National Retail Sales Tax

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A proposal for fundamental tax reform that would replace the income tax system with a consumption tax, to be collected by levying a flat-rate tax on all sales from businesses to households.

Background

One proposal for fundamental tax reform is to replace part or all of the current tax system with a national retail sales tax (NRST). The NRST is one potential form of a consumption tax.

Retail sales occur when businesses sell goods or services to households. Neither business-to-business nor household-to-household transactions are retail sales. For example, the sale of a newly constructed home to a family that will occupy it is a retail sale. But the sale of that same newly constructed home to a business that is planning on renting it to others is not a retail sale. Nor is a sale of an already existing home from one occupant to another.

Typically, proposed NRSTs would aim to tax all goods or services purchased or used in the United States. Exemptions would be provided for business purchases and education (both considered investments). Domestic purchases by foreigners would be taxed; foreign purchases by domestic would not. To ensure that no family in poverty has to pay the sales tax, the sales tax proposals typically also offer equal per-household payments called "demogrants" and equal to the sales tax rate times the poverty line.

A national retail sales tax structured along these lines would represent a sharp break from the current tax system. The tax base would shift to consumption. Rates would be flat. All exemptions, deductions, and preferences would be eliminated. Tax administration, enforcement, and point of collection would altered radically.

What Rate?

A key issue is the required tax rate in a sales tax. The first issue is how to define a tax rate. Suppose a good costs $100 and has a $30 sales tax. The tax-exclusive tax rate would be 30 percent, since the tax is 30 percent of the pre-tax selling price ($100). The tax-inclusive rate would be 23 percent, which is obtained by dividing the $30 tax by the total consumer cost ($100+$30). Sales taxes are typically quoted in tax-exclusive terms, but income taxes are typically quoted as tax-inclusive rates. For example, a household that earns $130 and pays $30 in taxes would normally think of itself as facing about a 23 percent (30/130) income tax rate. Although there is no single correct way to report the sales tax rate, it is crucial to understand which approach is being used. The tax-inclusive rate will always be lower than the tax-exclusive rate and the difference grows as the rates rise. At a rate of 1 percent the difference is negligible, but a 50 percent tax-exclusive rate corresponds to a 33 percent tax-inclusive rate.

To determine the revenue- and budget-neutral tax rate in a national sales tax requires estimating the rates of evasion, avoidance, the extent to which deductions, exemptions and credit would be re-introduced, and the impact on economic growth. With extremely conservative assumptions about the magnitude of evasion, avoidance, and statutory base erosion, it would require a 60 percent tax-exclusive (38 percent tax-inclusive) tax rate to replace existing federal taxes, and a 26 percent tax-exclusive (21 percent tax-inclusive) tax rate to replace the existing personal income tax. These estimates do not include any allowance for economic growth, but even if the economy grew by 5 percent, which would be an enormous effect relative to existing estimates, the tax-exclusive tax rates would only come down to 57 percent and 19 percent to replace all federal taxes, or the income tax, respectively.

Note that the eventual sales tax rate that households would face would likely be significantly higher because existing state sales tax would be added. In addition, most or all state income taxes would probably be abolished in the absence of a federal income tax system (since the states depend on the federal income tax system for reporting purposes) and converted to sales taxes. These would add considerably to the combined sales tax rate. Any transition relief provided to households would reduce the tax base and raise the required rate further. And if major consumption items like food, housing, or health care were exempted from the base (the assumption above do not allow for such large exemptions), the tax-exclusive rate could rise to over 100 percent. In short, any realistic plan for a national retail sales tax that replaced the bulk of the federal tax system would require extremely high tax rates. Sales taxes at such high rates raise crucial questions about enforceability.

Advocates and sponsors of sales tax proposals have suggested that much lower rates, on the order of 23-30 percent would be sufficient to replace the entire federal system. These estimates are lower than the ones above for three reasons. First, they are quoted in tax-inclusive terms. Second, they assume that there is no evasion, no avoidance, and no statutory base erosion due to political pressures or hard-to-tax items.

Third, quite simply, the advocates made a mathematical mistake in calculating their required tax rate. An analysis of the required rate in a sales tax requires some assumption about what happens to the level of (the prices that consumers see before sales taxes are imposed) in the transition to a sales tax. Producer prices could (a) remain constant in nominal terms, (b) fall by the entire amount of the previously embedded taxes, or (c) fall by an amount between the first two benchmarks. In calculating their required rate, the NRST advocates assumed that producer prices would remain constant when they calculated the amount of revenue the government would obtain from a sales tax, but assumed that producer prices would fall when calculating the amount of spending the government would have to do to maintain current programs. These assumptions are obviously inconsistent, and they either understate government spending needs, overstate the revenue likely to be obtained, or both. Making a consistent assumption about producer prices – regardless of whether the assumption is (a), (b) or (c), leads to a higher rate than the advocates have assumed.

<u>Enforceability and Avoidance</u>

The results above suggest that even with rates of evasion much lower than in the existing income tax system, the required national retail sales tax would be well into the 30's and possibly even higher (on a tax-inclusive basis). Governments have gone on record noting that at rates of more than 12 percent, sales taxes are too easy to evade. Thus, the most optimistic assessment would be that there is no historical precedent for a country to enact a high-rate, enforceable, national sales tax. That does not mean it is impossible, but extreme caution would be appropriate.

Sales tax advocates admit that evasion would be a certainty, yet make no account for it in their estimates and hope that sentiments of fairness will induce taxpayers not to cheat. They also point to low marginal tax rates as an inducement not to cheat, but as shown above, the tax rate would not likely be low. Another claim is that detection of cheating would rise dramatically since only retailers would have to be audited, but this is misleading. Under the sales tax, businesses that make retail sales would be responsible for sending tax payments to the government, unless the buyer used a business exemption certificate, in which case no tax would be due. But the buyer would have the legal responsibility for determining whether the good is used as a business input or a consumption item. This means that auditing and enforcement would have to focus not just on retailers, but also on all businesses that purchase from retailers, to ensure that business exemption certificates were used appropriately.

