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The Equal Tax:

A Step Backward in Public Finance

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There is an idea to replace all of the general taxes in Oregon with a single tax, known as the "equal tax." This would be a 2% tax on all transactions in the state, with an additional 1% tax on the county level if local voters approve. Securities transactions would be taxed at 1/4 of 1%, with no county tax allowed.

The "equal tax" is generally known in public finance as a turnover tax. This tax is levied every time that a transaction takes place, and it has some serious drawbacks. The most serious problem is the 'cascading' nature of the tax when complex production processes involve many firms. If, for example, a manufacturer sells a part to another company a tax is paid on the value of that part. If this item then finds its way into another component that is sold to a third firm, the tax is levied on the total value on *that* transaction so that the original input is effectively taxed twice. This compounding occurs for all stages of a production process. In complex processes, the effective tax can be many times the rate on a single transaction.

The effect of cascading is to encourage production by large, integrated firms. A large firm can ship parts among sections of the firm without any sales taking place. The same product produced by a series of small firms would have higher tax rates. This feature also encourages inside production of most business services, since purchasing services outside of the firm subjects them to an additional tax. If a Fred Meyer store buys bread from a local bakery, it would pay the tax. But if Fred Meyer sets up its *own* bakery, it would not pay the tax.

The 2% rate on transactions is somewhat misleading since the effective rate would almost always be considerably higher than this. For example, the labor hired by a firm would be taxed, and the output also would be taxed. Thus, the effect for items produced in Oregon is closer to that of a 4% sales tax even in this very simple case. Alternatively, if an item is produced out of state, the tax is charged when the retailer purchases it and again when it is sold to the consumer.

While turnover taxes have seldom been used in the U.S., they were once used extensively in Europe. The problems with these taxes caused most European users to switch to Value Added Taxes. The latter taxes give credits for the intermediate sales of inputs, so the effective tax rate does not exceed the statutory rate on the final product. This eliminates many of the problems of the turnover tax, but the required rate is much higher than the one for a turnover tax.

Another substantial problem with the equal tax is the administrative and compliance costs associated with its implementation. In principle, each set of transactions would have to be monitored to enforce the tax. Purchases of goods from out of state would be difficult to monitor, and people would have a strong incentive to cheat on the tax by simply not reporting such expenditures.

An intergenerational issue has been raised with the use of transaction taxes to replace income taxes. Retirees often have built up some wealth and have paid income taxes on that money as it was earned. With the new tax system, they would be taxed at a relatively high level as they spent their savings as well. This would in effect double the taxation on the accumulated savings of this group.

Abolition of all other taxes also would have substantial impact on the perceived equity of the tax system. Without an income tax, it would be difficult to impose any progressivity in the tax system. Further, there is support for such taxes as the gasoline tax, whose proceeds are dedicated to building and maintaining the roads, because of the perceived relationship between the tax and the benefits generated. This link is removed under the proposed tax system.

Another negative feature of the equal tax is that it would substantially raise the amount of federal income taxes paid by Oregonians. Property taxes and state income taxes are deductible in figuring federal tax liabilities, but sales taxes are not. Hence, substituting a sales tax for the property and income taxes paid by individuals reduces the amount of federal tax deductions and increases the amount of federal tax paid by Oregonians. This increase would be hundreds of millions of dollars per year and could amount to over half a billion dollars per year.

Finally, there are many transactions where the effect of the tax is not clear, but where it could conceivably cause substantial problems. For example, the rate of 1/4 of 1% on securities purchases and sales appears low, but many financial institutions engage in what are known as overnight repurchase agreements, whereby treasury bonds are sold one day and repurchased the next. If these transactions were subject to the equal tax, they would not take place since the tax would substantially overshadow any benefits. Careful analysis is likely to uncover other types of transactions (such as commodity futures trades) which would be unfairly penalized by this tax.

In conclusion, the aim of simplifying the Oregon tax structure is a worthwhile one, but the "equal tax" would be a step backward in public finance. This type of tax generates many equity and enforcement problems and creates some serious distortions in economic incentives. Other countries which have used similar taxes have largely abandoned them, and we should be especially wary of taxes which have already proven unsuccessful elsewhere.

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