South Dakota Legislative Research Council

Issue Memorandum 95-35

TRANSACTION TAX

Introduction

The transaction tax or commerce tax is an alternative to the existing tax structure and is generally proposed as a one percent tax on each purchase, exchange, or transaction. Advocates of this alternative maintain that there will be no exemptions, exclusions, deductions or loopholes, except transactions protected by the U.S. Constitution. Two transactions protected by the Constitution are interstate commerce and federal government payments to states and localities.

A transaction tax is essentially a broad based uniform sales tax, but instead of having certain items exempted from the tax, it encompasses all transactions that occur between two or more parties. This tax is generally represented as replacing all other forms of taxes and fees, except for user or consumption fees and some licenses. No country or state is currently known to be using this form of tax.

There was a 1990 Montana initiative which proposed to amend their constitution to repeal all existing taxes and replace them with the “Trade Charge Levy” or as it is often referred to by South Dakota advocates as the “Just One Just Tax.” The initiative would have repealed all existing taxes, licenses, permits, and government charges except those related to user fees. User fees were not clearly defined in the Montana initiative and it was unclear whether it also applied to things such as hunting, fishing, and drivers’ licenses. In addition, sponsors of the initiative said that severance taxes would not be prohibited. The initiative failed on a vote of twenty-five percent for the initiative and seventy-five percent against.

Economic Influence

When Greece enacted this tax some two thousand years ago, life was relatively simple and transactions occurred infrequently. Today’s economy is a complex mix of wages, sales, purchases, services, and utilities resulting in frequent points when a transaction tax will be paid if enacted. It is unknown why Greece abandoned the transaction tax in favor of other taxes.

Most states and local governments use a tax system primarily composed of income, property, and sales taxes, which the supporters of a transaction tax argue intrudes into what one earns, owns, and spends. The proponents argue that the existing tax system discourages initiative and further discourages individual ambition and enterprise through subsidization of unproductive activities and speculation.

It is difficult to evaluate the merits of the transaction tax without fully understanding its ability to generate needed revenue and the ease or difficulty in collecting the tax. The tax may have a cumulative effect on some products, especially products with numerous processing steps. One will have to compare the market price of products produced and processed instate with products imported from out-of-state to measure the impact of the transaction tax. Some consideration should also be given to the potential effect on the state economy and how this tax may affect interstate commerce and competition. It is reasonable to expect that the transaction tax may be attractive to some industries and unattractive to others.

The table below lists several broad categories and the estimated transaction tax revenue. The list is not all inclusive and may double count some revenue. For example, hired farm labor is reported under farm production expenses as well as personal income. The list is incomplete because many transactions are not currently reported if there is no tax liability or other reason to record the data.

CATEGORY	TOTAL	TAX REVENUE	DATE OF DATA
Personal Income	12,860,000,000	128,600,000	1993
Farm Expenses	2,729,800,000	27,298,000	1993
Farm Sales	3,908,500,000	39,085,000	1993
Property Sales	803,000,000	8,030,000	1994
Total Assests (Insured Commercial Banks)	12,298,600,000	122,986,000	Sept. 30, 1994
Gross Sales and Use Taxable Items	25,376,300,000	253,763,000	1994
Wholesale Sales (Includes Livestock & Grain)	6,500,000,000	65,000,000	1992
TOTALS	**64,476,200,000**	**644,762,000**	

Though this is only a partial list, the projected revenue is far from sufficient to replace the property, sales, and other taxes. It is estimated that between two and three billion dollars is needed to operate the state and all its polictical subdivisions. The above list is missing some categories like purchases and sales of stocks and bonds and it does not account for the roll-over effect price of some items. Another way to view the funds needed to replace the existing taxes is to assume it would take approximately 15 to 20 percent of personal income.

Management, Allocation, and Enforcement

Unlike the current tax system, there only needs to be one tax collection mechanism, either at the local government level or the state. The proponents suggest that tax collections be the responsibility of local governments and a formula be determined by the Legislature on how much is to be retained at the local level with the balance being forwarded to the state. This may dramatically alter the amount of funds various local governments, especially school districts, have to spend depending on where the transaction tax is paid.

Several rural counties may find their revenues dramatically reduced while others may benefit, depending on the location of shopping centers and where farm products are sold and purchased. For example, Buffalo County has no marketing centers, while Stanley County has one of the largest livestock auction markets in the state. Another area that may be troublesome is determining which local government will receive the tax payment owed by ranch or farm operations lying in two or more counties. The state may have to establish formulas or procedures to compensate for these potential inequities and uncertainties.

The state could take responsibility for collecting the revenue and then develop a distribution formula. It is safe to assume there would be debates on how the funds will be distributed, similar to the discussions on the school formula, except discussions would now include all general and special purpose governments.

The transaction tax may limit certain localities, however, from choosing to levy more taxes for the purpose of offering enhanced services or constructing improved infrastructure. Their only means to do so would be through additional user fees or achieving economic efficiency. Information in publications supporting the transaction tax suggests more fees to recoup costs of services and utilities, instead of subsidization through taxes. This policy may increase user costs beyond the capabilities of consumers in sparsely populated areas.