Most importantly, the sales tax would generate tremendous opportunities for evasion. For example, in the income tax, the rate of evasion is around 15 percent. But income where taxes are withheld and reported to government by a third party has evasion rates of around 5 percent. For income where taxes are not withheld and there is no cross-reporting, evasion is around 50 percent. Since the sales tax would feature no withholding and no cross-reporting, the possibility of high evasion rates needs to be taken quite seriously.

Advocates also assert that the sales tax would be more effective than the current system at raising revenue from the underground economy. The classic example is that of a drug dealer who currently does not pay income tax on the money he earns, but would be forced to pay taxes under a sales tax if he took the drug money and bought, for example, a Mercedes. The problem with this argument is laid out best by Rep. Richard Armey (R-Texas): "If there is an income tax in place, he [the drug dealer] won't report his income. If there is a sales tax in place, he won't collect taxes from his customers" and send the taxes to government. In the end, neither system taxes the drug trade. Many other countries have attempted to implement a retail sales tax, or variants, and almost all have abandoned the tax and moved to a value-added tax.

Finally, some sales tax advocates would eliminate the IRS and have the states administer the tax. Even though the states would keep 1 percent of the revenue they collect, they would have poor incentive to collect federal taxes adequately. Even the Wall Street Journal, no fan of big government, notes that "it is fantasy to think of 'getting rid of the IRS.'"

<u>The Tax Base</u>

The broader the base, the lower the rate can be, but taxing a broad base will be hard. Some items are quite difficult to tax, like imputed financial services. Other items may not be taxed for reasons of social policy, like child care, rent, and food. Some sectors might not be taxed because of strong political influences—housing and health, for instance, though exemptions here may also be related to social policy. These issues create serious trade-offs. For example, taxing health insurance under a NRST would raise the number of uninsured by an estimated 6 million to 14 million people. But health, food and housing comprise about half of all personal consumption, so exempting even just one of these sectors would cut deeply into the sales tax base and raise the rates even further.

Economic Growth

Estimates suggest a well-functioning, broad-based consumption tax, with limited personal exemptions, limited transition relief and moderate rates could raise income per person by up to 2 percent over 10 years. But more generous transition relief or erosion of the tax base would drive the growth effects to zero quickly.

Would a Sales Tax Be Fair?

Taxing consumption instead of income is often justified on grounds that consumption may be a better indicator of long-run ability to pay taxes, since income varies significantly from year to year. But for people who face constraints on what they can borrow, the long run may not be the most relevant time period. Clearly, there is nothing inherently fair (or unfair) about having just a single rate. If households are classified by annual income, the sales tax is sharply regressive. Under the AFT proposal, taxes would rise for households in the bottom 90 percent of the income distribution, while households in the top 1 percent would receive an average tax cut of over $75,000. If households are classified by consumption level, a somewhat different pattern emerges. Households in the bottom two-thirds of the distribution would pay less than currently, households in the top third would pay more. Still, households at the very top would pay much less, again receiving a tax cut of about $75,000. There appears to be little sound motivation for heaping huge tax cuts on precisely the groups whose income and wealth have benefited the most from recent events, and raising burdens significantly on others.

Advocates like to assert that sales taxes are pro-family relative to the income tax. But children and families benefit disproportionately from numerous features of the current system, including dependent exemptions, child credits, child care credits, earned income credits and education credits. And the preferential treatment of housing, health insurance, and state and local tax payments also plausibly helps families, since they consume relatively more housing, medical services, and government-provided services such as education. All of these preferences would be eliminated under a sales tax. Moreover, compared to childless couples, families with kids generally have high consumption relative to income, so switching from income tax to a consumption tax would further raise tax burdens during years when family needs were highest. Based on 1996 data, a recent study found that enactment of a broad-based, flat-rate consumption tax like the sales tax or flat tax would hurt families with incomes less than $200,000, because of the loss of tax preferences, but would help families with income above $200,000, due to the dramatic reduction in the top tax rate. Incorporating the 1997 and 2001 tax changes—especially the child and education credits-— would only exacerbate these results.

Lessons from the States

Sales taxes already exist in 45 states, the District of Columbia, and over 6,000 localities. State tax rates range from 3 percent to 7 percent. While state sales taxes are widely viewed as successful in certain ways, they are very poor models for federal reform. States only tax about half of private consumption of goods and services. Many states exempt goods such as food, electricity, telephone service, prescription medicine and so on. Most states do not tax services very well, if at all. In addition, between 20 and 40 percent of state sales tax revenue stems from business purchases, which are not retail sales. This causes cascading of the sales tax, which distorts relative prices in capricious ways and gives firms incentives to merge with other firms in order to avoid the tax. States often do not require their own government to pay sales taxes. And states do not provide demogrants; instead they help the poor by exempting specific items like food. These findings suggest that running a pure, broad-based sales tax as envisioned by federal proposals noted above could be quite difficult in practice.

Conclusion

As a replacement for the existing federal tax system, a national retail sales tax is a non-starter. The required rate would be sufficiently high to make enforcement too difficult and evasion too tempting. The historical record should suggest great caution in this regard. Even if the tax were enforceable at these rates, the implied effects on economic growth would be small at best, and certain sectors of the economy, such as employer-provided health insurance, could be affected significantly. The sales tax would raise burdens on low- and middle-income households and sharply cut taxes on the top 1 percent.

Additional Readings

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