CHAPTER EIGHT

THINKING OUTSIDE THE BOX: OTHER TAXES

Most of this report's chapters have focused on ways of reforming the major taxes currently levied by state and local governments. But some states use unusual revenue sources that other states don't—and these taxes are occasionally proposed as options for comprehensive tax reform. This chapter looks at two such proposals: the value-added tax and the gross receipts tax.

Value-Added Taxes (VATs)

In recent years, lawmakers in a number of states have suggested that a particular type of sales tax, called the value-added tax or VAT, might be a cure-all for state budgetary problems. Although Michigan is the only state that currently relies on a VAT as a major revenue source, several other states have recently considered implementing this type of tax.

The value-added tax is exactly what its name implies. It is a tax on the *value added* at each stage of the production of goods and services. For any firm paying the VAT, the "value added" for a particular item is the amount by which the sales price of the product exceeds the cost of all the products purchased to make that item. Because the tax is paid at each level of production, and is often not itemized on the final bill to consumers, some try to characterize the VAT as a tax on business. But most analysts agree that "the value-added tax is essentially a sales tax on consumer purchases that businesses collect in stages."[12] From a tax fairness perspective, in other words, a VAT is just like a sales tax—it's regressive, requiring low-income consumers to pay more of their income in tax than wealthier taxpayers must pay.

How a Value-Added Tax Works

	Price	Value Added	Tax at 5%
Raw materials	$40	$40	$2
Manufactured product	140	$100	5
Wholesale sale	200	$60	3
Retail sale	300	$100	5
Total		**$300**	**$ 15**

The following example shows how a VAT would apply to the production and sale of a chair:

- First, a supplier sells raw materials (for example, wood) to a manufacturer for use in producing the chair. If the raw materials are sold for $40, the materials supplier pays tax on the whole $40. A five percent tax rate on the $40 of value added equals a $2 tax.
- Second, the manufacturer builds the chair and sells it to a wholesaler for $140. The manufacturer pays a VAT only on the value it has added to the chair. Since the manufacturer has taken raw materials worth $40 and made a chair worth $140, the manufacturer's value added is $100. A five percent tax on the $100 value added is $5.
- Third, the wholesaler sells the chair to a retailer for $200. The wholesaler bought the chair for $140 and sells it for $200, so the wholesaler's value added is $60. The five percent tax is $3.
- And finally, the retailer sells the chair for $300. Since the retailer bought the chair for $200 and sold it for $300, the retailer's value added is $100—and the five percent tax is $5.

At the end of this process, the outcome from the consumer's perspective is just the same as if the state had imposed a retail sales tax on the $300 price. The main difference is that the VAT is collected a little bit at a time at each stage of the production process, rather than being collected in one lump sum at the time of the final retail sale.

[12]Congressional Budget Office, *The Economic Effects of Comprehensive Tax Reform*, 1997

Why Adopt a VAT?

Policymakers seeking to impose a state VAT usually have one of two tax policy goals in mind, depending on which existing tax they want to replace. European VATs were created to eliminate structural problems in existing sales taxes. In particular, European sales taxes often applied not only to retail purchases but to "business to business" transactions which should be exempt. When sales taxes apply to these business inputs, the tax is typically passed through to consumers in the form of higher retail prices. In other words, taxing business inputs amounts to taxing consumers multiple times on the same retail purchase. This problem, known as "pyramiding," is discussed in more detail in Chapter Three. Pyramiding is both regressive and unpredictable (because the number of times the tax is paid depends on the number of stages of production), and encourages businesses to "vertically integrate" to avoid paying taxes on inputs to the production process. VATs are especially well designed to avoid taxing business inputs, since each component of a retail product's value added is taxed exactly once. In other words, European countries replaced their poorly structured sales taxes with a better-functioning sales tax.

In Michigan, the rationale for adopting a VAT was quite different: their VAT was adopted to replace the corporate income tax, not the sales tax. Corporate income taxes tend to fluctuate widely over the business cycle because they are based on corporate profits, which vary dramatically during periods of economic growth and downturns. Michigan's corporate tax was especially volatile due to the importance of auto sales to its economy. A VAT is an inherently more stable and predictable revenue source than a corporate profits tax, because the tax base is a firm's total amount of economic activity rather than its profits. In other words, Michigan replaced its corporate profits tax with what amounts to a second sales tax, choosing revenue stability as a primary goal of its "Single Business Tax."

