing insurance companies to deduct the amount they pay in claims assessments from the amount they collect in premiums before they calculate their Insurance Premium Tax.

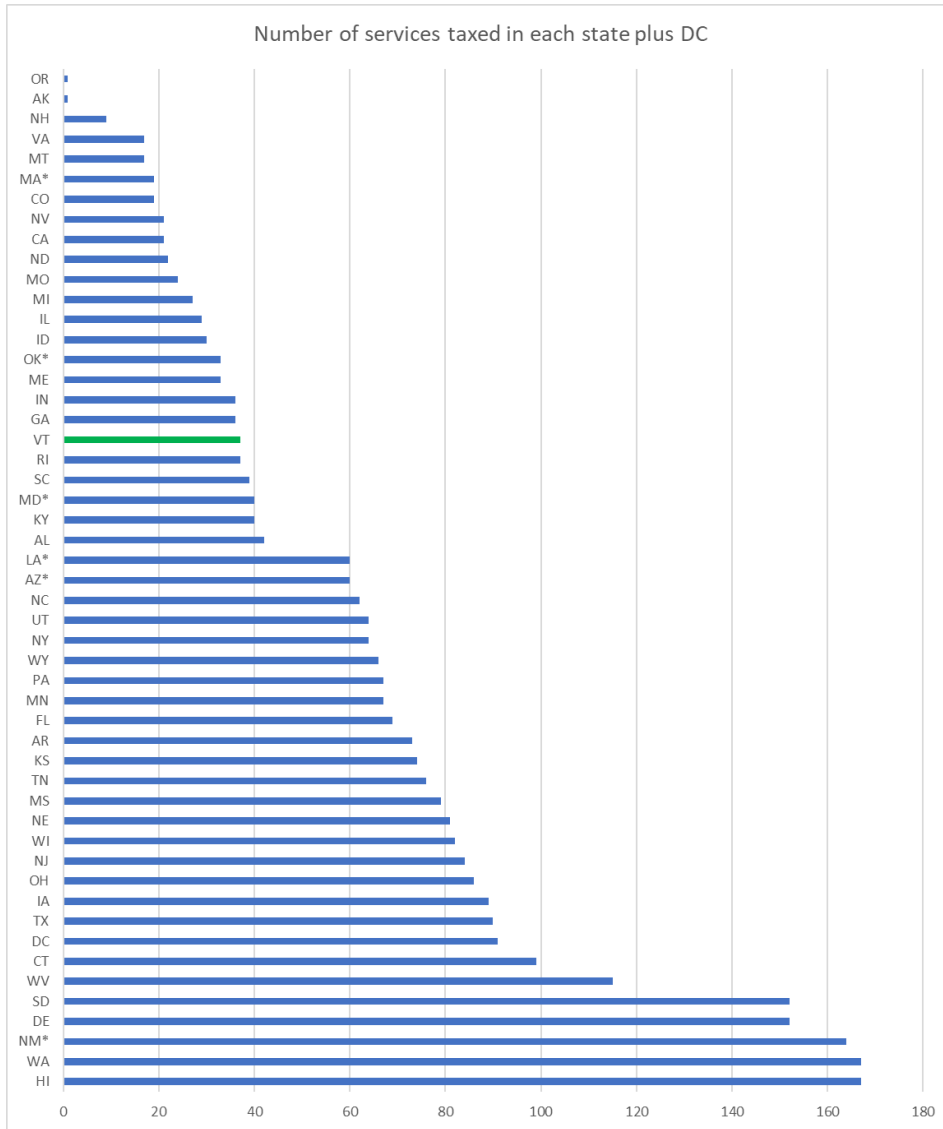
#### **Further Considerations on Expanding the Sales Tax Base**

*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, with the single exception of health care, for which we recommend broader provider taxes. 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.

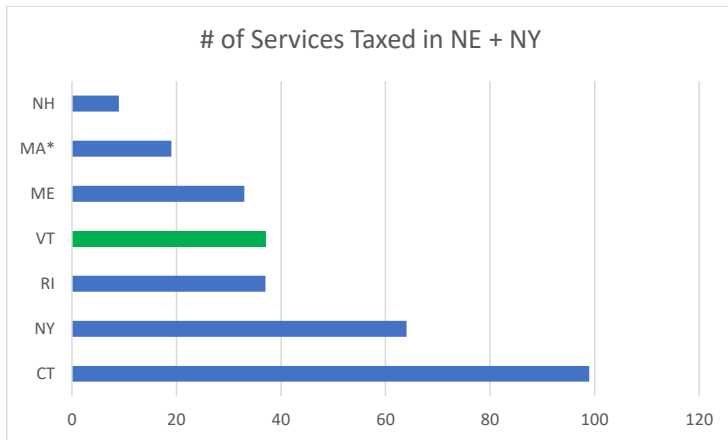
By some measures, Vermont has a fairly narrow sales tax base. If you look just at the number of services Vermont taxes, you see that Vermont is on the lower end of the spectrum.



