

December 3, 2009

Sara Teachout  
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Vermont Joint Fiscal Office  
1 Baldwin Street, Drawer 33  
Montpelier, VT 05633

Dear Ms. Teachout,

Thank you again for the opportunity to testify on November 17 before Vermont's Blue Ribbon Tax Commission. This letter answers a question that came up during the testimony about the feasibility of repealing the general sales tax.

I attach a spreadsheet-based model of the Vermont personal income tax. Constructed by the Tax Foundation's chief economist Patrick Fleenor, it shows how much additional revenue Vermont would have collected in 2007 if the base-broadening provisions that you are contemplating now had been in effect that year. The figure is close to the figure reported for general sales tax revenue by Census. That is, the Census Bureau reports \$334 million in general sales tax revenue for FY 2007, and our model shows that aggressive base broadening applied to tax year 2007 would have brought in an additional \$338 million.

[See row 52, columns H and K for the "in-state toggle." Entering 1 replicates the law as it existed in 2007, producing revenue estimates in column L. The ratios of those estimates to actual revenues in column N are very close to 1 (see column O). Entering 0 produces estimates of what contemplated base-broadening measures would achieve in new revenue. Any value between 0 and 1 can be entered.]

Of course, the time periods only overlap for six months, and the top rate has changed slightly since, and there are undoubtedly other caveats. Vermont's legislative staff points out that the Census figure does not include the revenue generated by sales taxes on automobiles or meals/lodging because the state has treated those as separate excises. Nevertheless, we believe that a zero rate on general sales would have a salutary result, and that this comparison establishes the feasibility of the idea.

Even if it is feasible, is it wise for Vermont to repeal its sales tax? Here are the pros and cons from our perspective.

#### **General Advantages of Relying on Either Sales or Income Taxes, but Not Both**

The Tax Foundation's State Business Tax Climate Index rewards states that do without one of the major taxes. By "major tax," we refer to taxes on personal income, corporate income and general sales. The intuition behind this scoring decision is that states with a zero rate on a major tax:

- Achieve great economies in administration, both for taxpayers and the revenue department;
- Apply salutary political pressure to protect the remaining taxable base from economic development experts and ambitious legislators who would grant unwise tax exemptions, deductions and credits to benefit targeted voters or corporations; and
- Attract businesses and individuals to the state in a non-discriminatory manner.

The most common criticism of states that do without a major tax is false -- that they have more volatile revenue -- but there's no panacea in tax policy. And revenue stability is an imperative for state tax systems. Unlike corporations that can cut expenses quickly through layoffs and quick reversals of previous plans, state governments are incapable of rapid change. Their spending commitments are long-term and often legally binding. Their workforces are heavily unionized with costly limitations on termination. For these reasons and more, states must avoid revenue fluctuations that lead to large deficits and panicky revenue grabs, usually enacted as cigarette tax hikes on the poor and new, higher tax rates on business or high incomes. Budgetary institutions such as rainy-day funds have an important role to play here, but the structure of the tax system is critical.

### **Potential Hazard of Using Fewer Taxes**

Taxes can be well designed, and if they are, repeal is clearly inadvisable. For example, Pennsylvania should not repeal its 3.07 percent tax on personal income with few statutory preferences for the sake of depending more heavily on its corporate tax and its general sales tax. If it did so, effectively adopting the Florida model, it would probably be forced to enact some positive base-broadening reforms of its remaining taxes, but we would not recommend abandoning such a clean, reliable revenue producer as a low-rate, broad-base tax on personal income.

Similarly, state legislators and tax commissions must keep spending projections in mind. Repealing a major tax without adequate planning could lead to just the sort of panicky budget-balancing process I describe above and could degrade the state's tax system.

### **Specific Advantages for Vermont of Repealing Its Sales Tax**

There are four good reasons to repeal the general sales tax: competitiveness, feasibility, revenue stability, and progressive appeal.

*Tax Competition.* Delaware, New Hampshire and Oregon all gain substantial economic activity from their zero rate on general sales as shoppers flood across borders to stores that locate there for the tax advantage. It is difficult to estimate the extra revenue brought in by property taxes, wage taxes, etc. but it is considerable. Massachusetts shoppers flooded into New Hampshire on Black Friday, and there's good reason to think retail outlets would crop up in Vermont along the borders of western Massachusetts and eastern New York. It would even the score on the New Hampshire border, possibly even giving Vermont a slight tax edge for retail site location, depending on commercial property tax rates.

*Feasibility.* As Volume 2 of the Joint Fiscal Office's tax reform compendium pointed out in Section 3, Vermont collects comparatively little with its general sales tax. It has a lower-than-average statutory rate, and the grocery exemption has cut into collections. It is, therefore, from a practical revenue-replacement perspective, the only major tax the state can repeal.

*Revenue Stability.* As sales tax scholar John Mikesell at the University of Indiana has pointed out, the reputation of sales taxes as revenue sources that are steadier than income taxes was damaged by the wave of grocery exemption enactments that has now swept most of the country. So if Vermont were to consider cutting or repealing its sales tax, it would probably sacrifice nothing in revenue stability. This is especially likely because the base-broadening provisions contemplated on the income tax side will make that a steadier revenue source.

*Progressive Appeal.* Nationwide, sales taxes used to provide more revenue than personal income taxes. Income taxes have since surpassed sales taxes, but the balance is still close. In Vermont, however, the sales tax has played a much smaller role, sometimes bringing in less than half of

what income taxes brought in. This ratio reflects the desire of Vermonters for a progressive tax system, which can be engineered much more easily with income taxes than with sales taxes. The grocery exemption is a clumsy and mostly ineffective way to do something along those lines with the sales tax, but total reliance on income taxes, as in Oregon, Delaware and Montana, is a far better solution from a progressive perspective.

We would be glad to provide any information we can to the Blue Ribbon Commission or to legislative staff. Thank you again for soliciting the views of the Tax Foundation.

Sincerely,

A handwritten signature in cursive script that reads "Bill Ahern". The signature is written in black ink and is positioned below the word "Sincerely,".

William Ahern  
Director of Policy and Communications  
Tax Foundation