Problems with a VAT

Each of these rationales has some merit: replacing a sales tax with a VAT will improve the horizontal equity of the sales tax (by ensuring that each retail transaction is taxed the same way), and replacing a corporate profits tax with a VAT will make revenues more stable. But implementation of either approach at the state level is problematic, for several reasons:

- What works on a national level in Europe may not work on the state level in America. If one state adopts a VAT while neighboring states do not, the inability of states to tax purchases from some out-of-state sellers will mean that some value added won't be taxed, and sales made to other states will create the same problem. Put another way, a VAT can't easily work in one state without a lot of help from other states.
- Unlike a retail sales tax, a VAT often isn't itemized on retail receipts (although it can be). Thus, consumers may be less aware that they are paying a VAT. Invisible taxes make it harder for consumers to see how much they are really paying.
- People don't understand how VATs work. Calling a VAT a "Single Business Tax" may fool people into thinking that a VAT falls on business rather than consumers.
- Abandoning a corporate profits tax for a VAT makes the tax system less responsive to a business' ability to pay taxes. This is part of the reason why Michigan's VAT is currently slated to be repealed by 2009: the VAT is especially painful for businesses not turning a profit.
- Because a VAT is passed through to consumers like a sales tax, replacing a corporate profits tax with a VAT will make already-unfair state tax systems even more regressive.

Value added taxes have been enacted internationally to address important concerns about structural flaws in sales taxes. But as a replacement for corporate profits taxes on the state level, the main impact of a VAT will be a more regressive tax system—and a host of angry businesses.

Gross Receipts Taxes

A **gross receipts tax** (GRT) is still another type of sales tax. The main difference between a retail sales tax and a GRT is that sales taxes apply (in theory, anyway) only to retail sales, while a GRT applies to the sales made by companies at every stage of the production process, including manufacturing companies, wholesalers, and retailers. In other words, a GRT is a sales tax that applies to more types of transactions. From the consumer's perspective, the major distinction between gross receipts taxes and retail sales taxes is that gross receipts taxes are not necessarily itemized on customers' bills.

The gross receipts taxes currently used by states typically only apply to the sales receipts from certain types of products, with utilities and insurance being the most common targets. In fiscal year 2002, state and local governments raised more than $30 billion in gross receipts taxes on utilities and insurance—twice as much as what the states raised from excise taxes on alcohol and tobacco.

When state policymakers propose a gross receipts tax as a proposal for comprehensive tax reform, however, what they usually have in mind is something very different from the single-item gross receipts taxes that most states currently use. These proposals typically would impose a very low tax rate on a very broad base of economic activity. For example, a Nevada tax reform commission recently proposed a gross receipts tax of 0.25 percent on all business revenues over $450,000 a year.

This sort of gross receipts tax is quite rare on the state level. The most comprehensive current GRT is the Washington State Business and Occupation Tax, which taxes different types of companies at different rates ranging from 0.138 percent to 1.5 percent.

There are three main problems with GRTs. First, like any sales tax, a GRT hits low-income taxpayers the hardest. Second, because GRTs are based on the amount that a business sells rather than on its profit, a GRT is not sensitive to a business' ability to pay. Third, GRTs lead to severe pyramiding problems, because the tax applies not just to retail sales but to all stages of the production process.

The first two of these problems are basically identical to those faced by value added taxes (see above); the third, however, separates GRTs from VATs. VATs are explicitly designed to get around the problem of tax pyramiding, while GRTs have no mechanism for avoiding it. As a result, it doesn't make much sense to compare the tax rate of a broad-based GRT to the tax rate of a general sales tax: a GRT is a multi-stage tax, whereas the sales tax is a single-stage tax. So, for example, if a GRT of 0.25 percent applies to four stages in the production of a product, that's roughly equivalent to a retail sales tax of one percent.

As in Michigan, some of the strongest opposition to Washington's GRT comes from businesses. The firms that tend to dislike the Washington state tax most are those that engage in high-volume, low-profit-margin activities—and those that frequently don't turn a profit at all.