One issue that must be resolved is whether it is the seller's or the buyer's responsibility to remit the tax and where it must be paid. Like all taxes, the transaction tax will require monitoring of collection and distribution of funds. Uniform enforcement of the system is essential but may be difficult if the counties are designated as the tax collectors. Difficulties will occur when transactions occur between and among parties from different counties. For instance, the location of agricultural purchases and sales or the tax liability as a product is manufactured in one county and sold through its warehouse located in another county may not be easily identifiable.

Impact on Cost of Goods

There is not enough information available concerning the cumulative effect of a transaction tax on a price of an item. Follow the chain of transactions as a bushel of wheat is made into bread, starting when the wheat is ready to harvest.

1. Combiner charges a farmer for harvesting wheat.
2. Trucker charges the farmer for hauling wheat to the elevator.
3. Farmer sells wheat to the elevator.
4. Railroad charges the elevator to transport the grain to the miller.
5. Miller processes the wheat into flour

and sells to a baker.

6. Trucker charges a fee to transport the flour to the baker.
7. Baker makes the bread and trucks it to the retailer.
8. Retailer sells a loaf of bread to a farmer, completing the cycle.

Farm and ranch operations involving numerous and substantial financial transactions with profit margins depending on uncontrollable variables may find the transaction tax a burden as heavy as the property tax. Farmers have little control on the prices they pay for supplies or the prices they receive for production and would be unable to pass on the cost of this tax. Basically, farmers would be exchanging an exemption of property taxes for their current exemptions of sales taxes.

Each person and company will continue striving for profit from their component within the production chain and will pass on the costs of transaction taxes to the consumer. The issue is whether the cumulative effect is more or less than existing taxes. It is assumed that each seller is able to pass additional taxes onto the middleman or consumer; if not it will reduce the seller's profit margin.

Certain products which require less processing may receive an economic advantage over other products which require numerous steps for processing. Other producers may be influenced by the margin of profit each step takes and the types of taxes that would have been levied on the profits of each company.

The transaction tax may also encourage vertical integration with some products which are manufactured or processed by a chain of small companies, because there is an economic incentive to reduce the number of transactions. At worst it may encourage processing to leave the state. Each company would have to weigh tax structures offered in other states to South Dakota's and determine the most feasible place to do business.

Other Factors to Consider

Local governments and the state use property ownership records, business sales tax licenses, and other means to determine who is liable for the various taxes. It is reasonable to assume not everyone will wish to comply with this new tax and a capacity to monitor or audit activity is needed. The transaction tax base is very broad, requiring every citizen at one time or another to pay or remit this tax.

The transaction tax raises several other questions and concerns, including:

- It may encourage bartering to avoid payment of taxes and it is suggested in one document that each party pay half of the appropriate tax liability.
- The tax liability for medicine and health care may raise concerns.
- Taxes currently earmarked for certain programs would be eliminated and it would have to be resolved whether to dedicate a portion of the revenue for these programs or make them compete on an annual basis.

- Political subdivisions may have bonds or other obligations where taxes or fees are pledged to retire the debt. One solution might be to continue collecting the tax until the debt is retired or request bondholders and borrowers to accept income from a transaction tax. This may affect the terms offered and confidence of the bondholders and borrowers.

- There is an inability to deduct property or income taxes from your adjusted taxable income when calculating your federal income tax liability which may negatively affect many taxpayers.

- It is assumed there will be one percent tax when funds are borrowed from a bank and repaid, thus impacting borrowing and lending practices.

Conclusion

In its most simplistic form, a person would expect to pay a one percent tax when the income is earned and when it is expended. This does not consider how a person's buying power may be diminished as the price of products is determined by the cumulative effect of the transaction tax. Using the figures for personal income also suggests that there would be insufficient funds generated to operate the state and its political subdivisions.

The merits of this tax system stem from the ability to decrease the size of government and streamline operations through improved efficiencies in tax collection and government expenditures. If efficiencies are not achieved, the end result is that the tax burden will have been shifted from one person or business to another. It is difficult to determine whether the transaction tax may be more or less progressive until the cumulative effect is determined on the price of goods sold and the purchasing power of income. There is no clear answer on whether the transaction tax is more or less fair, and as with most changes in the tax system there would be winners and losers.

The logic behind the tax is to avoid taxes which only penalize the poor or make them assume an undue burden and give exemptions or loopholes to the wealthy. The transaction tax does not necessarily favor one party or another and does not have a negative effect on savings (like an income tax) or on owning property (like a property tax). People and businesses with a large dollar volume of transactions will pay more taxes, but the volume of transactions does not necessarily represent profit or ability to pay.

The other weakness is inequities which may occur with the traffic of interstate goods and services. South Dakota does not have a self-sufficient economy or large consumption base. Decisions will be made along the buying and selling chain on whether to produce, process, manufacture, sell and buy instate goods and services versus out-of-state. Obviously with major changes in a tax system, some companies and individuals will find the transaction tax unattractive and may decide to relocate. It is also reasonable to assume that businesses and individuals may find the transaction tax attractive and wish to relocate to South Dakota.

This issue memorandum was written by Fred

Baatz, Research Analyst for the Legislative Research Council. It is designed to supply background information on the subject and is not a policy statement made by the Legislative Research Council.