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.<sup>37</sup> (Due to differences in how states define various taxes, these are not perfect comparisons. For instance, Vermont's per capita number does not include the Meals and Rooms tax.)

## 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 42<sup>nd</sup> (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.

May 2020

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.

<sup>37</sup>The Tax Foundation calculates each state's Sales Tax Breadth based on what percent of consumer transactions are included. <https://taxfoundation.org/2021-state-business-tax-climate-index/#Sales>

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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 and gasoline. 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. One usually thinks 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 labor 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 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. The legislature is charged with making these difficult and important distinctions when necessary, but all other things being equal, it is probably better to reduce subjectivity in the tax code when possible.

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. While this shift is clearly beneficial for the environment, and therefore to be applauded, it does raise the question of how we pay for roads and other elements of our transportation system.

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 exclude consumer purchases of education or food, and we see no compelling reason not to extend the health care provider tax to the remaining exempt categories of providers, and to harmonize the provider tax rates with each other and with the sales tax rate.

**Because we find no compelling reason to exempt any form of consumer activity from the Vermont sales tax, with the proviso that it be levied as a provider tax on health care, 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 Chapter 10 for our recommended implementation plan and timeline. We recognize the special nature of education and health care, and note that an alternative approach may be to expand the sales tax in three steps, lowering the rate as appropriate with each step:

1. To non-essential goods and services not currently covered, including newspapers, automotive services, professional services, personal and household services, etc.
2. To essential goods, like groceries, residential energy, and clothing.
3. To education

Simultaneously and in parallel, you can work to expand and harmonize the health care provider tax.

### **If Vermont Expands the Tax Base, What Should the Legislature Do with the Money?**

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 (in the form of an expanded provider tax for the health care sector):

1A. With the current 6% sales tax, and a 6% provider tax, making no accommodation to protect low-income Vermonters, you would add around \$500 million in sales tax/provider tax revenue<sup>38</sup> to the current sales tax revenue of \$389.3 million<sup>39</sup> and the current provider tax of \$172 million.<sup>40</sup>

<sup>38</sup> See [Appendix 1: Vermont Sales Tax Calculator online at XXX](#)

<sup>39</sup> Current sales tax base and sales tax revenue from VT Dept of Taxes, "06302020SUTStatsFiscalReport75Day"

<sup>40</sup> [https://lifo.vermont.gov/assets/Meetings/Tax-Structure-Commission/2020-11-09/a0673e9861/GENERAL-351044-v1-2020\\_Provider\\_Tax\\_presentation.pdf](https://lifo.vermont.gov/assets/Meetings/Tax-Structure-Commission/2020-11-09/a0673e9861/GENERAL-351044-v1-2020_Provider_Tax_presentation.pdf)

1B. With the same assumptions, but rebating to low-income Vermonters the full amount collected from them, and assuming a 15% cost to administer the rebate program, a 6% sales tax will raise an additional ~~\$375220~~ million.<sup>41</sup>

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 3.34%<sup>42</sup>.

2B. In the revenue-neutral scenario, if you hold low-income Vermonters harmless, you can lower the sales tax rate to 3.76%.<sup>43</sup>

We have reviewed the suggestion that a 3.76% 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, as recommended in Chapter 5:

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 minor distortions in economic behavior created by a higher rate imposed inconsistently.
- Holding low-income Vermonters harmless means they will not bear any increased costs for the things they purchase in the newly taxed categories, and, as with all Vermonters, the tax they

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<sup>41</sup> See [Appendix 1: Vermont Sales Tax Calculator, online at XXX](#)

<sup>42</sup> Ibid.

<sup>43</sup> Ibid.

pay on things that are currently taxed will go down, so low-income Vermonters should be unaffected or even marginally better off.

- While Vermont businesses will ultimately benefit from simpler, fairer system that treats every business's output the same, we are aware that for businesses that have never collected or remitted sales tax, the prospect can be daunting. This is particularly true for the many businesses who provide services to consumers and to other businesses, as they 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 businesses. We also note that sales tax compliance software is more readily available now than when Florida and Massachusetts expanded their sales tax bases. We also recall the recent objections to the increased administrative burden raised by local providers to extending the sales tax to software, but note the tens of thousands of businesses in Vermont who currently collect and remit the sales tax without much effort. If the West Wardsboro General Store can comply, one expects that a software company can comply.
- 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's 4% rate and Massachusetts's 6.25% rate. As with Vermont, localities in both states add a local sales tax to that, so in some cases Vermont's advantage will be even larger. Vermont will also have 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 3.75% sales tax to all consumer purchases of goods and services, harmonizing the provider tax at 3.75% and expanding it to include all health care categories, creating mechanisms to make this change neutral for low-income Vermonters, and deploying the additional \$20+ million in new revenue first to cover the administrative costs of collecting sales tax and provider tax from a larger number of entities, and second 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<sup>44</sup>, and as we've seen, collecting and remitting the sales tax does not appear to be particularly burdensome for the thousands of businesses large and small in Vermont who do so, but, as we all know, sometimes people are not particularly good at assessing the likely consequences of any given course of action. 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). We do note these recommendations, along with giving Vermont one of the lowest sales tax rates in the country, will also give Vermont the broadest sales tax base in the country. This is an advantage for all the reasons discussed above; however, it does mean that there are some categories of goods and services that Vermont will include in the sales tax that are taxed in only a very small number of other states.

We note one final advantage of this approach: legislative efficiency. If you do in fact include all the major categories of consumer transaction (except health care) in the sales tax, you and future legislatures will avoid the perennial and chronic discussion and debate about whether to include or exclude this or that category or industry. Imagine not having to talk about that particular issue for the next, say, 10 years.

### **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 an additional tax on meals prepared at home is almost nonsensical, and four of the eight exemptions to the Meals tax exist 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

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<sup>44</sup> As noted above, sales increase in the month or so before a sales tax is imposed or raised and decrease for a couple of months after before returning to their pre-increase level, and presumably the same phenomenon occurs in reverse when one lowers or eliminates a sales tax.

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 they're working is high, and the value of the benefit to relatively low-wage workers is high, so we do not see any justification for ending this exemption, and support its 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."<sup>45</sup> Since we are recommending that the sales tax be extended to groceries, **we recommend repealing this exemption and reclassifying these items as groceries and including them in the 3.76% sales tax.**

### **Rooms Tax**

The Vermont Rooms tax is intended to tax the act of staying somewhere temporarily for fun or for work. 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. The value of housing provided as part of employment is reported as part of the employee's income, so we support maintaining this exemption from the Rooms tax. We believe that housing is a such a significant benefit that this should be included in the employee's income. We therefore support

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<sup>45</sup> Vermont Tax Expenditures 2019 Biennial Report, 2019.



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 sections 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 erode gradually then quickly. 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 fully support the transition to zero-emissions vehicles, and one of us has driven an electric car for over two years. We have been very deliberate in thinking through the implications of this transition for Vermont and Vermont's ability to pay for its transportation system as fewer and fewer people use gasoline and pay gas taxes. Vermont is not alone in trying to figure out how to manage tax revenue through this transition. Per recent research conducted by the National Council of State Legislatures<sup>46</sup>, "(t)wenty-eight states have laws requiring a special registration fee for plug-in electric vehicles." These fees range from \$50 (Colorado & Hawai'i) to \$212.78 (Georgia).

That same article notes that in addition to special registration fees, over a dozen states are considering Road User Charges (RUCs), also known as Vehicle Miles Traveled (VMT) fees or Mileage-Based User Fees (MBUF). Instead of collecting gas taxes, these programs aim to charge drivers based on how many miles they drove. We can imagine a time when the technology will allow for even greater precision, and the State will be able to charge vehicle owners for the pound-miles they travelled, capturing the wear on the roads of both the distance the vehicle traveled and its weight.

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<sup>46</sup> <https://www.ncsl.org/research/energy/new-fees-on-hybrid-and-electric-vehicles.aspx>

**At the moment, however, based on ease of implementation, we recommend a special registration fee for electric vehicles, to be set based on what the average Vermonter pays in state gasoline taxes in a year.**

**Conclusion**

We are aware that implementing these recommendations will require a great deal of work on the part of the legislature, the Vermont Department of Taxes, the LJFO, and others in state government. They will also require quite a bit of work on the part of the affected businesses and other organizations. 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, and we believe the benefits for Vermonters and for Vermont are worth the effort.